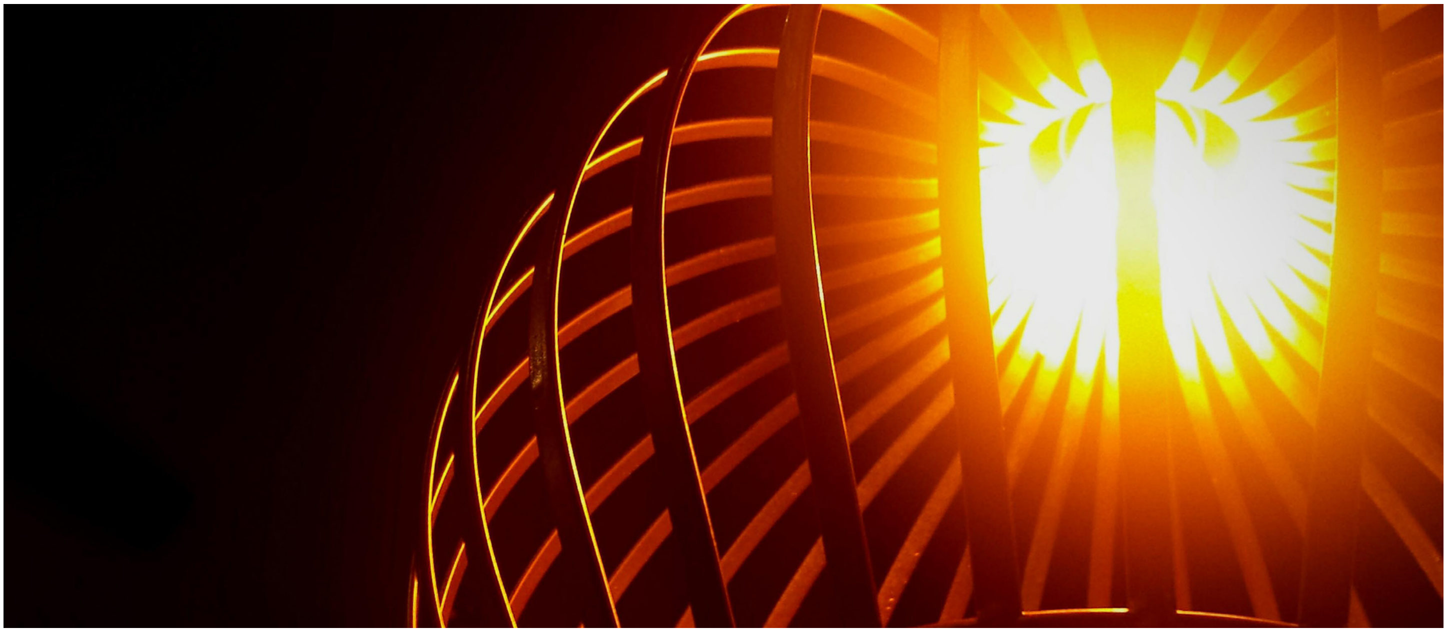
Accounting Spotlight
October 28, 2020



In This Issue

Current Expected Credit Losses Postadoption Complexities

Background

The FASB's new standard on accounting for expected credit losses (i.e., the guidance in ASU 2016-13,[1] as amended,[2] which is codified in ASC 326[3]) adds to U.S. GAAP an impairment model (the "CECL model") that is based on expected losses rather than incurred losses. Under the new guidance, an entity recognizes its estimate of expected credit losses as an allowance. Accordingly, the CECL model incorporates forward-looking information and results in earlier loss recognition than incurred loss models do.

The financial reporting impact of the new CECL standard varies from industry to industry. While banks and other financial institutions (e.g., credit unions and certain asset portfolio companies) are often viewed as being the most significantly affected by the new CECL standard from a financial reporting and regulatory perspective, ASC 326 applies to all entities. Although many nonbank commercial entities do not engage in significant lending activities, substantially all commercial entities have financial instruments and other assets (e.g., trade

[1] FASB Accounting Standards Update (ASU) No. 2016-13, *Measurement of Credit Losses on Financial Instruments*.

[2] To amend and clarify the guidance in ASU 2016-13, including the effective date and transition provisions, the FASB subsequently issued the following ASUs:

- ASU 2018-19, *Codification Improvements to Topic 326,* Financial Instruments — Credit Losses.
- ASU 2019-04, *Codification Improvements to Topic 326,* Financial Instruments — Credit Losses*, Topic 815,* Derivatives and Hedging, *and Topic 825,* Financial Instruments.
- ASU 2019-05, *Financial Instruments — Credit Losses (Topic 326): Targeted Transition Relief.*
- ASU 2019-10, *Financial Instruments — Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): Effective Dates.*
- ASU 2019-11, *Codification Improvements to Topic 326,* Financial Instruments — Credit Losses.
- ASU 2020-02, *Financial Instruments — Credit Losses (Topic 326) and Leases (Topic 842): Amendments to SEC Paragraphs Pursuant to SEC Staff Accounting Bulletin No. 119 and Update to SEC Section on Effective Date Related to Accounting Standards Update No. 2016-02,* Leases (Topic 842).
- ASU 2020-03, *Codification Improvements to Financial Instruments.*

[3] For titles of *FASB Accounting Standards Codification* (ASC) references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*."

receivables, contract assets, certain lease receivables, financial guarantees, loans and loan commitments, and held-to-maturity debt securities) that are subject to the new CECL standard.

The guidance in ASC 326 became effective in the first quarter of 2020 for calendar-year-end public business entities that are SEC filers (as defined in U.S. GAAP), excluding smaller reporting companies (as defined by the SEC). Although many public business entities have been applying the new CECL standard for almost a year, the current economic environment is creating new complexities that companies may find challenging to address with their current processes. Entities may want to evaluate how they can enhance their policies and processes related to the new CECL standard, especially as year-end approaches. This *Accounting Spotlight* focuses on certain postadoption complexities that entities, particularly in commercial industries, are facing with the new CECL standard. For an overview of how the new CECL standard affects nonbank entities, see Deloitte's July 1, 2019, *Heads Up*.

Disclosure Considerations

After the issuance of Form 10-Q filings for the first quarter of 2020, we analyzed a sample of disclosures by Fortune 100 nonbank entities in connection with the new CECL standard. Not surprisingly, we observed that many nonbank entities either (1) disclosed that the impact of the new CECL standard is immaterial to their financial statements or (2) did not disclose the adoption of the new CECL standard at all.

In addition, while the new CECL standard requires entities to consider information derived from reasonable and supportable forecasts when determining their estimate of expected credit losses, many nonbank entities did not disclose the specific forward-looking information incorporated into their credit loss models; rather, these entities opted to disclose their consideration of general macroeconomic information. Further, approximately 40 percent of the nonbank entities disclosed that the conditions caused by the COVID-19 pandemic were considered in their credit loss models.

While many of the disclosure requirements in ASC 326 do not apply to trade receivables with an original maturity of one year or less, all entities with financial instruments that are within the scope of the new CECL standard must provide certain enhanced disclosures. Specifically, ASC 326-20-50-10 requires entities to provide users with information that allows them to understand the following:

- The method and information management used to develop its estimate of expected credit losses.
- If applicable, the circumstances that caused a change in management's estimate of credit losses, resulting in either additional credit loss expense (or reversal of an expense) during the period.

To meet the disclosure objectives of ASC 326, entities will need to describe, among other things, how their allowance method takes into account (1) past events, (2) current conditions, and (3) reasonable and supportable forecasts.[4] The CECL disclosure requirements emphasize that it is important for an entity to consider past, current, and future events and circumstances when determining expected credit losses (and to provide financial statement users with relevant information about how expected losses were determined). This can be particularly challenging during an economic downturn or recovery.

For more information about disclosure observations, see Deloitte's July 1, 2019, *Heads Up*.

[4] See the disclosure requirements in ASC 326-20-50-10 and 50-11.

Models and Data

The new CECL standard does not prescribe any single method for determining expected credit losses. Consequently, entities have latitude to develop processes that are appropriate for the credit risk (and financial statement misstatement risk) associated with their specific assets that are within the scope of the new CECL model. We have observed that many nonbank entities are leveraging legacy credit impairment models to determine expected credit losses under the CECL model. Specifically, many nonbank entities use an aging method to determine their credit loss provision for trade receivables (see Example 5 in ASC 326-20-55-37 through 55-40 for an illustration of the aging method). When complying with the new CECL standard, entities generally base expected losses for each aging bucket on historical loss rates adjusted for expected changes in loss rates as a result of current and forecasted economic conditions (i.e., adjustments are required when entities expect loss rates to differ from historical rates). These models can present challenges in periods of economic downturn or recovery. Certain of those challenges are described below.

Aging May Not Reflect Current Expected Credit Risk

In an economic downturn or recovery, the number of days a receivable has been outstanding or past due may not be indicative of the expected credit loss associated with the receivable. Accordingly, in such circumstances, entities may need to make additional qualitative adjustments to determine expected credit losses. Entities may want to consider whether their current processes facilitate appropriate qualitative adjustments and whether their controls are sufficiently precise to prevent or detect material misstatements.

A Downturn or Recovery May Affect Different Entities at Different Times

The new CECL standard requires entities to determine expected credit losses for each pool of in-scope financial instruments (e.g., receivables). Receivables are pooled to the extent that they exhibit similar risk characteristics. While the current economic conditions are having a negative effect on many industries, these conditions are resulting in accelerated growth in certain industries. Entities may have adopted the new CECL standard and initially identified a single pool of receivables, or they may have pooled receivables on the basis of geography. Because current economic conditions are affecting industries (and geographies) differently, pools that entities established upon adopting the new CECL standard may no longer consist of receivables that exhibit similar risk characteristics and may need to be adjusted.

Concessions Versus Credit Losses

Even if an entity concludes that it does not need to change its existing expected credit loss models to address the current or expected economic environment, it may want to consider how the current economic environment is affecting the data used to determine expected credit losses. Commercial entities will need to consider how to evaluate credit losses and differentiate them from customer concessions that may be influenced by credit risk but that should be accounted for as variable consideration in accordance with ASC 606. Both credit losses and price concessions provided to customers might be reflected as current adjustments to (or write-offs of) accounts receivable balances; however, only credit losses should be included in the historical data used as a starting point for determining expected credit losses under the CECL model. Because of the volume of contract modifications and price concessions that have resulted from the current economic downturn, entities may find it difficult to consistently differentiate between credit events and price concessions. This could significantly affect the data entities use to estimate expected credit losses in both current and future periods as well as the processes for making the qualitative adjustments discussed above. It is important for companies to determine the data they need to consistently estimate expected credit losses as well as to consider whether the controls over the processes are designed appropriately to address the risks related to the relevance and reliability of data.

Governance and Forecasting

In developing forecasts during the current economic downturn, including those used in determining expected credit losses, entities have needed to make quick, judgmental decisions regarding assessments, process design, internal controls, and governance. It is important to ensure that governance committees (i.e., the parties responsible for evaluating and challenging forecasts) are provided with enough information to make informed decisions. With all the uncertainties related to the current economic downturn, including the timing and pattern of economic recovery, more companies are preparing multiple forecasts with different recovery scenarios and are probability-weighting the likelihood of each outcome.

In the current economic environment, commercial entities may find that their expected credit loss models rely more heavily on forward-looking expectations than historical data. Because of the enhanced reliance on forecasted information that is not entity-specific, existing controls may not currently address risks of material misstatements. Entities should consider whether they need to implement new internal controls over the management and validation of forecasted information.

Where to Find Additional Information

For a comprehensive discussion of the new CECL standard, see Deloitte's *A Roadmap to Accounting for Current Expected Credit Losses*. In addition, if you have questions about the standard or need assistance with interpreting its requirements, please contact any of the following Deloitte professionals:

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