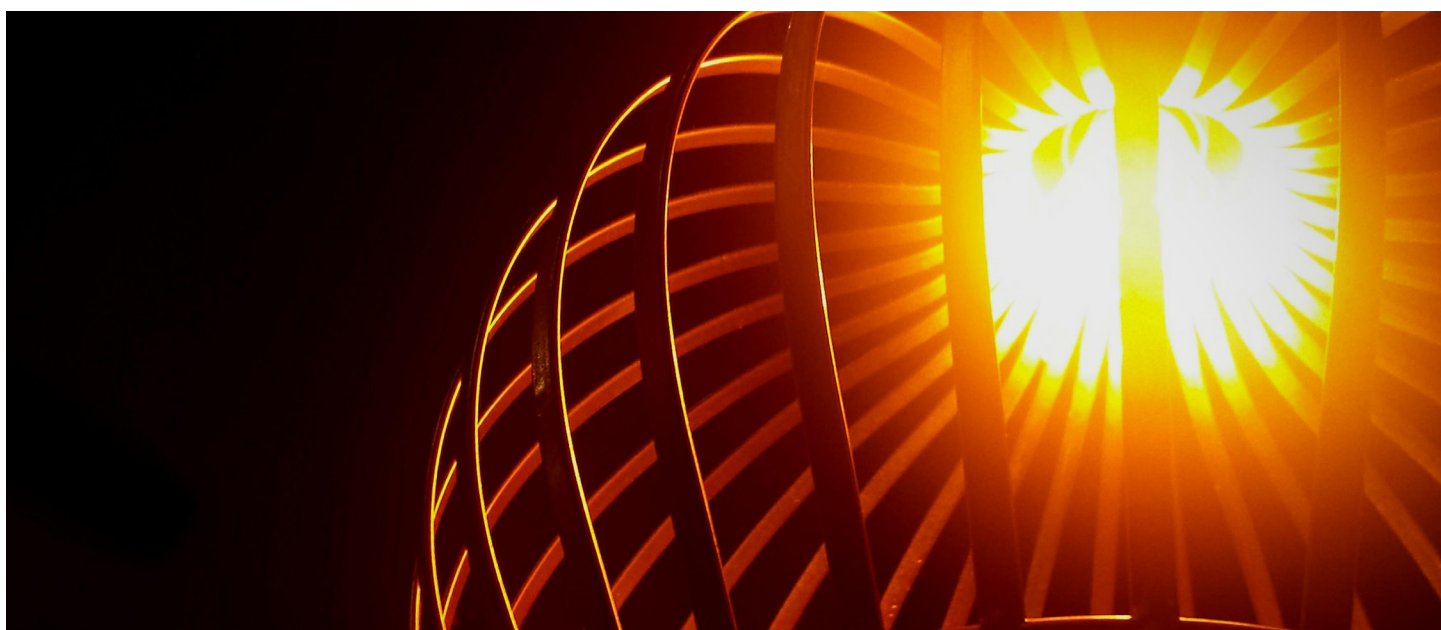




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Current Expected Credit Losses Complexities for Commercial Entities

Background

The new current expected credit loss (CECL) standard (i.e., the guidance in [ASU 2016-13](#),¹ as amended, which is codified in ASC 326²) has been a topic of focus for many entities in the financial services industry since the FASB and International Accounting Standards Board established a Financial Crisis Advisory Group in 2008 to advise the boards on improvements to financial reporting in response to the financial crisis. ASU 2016-13 changes the impairment model for financial instruments measured at amortized cost by requiring these assets to be measured and presented at the net amount expected to be collected, which may accelerate the recording of losses. Under legacy U.S. GAAP, impairments are not recorded until an incurred loss is probable. However, under the new CECL standard's impairment model (the "CECL model," which is codified in ASC 326-20), an entity should recognize an allowance that reflects its estimate of lifetime expected credit losses instead of recording an allowance that is limited to losses that have been incurred.

Given their nature and operations, many public-company financial institutions will be significantly affected by the new CECL standard and are finding it necessary to develop new systems and processes to effectively adopt the standard. While many nonbank commercial entities do not have significant lending activities, substantially all commercial entities have financial instruments and other assets (e.g., trade receivables, contract assets, lease receivables, financial guarantees, loans and loan commitments, and held-to-maturity debt securities) that are subject to the new CECL standard.

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

² For titles of FASB Accounting Standard Codification (ASC) references, see Deloitte's ["Titles of Topics and Subtopics in the FASB Accounting Standards Codification."](#)

We would not expect many commercial entities that do not engage in significant lending activities to be significantly affected by the new CECL standard. However, the standard involves complexities that do apply to many commercial entities, and those complexities could present implementation challenges.

Leveraging Current Processes

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 assets within the scope of the new CECL model. We would expect that most entities will be able to leverage existing credit impairment models to determine expected credit losses. However, there are certain aspects of the new CECL standard that may require an entity to change existing practices or scrutinize historical data to isolate relevant information. In addition, because an entity will need to establish a reserve for its lifetime expected credit losses by using reasonable and supportable forecasts, the entity may have to put processes in place to incorporate forward-looking assumptions into its reserve method.

Pooling of Receivables

Under the CECL model, entities are required to pool their financial instruments and other in-scope assets when the assets have similar risk characteristics. That is, the new guidance does not permit an entity to measure the expected credit losses on a financial asset individually unless the asset has a unique risk profile that does not align with any of the other assets held by the entity. ASC 326-20-30-2 states:

An entity shall measure expected credit losses of financial assets on a collective (pool) basis when similar risk characteristic(s) exist (as described in paragraph 326-20-55-5). If an entity determines that a financial asset does not share risk characteristics with its other financial assets, the entity shall evaluate the financial asset for expected credit losses on an individual basis. If a financial asset is evaluated on an individual basis, an entity also should not include it in a collective evaluation. That is, financial assets should not be included in both collective assessments and individual assessments.

It is important for an entity to understand how credit loss reserves are currently being established so that it can evaluate the likely impact of the CECL model on its existing processes. Relevant considerations include the following:

- *Specific identification of credit losses* — Because the CECL model requires credit losses on financial assets with similar risk characteristics to be measured on a pooled basis, it would generally not be appropriate for an entity to rely *only* on specific reserves unless all of the entity's financial assets have unique credit risks. However, since the CECL model requires instruments with unique risk characteristics to be removed from a pool when their credit risk deviates from that of other assets in the pool, specifically reserving for unique credit risks in such circumstances will remain appropriate. Nevertheless, an entity would still be required to measure the lifetime expected credit losses of the rest of the pool, and asserting zero expected credit losses for a pool is generally not appropriate.³ There may also be circumstances in which a financial instrument that has been removed from one pool will need to be added to another pool. Consequently, it will be important for an entity to carefully identify and monitor pools when applying the CECL model.
- *Matrix reserve approach* — When applying an incurred loss model under current U.S. GAAP, some entities establish their reserve for credit losses on trade receivables by using an invoice aging schedule. For example, an entity that has 30-day payment terms might reserve no amounts for current balances outstanding, 4 percent for

³ ASC 326-20-30-10 provides that an "entity's estimate of expected credit losses shall include a measure of the expected risk of credit loss even if that risk is remote, regardless of the method applied to estimate credit losses." Only if an entity can support an assertion that the expectation of nonpayment of the amortized cost basis of an asset is zero would no credit loss provision be recorded.

any past-due balances outstanding 1–30 days, 10 percent for any past-due balances outstanding 31–60 days, 25 percent for any past-due balances outstanding 61–90 days, and so forth. Under the new CECL standard, ASC 326-20-30-3 provides that credit loss estimation methods that use an aging schedule could be appropriate for determining lifetime expected credit losses; an example of such an approach is included in the standard’s implementation guidance.⁴ However, because of the requirement to pool receivables to the extent that they exhibit similar risk characteristics (and the requirement to pool only receivables that exhibit similar risk characteristics), entities may need to disaggregate their customer (receivable) population into separate pools (e.g., based on geography, industry, or size) or may need to supplement existing processes or policies to demonstrate how the aging of receivables accurately forecasts lifetime expected credit losses for pools of recorded financial assets. Further, it would not be appropriate to assume zero expected losses for amounts in the current bucket since any receivable that is ultimately impaired starts as a current receivable.

These considerations are illustrated in the example below.

Example

Entity X sells goods to various retailers, which are provided with 30-day payment terms. The retailers are predominantly located in either of two geographical areas (Geography A and Geography B). Entity X has historically established its reserve for uncollectible accounts receivable by using a single aging analysis based on historical write-offs and adjustments, reserving 0 percent for current receivables, 10 percent for receivables that are 1–30 days past due, 25 percent for receivables that are 31–60 days past due, 40 percent for receivables that are 61–90 days past due, and 75 percent for receivables that are more than 90 days past due. Most of X’s historical write-offs have been related to its smaller customers, and its write-off history in Geography A has been 50 percent greater than in Geography B. In addition, X routinely grants credit to customers even if they have invoices outstanding for more than 60 days. Accordingly, it is common for X to have customers with receivable balances in the current, 1–30 days past due, and 31–60 days past due aging buckets.

When adopting the new CECL standard, X may need to disaggregate its receivable balance into separate pools to estimate expected credit losses. This is because its historical loss information suggests that (1) the credit risk of customers in Geography A is different from that of customers in Geography B and (2) the credit risk of large customers is different from that of small customers. In addition, because a single customer may have outstanding invoice balances that span multiple aging buckets (each reserved at a different percentage), X may need to support why its existing method appropriately calculates lifetime expected credit losses for each pool. This is because invoices with the same customer or pool of customers in different aging buckets may have the same lifetime collection risk (since they are due from the same customer or pool of customers), but each invoice is being reserved at a different amount under the existing method. Further, it is likely that under the CECL model, it will no longer be appropriate to reserve 0 percent for current receivables since it would be difficult for an entity to support an assertion that it expects to collect 100 percent of the current receivables balance.

In applying the CECL model, X may also need to develop a process and related controls for monitoring economic conditions in Geography A and Geography B so that it can adjust its historical loss information in response to changes in market conditions that could affect expected loss rates.

While commercial entities should be able to leverage existing methods when developing expected loss reserves, some changes may be required to align those methods with the CECL model.

⁴ See ASC 326-20-55-37 through 55-40.

Use of Historical Data

Under current U.S. GAAP, entities most likely use some form of historical collection data to establish a historical loss rate and calculate their reserve for uncollectible accounts related to their trade receivables balance. ASC 326-20-30-8 states that “[h]istorical credit loss experience of financial assets with similar risk characteristics generally provides a basis for an entity’s assessment of expected credit losses.” In accordance with ASC 326-20-30-9, an entity is required to consider whether the historical loss rates differ from what is currently expected over the life of the trade receivables (on the basis of current conditions and reasonable and supportable forecasts about the future); if so, the entity should make appropriate adjustments to the historical loss data. These adjustments can be qualitative and should reflect changes in relevant conditions (internal and external) that suggest that the historical loss information may not adequately predict expected losses. If the life of a receivable is relatively short, an entity may need to make only minimal adjustments to the historical loss data to estimate expected credit losses.

Although it may be appropriate for an entity to use historical loss information to calculate a reserve for uncollectible accounts, historical loss or write-off information may include invoice or receivable adjustments that are not credit-related. For example, an entity’s historical write-off data may include items such as those related to price concessions, volume or other rebates, credit memos for returned items, credit card charge-offs, and disputed balances. While all of these items could be appropriate adjustments to the recorded receivables balance (i.e., adjustments that reflect amounts the entity is unable to collect on the recorded receivable balance), they are most likely not credit-related and could often affect the amount of revenue recognized for the transaction (i.e., they may be forms of variable consideration under ASC 606). Using historical loss data that include write-offs unrelated to credit events could overstate the reserve recorded for expected credit losses.

Entities will need to ensure that they have an appropriate understanding of the transactions included in the historical data they are using to calculate the allowance for expected credit losses. This may be more straightforward for entities with systems in which there is an identifier for each type of credit loss recorded. However, other entities may not have systems with such capabilities. These entities might need to establish a separate process to isolate credit losses in the historical data they use to estimate expected credit losses.

Scope Challenges

The CECL model applies to most financial assets measured at amortized cost,⁵ including trade receivables and financing receivables.⁶ Recovery of these balances is generally predicated on the customer’s ability and intent to pay amounts when due. However, other assets may also be exposed to elements of credit risk but may require an entity to take additional considerations into account to determine whether they are within the scope of the CECL model. Such other assets include the following:

- *Vendor rebates* — Vendor rebate arrangements can vary greatly between entities. Similarly, a single entity can have various types of vendor rebate programs. Recorded balances and the related arrangements need to be analyzed carefully and may require an entity to use judgment when determining whether an accrued vendor rebate is within the scope of the CECL model. Some rebate programs entitle an entity to (1) a cash-back payment once a certain volume of purchases is achieved or (2) cash rebates based on a percentage of goods or services purchased during a certain period. If an entity is entitled to a cash rebate because the necessary conditions (e.g., minimum volume commitment) have been satisfied, the resulting accrued rebate receivable

⁵ ASC 326-20-15-3 lists financial assets that are excluded from the scope of the new CECL standard’s credit loss measurement guidance.

⁶ Although not specifically identified in ASC 326-20-15-2 as financial assets measured at amortized cost, contract assets within the scope of ASC 606 are also subject to the CECL model, as ASC 606-10-45-3 indicates.

is likely to be within the scope of the CECL model. This is because the amount due represents a financing receivable that is due on demand or on a fixed or determinable date.

However, if accrued rebate receivables can only be applied toward future purchases or to offset an amount due to the vendor, such balances would most likely be outside the scope of the CECL model. This is because the realization of the accrued rebate is dependent on offsetting amounts that would otherwise be paid to the vendor rather than on the vendor's payment of amounts when due.

Some rebate programs might be structured in such a way that the parties' established practice is to apply accrued rebate receivables against amounts due to the vendor, but include a cash-out feature in the event that the customer-vendor relationship is terminated. These arrangements may require an entity to perform additional analysis and monitoring to determine the respective balances at period-end (e.g., whether the amount the entity is entitled to from the vendor (i.e., the receivable) is greater than the amount due to the vendor (i.e., the payable), and whether there is a right to set-off) and thereby determine whether any balance is subject to the CECL model.

- *Refundable customer advances* — An entity may advance funds to a customer that enters into a new contract to obtain goods or services from the entity. A contract may require an advance to be repaid if the customer cancels the contract, but may further stipulate that the advance will be "forgiven" if the customer remains a customer for a certain period or purchases a specific quantity of goods or services over the contract term. While the recovery of the advance is partially predicated on the credit quality of the customer, any recorded asset related to the advance is outside the scope of ASC 326-20. Specifically, the advance is neither (1) a financing receivable nor (2) a contract asset within the scope of ASC 606. The advance does not meet the definition of a financing receivable because the amount is not due on demand or on a fixed or determinable date (since the entity's ability to recover the asset for cash is dependent on either future purchases made by the customer or the customer's termination of the contract). Further, the advance does not meet the definition of a contract asset within the scope of ASC 606 because the asset is not related to the revenue recorded by the entity.

However, if the customer cancels the contract and is required to repay the advance, any remaining balance due from the customer at the time of cancellation would be within the scope of the CECL model.

Don't Forget Documentation

Obtaining an understanding of the new CECL standard and performing a deep dive into the balances in the entity's financial statements are critical to ensuring that the standard is properly implemented and that appropriate policies and procedures are established. Although the ultimate impact of the new CECL standard on the financial statements in the period of adoption may not be material, it is important to ensure that there is sufficient documentation to support all judgments and decisions made by management, including those that resulted in no change to the financial statements or the models already in place at the entity. Relevant considerations include the following:

- Determining which accounts and transactions are or are not within the scope of the CECL model.
- Pooling in-scope accounts that have similar risk profiles.
- Identifying the appropriate historical data to use in the impairment model.
- Developing or updating an impairment model to ensure compliance with the CECL standard.

- Ensuring that the historical data being used are representative of the assets in the current economic environment (i.e., determining that the current composition of receivables is similar to the receivables included in the historical period).
- Identifying sources of information to create reasonable and supportable future forecasts, and then analyzing that information to determine whether the credit loss reserve calculation should be adjusted.

For many entities, the new CECL standard will not significantly affect the financial statements and may not require a significant overhaul of processes or controls. However, updating policies to align them with the standard will be important. Policy updates may include those related to the following:

- Consideration of what is currently expected over the life of the balance on the basis of both current conditions and reasonable and supportable forecasts. Although forecasts may not alter the calculation of the credit loss reserve, an entity needs to document how it considered forecasts and concluded that no additional adjustment was necessary.
- Procedures related to the identification of assets that may no longer have the same risk profile as the rest of the pool. Establishing pools of assets based on a similar risk profile is a key step in implementing the new CECL standard. An entity also needs to have documented procedures in place to ensure that (1) those assets continue to have the same risk profile and (2) if something were to change, the entity can identify the need to change its pooling in a timely manner.
- Establishing a procedure for ensuring that balances within the scope of the CECL model are appropriately identified as the entity enters into new transactions or arrangements.

Where to Find Additional Information

For additional discussion about the impact of the new CECL standard on nonbanks, see Deloitte's July 1, 2019, *Heads Up*. 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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