The new credit-loss accounting rules apply to corporate entities, too

While banks immediately grasped the implications of the new CECL rule, corporate entities have been slower to respond. The time to prepare is now. We describe the accounting and governance changes needed to comply.
Introduction

When FASB announced an accounting standards update for the treatment of credit losses on financial assets measured at amortized cost in June 2016, banks and other financial institutions immediately recognized the significance of the change. As a result, financial institutions got to work preparing for implementation well ahead of the effective date. Manufacturers, consumer goods entities, and many other corporate entities are also significantly impacted by this new accounting standard. However, many of these entities have been less proactive about preparing for the change. Now, time is running out to implement the CECL (Current Expected Credit Loss) update. In this paper, we share best practices for entities to use to get ready for CECL.

CECL may significantly impact how both financial and non-financial entities calculate credit loss reserves. However, for non-financial entities (“corporates”), CECL also requires a major shift in perspective, because for the first time they will need to measure potential credit losses from a forward-looking perspective, in particular exposure related to long-term trade receivables.

With little or no experience forecasting or modeling economic conditions, and potentially insufficient data available to do so, corporates are facing a complex challenge to comply with CECL. This is similar to the challenge that entities faced when they had to implement IFRS9, the international standard for accounting for financial instruments, which was announced in 2013. As entities implement CECL, there are valuable lessons from that experience:

Lessons learned from IFRS 9

— Starting early was not early enough! Some entities started as early as three years ago and reported they should have begun much sooner.
— Data was significantly harder to obtain than imagined.
— Developing and refining models was more time consuming than planned.
— Meaningful refinement to inputs following testing and parallel runs caused anticipated further delays.
— Disclosures should not be pushed to the end of the implementation.

1 IFRS 9 Financial Instruments effective for IFRS reporting entities as of January 1, 2018 contains an expected credit loss model that is similar to ASU 2016-13’s CECL.
Data

Complying with CECL’s new data requirements may be a challenge for many corporate entities because CECL requires historical data on losses. Many entities lack this data because they have never had to consistently track, maintain, or retain it. In addition, most corporates will not have forecasted macroeconomic data. Those that use forecasted information may use it solely for internal purposes such as financial planning and analytics, and change will be required to be able to utilize this data for US GAAP financial reporting. Where data is not available internally, some entities will need to obtain proxy data (e.g., for trade receivable loss histories, risk metrics) from a vendor, which poses its own set of risks. Purchased data may represent a close approximation of conditions in a particular industry, however, its use requires management’s judgment as well as internal controls to validate the completeness, accuracy, and relevance of the externally sourced data. Corporate entities that use a provision matrix approach (see “Provision Matrix” below) for assessing the credit risk on trade receivables today may be better prepared and will have applicable historical data available to assist in the adoption of CECL.

Understanding CECL

CECL requires entities to measure expected credit losses over the life of an amortized cost measured asset—an assessment that is fundamentally new for corporates.

For example, for a consumer goods entity with long-duration receivables where the entity determines that the unemployment rate is the primary condition that may cause expected credit losses to differ from those experienced in the historical period, CECL would require that the entity predict the future unemployment rate over the period of time the entity considers to be reasonable and supportable, and then use that forecasted data as an input to determine the lifetime expected losses.

For periods beyond the reasonable and supportable forecast period, reversion to unadjusted historical loss information at the input or output level is required.

Fintech

Institutions engaged in financial technology (“Fintech”) services may find that their assets are in the scope of CECL. Fintech entities may encounter complexity for assets that behave like revolving lines of credit or credit cards. The complexity for these types of instruments stem from the ability to determine the contractual life of the asset. Additionally, entities will need to determine whether undrawn credit lines are unconditionally cancellable or not, with the answer driving a potential calculation for a CECL reserve on the unfunded balance. Typically lacking the volume of historical data and robust modeling & forecasting processes of banking entities, Fintech entities may struggle with some of the requirements of building a CECL calculation process that depends heavily on availability of these components.

Asset-specific issues

As noted, estimating losses for trade receivables will be a major challenge for corporates, but it is only one of several asset types that need to be considered under CECL.

Trade Receivables and Contract Assets

ASC 326 requires entities with trade receivables to recognize CECL on the basis of lifetime expected losses. This requirement affects trade receivables that arise from transactions within the scope of “ASC 606, Revenue from Contracts with Customers” (i.e. receivables from contracts with customers where payment is due based only on the passage of time).

ASC 326 does not prescribe a specific method for estimating CECL, but requires an entity to estimate CECL on a pooled basis where similar risk characteristics exist. Thus, corporate entities should assess trade receivables on a collective basis based on credit risk characteristics (e.g. Internal or external (third-party) credit score or credit ratings, geographical location, financial asset type, etc.).
At each reporting period, entities will quantify the key adjustment factors that impact the collectibility of their trade receivables, including them in the calculation of CECL, as appropriate. A discounted cash flow approach is permitted but not required, and there is no recognition threshold.

Contract assets represent rights to consideration in exchange for transferred goods or services in which the right to receive consideration is conditioned on something other than the passage of time. Contract assets arising from ASC 606 are also within the scope of CECL and will need to be evaluated for credit losses each reporting period under the new model. Corporates will also need to evaluate whether trade receivables with significant financing components may be more akin to lending activities and therefore need to be treated as loans rather than trade receivables when measuring CECL. As a result, the provision matrix approach discussed below may not be appropriate for these situations:

— Provision matrix approach: In the past, many entities have calculated trade receivable losses using a provision matrix, with historical loss rates subdivided into categories based on the number of days past due. This approach could be used to calculate CECL, if the matrix 1) is based on the entity’s historical default rates over the expected life of the trade receivables, and 2) is adjusted to reflect current economic conditions as well as reasonable and supportable forecasts of future economic conditions. To arrive at the CECL amount, the entity would apply the adjusted historical loss rates to trade receivable balances outstanding at period-end by delinquency/days-past-due category. At the end of each reporting period, the entity would update the historical observed loss rates, incorporating changes in the forward-looking estimates.

Here is an illustrative example of a provision matrix for measuring CECL:

### Provision Matrix

<table>
<thead>
<tr>
<th>Assets in scope of CECL</th>
<th>Lifetime expected loss rates* (%)</th>
<th>Gross carrying amount of trade receivables ($)</th>
<th>Lifetime expected credit losses ($)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current balances</td>
<td>0.42%</td>
<td>535,812</td>
<td>2,238</td>
</tr>
<tr>
<td>Balances up to 30 days past due</td>
<td>0.96%</td>
<td>246,624</td>
<td>2,369</td>
</tr>
<tr>
<td>Balances up to 60 days past due</td>
<td>2.93%</td>
<td>81,106</td>
<td>2,379</td>
</tr>
<tr>
<td>Balances up to 90 days past due</td>
<td>7.93%</td>
<td>21,140</td>
<td>1,676</td>
</tr>
<tr>
<td>Balances up to 120 days past due</td>
<td>18.65%</td>
<td>13,212</td>
<td>2,464</td>
</tr>
<tr>
<td>Balances up to 150 days past due</td>
<td>32.64%</td>
<td>9,703</td>
<td>3,167</td>
</tr>
<tr>
<td>Balances greater than 150 days past due</td>
<td>100.00%</td>
<td>1,379</td>
<td>1,379</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>908,976</td>
<td>15,674</td>
</tr>
</tbody>
</table>

* Lifetime expected loss rates are determined based on historical loss rates over the expected remaining life of the trade receivables adjusted for forward-looking estimates.
**Cash and Cash Equivalents**

As with all assets in the scope of CECL, assessment of credit losses must include forward-looking considerations. If certain conditions are met, an entity may not be required to estimate CECL for cash and cash equivalents.

**Debt Securities**

Investments “held to maturity” are in the scope of CECL. The zero-loss expectation exception may be available for certain debt securities, such as US Treasury Bills. This zero-loss expectation exception applies when historical credit loss experience adjusted for current conditions and reasonable and supportable forecasts provides an expectation that non-payment of the amortized cost basis is zero. If the exception applies, the entity is not required to estimate and recognize an allowance for credit losses. Other debt securities may require new credit risk models capable of creating the forecasts necessary to measure CECL.

Available for sale (“AFS”) debt securities are not in scope of CECL. However, ASU 2016-13 changed the existing AFS debt security impairment model as follows:

- When determining whether a credit loss exists, an entity is not allowed to consider:
  - The length of time during which the fair value has been less than the amortized cost basis
  - The historical and implied volatility of the fair value
  - Changes in fair value after the balance sheet date.

- Credit losses are recognized through an allowance account rather than through a direct write-down of the amortized cost basis. Recognize reversals of credit losses immediately, including reversals due to fair value increases.

- Credit losses are limited to the difference between the amortized cost basis and fair value of a debt security.

**Leases**

A net investment in a finance lease is recognized by a lessor for sales-type and direct financing leases. The net investment in leases is in scope of CECL and may require dedicated credit risk models to measure CECL. As with all assets in the scope of CECL, incorporating forward-looking estimates is required, and corporate entities should assess their ability to satisfy this requirement for net investments in finance leases. The impact may be more significant for lessors that hold finance (capital) leases in longer-term and/or large equipment or machinery such as ships, planes or entire facilities. A key consideration relating to CECL for the net investment in finance leases is that the allowance will contain both a credit risk component relating to the lease cash flows, and a non-credit risk component relating to the risk of loss on the leased asset. It may be necessary to measure the loss rates for each component separately if they differ significantly.

Receivables from investments in operating leases are outside the scope of CECL. An amount which cannot be collected is adjusted to lease income under the measurement guidance within ASC 842, Leases. Separately, at lease commencement, the assessment is made whether collectibility is probable or not, which could impact lease classification.

**Timeshares**

Financing receivables arising from time-sharing activities are in scope of CECL when they give rise to expected credit losses. CECL amends the industry-specific guidance for entities engaged in time-sharing activities by superseding the existing allowance recognition methodology in ASC 978-310 with reference to CECL’s general measurement principles. ASC 978-310’s current reference to “allowance for uncollectibles” wherein “uncollectibles” is a specifically defined term will be replaced with “allowance for credit losses” upon the adoption of CECL.
The application of CECL’s measurement framework to timeshare receivables presents fundamental CECL interpretative questions, which are unique to this industry. One such issue that entities will need to consider is the interaction of CECL’s application to timeshare receivables and interpretative decisions the industry has already reached in connection with their adoption of ASC 606. Specifically, the AICPA Timeshare Task Force reached the conclusion that defaults on timeshare receivables generally arise due to an implicit right of return and, therefore, are not “credit-related.”

Financial Reporting Disclosures
CECL introduces new and amended disclosure requirements for all entities. The disclosure that may be most challenging to implement for public business entities is the vintage disclosure. Public business entities are required to provide credit quality disclosures of the amortized cost basis for financing receivables, contract assets, and net investment in leases by vintage year of origination.

Taking steps to prepare for CECL

<table>
<thead>
<tr>
<th>Assets in scope of CECL</th>
<th>Accounting change steps required</th>
</tr>
</thead>
<tbody>
<tr>
<td>If your entity has only the following in the scope of CECL:</td>
<td>1. Balance sheet CECL scoping</td>
</tr>
<tr>
<td>— Trade receivables and contract assets that are short term (&lt;12 months)</td>
<td>2. CECL training presentation</td>
</tr>
<tr>
<td>— Cash &amp; Cash Equivalents that are liquid short-term deposits.</td>
<td>3. Position papers:</td>
</tr>
<tr>
<td></td>
<td>a. Trade receivables under CECL</td>
</tr>
<tr>
<td></td>
<td>b. Cash &amp; cash equivalents and other assets under CECL</td>
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<td></td>
<td>c. Transition date accounting</td>
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<td></td>
<td>d. Financial reporting disclosures</td>
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<td></td>
<td>e. Qualitative considerations around forward economic guidance</td>
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<td></td>
<td>4. Loss rate calculation approach design &amp; implementation</td>
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<tr>
<td></td>
<td>5. New controls</td>
</tr>
</tbody>
</table>

If your company also has the following in the scope of CECL:
|  | CEEC readiness assessments, CECL gap assessments, and the creation of credit risk models may be required. |
| — HTM debt securities | |
| — AFS debt securities | |
| — Loans at amortized cost | |
| — Long duration receivables and contract assets | |
| — Receivables with a financing component | |
KPMG is actively supporting many major CECL accounting change efforts across industries. In addition, our accounting and credit risk professionals have gained many applicable insights from helping institutions implement IFRS 9, which has similar requirements to CECL. These capabilities enable our teams to bring deep practical understanding as well as industry experience and technology tools to CECL implementation efforts. Let’s discuss how we can help you.

For more information, contact us:

**Reza Van Roosmalen**  
Principal,  
Accounting Advisory Services  
212-954-6996  
rezavanroosmalen@kpmg.com

**Patricia Alonso de la Fuente**  
Managing Director,  
Accounting Advisory Services  
212-954-2111  
patriciaalonso@kpmg.com

**Stephanie Petruzzi**  
Director,  
Accounting Advisory Services  
703-286-6916  
spetruzzi@kpmg.com

**Brandon Isaacs**  
Director,  
Accounting Advisory Services  
703-343-2812  
brandonisaacs@kpmg.com

**John Lyons**  
Director,  
Accounting Advisory Services  
212-954-6804  
johnlyons1@kpmg.com

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