CECL 2023-3: GENERAL QUESTIONS ABOUT THE CECL STANDARD

Q1: Does the application of the word forecast infer computer-based modeling analysis is required?
No.
Q2: If an entity's actual credit losses differ from its estimate of expected credit losses, is it required to modify its forecasting methodology?
Estimates of expected credit losses often will not predict with precision actual future events. An entity should continue to refine future estimates of expected credit losses based on actual experience.

Historical Loss Information

Q3: Can an entity's process for determining expected credit losses consider only historical information?
No.
Q4: How should an entity determine which historical loss information to use when estimating expected credit losses?
An entity may use historical loss information that is nonsequential. The appropriate historical loss period can vary between loan portfolios, products,

pools, and inputs. An entity should consider both the appropriate historical period and the appropriate length of the period when developing those estimates. An entity should use judgment in determining which historical loss information is most appropriate for estimating expected credit losses, it does not have to use historical losses from the most recent periods. Once the historical period has been chosen, consider adjustments to historical loss information for differences in current asset specific risk characteristics, such as underwriting standards, portfolio mix, or asset term within a pool at the reporting date or when an entity's historical loss information does not reflect the contractual term of the financial asset or group of financial assets. For periods beyond the reasonable and supportable forecast period, an entity should revert to historical loss information that may not be from the same period used to estimate its reasonable and supportable forecast. In other words, an entity should use historical loss information that is more reflective of the remaining contractual term of the financial assets for periods beyond the reasonable and supportable forecast period.

Reasonable and Supportable

Q5: Is an entity required to consider all sources of available information when estimating expected credit losses?
No, an entity should consider relevant information that is reasonably available that can be obtained without undue cost and effort. However, an entity should not ignore available information that is relevant to the estimated collectibility of the reported amount.
Q6: What if external data are not costly, but internal data are more relevant to an entity's loss calculation, Is the entity required to obtain and/or use the external data?
No, the guidance allows an entity to use judgment in estimating expected credit losses, which includes the flexibility to decide which information should be used in estimating expected credit losses (internal or external data or a combination of both).
Q7: Should an entity use external data to develop estimates of credit losses if internal information is available?

The guidance does not prescribe what type of information can be used in developing an estimate of expected credit losses as long as that information is relevant to the entity, which means that an entity can use internal information, external information, or a combination of both internal and external forms of information in developing an estimate of expected credit losses. However, if an entity does not have the internal information that would be relevant to developing expected credit losses, it should consider external information to develop an estimate of expected credit losses.

Q8: May the length of reasonable and supportable forecast periods vary between different portfolios, products, pools, and inputs?

Yes.

Q9: Does an entity need to include the full contractual period in its estimate of the reasonable and supportable forecast period?

No.

Q10: Should an entity reevaluate its reasonable and supportable forecast period each reporting period?

Yes.

Q11: Is an entity required to correlate reasonable and supportable forecasts to macroeconomic data, such as nationwide or statewide data?

No.

Q12: When developing a reasonable and supportable forecast to estimate expected credit losses, is probability weighting of multiple economic scenarios required?

No.

Q13: Is there a standard threshold that can be used to adjust historical loss information?

No.

Reversion to Historical Loss Information

Q14: What should an entity do if it cannot forecast estimated credit losses over the entire contractual term?

For periods beyond which the entity is able to make or obtain reasonable and supportable forecasts of expected credit losses, it is required to revert to historical loss information that reflects expected credit losses during the remainder of the contractual term.

Q15: Can an entity adjust the historical loss information used in the reversion period for existing economic conditions or expectations of future economic conditions when developing estimates of expected credit losses?

No, However, the historical loss information should be adjusted for differences in current asset-specific risk characteristics.

Is An Equity Security within the Scope of CECL?

No, CECL is not applicable to equity securities. ASC 321, Investments – Equity Securities provides the applicable guidance for equity securities, including impairment considerations for securities without readily determinable fair values for which the measurement alternative has been elected. Under that ASC, securities without readily determinable fair values for which the measurement alternative has been elected are considered impaired and written down to its fair value if a qualitative assessment indicates that the fair value is less than the carrying value.[1]

Note that preferred stock that by its terms either must be redeemed by the issuing entity or is redeemable at the option of the investor is a debt security for accounting purposes, regardless of its legal form.[2] Thus, the CECL model would apply if such preferred stock is carried at amortized cost by the investor, and irrespective of how it is classified by the issuer. In practice, to be considered redeemable at the option of the investor, that investor must have a unilateral right to redeem.

Did the Model for AFS Debt Securities Change?

While not in the scope of the primary CECL model applicable to assets carried at amortized cost (and certain other items), targeted amendments were made to the existing impairment model for AFS debt securities. The existing guidance that requires an estimate of credit losses only when the security is considered impaired (i.e., fair value is less than its amortized cost basis) did not change, nor has the requirement to recognize in income the credit losses and in other comprehensive income any noncredit losses. Further, if there is an intent by the entity to sell the impaired security or more likely than not will be required to sell the security prior to recovery of its amortized cost basis, the security's basis should be written down to its fair value through net income in accordance with existing guidance.

However, for an impaired AFS debt security for which there is neither an intent nor a more-likely-than-not requirement to sell, an entity will record credit losses as an allowance rather than a reduction of the amortized cost basis. As a result, entities will be able to record reversals of credit losses in current period income as they occur, which is prohibited under existing GAAP. Additionally, the allowance is limited by the amount that the fair value is less than the amortized cost basis, considering that an entity can sell its investment at fair value to avoid realization of credit losses.

An entity should not consider the length of time that the security has been in an unrealized loss position to avoid recording a credit loss. Further, in determining whether a credit loss exists, the historical and implied volatility and recoveries or additional declines in the fair value after the balance sheet date should no longer be considered. As a result, whether the impairment is other-than-temporary (OTTI) is no longer a consideration in recording credit losses. Further, unlike the CECL model that required pooling of assets with similar risk characteristics, credit losses for AFS debt securities must be determined on an individual basis and use a discounted cash flow model.

When is CECL Effective?

The ASU, as amended, has the following effective dates for calendar year end entities:

SEC Filers Excluding smaller reporting companies	January 2020
All Other Entities (Including SRCS)	January 2023

All entities may elect to early adopt CECL.

An entity will determine its effective date based on its most recent SRC determination as of November 15, 2019, in accordance with SEC regulations. The effective date for that entity will not change even if the entity subsequently loses its SRC status.

Is CECL Effective Retrospectively or Prospectively??

It is generally effective on a modified retrospective basis. An entity must apply the amendments through a cumulative-effect adjustment to retained earnings as of the beginning of the first reporting period in which the guidance is effective (that is, a modified-retrospective approach), except for certain debt securities and purchased credit impaired assets for which a prospective transition approach is required.

Are New Disclosures Required Under CECL?

The objective of the disclosures is to enable a user of the financial statements to understand the credit risk inherent in a portfolio and how management monitors the credit quality of the portfolio, management's estimate of expected credit losses and changes in the estimate of expected credit losses that have taken place during the period.

To achieve the objective, the ASU has numerous required disclosures. Many of the disclosures carry forward from existing requirements. However, CECL made certain amendments (additions and deletions) both to the scope and content of the existing disclosures, as well as introducing new disclosures. For example, unlike existing GAAP, the impairment model for HTM debt securities will differ from that of AFS debt securities. Therefore, many existing disclosures remain for AFS debt securities but are not applicable to HTM debt securities. The ASU requires disclosure of a roll-forward of the reserve account and introduces[3] a requirement that a public business entity present the amortized cost basis within each credit quality indicator by year of origination and gross write-offs recorded in the current period for financing receivables and net investments in leases (vintage).[4] However, except for credit card receivables, there is an exception from having to provide vintage disclosures for receivables, including trade receivables, that are due in one year or less.[5] Systems and processes may need to be updated to not only to be in accordance with the new CECL measurement model, but also for providing the required disclosures including the vintage disclosures.

What Type of Disclosures Apply Prior to Adopting CECL?

FASB Accounting Standards Codification (ASC) 250, Accounting Changes and Error Corrections, paragraph 10-S99-5 and Staff Accounting Bulletin (SAB) No. 74 (Topic 11M), Disclosure of the Impact that Recently Issued Accounting Standards Will Have on the Financial Statements of the Registrant When Adopted in a Future Period, indicate that "registrants should discuss the potential effects of adoption of recently issued accounting standards… [and] that this disclosure guidance applies to all accounting standards which have been issued but not yet adopted by the registrant unless the impact on its financial position and results of operations is not expected to be material."

While SAB 74 disclosures are both qualitative and quantitative, they should become more robust and quantitative as the effective date for a new accounting standard draws near. The following types of SAB 74 disclosures are expected in the periods before new accounting standards are effective:

- **A comparison of accounting policies**. Registrants should compare their current accounting policies to the expected accounting policies under the new accounting standard(s).

- **Status of implementation**. The status of the process should be disclosed, including significant implementation matters not yet addressed or if the process is lagging.

- **Consideration of the effect of new footnote disclosure requirements in addition to the effect on the balance sheet and income statement**. A new accounting standard may not be expected to materially affect the primary financial statements; however, it may require new significant disclosures that require significant judgments.

- **Disclosure of the quantitative impact of the new accounting standard if it can be reasonably estimated**.

- **Disclosure that the expected financial statement impact of the new accounting standard cannot be reasonably estimated**.

- **Qualitative disclosures**. When the expected financial statement impact is not yet known by the entity, a qualitative description of the effect of the new accounting standard on the entity's accounting policies should be disclosed.

Will Adopting CECL Impact an Entity's Internal Control Over Financial Reporting?

Yes. Those responsible for overseeing the adoption should have proactive and routine conversations with members of senior management and the board of directors to ensure there is sufficient transparency of the adoption efforts and potential impact. Regardless of whether the entity is subject to the provisions of Sarbanes-Oxley, the new standard will impact the internal control environment. Taking a fresh look at the internal control environment is key and should be done early in the adoption process and throughout the various implementation phases.

For example, accumulation of data will be a key element in the credit loss process. Determining the relevance and reliability of the data being used in the forecasting process will be a key challenge for entities. Additionally, developing a forecast that is both reasonable and supportable may consider both publicly available information and involve subject matter experts which may be from internal or external third-party resources. The information used, and judgments made, by decision makers are to be supported by effective internal control structures. Internal controls will vary depending on how the information is derived. For third-party provided data, management may consider control activities to validate integrity, relevance and reliability. Understanding the source of the data and how the data will be used in developing the forecast will be critical to avoid placing inadvertent reliance.

We encourage those charged with oversight of CECL implementation to read the publication issued by the Financial Executives International's (FEI) Committee on Corporate Reporting (CCR) publication on Internal Control over Financial Reporting for the Current Expected Credit Loss (CECL) Standard released in November 2018 as well as the Center for Audit Quality's (CAQ) publication related to (Preparing for the New Credit Losses Standard), which was published in May 2019 as a tool to be used by Audit Committees.

DOWNLOAD THE FULL PUBLICATION >>

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[1] See ASC 321-10-35-2 through 35-4
[2] See ASC 320-10-20 Definition of Debt Security
[3] See ASC 326-20-50-6

[4] See ASC 326-20-55-15 for Application of the Term Credit Quality Indicator
[5] See ASC 326-20-50-9