CECL 2023-2: TYPES OF FINANCIAL ASSETS WITHIN THE SCOPE

What Type of Financial Assets are Within the Scope of CECL?

The scope of CECL is broad and includes the following:

ITEM	NATURE
Loan Receivables/Notes Receivable	Financial Assets measured at amortized cost
Held-to-maturity debt securities	Financial Assets measured at amortized cost
Trade receivables and contract assets that result from revenue transactions or other income	Financial Assets measured at amortized cost
Receivables that relate to repurchase agreements and securities lending agreements	Financial Assets measured at amortized cost

ITEM	NATURE
Loans to officers and employees	Financial Assets measured at amortized cost
Cash equivalents	Financial Assets measured at amortized cost
Receivables arising from time-sharing activities	Financial Assets measured at amortized cost
Receivables resulting from salts-type or direct financial leases	Net investments in leases recognized by a lessor
Loan commitments, standby letters of credit, financial guarantees, and other similar instruments	Off-balance-sheet credit exposures not accounted for as insurance or derivatives
All reinsurance recoverables, regardless of the measurement basis of those recoverables	Reinsurance recoverables

What Type of Financial Instruments are Outside the Scope of CECL?

The CECL model does not apply to financial assets measured at fair value through net income, available-for-sale debt securities, loans made to participants by defined contribution employee benefit plans, policy loan receivables of an insurance entity, or promises to give (pledges receivable) of a not-for-profit entity.

The FASB observed that some related-party loans may be viewed as a capital contribution rather than a loan to be repaid. Accordingly, it was decided to scope out loans and receivables between entities under common control from the CECL model; however, other related party loans are within its scope.

Are Operating Lease Receivables in the Scope of CECL?

Although the CECL model did not specifically address receivables arising from operating leases, they appear to meet the definition of financial assets and thus would be within its scope. However, the FASB clarified that operating lease receivables accounted for by a lessor in accordance with the leasing guidance in Topic 842 are not in the scope of the CECL model. Instead, impairment of receivables from operating leases should be accounted for in accordance with Topic 842, Leases.[1] Further, being an operating lease, the leased asset remains on the lessor's books and is assessed for impairment like any other similar asset under Topic 360, Property, Plant and Equipment.

Are Trade Receivables Within the Scope of CECL?

Yes, CECL requires measurement of the expected credit loss even if that risk of loss is remote, regardless of the method applied to estimate credit losses. That is, life-of-asset losses must be considered. However, if a pool of assets has never historically incurred losses and current conditions and supportable forecasts show zero risk of nonpayment, then no allowance is required. However, this is an extremely narrow scope exception for measuring credit losses for a financial asset where even if a technical default occurs, the expectation of nonpayment is zero. The example provided in the ASU is of US Treasury Securities, which are explicitly guaranteed by the sovereign US Government, which can print its own currency. Cash equivalents[2] may also meet the scope exception from measuring credit losses. However, most other types of instruments, including AAA-rated corporate bonds and trade receivables, are not expected to meet this scope exception considering that upon a default the loss is likely to be more than zero. However, the Accounting Standards Codification indicates that the provisions of the Codification need not be applied to immaterial items.[3] But, entities would still be required to document the basis for concluding that CECL does not have a material impact.

The following example adapted from ASU 2016-13[4] illustrates application of the new CECL model to trade receivables for a consumer entity that estimates credit losses using an aging schedule:

Background and Existing Model:

Consumer Entity Appliances Inc. has $40 million of trade receivables. Under prior GAAP, the allowance of $4.8 million is based on aging at period end using historical loss rates as follows (see table on the next page):

- 0% for the current receivables of $19 million.
- 6% for receivables that are 1-30 days past due of $11 million.
- 28% for receivables that are 31-60 days past due of $6 million.
- 54% for receivables that are 61-90 days past due of $3 million.
- 87% for receivables that are more than 90 days past due of $1 million.

Application of New CECL Model:

Management believes that this historical loss information is a reasonable base on which to determine expected credit losses because the composition of the trade receivables at the reporting date is consistent with that used in developing the historical credit-loss percentages That is, the similar risk characteristics of its customers and its lending practices have not changed significantly over time. However, management has determined that current reasonable and supportable forecasted economic conditions have deteriorated as compared with the economic conditions included in the historical information. Specifically, unemployment has increased as of the current reporting date, and management expects there will be an additional increase in unemployment over the next 15 months. Based on its past experience for similar increases in the unemployment rate, management adjusts the historical loss rates to reflect the differences in current conditions and forecasted changes for an estimated allowance of $5.2 million (see table below).

Aging (past due)	Amortized Cost Basis (million)	Existing Loss Rate	Existing Allowance (million)	New Adjusted Loss Rate	Allowance Under CECL
Current	$19,000,000	0%	$0	1.50%	$285,000
1-30 days	$11,000,000	6%	$660,000	6.09%	$669,900
31-60 days	$6,000,000	28%	$1,680,000	28.42%	$1,705,200
61-90 days	$3,000,000	54%	$1,620,000	54.81%	$1,644,300
>90 days	$1,000,000	87%	$870,000	88.31%	$833,050
Allowance			$4,830,000		$5,187,450

Further, CECL requires that trade receivables sharing similar risk characteristics be pooled. An entity should determine whether its current segmentation practices for purposes of the aging analysis under the incurred loss model is consistent with the ASU's requirement to pool financial assets with similar risk characteristics. For instance, management of Appliances Inc. determines that it is appropriate to pool customers by geography (US, World), type (Corporate, Others) and Past Due Status (Aging Buckets). Management could group the trade receivables similar to the table below and then apply the appropriate loss rate(s) determined under CECL to each of the pools/buckets to arrive at the allowance for credit losses:

Geography	Type	Current	1-30 Days Past Due	31-60 Days Past Due	61-90 Days Past Due	>90 Days Past Due
US	Corporate	$X	$X	$X	$X	$X
US	Others	$X	$X	$X	$X	$X
World	Corporate	$X	$X	$X	$X	$X
World	Others	$X	$X	$X	$X	X

As indicated above, CECL requires that a credit loss be recorded for expected losses even if the receivable is current i.e., not yet past due. While the entity may expect full recovery on an individual customer contract, on a portfolio (pool) level some loss would generally be expected. The FASB discussed that financial assets generally are priced assuming an estimated likelihood of credit losses on similar assets, even though the entity may initially expect to collect all of the contractual cash flows on each individual asset.[5] Similarly, while an entity might not currently expect a loss on an individual asset, it ordinarily would expect some level of losses in a group of assets with similar risk characteristics. That risk of loss would need to be reflected in the allowance, even if the risk is remote. Further, the allowance needs to consider reasonable and supportable forecasts. Entities should consider relevant data, whether internal, external or a combination of information. As previously noted the standard requires reversion to historical loss information for periods than cannot be forecast based on reasonable and supportable information. However, considering the short-term nature of the trade receivables, it is expected that entities will generally have reasonable and supportable forecasts. Other assets, such as contract assets, may have longer durations, depending on the nature of the arrangement.

An example in the ASU regarding estimating the CECL reserve for trade receivables indicates that application of CECL to short-term receivables is not expected to differ significantly from current practice.[6] However, it is key that entities consider forward looking information and expectation of losses in developing and documenting the allowance at inception and each reporting period instead of basing the allowance only on incurred losses. Further, entities need to determine if an allowance should be recognized even for current receivables that are not yet past due.

In general, the process for estimating life-of-trade receivables credit losses using an aging schedule can be summarized as follows:

- Pool receivables with similar risk characteristics.[7]
- Consider whether historical loss rates need to be adjusted for asset specific characteristics (e.g., difference in the portfolio mix).[8]
- Adjust historical loss rates for current conditions and reasonable and supportable forecasts. If required (e.g., for longer duration receivables),

revert to historical loss rates for future periods beyond those that can be reasonably forecast.[9]
- Apply revised loss rates to the amortized cost (i.e., trade receivable balance) to determine the CECL allowance.[10]

To ease application of the CECL model, the FASB staff issued a series of Q&As, available on the designated Credit Losses page on FASB website, addressing questions related to using historical loss information, making reasonable and supportable forecasts and reversion to historical loss information. A summary is provided in the next article in our series; see the FASB Q&A Publication for details[11]:

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[1] See Accounting Standards Update (ASU) No. 2018-19, Codification Improvements to Topic 326, Financial Instruments – Credit Losses
[2] Short-term highly liquid investments that are readily convertible to known amounts of cash and so near their maturity that they present insignificant risk of changes in value because of changes in interest rates
[3] See ASC 105-10-05-6
[4] See Example 5 (ASC 326-20-55-37 through 55-40)
[5] See BC69 of ASU 2016-13
[6] See Example 5 (ASC 326-20-55-37 through 55-40)
[7] See ASC 326-20-30-2
[8] See ASC 326-20-30-8
[9] See ASC 326-20-30-9
[10] See Example 5 (ASC 326-20-55-37 through 55-40)
[11] Staff Q&A Topic 326, No. 2: Developing an Estimate of Expected Credit Losses on Financial Assets