Applying the New Expected Credit Loss Model at Nonprofits

Today's Speaker

Amelia Crawford

Director, Not-for-Profit

Assurance Services

Learning Objectives

- Understanding the new credit loss standard and how it will affect not-for-profit organizations
- Calculating the CECL allowance
- Implementation of the credit loss standard including disclosures in the footnotes to the financial statements.

Why are we here?

Accounting Standards Update (ASU) 2016-13 – Codified in ASC 326 (or Topic 326)

Current Expected Credit Loss (CECL) model established with ASU 2016-13

Immediate recognition of estimated expected credit losses over the life of a financial instrument.

Management must determine an estimate of expected credit losses which considers historical, current, and future economic conditions and events.

Timeline

ASU 2016-13

June 2016

Effective Date

FY Beginning after December 15, 2022

Implemented

FYE December 31, 2023

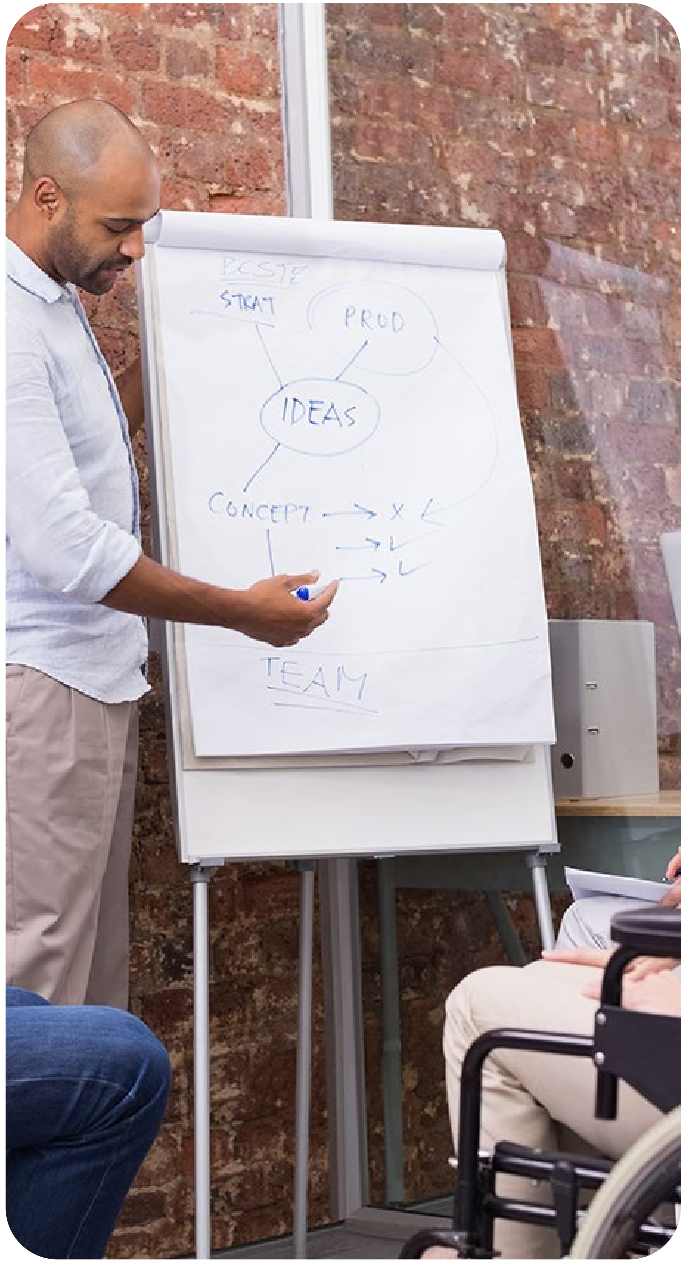
Upcoming Implementation

FYE June 30, 2024 or later

Previous State

Previous US GAAP required an “incurred loss” methodology which delayed recognition until it was probable a loss has been incurred.

The global financial crisis has unscored the need for users of the financial statements to have losses recorded when expected rather than waiting to meet the “probable” threshold.



Overview of ASC 326

- Topic 326 is intended to improve financial reporting by requiring earlier recognition of credit losses on loans and other financial assets carried at amortized cost, which includes trade receivables.

- Replaces the current incurred loss impairment model that recognized losses when a probable threshold was met with a requirement to recognize lifetime expected credit losses immediately when a financial asset is originated or purchased.

- An increase in allowances is expected.

Breakdown of Terms Used

Financial Asset

A financial asset is cash, evidence of an ownership interest in an entity, or a contract that conveys to one entity a right to do either of the following:

a. Receive cash or another financial instrument from a second entity.
b. Exchange other financial instruments on potentially favorable terms with the second entity.

Amortized Cost Basis

The amortized cost basis is the amount at which a financing receivable or investment is originated or acquired, adjusted for:

- applicable accrued interest,
- accretion,
- amortization of premium or discount and net deferred fees or costs,
- collection of cash,
- write-offs,
- foreign exchange,
- and fair value hedge accounting adjustments.

Old vs. New

Previous incurred loss model

- Losses recorded when probable of being incurred.
- No indication of loss means no reserve required.
- Based on historical experience.
- Typically applied to past-due amounts for trade receivables.

New expected loss model

- No threshold for recognition.
- Allowance is required, even if remote.
- Based on reasonable and supportable forecasts for future credit losses, factoring in historical and current data as well as forecasts of the future.
- Applied to all balances, including those considered current.

Transition Guidance

- Implement using a modified retrospective approach
- Analyze the cumulative effect of applying the standard as an adjustment to opening net assets in the period of application.
  - This adjustment is the difference between the old model (incurred loss) and the new model (CECL)

CECL Adoption In Steps

1. Determine what instrument types are within scope
2. Group instruments within each instrument type into risk pools that have similar risks
3. Select method for determining losses
4. Compute historical loss experience
5. Adjust historical loss experience for current conditions and reasonable and supportable forecast

Step 1

Determine what instrument types are within scope

ASC 326 Scope

Step 1: Determine instrument types within scope

15-2 The guidance in this Subtopic applies to the following items:

a. Financial assets measured at amortized cost basis, including the following:
   1. **Financing receivables**
   2. Held-to-maturity **debt securities**
   3. Receivables that result from revenue transactions within the scope of Topic 605 on revenue recognition, Topic 606 on revenue from contracts with customers, and Topic 610 on other income
   4. Subparagraph superseded by Accounting Standards Update No 2019-04.
   5. Receivables that relate to repurchase agreements and securities lending agreements within the scope of Topic 860

b. Net investments in leases recognized by a lessor in accordance with Topic 842 on leases

c. Off-balance-sheet credit exposures not accounted for as insurance. Off-balance-sheet credit exposure refers to credit exposures on off-balance-sheet loan commitments, standby letters of credit, financial guarantees not accounted for as insurance, and other similar instruments, except for instruments within the scope of Topic 815 on derivatives and hedging

d. **Reinsurance recoverables** that result from insurance transactions within the scope of Topic 944 on insurance.

	Does Subtopic 326-20 apply?
Financial assets measured at amortized cost	✔
Net investment in leases	✔
Off-balance sheet credit exposures not accounted for as insurance	✔
AFS debt securities	Subtopic 326-30 applies[1]
Financial assets measured at fair value through net earnings	✘

ASC 326 – Scope Exclusions

Step 1: Determine instrument types within scope

Excerpt from ASC 326-20

> Instruments

15-3 The guidance in this Subtopic does not apply to the following items:

a. Financial assets measured at **fair value** through net income
b. Available-for-sale debt securities
c. **Loans** made to participants by defined contribution employee benefit plans
d. Policy loan receivables of an insurance entity
e. Promises to give (pledges receivable) of a not-for-profit entity
f. Loans and receivables between entities under common control.
g. Receivables arising from operating leases accounted for in accordance with Topic 842.

Pledges receivables are **NOT** included within the scope of CECL. However, other receivables are within scope.

Common Financial Instruments in Scope

- Trade receivables from tuition and fees or other services
- Loans Receivables
- Financial Receivables
- Net investment in sales-type and direct financing leases

Step 2

Group instruments (within each instrument type) into risk pools that have similar risks

Entities are <u>required</u> to group assets that have similar risk characteristics.

Step 2: Group assets with similar risks into risk pools

Ways to Pool	Examples
• Aging	• Current vs. 31-60 days vs. 61-90 days vs. 91-120 days vs. > 121 days past due
• Collateral	• Collateralized vs. not, Type of collateral, etc.
• Credit rating	• AAA / BB+ / not rated, consumer credit score, etc.
• Geographic location	• By country, by state, by region, etc.
• Size of receivable or customer	• > $10K, between $10K and $5K, < $5K, etc. • Large financially stable entities vs. start-ups, etc.
• Expected term until repayment or write-off	• 60 days, 180 days, > 1 year, etc.
• Industry	• Manufacturing, financial services, retail, etc.
• Other	• Interest rate, vintage (year of origination), payment structure (e.g. interest only, amortized, PIK interest), etc.

Step 3

Select the method for determining losses

Step 3: Select method for determining losses

- Standard does not require a specific method but gives examples;
- Consider data requirements and availability when selecting a method;
- See separate file for examples of the 2 most common methods for AR allowance.

Example Methods* ***Most commonly used for AR**	**Summary**
• Loss Rate*	A historical loss rate for each "pool" with similar risk characteristics is computed. For example, 2.5% of credit sales to corporate customers were written off during the 5 previous years. **FN 1**
• Aging*	A migration analysis is conducted for each "pool" in order to construct an AR aging for a period. For example, if there were $100M in credit sales during the previous 2 years and $40M was collected in < 30 days, then $40M would represent the < 30 day aging category. Then total write-offs related to all credit sales is applied to each aging category to develop a loss rate by aging. **FN 1**
• Others	Discounted Cash Flow (DCF), Vintage, Probability of Default, Roll-rate, etc.

FN 1 – These historical loss rates are then the starting point and adjusted for current conditions and "reasonable and supportable forecasts."

Step 4

Compute the historical loss experience.

Historical loss experience is the starting point for developing the expected credit loss estimate.

Step 4: Compute historical loss experience

- An entity must use historical loss experience if it exists and is pertinent;
- Biggest change for many entities;
- Management should consider the availability and accuracy of data available;
- Entities should consider:
  - What is the appropriate historical period (does not have to be the most recent); and
  - What length of period is sufficient (does not have to be sequential). At a minimum the length of time should at least equal to remaining expected period until repayment or write-off.

Step 5

Adjust historical loss experience for current conditions and reasonable and supportable forecasts

Step 5: Adjust historical loss for current conditions and R&S forecast

An entity shall not rely solely on past events to estimate expected credit losses. Current conditions and "reasonable and supportable" future forecasts must be considered, and the historical loss rate should be adjusted if necessary.

ASC 326 Guidance	Application of Guidance
• Current conditions	• What current factors would perhaps change historical loss rates? • Current aging vs. historical aging • Current customer type vs. historical • Current customer creditworthiness vs. historical • Current GDP growth, unemployment, or other economic indicator(s) vs. historical • Current industry specific issues?
• Future considerations	• What in the future would perhaps change historical loss rates? • Industry specific forecasts • Forecast of GDP growth, unemployment or other economic indicator(s) vs. historical loss period used • If estimates are only reasonable for 1, 2 or 3 years - Entities may revert to historical estimates beyond the R&S period.

Example of Allowance Components

New CECL estimate: 5.5% loss rate

Historical Loss Rate

Historical loss rate for all AR related to tuition and fees receivable for a private institution: **4.0%**

Current Conditions

New nursing school opened (subset of AR)

Tuition and fees related to a new degree program at the College: **+ 1.0%**

Reasonable and Supportable Forecast

Customer segment risk: **+.5%**

Nursing school is drawing students from a more local geography

One and done, right?

Subsequent Measurement

At each reporting period, an update to the estimate of lifetime expected credit losses should be done and the allowance should be adjusted accordingly.

Increases and decreases as a result are classified as credit loss expense.

What about write-off and recoveries?

- Write-offs should be made in the period in which a determination is made that the financial asset (or portion thereof) is uncollectible.

- “Uncollectible” is not technically defined, requires judgement from management. Generally, when all means of recovering the balance have been exhausted, management may determine the balance is uncollectible.

- Remove the allowance and asset balance, any net difference would be recorded to credit loss expense.

- Recoveries would be recorded as a debit to cash and credit to income.

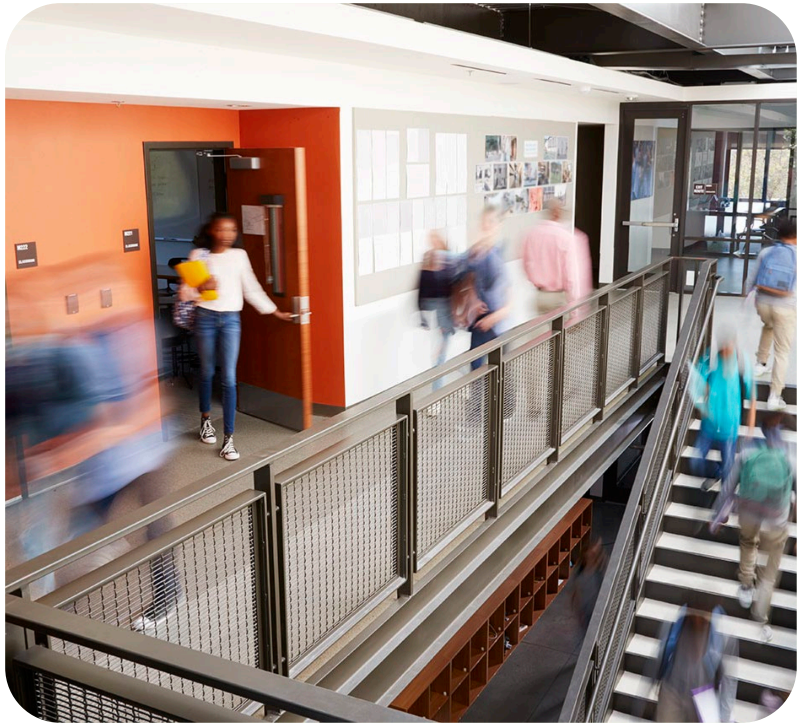
Can the Allowance be Zero under CECL?

- ASC 326-20-55-48, Example 8: Gives example of when "expected nonpayment is zero" and uses U.S. Treasury securities as an example. Example says it's not intended to be only applicable to U.S. Treasury securities, however, the criteria it lists (e.g., ability to print currency) suggest otherwise.
- Big 4 and national firms' interpretive guidance suggest it would be "challenging" for an entity to establish an allowance of zero, even if the entity does not have a history of losses and even for a receivable due from a highly rated customer.
- However, in very limited facts and circumstances, an allowance might be immaterial.
  - No entity-specific history of write-offs;
  - Current conditions and R&S forecast don't indicate any change;
  - Receivables are due from large, stable, and financially sound industries (e.g., oligopolies);
  - Multiple examples of comparable (in terms of customer base) public companies

Example NFP University Disclosure

ASC 326-20-50-10 and ASC 326-20-50-11 require disclosure of management's policy and methodology for developing the estimate of the allowance for credit losses. In this example, a sample narrative disclosure could be:

Student accounts receivable consists of amounts billed to students for tuition and auxiliary charges. Accounts receivable are presented net of an allowance for credit losses, which is an estimate of amounts that may not be collectible. The University separates accounts receivable into risk pools based on their aging. In determining the amount of the allowance as of the balance sheet date, the University develops a loss rate for each risk pool. This loss rate is based on management's historical collection experience, adjusted for management's expectations about current and future economic conditions. At June 30, 20X4, the University increased its historical loss rates for each aging category by 10% due to rising inflation and indicators of a potential recession.



Example NFP University Disclosure

ASC 326-20-50-13 requires a roll forward of the allowance for credit losses. In the year of adoption, the roll forward is required to include the impact of adoption recognized as a cumulative effect adjustment as of the beginning of the period. The roll forward is not required for the prior comparative period in the year of adoption, but is required for each period for which a statement of financial position is presented in subsequent periods. The roll forward disclosure in this example would be:

Changes in the allowance for credit losses for the years ended June 30, 20X4 were as follows:

	20X4
Balance, beginning of the period	**$170,344**
Impact of the adoption of the new credit loss standard	35,843
Provisions	61,610
Write-offs, net of recoveries	(80,815)
Balance, end of the period	**$186,982**

ASC 326 - Key Takeaways

Takeaway 1

Topic 326 is <u>not</u> just for banks.

Takeaway 2

Trade and notes receivables will likely be what most non-financial services entities will need to analyze.

Takeaway 3

Historical loss experience will need to be computed.

Takeaway 4

Historical loss experience is only the starting point.

Management must consider (and document) their consideration of current conditions and "reasonable and supportable" forecasts.

Questions?

Amelia Crawford

Director, Not-for-Profit

Assurance Services

acrawford@cbh.com

cbh.com

Cherry Bekaert
Your Guide Forward

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