ASU 2016-13
FINANCIAL INSTRUMENTS – CREDIT LOSSES

January 23, 2024

AGENDA

TOPIC	SPEAKER
Intro	Yulia Murzaeva, Principal
Overview	Elad Menna, Senior Manager
Cash Equivalents	Cindy Bischof, Manager
CECL Model: ASC 326-20	Cindy Bischof, Manager
Held to Maturity Debt Securities	Elad Menna, Senior Manager
Financial Statement Updates	Elad Menna, Senior Manager
Management Responsibilities	Cindy Bischof, Manager
Resources	Cindy Bischof, Manager
Q&A	Yulia Murzaeva, Principal Elad Menna, Senior Manager Cindy Bischof, Manager

SPEAKERS

Moderator

Yulia Murzaeva
Principal
GHJ

Speaker

Elad Menna
Senior Manager
GHJ

Speaker

Cindy Bischof
Manager
GHJ

IMPLEMENTATION TIMELINE

Effective for fiscal years beginning after 12/15/22 for all:

- Private companies
- Nonprofit entities
- Employee benefit plans

WHY THE CHANGE?

- Global financial crisis of 2007 and 2008 highlighted weaknesses in the "incurred loss" approach.
- In 2008, the FASB and the IASB jointly established the Financial Crisis Advisory Group (FCAG) to assist in identifying ways financial reporting could be improved.
- Suggested incorporating forward-looking information in addition to historical results.

ASC 326 OVERVIEW

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TOPIC 326

SUBTOPIC 326-20

- Financing Receivables
  - Loans
  - Trade accounts receivable
  - Notes receivable
  - Credit cards
  - Receivables relating to a lessor’s right(s) to payment(s) from a leveraged lease that should be recognized as an asset in accordance with paragraphs 842-10-65-1(z)…
  - Lease receivables arising from sales-type leases or direct financing leases
- Cash Equivalents
- Held-to-Maturity Debt Securities
- Contract Assets
- Net Investment in Sales-Type and Direct Financing Leases
- Reinsurance Receivables
- Receivables that Relate to Repurchase Agreements and Securities
- Lending Agreements
- Off-Balance Sheet Credit Exposures
- Programmatic Loans

SUBTOPIC 326-30

- Available for Sale (AFS) Debt Securities

WHAT IS OUT OF SCOPE FOR CECL?

- Financial assets measured at fair value through net income
  - Investments that fall under the fair value hierarchy (equity securities, private investments)
  - Debt Investments Categorized as Trading
- Loans made to participants by defined contribution employee benefit plans
- Policy loan receivables of an insurance entity
- Promises to give (pledges receivable) of a not-for-profit entity
- Loans and receivables between entities under common control
- Receivables arising from operating leases

NONPROFIT IN SCOPE

In Scope

- Trade receivables that result from exchange-type revenue transactions (ASC 606) are in scope:
  - Gift shop or merchandise sales
  - Tuition income
  - Program fee income
  - Membership dues (when accounted for under the exchange model)
  - Conference and exhibit registration fees
  - Patient receivables for nonprofit healthcare entities

NEW TERMINOLOGY

Bad debt expense

→ Credit loss expense

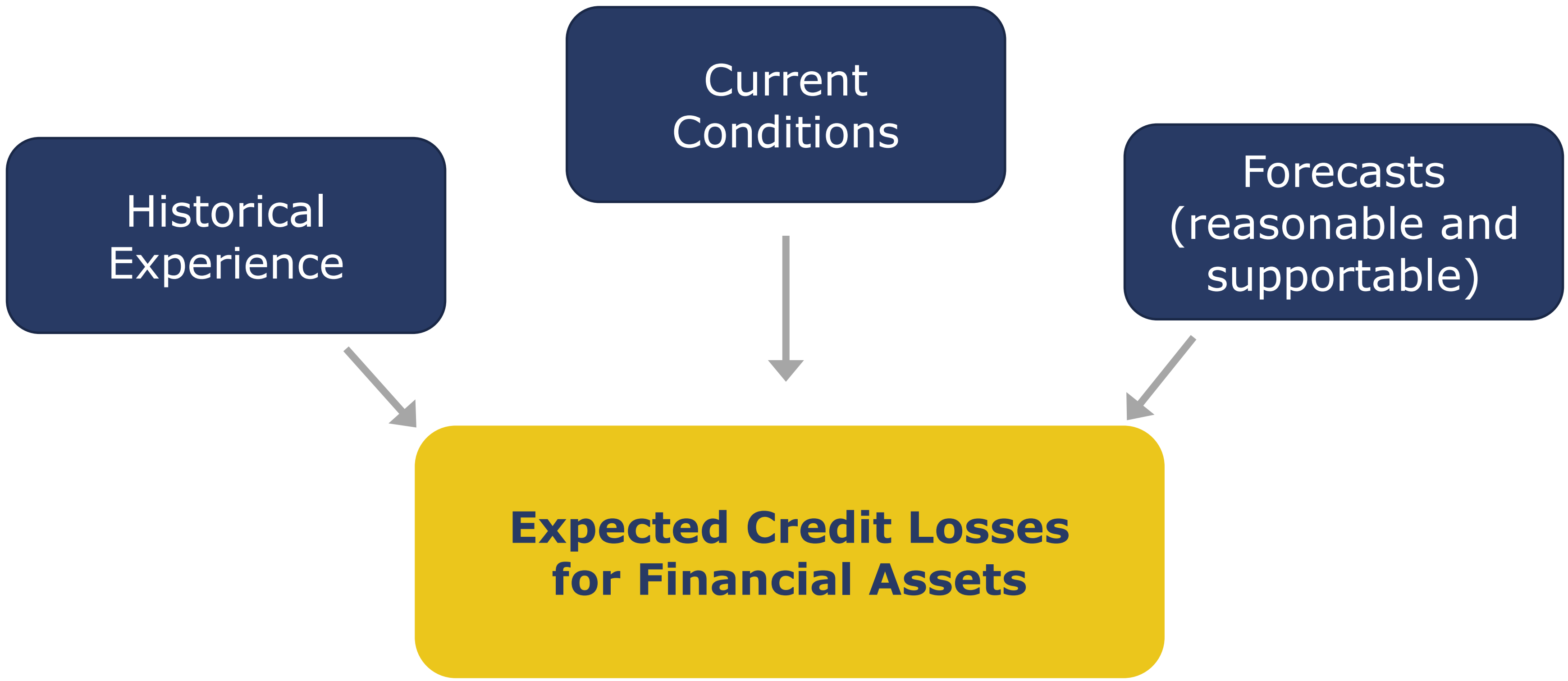
Allowance for doubtful accounts

→ Allowance for credit loss (ACL)

KEY CHANGES

	PREVIOUS INCURRED LOSS MODEL	NEW CECL MODEL
Recognition Threshold	When probable threshold is met for loss or when incurred as of balance sheet date	Estimate and recognize all expected credit losses over the contractual terms for financial assets in scope immediately, even if risk of loss is remote
Pooling of Assets	Allowed but not required	Required
Consideration of Economic Conditions	Consider current economic conditions only	Consider current economic conditions as well as management's reasonable and supportable forecast of future economic conditions

KEY CHANGES


Current Conditions
Historical Experience
Forecasts (reasonable and supportable)
Expected Credit Losses for Financial Assets

PRINCIPLES-BASED STANDARD

- Left to management judgement:
  - How to pool financial assets
  - Which method to use to calculate historical losses
  - How to forecast future losses
  - What time period is reasonable and supportable to forecast future losses
  - How to revert back to historical losses after the forecast period ends

CASH EQUIVALENTS

ZERO EXPECTED CREDIT LOSSES

- Cash equivalents are measured at amortized cost and are in scope for CECL.
  - Treasury bills, money markets, certificates of deposit
- No measure of credit loss is required for a financial asset/group of assets if historical credit loss information, adjusted for current conditions and reasonable and supportable forecasts, results in an expectation that nonpayment of the amortized cost basis is zero.
- In some cases, management may determine that the expected losses approximate zero.

ZERO EXPECTED CREDIT LOSSES

- Example from ASC 326-20-55-48 through 55-50
  - Entity invested in U.S. Treasury securities
  - Management performs a qualitative analysis
  - Considerations noted:
    - Long history of no credit losses for U.S. Treasury securities
    - Backed by a sovereign entity that can print its own money
    - The sovereign currency is routinely held by central banks and other major financial institutions, used in international commerce and commonly viewed as a reserve currency
  - Concludes that this indicates that historical credit loss information should be minimally affected by current conditions and reasonable and supportable future forecasts.
  - Specifically notes that this example is not intended to be only applicable to U.S. Treasury securities

CECL MODEL
ASC 326-20

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CECL IMPLEMENTATION STEPS

1. Determine Pools
2. Calculate Historical Loss Rate
3. Adjust for Current Conditions and Reasonable and Supportable Forecasts

STEP 1 - POOLING

- Pooling is <u>required</u>
- Pool into groups that share similar risk characteristics
- Possible to have only one pool if receivables are homogenous in management's opinion
- Interpretive guidance indicates pools should be consistent with internal policies for monitoring credit risk
- Items that are unique (i.e. do not share similar risk characteristics) should be evaluated independently

STEP 1 - POOLING

Management may consider any one or a combination of the following potential risk characteristics when identifying pools:

- Internal or external credit score/ratings
- Risk ratings or classification
- Financial asset type
- Collateral type
- Size
- Effective interest rate
- Term
- Geographical location
- Industry of the borrower
- Vintage
- Historical or expected credit loss patterns
- Reasonable and supportable forecast periods

Standard further notes this is not intended to be an all-inclusive list.

STEP 2 – HISTORICAL ANALYSIS

Basis for Determining Allowance for Credit Loss (ACL)

- Historical credit loss experience of financial assets with similar risk characteristics generally provides a basis/starting point for an entity's assessment of credit loss.
- Historical loss information can be external, internal or both.

Determine Historical Period

- Up to management judgement what historical period will be used for the baseline.

Calculate Credit Losses Over Selected Period

- Calculate credit loss expense for each pool over that period.
- Consider if data needs to be cleaned (i.e. Are there items unrelated to credit loss included in credit loss expense)?

STEP 2 – HISTORICAL ANALYSIS

METHOD	DESCRIPTION
Discounted Cash Flow	Compares an asset's amortized cost with the present value of the estimated future principal and interest cash flows.
Loss-Rate	Calculates an estimated loss rate, which is multiplied by the asset’s amortized cost.
Roll-Rate	Uses historical trends in credit quality indicators (i.e. delinquency)
Probability-of-Default Methods	Multiplies the probability of default (i.e. probability of default in a given time frame) by the loss given default (% not expected to be collected due to default).
Methods that Utilize an Aging Schedule	Calculates based on how long a receivable has been outstanding.

EXAMPLE USING LOSS-RATE

	2020	2021	2022	2023
Annual Net Write-offs	185,000	170,000	165,000	190,000
Annual Average Accounts Receivable	15,000,000	12,750,000	13,000,000	14,000,000
Annual Loss Rate	1.23%	1.33%	1.27%	1.36%

Average annual loss rate = 1.30%

AR Balance at 2023 Year-End	$15,000,000
Average Annual Loss Rate	1.30%
Estimated Expected Credit Loss	$195,000

STEP 3 – ADJUST FOR CURRENT CONDITIONS AND FUTURE FORECASTS

- Historical experience may not fully reflect an entity’s expectations about the future
- Management should adjust historical loss information, as necessary, to reflect the current conditions and reasonable and supportable forecasts not already reflected in the historical loss information.
- ASC-326-20-55-4 gives full list of factors to consider and acknowledges that other factors may apply.
- Non-credit related adjustments (returns, discounts, etc.) should not be considered for CECL purposes.

STEP 3 – ADJUST FOR CURRENT CONDITIONS AND FUTURE FORECASTS

- Entities need to consider if adjustments need to be made to the historical loss rate for differences in current asset-specific risk characteristics, such as differences in:
  - Underwriting standards
  - Portfolio mix
  - Asset term

STEP 3 – ADJUST FOR CURRENT CONDITIONS AND FUTURE FORECASTS

- Adjust for current macroeconomic conditions and management's future forecasts

- **Macroeconomic Variables for Forecasting:**
  - Business-to-Business: Cost of Capital (Interest Rates)
  - Direct to Consumer: Unemployment Rate
  - More Specific Needs:
    - Real Estate Values
    - Construction/Housing Starts
    - ISM Manufacturing Index
    - Etc.

STEP 3 – ADJUST FOR CURRENT CONDITIONS AND FUTURE FORECASTS

	2020	2021	2022	2023
Annual Net Write-offs	185,000	170,000	165,000	190,000
Annual Average Accounts Receivable	15,000,000	12,750,000	13,000,000	14,000,000
Annual Loss Rate	1.23%	1.33%	1.27%	1.36%

Average Annual Loss Rate	1.30%
10 Basis Point Adj for Forecast	.10%
Adjusted Loss Rate	1.40%

AR Balance at 2023 Year-End	$15,000,000
Adjusted Annual Loss Rate	1.40%
Estimated Expected Credit Loss	$210,000

STEP 3 – ADJUST FOR CURRENT CONDITIONS AND FUTURE FORECASTS

Reversion to Historical

- Only adjust historical loss information for existing economic conditions or expectations of future economic conditions for periods that are within the reasonable and supportable forecast period.
- Recommend reverting back to the historical rate "immediately" if a reliable forecast is not available for the entire period.

STEP 3 – ADJUST FOR CURRENT CONDITIONS AND FUTURE FORECASTS

Reversion to Historical – Recap Example from ASC 326-20-55-19 through 21

- Community Bank provides 10-year amortizing loans to customers.
- Manages those loans on a collective basis based on similar risk characteristics.
- Believes most recent 10-year period is a reasonable historical period.
- Historical loss rate over this period is 1.5%.
- Determined no adjustments were needed for any changes in asset-specific risk characteristics.
- Determined that the primary significant factors that could affect the collectability of their loan portfolio are real estate values and unemployment rates.

STEP 3 – ADJUST FOR CURRENT CONDITIONS AND FUTURE FORECASTS

Reversion to Historical – Recap Example from ASC 326-20-55-19 through 21

- Observed that real estate values in the community have decreased and the unemployment rate in the community has increased as of the current reporting period date.
- Expects that there will be an additional decrease in real estate values over the next one to two years, and unemployment rates are expected to increase further over the next one to two years.
- Management estimates a 10-basis-point increase in credit losses incremental to the 1.5% historical lifetime loss rate due to the expected decrease in real estate values.
- Management estimates a 5-basis-point increase in credit losses incremental to the historical lifetime loss rate due to the expected deterioration in unemployment rates.
- Historical loss rate adjusted 15-basis-points to 1.65%.
- No further reversion adjustments are needed because the bank has applied a 1.65% loss rate where it has immediately reverted into historical losses reflective of the contracture term in accordance with ASC 326-20-30-30-8 through 30-9. This approach reflects an immediate reversion technique for the loss-rate method.

HELD-TO-MATURITY DEBT SECURITIES

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HTM DEBT SECURITIES

- CECL requires an ACL for expected credit losses, even if the risk of loss is remote (exceptions: U.S. Treasury securities and certain mortgage-backed government securities).
- The assessment of expected credit losses for HTM securities under CECL must be performed on a collective basis when similar risk characteristics exist, and expected credit losses must be recognized upon initial recognition (i.e., at the time of purchase).
- CECL model replaces legacy impairment guidance.
- Any expected credit losses should be recognized as an offsetting allowance to the amortized cost basis of the HTM debt security.
- Probability of default method utilizing historical loss data for corporate and municipal bonds (historical loss rate x historical recovery rates).
    - Available online (Moody’s)
- Forecasted corporate bond defaults are available on Reuters. Qualitative or quantitative adjustments to the ECL can be made utilizing this data.
- Per Nuveen, default rates to municipal bonds are expected to remain steady.

FINANCIAL STATEMENT UPDATES

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FINANCIAL STATEMENT PRESENTATION

- Allowance must be presented on the face of the balance sheet in one of two ways:

  1. Deduction from assets' amortized cost basis
     - i.e., separate line item

  2. Amount disclosed, but asset shown net
     - i.e., receivables, net of allowance of $XXX

- Income Statement/Statement of Cashflows
  - Bad debt expense is now credit loss expense

REQUIRED DISCLOSURES

- The following disclosures are required by portfolio segment (pools)
  - Method for developing the allowance for credit losses and management's estimation inputs used
  - How expected loss estimates are developed
  - Accounting policies and allowance methodology
  - Factors that influenced management's current estimate
  - Risk characteristics for portfolio segments
  - Changes in allowance methodology from prior periods
  - Reversion method used for periods without reasonable and supportable forecasts
  - Significant purchases and sales of financial assets subject to CECL
- Rollforward of the allowance for credit losses

MANAGEMENT’S RESPONSIBILITIES

MANAGEMENT'S RESPONSIBILITIES

- Management's methodology for estimating credit losses should be well documented, including assumptions made, with clear explanations of the supporting analysis and rationale for the judgments made.
- Developing, maintain, and document a systematic, disciplined, and consistently applied process for determining the allowance for credit loss in accordance with GAAP.
- To fulfill that responsibility, management is expected to design, document, and implement policies, procedures, internal controls, systems, and models that result in the development of management's best estimate of the ACL.
- Ensure that their expected credit loss model makes appropriate use of inputs and assumptions.
- Ensure there are internal controls in place to verify complete and accurate data is used in the model.

RESOURCES

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RESOURCES

Background Information

- A Brief Introduction to ASU 2016-13: Financial Instruments – Credit Losses, *By Elad Menna*
- CECL on the Horizon: What Private Companies and Nonprofits Need to Know, *By Cindy Bischof*
- The New Era of Expected Credit Losses: Convergence, *By Aditya Nukala*
- AICPA CECL Practice Aid
- FASB Guidance

Reach out to our team for the implementation toolkit, including templates and additional in-depth guidance

BIOS

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YULIA MURZAEVA
PRINCIPAL

Yulia Murzaeva, CPA, CIA, exclusively serves nonprofit organizations and provides audit and consulting services to a wide range of clients with an emphasis on GHJ's arts and culture, clinics and healthcare and social service subniches.

Yulia is the audit quality control lead at the Firm and oversees the implementation of new accounting and auditing standards, as well as several other audit quality and efficiency initiatives.

In 2022, Yulia spent several months working at the AICPA Governmental Audit Quality Center where she concentrated on advocacy for the latest regulatory and audit quality issues and serving as AICPA's subject matter expert on governmental and single audit accounting and auditing matters, including working with the senior representatives from the U.S. Department of Health and Human Services. She continues to be a speaker for AICPA webinars and conferences.

Yulia is passionate about opportunities for women and currently co-chairs GHJ's Women's Empowerment Cohort. In addition, she volunteers her time by being on the Audit Committee of the Chronicle of Philanthropy, the premier source of news, information, analysis, and opinion in the nonprofit world. In 2023, Yulia has been recognized by the *Los Angeles Business Journal* as Woman of Influence: Accounting.

Yulia graduated from Minnesota State University, Moorhead, where she received a Bachelor of Science degree in Accounting and has worked with GHJ since 2017.

Yulia is married and has two daughters. She enjoys spending time with family, reading and an occasional Zumba class.

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RELATED INDUSTRIES AND SERVICES

- Advisory Services
- Audit and Assurance
- Arts and Culture
- Clinics and Healthcare
- Education
- Health and Wellness
- Nonprofits
- Nonprofit Audits
- Private Foundations
- Single Audit
- Social Services

CINDY BISCHOF
MANAGER

Cindy Bischof, CPA, has more than 10 years of public and private accounting experience and is a member of GHJ's Audit and Assurance Practice.

Prior to joining GHJ in 2019, Cindy began her career at a Big Four public accounting firm and later transitioned to internal audit at Bank of America and Northern Trust in Chicago. Cindy regularly assists nonprofit and private foundation clients with financial statement audits and reviews.

She took time off to raise her two daughters prior to joining GHJ and was drawn to the Firm's forward-thinking #BeMore culture and dedication to clients.

Cindy graduated from Vanderbilt University, where she received a Bachelor of Art degree in Economics. She earned a Masters of Accounting from Ohio State University and an MBA from the University of Chicago Booth School of Business.

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RELATED INDUSTRIES AND SERVICES

- Audit and Assurance
- Nonprofit Audits
- Nonprofits
- Private Foundations

ELAD MENNA
SENIOR MANAGER

Elad Menna, CPA, is a member of GHJ's Audit and Assurance Practice with over nine years of accounting experience and specializes in assurance services for food and beverage and manufacturing clients. Elad also services clients within the technology (SaaS), media and entertainment and nonprofit industries. He is part of the GHJ's Food and Beverage Practice and Employee Benefit Plan Audit Management Group.

In addition to performing assurance services, Elad assists clients with process improvements and technical accounting guidance. He leads the technical consulting group for the new lease accounting pronouncement (ASC 842). He also provides ongoing training, mentoring GHJ employees as well as assists with business development initiatives.

Prior to joining GHJ in 2014, Elad graduated from the University of California, Santa Barbara, where he received a Bachelor of Arts degree in Economics and Accounting. He is a licensed CPA in the State of California.

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RELATED INDUSTRIES AND SERVICES

- Agriculture
- Audit and Assurance
- Employee Benefit Plans
- Food and Beverage
- Manufacturing and Distribution
- Media and Entertainment
- SAAS

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January 23, 2024

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