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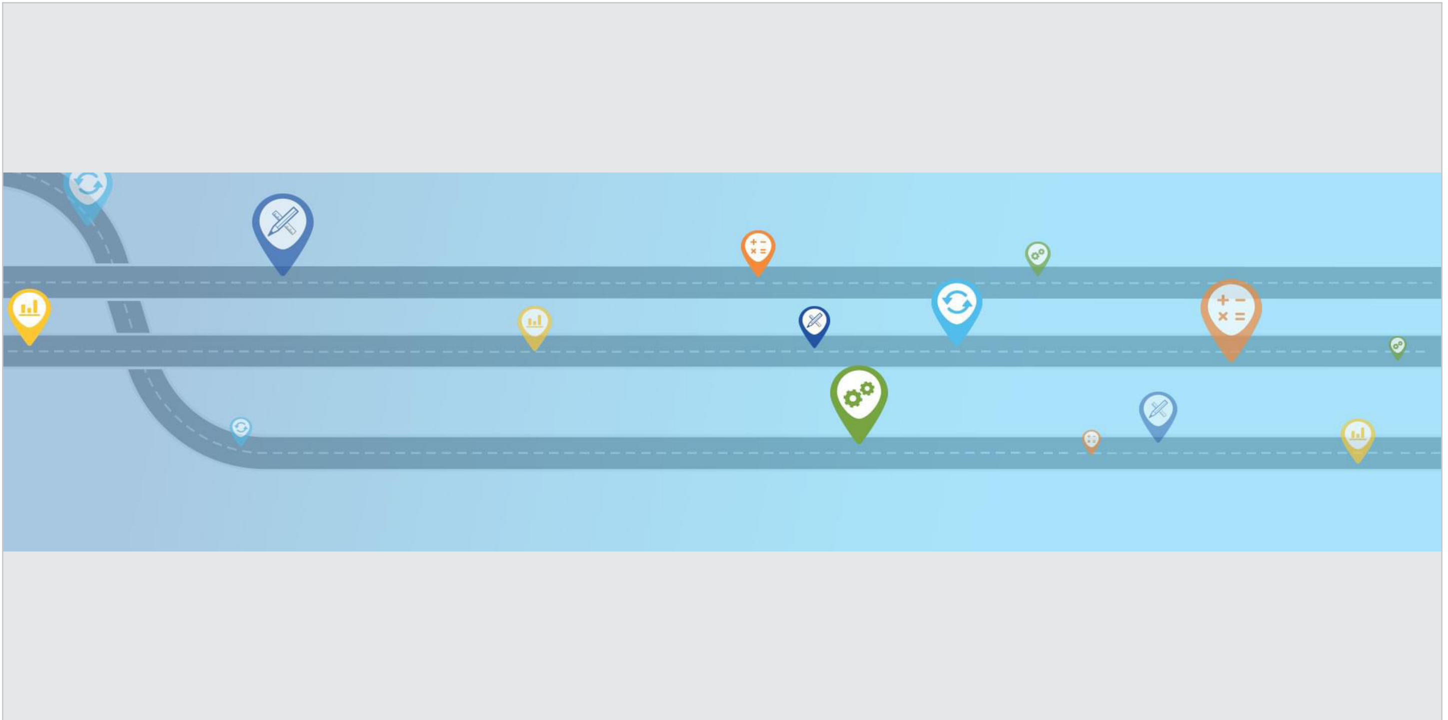

Article

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The Impact of CECL's Financial Reporting | Moody's Analytics

FASB's new accounting standard will have a significant effect on financial statements. Financial institutions must educate their investors and shareholders about how CECL-driven disclosure and reporting changes could potentially alter the bottom line.

The current expected credit loss (CECL) accounting standard addresses the most significant estimate on a bank's balance sheet, and requires assessment for expected credit losses for arguably the largest share of a bank's assets. While the adoption of the CECL standard is still a couple of years away, banks have already started their implementation efforts, focusing on methodology. Disclosure and reporting, however, have not been given much consideration.

Before we delve further into this issue, let's consider, for a moment, the tremendous size of the market to which CECL's rules will apply. In 2016, just for commercial banks, savings banks and credit unions, the aggregate amount of loan and lease receivables and HTM securities was almost $10.6 trillion. For context, Germany's nominal GDP as of 2016 was $3.4 trillion. What's more, CECL applies to all entities holding financial assets and net investment in leases that are not accounted for at fair value through net income.

Some of the most important decisions banks must make before the CECL adoption date are related to the financial reporting requirements. According to the Financial Accounting Standards Board (FASB), "the main objective of the CECL standard is to provide financial statements users with more decision useful information about the expected credit losses."

Providing relevant disclosures that are detailed enough to achieve this objective may be a daunting task, due to operational challenges and the fact that a bank's best estimate of expected credit losses can be subjective. Moreover, investors and shareholders could also be facing challenges in navigating quantitative and qualitative information, and in comparing various methodologies allowable under CECL.

While the earliest standard adoption date is still two years away, the focus on expected CECL impact is reflected in the many quarterly earnings calls where CECL is already being routinely discussed. The level of detail management reveals about CECL implementation efforts and the standard's expected impact on financials could vary significantly, making it difficult for the industry as a whole to achieve transparency and comparability.

Let's now discuss some of the CECL pre-adoption disclosures that financial statements preparers could consider during the implementation phase.

Disclosure Requirements in Early Implementation Stages

While CECL allowance can be measured with various methodologies, the credit loss estimate should be based on historical credit loss experience reflective of the contractual asset life, adjusted for current conditions and reasonable and supportable forecasts. The new standard aims to achieve earlier, more timely recognition and reporting of credit losses.

However, potential comparability issues arise when various expected credit loss (ECL) estimate methodologies are coupled with the subjectivity inherent in considering forward-looking information. The disclosures provided to support the recorded allowances could differ significantly among peer institutions, and this variation could lead to relevant information being obscured and users being overwhelmed with details.

To ensure that institutions can comply with CECL requirements (both in substance and in form), disclosures need to be considered at the beginning of CECL implementation and revisited throughout the process.

The transition from incurred to expected loss methodology could also significantly impact retained earnings. Entities should therefore consider communicating proactively about the change in calculations before CECL's effective implementation date. These disclosures will help mitigate or avoid any panic or "emotional reactions" when the first financials are released using the new methodology.

CECL vs. Incurred Loss: Disclosure Differences

Under today's incurred loss standards, certain performance indicators directly correlate with changes in reserves. For example, increases in past due or non-pass-rated loans generally correlate with an increase in the allowance.

In contrast, under CECL, it is possible that similar changes will not result in the same directional change in allowance; indeed, depending on the significance of other components of the ECL, the allowance could even move in the opposite direction. For example, when assessing period-over-period

drivers of the allowance changes, while there may be an increase in delinquencies, these could still be lower than previously expected, causing the allowance to decrease compared to the prior period.

Updates to more optimistic forecasts could have the same effect. To make sense of CECL allowance changes, management should invest in the methodological and operational ability to isolate each of the allowance components and their related contribution to the total amount/change.

The presentation of amortized cost (based on vintage and credit quality indicators) is one significant CECL disclosure requirement for the public business entities. This information might not have been collected previously, but must be under CECL.

For example, origination, modification and maturity dates have not traditionally been required for estimating credit loss reserves. This and other data gaps must be revealed as part of every firm's CECL readiness assessment, which is intended to provide management with enough time to start collecting and putting this information to use. If the required data is not collected for the relevant historical periods, entities will not be able to disclose five-year history (which is mandatory for the vintage disclosure) in their 2020 financials.

Entities also need to understand how investors will use this new disclosure. Before issuing the CECL standard, FASB considered requiring an amortized cost basis roll-forward and a separate disclosure of the current period credit loss expense, representing the portion related to current-period originations.

Faced with significant objections from the preparers, FASB mandated that only the existing credit quality disclosures—of the amortized cost basis for financing receivables and net investment in leases—be expanded to include the year of origination. However, it is important to note that FASB expects users of financial statements to "derive their own roll-forward of the balances and related allowance for credit losses for each origination year."

What's more, the internal controls over financial reporting will have to change to accommodate the use of new data points in the credit loss estimate. Therefore, to ensure integrity over financial reporting, entities need to start designing robust controls frameworks while automating data collection for CECL estimates.

Required Disclosures Ahead of Adoption

As entities are beginning their implementation projects to become compliant with CECL, perhaps the biggest challenge is the credit loss estimate methodology itself. The estimate is highly subjective under the new standard, and will require management to make several elections to address factors feeding the final credit loss amount.

FASB recognized the magnitude of the operational challenges that entities would face and allowed for an extended period of implementation for CECL. Management should use this period to engage in a dialogue with the users of their financial statements, so that the impact to the bottom line does not come as a surprise.

The Securities and Exchange Commission (SEC) specifically addressed this concern in 2016 by providing their expectations for the progression of disclosures from CECL issuance to adoption. During a FASB Emerging Issues Task Force meeting, the SEC reminded institutions to include disclosures on the impact to financial statements of the recently-issued accounting standards (including CECL) to be adopted. "If a registrant does not know or cannot reasonably estimate the impact, then consider additional qualitative financial statement disclosures to assist the reader in assessing the significance of the impact that the standard will have when adopted," the SEC noted in its minutes of the meeting.

Given that CECL implementation spans across multiple years (with early adoption allowed after December 15, 2018), regulators, auditors and investors might expect to see a progression in financial statement disclosures from the time the new standard was first mentioned to the time of adoption.

During the American Institute of Certified Public Accountants (AICPA) 2017 National Conference on Banks and Savings Institutions, the SEC noted that the guiding principle of communicating before CECL adoption is to describe what you know without saying more than you know. Moreover, the SEC emphasized that only content that is prepared within the internal controls of the financial reporting framework should be selected to provide public disclosures.

To support the disclosures required by the SEC before CECL adoption, institutions should first consider their ability to provide a quantitative impact analysis or a qualitative analysis identifying the directional trend in allowance changes. In the absence of the preliminary estimate, disclosures could include (1) changes in policies; (2) descriptions of the incorporation of the historical information reflecting contractual life of the asset, or pools of assets; and (3) reasonable and supportable forecasts.

If applicable, entities could consider describing the policy changes of transitioning from OTTI (other than temporary impairment) methodology to CECL. If the entity has a significant portfolio of purchased credit impaired assets that is expected to be active at the time of CECL adoption, it could disclose changes in the accounting policy required for these assets. This disclosure would include income recognition, credit loss recognition, pool accounting (if applicable) and balance sheet gross-up approach.

These topics would be important to articulate, as they represent differences from the incurred loss methodology in effect today.

As the CECL effective date gets closer, any inability to provide quantitative information about the estimate needs to be substantiated by disclosures related to the remaining phases of the CECL project. Every disclosure iteration should be supported by the implementation status, outstanding significant milestones and project timelines and deliverables, so that progression can be demonstrated and executed within an internal controls framework.

Parting Thoughts

Financial institutions should consider the accounting principles recently outlined by Wesley R. Bricker, the SEC's chief accountant.

During his speech before the AICPA National Conference on Banks and Savings Institutions in September 2016, Bricker said that companies should "focus on investor outreach and education," so that investors can sufficiently understand the effect of the new accounting standards (like CECL) on financial reporting. "Disclosure regarding what is changing, why it is changing and how, as well as the company's adoption plan and potential impact on financial results and position, will be useful to investors and should be disclosed," he elaborated.

Before the same conference in 2017, the SEC continued stressing the importance of pre-adoption disclosures to avoid market shock, while also emphasizing the importance of controls over that information. When approving the CECL implementation plan, management should incorporate the expected progression in pre-adoption disclosures—and build the appropriate governance and controls framework to support the issuance of that information to the public.

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