



Article

NOVEMBER 2017

By Masha Muzyka

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.

AUTHORS



Masha Muzyka

Risk and Accounting Solutions

CECL, IFRS 9, and IFRS 17 expert; credit risk and insurance risk specialist; strategic planning and credit analytics solutions consultant

© 2018 Moody's Corporation, Moody's Investors Service, Inc., Moody's Analytics, Inc. and/or their licensors and affiliates (collectively, "MOODY'S"). All rights reserved.

CREDIT RATINGS ISSUED BY MOODY'S INVESTORS SERVICE, INC. AND ITS RATINGS AFFILIATES ("MIS") ARE MOODY'S CURRENT OPINIONS OF THE RELATIVE FUTURE CREDIT RISK OF ENTITIES, CREDIT COMMITMENTS, OR DEBT OR DEBT-LIKE SECURITIES, AND MOODY'S PUBLICATIONS MAY INCLUDE MOODY'S CURRENT OPINIONS OF THE RELATIVE FUTURE CREDIT RISK OF ENTITIES, CREDIT COMMITMENTS, OR DEBT OR DEBT-LIKE SECURITIES. MOODY'S DEFINES CREDIT RISK AS THE RISK THAT AN ENTITY MAY NOT MEET ITS CONTRACTUAL, FINANCIAL OBLIGATIONS AS THEY COME DUE AND ANY ESTIMATED FINANCIAL LOSS IN THE EVENT OF DEFAULT. CREDIT RATINGS DO NOT ADDRESS ANY OTHER RISK, INCLUDING BUT NOT LIMITED TO: LIQUIDITY RISK, MARKET VALUE RISK, OR PRICE VOLATILITY. CREDIT RATINGS AND MOODY'S OPINIONS INCLUDED IN MOODY'S PUBLICATIONS ARE NOT STATEMENTS OF CURRENT OR HISTORICAL FACT. MOODY'S PUBLICATIONS MAY ALSO INCLUDE QUANTITATIVE MODEL-BASED ESTIMATES OF CREDIT RISK AND RELATED OPINIONS OR COMMENTARY PUBLISHED BY MOODY'S ANALYTICS, INC. CREDIT RATINGS AND MOODY'S PUBLICATIONS DO NOT CONSTITUTE OR PROVIDE INVESTMENT OR FINANCIAL ADVICE, AND CREDIT RATINGS AND MOODY'S PUBLICATIONS ARE NOT AND DO NOT PROVIDE RECOMMENDATIONS TO PURCHASE, SELL, OR HOLD PARTICULAR SECURITIES. NEITHER CREDIT RATINGS NOR MOODY'S PUBLICATIONS COMMENT ON THE SUITABILITY OF AN INVESTMENT FOR ANY PARTICULAR INVESTOR. MOODY'S ISSUES ITS CREDIT RATINGS AND PUBLISHES MOODY'S PUBLICATIONS WITH THE EXPECTATION AND UNDERSTANDING THAT EACH INVESTOR WILL, WITH DUE CARE, MAKE ITS OWN STUDY AND EVALUATION OF EACH SECURITY THAT IS UNDER CONSIDERATION FOR PURCHASE, HOLDING, OR SALE.

MOODY'S CREDIT RATINGS AND MOODY'S PUBLICATIONS ARE NOT INTENDED FOR USE BY RETAIL INVESTORS AND IT WOULD BE RECKLESS AND INAPPROPRIATE FOR RETAIL INVESTORS TO USE MOODY'S CREDIT RATINGS OR MOODY'S PUBLICATIONS WHEN MAKING AN INVESTMENT DECISION. IF IN DOUBT YOU SHOULD CONTACT YOUR FINANCIAL OR OTHER PROFESSIONAL ADVISER.

ALL INFORMATION CONTAINED HEREIN IS PROTECTED BY LAW, INCLUDING BUT NOT LIMITED TO, COPYRIGHT LAW, AND NONE OF SUCH INFORMATION MAY BE COPIED OR OTHERWISE REPRODUCED, REPACKAGED, FURTHER TRANSMITTED, TRANSFERRED, DISSEMINATED, REDISTRIBUTED OR RESOLD, OR STORED FOR SUBSEQUENT USE FOR ANY SUCH PURPOSE, IN WHOLE OR IN PART, IN ANY FORM OR MANNER OR BY ANY MEANS WHATSOEVER, BY ANY PERSON WITHOUT MOODY'S PRIOR WRITTEN CONSENT.

CREDIT RATINGS AND MOODY'S PUBLICATIONS ARE NOT INTENDED FOR USE BY ANY PERSON AS A BENCHMARK AS THAT TERM IS DEFINED FOR REGULATORY PURPOSES AND MUST NOT BE USED IN ANY WAY THAT COULD RESULT IN THEM BEING CONSIDERED A BENCHMARK.

All information contained herein is obtained by MOODY'S from sources believed by it to be accurate and reliable. Because of the possibility of human or mechanical error as well as other factors, however, all information contained herein is provided "AS IS" without warranty of any kind. MOODY'S adopts all necessary measures so that the information it uses in assigning a credit rating is of sufficient quality and from sources MOODY'S considers to be reliable including, when appropriate, independent third-party sources. However, MOODY'S is not an auditor and cannot in every instance independently verify or validate information received in the rating process or in preparing the Moody's publications.

To the extent permitted by law, MOODY'S and its directors, officers, employees, agents, representatives, licensors and suppliers disclaim liability to any person or entity for any indirect, special, consequential, or incidental losses or damages whatsoever arising from or in connection with the information contained herein or the use of or inability to use any such information, even if MOODY'S or any of its directors, officers, employees, agents, representatives, licensors or suppliers is advised in advance of the possibility of such losses or damages, including but not limited to: (a) any loss of present or prospective profits or (b) any loss or damage arising where the relevant financial instrument is not the subject of a particular credit rating assigned by MOODY'S.

To the extent permitted by law, MOODY'S and its directors, officers, employees, agents, representatives, licensors and suppliers disclaim liability for any direct or compensatory losses or damages caused to any person or entity, including but not limited to by any negligence (but excluding fraud, willful misconduct or any other type of liability that, for the avoidance of doubt, by law cannot be excluded) on the part of, or any contingency within or beyond the control of, MOODY'S or any of its directors, officers, employees, agents, representatives, licensors or suppliers, arising from or in connection with the information contained herein or the use of or inability to use any such information.

NO WARRANTY, EXPRESS OR IMPLIED, AS TO THE ACCURACY, TIMELINESS, COMPLETENESS, MERCHANTABILITY OR FITNESS FOR ANY PARTICULAR PURPOSE OF ANY SUCH RATING OR OTHER OPINION OR INFORMATION IS GIVEN OR MADE BY MOODY'S IN ANY FORM OR MANNER WHATSOEVER.

Moody's Investors Service, Inc., a wholly-owned credit rating agency subsidiary of Moody's Corporation ("MCO"), hereby discloses that most issuers of debt securities (including corporate and municipal bonds, debentures, notes and commercial paper) and preferred stock rated by Moody's Investors Service, Inc. have, prior to assignment of any rating, agreed to pay to Moody's Investors Service, Inc. for appraisal and rating services rendered by it fees ranging from \$1,500 to approximately \$2,500,000. MCO and MIS also maintain policies and procedures to address the independence of MIS's ratings and rating processes. Information regarding certain affiliations that may exist between directors of MCO and rated entities, and between entities who hold ratings from MIS and have also publicly reported to the SEC an ownership interest in MCO of more than 5%, is posted annually at www.moody.com under the heading "Investor Relations — Corporate Governance — Director and Shareholder Affiliation Policy."

Additional terms for Australia only: Any publication into Australia of this document is pursuant to the Australian Financial Services License of MOODY'S affiliate, Moody's Investors Service Pty Limited ABN 61 003 399 657 AFSL 336969 and/or Moody's Analytics Australia Pty Ltd ABN 94 105 136 972 AFSL 383569 (as applicable). This document is intended to be provided only to "wholesale clients" within the meaning of section 761G of the Corporations Act 2001. By continuing to access this document from within Australia, you represent to MOODY'S that you are, or are accessing the document as a representative of, a "wholesale client" and that neither you nor the entity you represent will directly or indirectly disseminate this document or its contents to "retail clients" within the meaning of section 761G of the Corporations Act 2001. MOODY'S credit rating is an opinion as to the creditworthiness of a debt obligation of the issuer, not on the equity securities of the issuer or any form of security that is available to retail investors. It would be reckless and inappropriate for retail investors to use MOODY'S credit ratings or publications when making an investment decision. If in doubt you should contact your financial or other professional adviser.

Additional terms for Japan only: Moody's Japan K.K. ("MJKK") is a wholly-owned credit rating agency subsidiary of Moody's Group Japan G.K., which is wholly-owned by Moody's Overseas Holdings Inc., a wholly-owned subsidiary of MCO. Moody's SF Japan K.K. ("MSFJ") is a wholly-owned credit rating agency subsidiary of MJKK. MSFJ is not a Nationally Recognized Statistical Rating Organization ("NRSRO"). Therefore, credit ratings assigned by MSFJ are Non-NRSRO Credit Ratings. Non-NRSRO Credit Ratings are assigned by an entity that is not a NRSRO and, consequently, the rated obligation will not qualify for certain types of treatment under U.S. laws. MJKK and MSFJ are credit rating agencies registered with the Japan Financial Services Agency and their registration numbers are FSA Commissioner (Ratings) No. 2 and 3 respectively.

MJKK or MSFJ (as applicable) hereby disclose that most issuers of debt securities (including corporate and municipal bonds, debentures, notes and commercial paper) and preferred stock rated by MJKK or MSFJ (as applicable) have, prior to assignment of any rating, agreed to pay to MJKK or MSFJ (as applicable) for appraisal and rating services rendered by it fees ranging from JPY200,000 to approximately JPY350,000,000.

MJKK and MSFJ also maintain policies and procedures to address Japanese regulatory requirements.