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FASB Issues ASU 2020-02 on CECL — Easy to overlook but you don't want to miss it

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Recently, the FASB issued Accounting Standards Update (ASU) No. 2020-02, *Financial Instruments—Credit Losses (Topic 326) and Leases (Topic 842)—Amendments to SEC Paragraphs Pursuant to SEC Staff Accounting Bulletin No. 119 and Update to SEC Section on Effective Date Related to Accounting Standards Update No. 2016-02, Leases (Topic 842) (SEC Update).*

On the surface, it seems like a simple housekeeping amendment to add the SEC Staff guidance on Current Expected Credit Losses (CECL), ASC 326, to the FASB Codification and easily could be overlooked. However, it is worth a closer look, as it contains some good guidance on what the SEC staff would expect a registrant to perform and document when measuring and recording its allowance for credit losses for financial assets recorded at amortized cost. Even if you are a nonpublic company, you may find the guidance useful, as CECL was written to be more principles-based and does not provide a lot of detailed guidance on how it should be applied.

As an aside, this is a good time to remind everyone that CECL is not just applicable to banks and other financial institutions. Most companies will have financial assets recorded at amortized cost. For example, customer receivables from revenue transactions, even if they have short payment terms, are within the scope of CECL. Customer payments that are deferred, financed, or made in installments also will be within the scope of CECL. There are other receivables, like vendor rebates, that will be within the scope of CECL. Consequently, it would be a good idea for non-banks to take a look at the guidance in ASU 2020-02.

An example of the SEC staff guidance in ASU 2020-02 pertains to their expectations of what common elements a CECL methodology would consider. They would include:

- Identify relevant risk characteristics and pool loans on the basis of similar risk characteristics;
- Consider available information relevant to assessing the collectability of cash flows;
- Consider expected credit losses over the contractual term of all existing loans (whether on an individual or group basis), and measure expected credit losses on loans on a collective (pool) basis when similar risk characteristics exist;
- Require that analyses, estimates, reviews, and other allowance for credit losses methodology functions be performed by competent and well-trained personnel;
- Be based on reliable and relevant data and an analysis of current conditions and reasonable and supportable forecasts;
- Include a systematic and logical method to consolidate the loss estimates that allows for the allowance for credit losses balance to be recorded in accordance with GAAP.

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With regard to internal controls, the SEC staff believe that good controls over the CECL process would include written policies and procedures for the following:

- The roles and responsibilities of the registrant's departments and personnel (including the lending function, credit review, financial reporting, internal audit, senior management, audit committee, board of directors, and others, as applicable) who determine or review, as applicable, the allowance for credit losses to be reported in the financial statements;
- The registrant's selected methods and policies for developing the allowance for credit losses and determining significant judgments;
- The description of the registrant's systematic methodology, which should be consistent with the registrant's accounting policies for determining its allowance for credit losses;
- How the system of internal controls related to the allowance for credit losses process provides reasonable assurance that the allowance for credit losses is in accordance with GAAP;
- Include measures to provide reasonable assurance regarding the reliability and integrity of information and compliance with laws, regulations, and internal policies and procedures;
- Operate at a level of precision sufficient to provide reasonable assurance that the registrant's financial statements are prepared in accordance with GAAP.

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In supporting the measurement of the allowance for credit losses, a company should document the following:

- How portfolio segments are determined (e.g., by loan type, industry, risk rating, etc.) and the methodology used for each portfolio segment;
- The approach used to pool loans based on similar risk characteristics;
- For accounting policy or practical expedient elections set forth in FASB ASC Subtopic 326-20, documentation of the elections made;
- The method(s) used to determine the contractual term of the financial assets, including consideration of prepayments and when the contractual term is extended;
- If a loss-rate method is used, the historical data used to develop the components of the loss rate and how that rate is applied to the amortized cost basis of the financial asset as of the reporting date;
- The method for estimating expected recoveries when measuring the allowance for credit losses;
- The approach used to determine the appropriate historical period for estimating expected credit loss statistics;
- The approach used to determine the reasonable and supportable period;
- The approach used to adjust historical information for current conditions and reasonable and supportable forecasts;
- How the entity plans to revert to historical credit loss information for periods beyond which the entity is able to make or obtain reasonable and supportable forecasts of expected credit losses;
- The approach used to determine when a purchased financial asset would qualify to be accounted for as a purchased financial asset with credit deterioration.

There are other good insights provided in ASU 2020-02 regarding the application of CECL.

Regardless of whether you have adopted CECL already or do not plan to adopt until 2023, we highly recommend that you take a closer look at ASU 2020-02 to ensure that your process, methodology, and documentation to support your allowance for expected credit losses contains all of the necessary components, including adequate internal controls to sustain that process.

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