CECL standard implementation

What's at stake for companies in the consumer industry?

The Financial Accounting Standard Board's (FASB's) current expected credit loss (CECL) standard takes effect for entities that are US Securities and Exchange Commission filers for fiscal years beginning after December 15, 2019.[1] The new standard requires a company's allowance for credit losses to measure *expected* losses. Previously, when credit losses were measured under US GAAP, a company considered past events and current conditions in measuring its incurred credit loss estimate at the balance sheet date.

Why should the C-suites and boards of companies in the consumer industry take notice? Because CECL implementation could be one of the most challenging accounting change projects in decades if you have material portfolios in scope. The new standard applies to all companies holding financial assets and net investment in leases that are not accounted for at fair value through net income.[2] More specifically, it will impact companies that have financial assets such as loans, debt securities, trade receivables, off-balance-sheet credit exposures, and reinsurance receivables.

Although financial institutions are the most obvious companies affected by CECL—providing credit is core to their business—they are not alone. Companies in the consumer industry will also face the impact of the new requirements under the standard if they hold significant financial assets, whether or not they are involved in extending credit. Awareness of this potential exposure, a grasp of the challenges in CECL implementation, and a methodical approach to compliance can help prepare consumer industry executives to meet this fast-nearing deadline.

1. The Financial Accounting Standard Board's (FASB's) CECL standard takes effect for entities that are US Securities and Exchange Commission filers for fiscal years beginning after December 15, 2019. For public business entities that are not US Securities and Exchange Commission filers, it will be effective in the fiscal year after December 15, 2020, and for nonpublic business entities it will be effective in the fiscal year after December 15, 2021, per ASC 320-10-65-1a, as amended by ASU 2018-19.

2. FASB has released an amendment to exclude operating lease assets, as stated in ASU 2018-19.

With deadlines quickly approaching, how prepared are you?

Three types of holdings may present potential issues for companies in the consumer industry:

Lending products. For example, the automotive industry provides a notable example of how consumer companies that extend credit to their customers and dealers will need to adapt to CECL. Transitioning to CECL is expected to generally increase reserves for such automotive companies, and the impact will vary from company to company.

Held-to-maturity securities. The nature of a company's holdings under its corporate treasury policy will dictate the scope of CECL requirements. Institutions investing only in US Treasuries may apply the zero loss expectation, while other sovereign debt and agency securities (e.g., Fannie Mae, Freddie Mac) would require an analysis. All other holdings will require an evaluation along with expanded documentation.

Accounts receivable. CECL guidance is principles-based, thus permitting the use of different methodologies to estimate allowances. Because receivables are typically short-term, consumer companies will likely be able to leverage current processes with certain modifications to align with an expected loss model versus an incurred loss model.

Whatever the source of the allowance requirement, company leaders are likely to face several important questions in conveying the situation to their board and investors. Why is the number different, and how did we reach it? How can we best convey that the allowance will have a greater quarter-to-quarter P&L impact and be more volatile? How will the risk function regard the projections?

Common CECL implementation challenges

From our experience, companies are facing several challenges with CECL implementation, including:

The need for a broad gap assessment between the current and future state. Conducting an assessment following initial scoping can help identify critical components the project plan may be missing. Do we have the right data, people, and technology in place to be compliant by the implementation deadline?

No end-to-end view of the CECL estimation process. A comprehensive view of the process requires close integration between risk and finance, which can create uncertainty around governance, roles, and responsibilities. New CECL-driven estimation processes can upend the current view of product profitability.

Insufficient data, resulting in delays in modeling and making important decisions. CECL compliance requires a view of a full economic cycle. That cycle can extend beyond typical data retention guidelines, which creates a need to identify data gaps and address them with external data feeds.

Siloed work streams with limited cross-work-stream buy-in on critical decisions. Data required for estimation can reside in various places—for example, with the product team, the team managing the data hierarchy and data warehouse, the accounting function, or the risk modeling team. Prior interaction may have been limited and will now require further coordination, complicating the process. The forward-looking element of CECL requires much more data as well as lockstep coordination across these groups in process changes.

Resource constraints for model build, model risk management, and internal controls. If the gap assessment indicates insufficient resources are available for model builds, consumer industry company leaders will need to decide whether to acquire in-house talent or use external providers. In addition, should out-of-the-box technology not meet project requirements, work will be required to align solutions with the company's risk profile.

A systematic approach to CECL

Deloitte's end-to-end CECL implementation model, along with lessons learned in two years of client engagements, suggests a series of actionable review steps companies can consider as they assess and refine their programs:

Understand the current state. Existing allowance oversight could be inadequate for many companies under the CECL standard, requiring additional, more robust information for allowance decisions and preparation of external communications. A clear understanding of provision drivers for each period and the sensitivity of the estimate to the various assumptions driving loss, such as forecasts, are essential for effective disclosure, internal management, and investor communication. Also, a well-designed parallel run can boost management confidence in the implementation, with the design effort itself highlighting potential program issues earlier. Activities include:

- Inventory financial instruments in scope, and review existing credit models and methodologies
- Analyze current key modeling approaches and associated data
- Evaluate the current allowance for the credit losses program, including governance structure, processes, tools, data management, and other credit risk measurement frameworks
- Define strategic objectives and end-state target

Identify gaps. Well-controlled data that reflect a full credit cycle are essential for CECL compliance. Data remediation decisions should be reviewed by allowance governance leadership. Production data acquisition and management is often overlooked in CECL planning, possibly requiring significant effort to integrate into the CECL model calculation. Steps to consider include:

- Perform model assessment and identify changes required
- Perform data availability and data quality gap assessment for financial disclosures, risk data, and model inputs
- Identify the need for new or modified internal controls and processes

Develop and implement a roadmap. CECL can be more complicated than today's incurred loss model. Defining the target operating model will provide the roadmap for a solid production design. Tabletop reviews or walkthroughs of the end-to-end production process with representatives of all impacted functions may assist in identifying issues early and avoiding costly fixes late in the implementation. Steps include:

- Create a change management plan for the transition from current to target state
- Select an IT, data, and modeling approach; document business requirements; and make changes to IT and data delivery architecture
- Document accounting policies and design, implement, and test internal controls
- Develop and implement models
- Provide insights into sensitive drivers that impact financial results

Plan for post-implementation support. Meeting the CECL implementation deadline is not the end of the project. A sustainable process will be needed for model refinement, ongoing data collection, and other requirements. Steps include:

- Assess model performance
- Conduct training

A requirement . . . and an opportunity

The CECL standard ushers in a new era of accountability for credit loss allowances. By understanding the challenges that implementation is likely to present and giving consideration to the actions outlined here, companies in the consumer industry impacted by CECL can be better prepared to absorb this dramatic shift in accounting and reporting requirements.

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