Accounting Quality Insights

Companies Behind on Adopting Current Expected Credit Losses (CECL) Standard

As a response to the 2008 financial crisis and the outsized impact it had on banks, the Financial Accounting Standards Board (FASB) created a new credit-loss **standard** to replace the Allowance for Loan and Lease Losses accounting standard.

The previous accounting method, and what currently stands, allows companies to recognize credit losses on an "incurred loss" basis. The new credit-loss standard ASU 2016-13, ASC Topic 326 – *Current Expected Credit Losses (CECL),* recognizes credit losses on an expected basis, which accelerates when a company needs to acknowledge the credit loss.

This new standard is an effort to address the criticism from the 2008 financial crisis when the balance sheets of financial institutions and other organizations failed to reflect the negative outlook of the economy on respective loss calculations.

	PREVIOUS STANDARD Allowance for Loan and Lease Losses	***Examples of Issues with Previous Standard Highlighted During Financial Crisis***	NEW STANDARD Current Expected Credit Losses
When a Loss is Recognized	"Incurred loss" methodology delays recognizing credit losses until it is probable that a loss has been incurred	*Estimates based on expected credit losses by analysts devalued financial institutions before accounting losses were recognized*	Expected increases or decreases of expected credit losses are assessed every period
Amount of Loss to be Recognized	Loss recognized only if it is probable that the loss has been incurred and the amount of loss can be reasonably estimated	*Financial institutions couldn't record expected credit losses because they didn't meet the "probable" threshold*	Loss is recognized as the present value of expected future cash flows that won't be collected
Information Used for Determining a Loss	Past events & current conditions	*Amounts for expected credit losses were evaluated without considering future projections of economic conditions*	Past events, including historical experience, current conditions, and reasonable and supportable forecasts that affect collectability

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Due to the nature of the new credit-loss standard, banks are among the biggest sectors affected but they are not the only industry subject to the new rule. Companies that have certain financial instruments will also feel the impact if they use the following:

- Loans
- Debt securities
- Trade receivables
- Net investment in leases
- Off-balance sheet credit exposure
- Reinsurance receivables
- Other financial assets that have the contractual right to receive cash

FASB says it created the new standard to be scalable and flexible: "An entity must apply judgment in estimating expected credit losses. An entity's estimate of expected credit losses should reflect its expectations or its best estimate of expected credit loss," FASB **said** in a Staff Q&A post.

Trends in Disclosure

Looking at S&P 500 companies, we evaluated the progress that companies have made in implementing the new standard. This is the third major accounting standard change from FASB – the others being revenue recognition (ASC 606) and leases (ASC 842) – so we had few expectations regarding adoption progress.

Three companies adopted the new standard early, likely because the credit-loss standard was immaterial: LyondellBasell Industries [LYB], Skywork Solutions, Inc. [SWKS], and Phillips 66 [PSX].

Out of the early adopters, only energy firm Phillips 66 disclosed an impact, resulting in a $9 million reduction to retained earnings after adopting the new standard – a relatively small impact compared to its $58 billion in assets. Multinational chemical company LyondellBasell Industries and semiconductor maker Skyworks Solutions did not disclose an impact from the early adoption.

Looking at the remainder of S&P 500 companies, 58% are still evaluating the standard, while 42% had no disclosure related to CECL. The three companies that early adopted represent less than 1% of the S&P's large publicly traded companies. No companies have disclosed they are substantially done evaluating the new standard.

Although 58% of companies say they are still evaluating the new credit-loss standard, only 8% disclosed the type of accounting impacts it would have. By far, the most common impact disclosed relates to loan receivable reserves. The total accounting impacts disclosed are in the table below:

Accounting Impacts

Type of Impact	# of Companies
Loan receivables	23
Trade receivables	8
Debt securities	6
Reinsurance receivables	4
Regulatory capital	2
Investment in leases	1
Other receivables / not specified	23

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Wells Fargo & Company [WFC] and Synchrony Financial [SYF] were the only two companies to disclose how the new standard would affect their regulatory capital. Wells Fargo anticipates the new standard will improve regulatory capital and expects to decrease its allowance for credit losses, which is unusual. As mentioned earlier, the new standard is generally expected to accelerate the recognition of loan allowances. However, Wells Fargo expects a decrease to their allowance for credit losses between $0 and $1 billion for short term commercial loans and a decrease of $1.5 billion for residential mortgages. Synchrony expects the new standard to decrease regulatory capital.

Synchrony has time to manage the effects of the new credit-loss standard on its financial statements. In December, the Treasury Department issued a **rule** allowing a three-year phase-in of the negative impacts of the new standard on regulatory capital. The rule became effective on April 1.

"The final rule revises the agencies' regulatory capital rule, stress testing rules, and regulatory disclosure requirements to reflect CECL, and makes conforming amendments to other regulations that reference credit loss allowances," the Treasury Department said in a summary of its rule.

Companies Most Affected by the Rule

Of the companies disclosing the impact of the new standard, it's not a surprise that banks topped the list. It also shouldn't be surprising that insurance companies and financial services firms round out second and third place.

Reported Changes, by Industry

Industry	# of Companies
Banks	16
Insurance	7
Financial services	5
Real Estate Investment Trusts	2
Retail	2
Motor Vehicles	2
All others	6

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We found it interesting that motor-vehicle companies disclosed some impact from the new credit-loss standard; however, it makes sense for them to be affected since many offer consumer financing options. The two companies in the motor vehicle industry that disclosed an accounting impact were Harley-Davidson [HOG] and Ford Motors [F]. General Motors [GM] had no ASU 2016-13 disclosure in their latest quarterly filing, which is unusual considering the Company has substantial receivables (in 2018, GM Financial net receivables totaled $51,933 million).

Examples of Financial Impacts

We suspect many companies are behind on adopting the new standard considering only four companies disclosed some type of financial impact, aside from Phillips 66 which early adopted the standard.

Impact Disclosure

Company	Market	Expected impact to credit loss reserve *(in millions USD)*	Portfolio *(in millions USD)*
JPMorgan Chase & Co. [JPM]	NYSE	4,000 - 6,000 [1]	150,527 [1]
Wells Fargo & Company [WFC]	NYSE	(1,500) - (2,500)	948,249
Citigroup Inc. [C]	NYSE	400 - 600 [2]	319,186
Goldman Sachs Group, Inc. [GS]	NYSE	600 - 800	83,807

Notes: www.AuditAnalytics.com

1) Card portfolio only

2) Expected impact to credit loss reserve calculated based on disclosure

Conclusion

Of the S&P 500 companies implementing the new standard, most are still in evaluation mode. Banks are seemingly ahead of other firms in the adoption process, which could be expected as it is no surprise the new standard will have a material impact on them.

As we mentioned earlier, CECL is the third major accounting standard issued by the FASB in three years and we suspect this may contribute to companies falling behind in implementing the new rule. It takes time to properly implement any new standard and companies are still in the process of complying with the revenue recognition and lease-accounting standards.

With so many companies still evaluating the standard and few companies issuing any disclosures as to how it will affect their financial statements, we expect much more information to be released in the coming quarters.

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