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Financial Statements

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What to Expect When You're Expecting (Credit Losses)

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While the 2008 financial crisis might be a distant memory for some, the repercussions are still being felt in the corporate world today. One of the concerns highlighted in the aftermath of the crisis was the weakness in the existing accounting models for credit losses at the time of the crisis. Following the crisis, the Financial Accounting Standards Board (FASB) recognized a need to switch from what is called an "incurred loss model" to a "current expected credit loss" (CECL) model to provide more timely information to investors on potential credit losses. According to the FASB, "in the lead-up to the financial crisis, users were making estimates of expected credit losses and devaluing financial institutions before accounting losses were recognized, highlighting the different information needs of users from what was required by" the Generally Accepted Accounting Principles (GAAP).[1]

The new accounting standard, codified in the Accounting Standards Codification (ASC) 326, became effective for large public entities for fiscal years beginning after Dec. 15, 2019, and for all other entities for fiscal years beginning after Dec. 15, 2022.[2] Given that it has been pretty recent that all companies have had to implement the new model, it would be helpful to discuss the change in methodology under the accounting model and the impact that users can expect the change to have on financial statements.

Accounting for Credit Losses Under the "Incurred Loss Model"

Prior to the CECL, accounting guidance precluded recognition of credit losses until an entity determined that it was "probable" that a loss had been "incurred."[3] This meant that companies could generally only consider "past events and current conditions" when they measured a credit loss.[4] Critics of this previous guidance argued that this resulted in provisions for credit losses that were often "too little, too late."[5] This was a limitation that was accentuated during the 2008 financial crisis.

Another criticism of this prior model was that it created information asymmetry between the users of financial statements and the company. In particular, Securities and Exchange Commission Chief Accountant Wesley R. Bricker noted that under the prior model, "investors are on their own to develop an assessment of expected credit losses," but after the CECL's adoption, "management will provide their estimate of expected credit losses, which reduces information asymmetry for investors."[6]

Accounting for Credit Losses Under the CECL Model

Under the new model, a company presents on its balance sheet "the net amount expected to be collected on the financial asset."[7] A company will adjust the assets for *expected* credit losses, as opposed to *incurred* credit losses, as was the case under the previous model. In determining the expected credit losses, a company will need to consider

1 Accounting Standards Update (ASU) 2016-13.
2 A.S.C. 326-10-65.
3 A.S.U. 2016-13.
4 *Id.* at p. 3. ("Previously, when credit losses were measured under GAAP, an entity generally only considered past events and current conditions in measuring the incurred loss.").
5 A.S.U. 2016-13.
6 Wesley R. Bricker, "Remarks Before the Financial Executives International 36th Annual Current Financial Reporting Issues Conference: Effective Financial Reporting in a Period of Change," U.S. Sec. & Exch. Comm'n (Nov. 14, 2017), *available at* sec.gov/news/speech/speech-bricker-2017-11-14 (unless otherwise specified, all links in this article were last visited on July 26, 2024).
7 A.S.C. 326-20-30-1.

not only "past events and current conditions," but also such forward-looking information as "reasonable and supportable forecasts."[8] As a result, expected credit losses will likely be recognized in a company's financial statements earlier than under the previous model.

In particular, under the new model, a company first reports a valuation allowance (*i.e.*, allowance for credit losses) on its balance sheet. This valuation allowance is equal to the difference between the amortized cost of the financial asset and the net amount expected to be collected on the financial asset. In other words, this valuation allowance represents lifetime expected credit losses on the financial asset and *reduces* the net amount of the asset on the balance sheet.

For newly acquired financial assets, the estimated lifetime credit losses are recorded at the time that the assets are acquired. Under the prior model, an allowance would only be recorded for newly acquired assets if it was probable that a loss had already been incurred, which was highly unlikely. Under the new model, the allowance represents not *probable* incurred losses, but rather *expected* credit losses over the life of the asset, which are unlikely to be $0. Thus, for the *same* financial asset and under the *same* economic conditions, the net amount for the financial asset on the balance sheet would be *lower* under the new accounting model compared to under the previous model.[9]

Next, an increase in the valuation allowance is reported as an expense on a company's income statement, thereby reducing a company's net income and its retained earnings.[10] This could be a concern for financial institutions, since any downward effect on retained earnings could cause financial institutions to bump up against regulatory capital requirements, because retained earnings are part of a financial institution's common-equity-tier 1 (CET1) capital and therefore its CET1 capital ratio.[11]

While financial institutions and the 2008 credit crisis were key motivations for adopting the new model, the CECL model has replaced existing credit-loss models across a variety of different transactions. The range extends from trade receivables to corporate bonds[12] and allows for the use of "various methods" for determining what the amount should be.[13]

Implications for Investors

The new model requires companies to recognize credit losses before they are incurred, since they are recognizing *expected*, rather than *incurred*, credit losses. This could result in identifying the vulnerabilities of distressed companies earlier, which could lead to tighter credit conditions or higher borrowing costs for these companies.

Moreover, by incorporating future projections, the switch to CECL might lead to a greater impact of economic cyclicity. During economic downturns, the incorporation of future projections could lead to higher expected credit losses and, in turn, higher costs to secure financing. This might have a disparate impact, depending on the type of the firm or nature of its credit exposures.

In fact, a current debate among academics and practitioners is whether CECL will lessen or worsen lending during economic downturns. On one side of the debate, CECL proponents argue that earlier recognition of losses would have lessened the impact of the 2008 financial crisis. In particular, the Department of the Treasury and the Financial Stability Forum's Working Group on Loss Provisioning noted that "earlier recognition of loan losses could have potentially lessened the impact of the crisis, when banks had to recognize the losses through a sudden series of provisions to the loan loss allowance, thus reducing earnings and regulatory capital."[14]

On the other side of the debate, critics expressed concern that CECL would worsen economic downturns. For example, the American Bankers Association posited that "banks and other financial companies are finding — through the testing of their estimation models — that CECL would actually increase procyclicality, perhaps significantly. By increasing procyclicality into the banking system, CECL will cause economic downturns to be more severe and to last longer."[15]

A recent research paper found results that are consistent with the latter argument, concluding that "banks that adopted CECL prior to the COVID-19 pandemic increased loan-loss provisions and reduced loan growth during the accompanying recession more than other banks."[16] Those researchers also found that "counties in which CECL-adopting banks have higher market share experience larger increases in unemployment rates during the recession and slower subsequent recoveries."[17]

Another concern with CECL is the reliability of the loss estimate, since the expected losses are based on more speculative, forward-looking information. For example, a noted concern is that "[w]hile CECL removes discretion regarding the timing of recognizing credit losses, it potentially increases the discretion in the amount of recognized credit losses by allowing entities to use judgment in determining the length of a 'reasonable and supportable' forecasting period; the factors forecasted; and how to weigh historical, current, and forecasted information to determine the allowance for credit losses."[18]

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8 A.S.C. 326-20-30-7.

9 "The Current Expected Credit Loss Accounting Standard and Financial Institution Regulatory Capital," U.S. Dep't of Treasury (Sept. 15, 2020) at p. 15, *available at* home.treasury.gov/system/files/216/The-CECL-Accounting-Standard-and-Financial-Institution-Regulatory-Capital-Study-9-15-20.pdf ("As a result, CECL will generally require financial institutions to establish greater credit loss allowances than under [the incurred-loss methodology].").

10 A.S.C. 326-20-30-1.

11 "The Current Expected Credit Loss Accounting Standard," *supra* n.9 at pp. 14-15 ("This may be significant for bank capital purposes because retained earnings are a major component of a banking organization's ... CET1 capital. A reduction in CET1 capital lowers the banking organization's CET1 capital ratio, since CET1 capital is the numerator in this capital ratio. The CET1 capital is also a key input to various other financial institution regulatory capital measures.").

12 A.S.C. 326-20-15-2.

13 A.S.C. 326-20-30-3 ("The allowance for credit losses may be determined using various methods. For example, an entity may use discounted-cash-flow methods, loss-rate methods, roll-rate methods, probability-of-default methods, or methods that utilize an aging schedule.").

14 "Financial Institutions: Causes and Consequences of Recent Bank Failures," GAO-13-71 (Jan. 3, 2013).

15 "Current Expected Credit Loss Standards (CECL): Compliance and Operational Challenges with the Current Expected Credit Loss Standard," Am. Bankers Ass'n, *available at* stage-www.aba.com/advocacy/our-issues/cecl-implementation-challenges.

16 Jing Chen, Yiwei Dou, Stephen G. Ryan & Youli Zou, "The Effect of the Current Expected Credit Loss Approach on Banks' Lending During Stress Periods: Evidence from the COVID-19 Recession," Working Paper (July 10, 2023), *available at* ssrn.com/abstract=4110109.

17 *Id.*

18 Kurt H. Gee, Jed Neilson, Brent Schmidt & Biqin Xie, "Are Recognized Expected Credit Losses Decision-Useful and New to Investors? Evidence from CECL Adoption," Working Paper (Feb. 19, 2024), *available at* ssrn.com/abstract=4038479.

Another recent working paper found that despite the potential inaccuracy of the expected credit losses, investors have found the expected losses "decision-useful." In particular, using a sample of 200 publicly listed U.S. banks that adopted CECL, those researchers found that investors view the "day-1 application of CECL on banks' credit loss allowances" (*i.e.*, the credit losses incremental to the *incurred* losses under the previous model) as being useful information. In other words, the additional day-1 CECL credit losses "reflect information [that] investors use in pricing bank stocks."[19] The study also found that these additional day-1 CECL credit losses predict "future nonperforming loans and cumulative net charge-offs, relative to the [incurred-loss] allowance."[20] As a result, both of these findings suggest that even with the potential inaccuracy of the forward-looking nature of CECL, the information has been viewed as being useful for investors.

Conclusion

The implementation of the CECL model represents a fundamental change in how companies measure credit losses, thus shifting from the traditional incurred-loss model to a forward-looking, expected-loss model. This transition aims to provide investors with more timely and relevant information, potentially revealing the vulnerabilities of distressed companies earlier.

For bankruptcy practitioners, this model could potentially provide more insight into a company's financial health and enable more informed decisions during insolvency proceedings. However, the CECL model also increases reliance on forward-looking estimates, which could lead to potential inaccuracies or even to exacerbating economic downturns through constrained credit options. As practitioners incorporate the impact of this new model into their decisions, it will be essential for all stakeholders to closely monitor its impact and refine their approaches accordingly. abi

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19 *Id.*
20 *Id.*