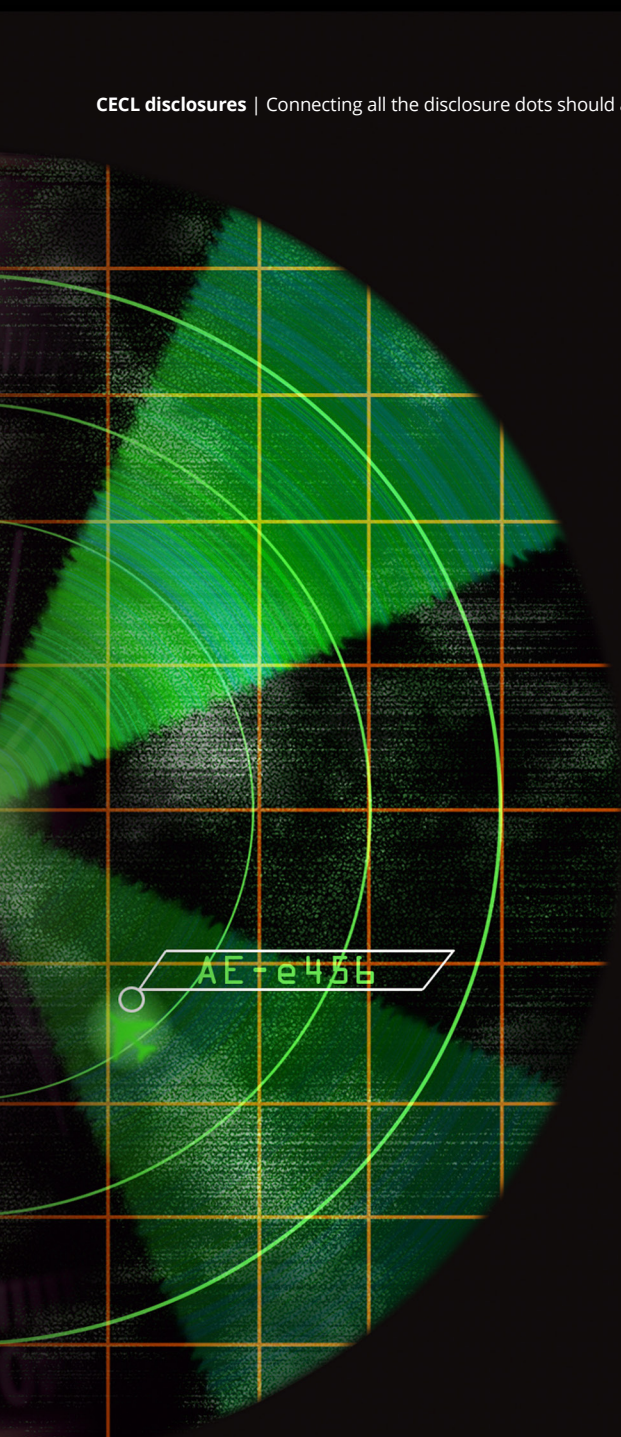


## **CECL disclosures**

Connecting all the disclosure dots should aid understandability



FASB's CECL<sup>1</sup> trifecta of being principles-based, involving complex models, and requiring life-of-the-loan estimates with reasonable and supportable (R&S) forecasts will challenge financial statement preparers to develop useful, transparent disclosures. Similarly, these three elements will challenge financial statement users to understand both individual company results and industry comparability. FASB appreciated the disclosure challenges CECL would present, emphasizing the need for companies to determine the right "Goldilocks" level of disclosures.<sup>2</sup> Furthermore, a major investment manager has suggested that complementing the required Generally Accepted Accounting

## Explicitly connecting FASB's and SEC's disclosures should aid transparency into CECL results

Principles (GAAP) disclosures with non-GAAP disclosures may be needed to provide investors with a more useful representation of the allowance for credit losses even though investors shy away from unaudited non-GAAP disclosures.<sup>3</sup> Companies that develop informative and transparent CECL disclosures may be rewarded by the investor community upon adoption and, perhaps even more so, when the economy enters its first, post-CECL adoption recessionary period. A disclosure approach that "connects all the disclosure dots" including FASB's credit quality indicator(s), allowance measurement methodology, and the period-over-period allowance change attribution with the SEC's critical accounting estimate disclosures should be valuable to investors.

### Leveraging international research efforts

International research efforts should provide useful insights for US companies developing their CECL disclosure approach. In May 2012, the Financial Stability Board (FSB) created the “Enhanced Disclosure Task Force” (EDTF), and the EDTF issued its first report outlining seven risk disclosure principles in October 2012.<sup>4</sup> Subsequently, the FSB requested the EDTF to develop disclosure guidance that may be useful to better understand the upcoming changes as a result of the new expected credit loss (ECL) approaches (IFRS 9 and CECL) and to promote consistency and comparability.<sup>5</sup> The EDTF’s November 2015 report highlighted the need to present relevant, qualitative, and—importantly—quantitative information regarding those factors and risks that create variability in the measurement of ECL, and why those factors and risks are the most significant.<sup>6</sup>

## UK Disclosure Task Force recommends alignment between disclosures for measuring credit losses and credit risk management disclosures.

Building on this international effort, several United Kingdom (UK) regulators concluded something more was needed, and in November 2017 formed the “Task Force on Disclosures about Expected Credit Losses.” Late last year, the Task Force issued its report and identified nine areas for disclosure consideration. While the report addresses IFRS 9 disclosures specifically, two recommendations clearly are applicable to CECL: (1) understanding the alignment between accounting for credit losses and credit risk management, and (2) understanding the measurement uncertainty caused by future economic conditions and critical judgments.<sup>7</sup>

### FASB’s CECL disclosure framework

FASB states that CECL disclosures should enable financial statement users to understand the credit risk inherent in a portfolio, how credit quality is monitored, the methodology to estimate ECL, and period-over-period changes in the estimation of ECL.<sup>8</sup>

In CECL, FASB retained the existing credit disclosure framework with its two discrete components.<sup>9</sup> The *credit quality component* is focused on how credit is monitored and assessed and on the credit quality indicator(s) used in the monitoring and assessing of credit risk. Specifically, companies are required to describe their credit quality indicator(s) by class of financing receivable and to disclose amortized cost by credit quality indicator(s) by year of origination (that is, by vintage year).<sup>10</sup>

## FASB’s separate credit quality and allowance measurement disclosure framework challenges understandability.

The *credit loss measurement* component is focused on describing and discussing, by portfolio segment, the method and information used in developing the allowance and the circumstances that caused the allowance to change period-over-period. Furthermore, companies are required to discuss the relevant risk characteristics and the factors that influenced the current allowance estimate, including historic, current, and R&S forecasted information.<sup>11</sup>

This two-component disclosure framework challenges preparers in providing easy-to-understand information in two ways: (1) the different grouping conventions of portfolio segment and class of financing receivable and (2) the lack of defined relationship between allowance measurement factors and credit risk indicators.



### **SEC's critical accounting estimates disclosure**

The Securities and Exchange Commission (SEC) staff's 2003 Interpretive Release provides useful information addressing companies' disclosure responsibilities for critical accounting estimates.<sup>12</sup>

## The SEC's Staff MD&A Interpretive Release warrants a reread given CECL's challenging estimates and forecasts.

The SEC staff notes that a company should analyze the sensitivity to change of its critical accounting estimates and should provide qualitative and quantitative information, if quantitative information is reasonably available.<sup>13</sup> The SEC's staff guidance, while over 15 years old, is relevant to CECL perhaps even more so than under the existing incurred-loss model. The potential, future volatility driven by CECL's R&S forecasts and the life-of-the-loan loss estimates warrants careful consideration of the guidance provided in the 2003 Release.

### **A possible disclosure approach**

Heading toward a January 2020 adoption, financial statement preparers should increase their focus on defining their CECL disclosure approach. Consistent with the international and UK disclosures recommendations, a disclosure approach that connects and aligns the FASB's credit quality indicator and allowance measurement disclosures with the SEC's critical accounting estimate sensitivity disclosures should improve transparency and thus enhance understandability.

To connect the disclosures dots, it is useful to start with the allowance measurement disclosures. These disclosures provide financial statement users insight into the drivers of the allowance and current period provision expense and useful information to estimate future CECL sensitivity including the impact of changing economic forecasts. In preparing these disclosures,

companies also may find that further disaggregation in portfolio segmentation from that disclosed today useful. Specifically, disaggregation may provide better linkage to the class of financing receivable disclosures and better align modeling drivers with SEC accounting estimate sensitivity disclosures. For example, separating overall commercial loans into commercial and industrial, and commercial real estate could better align discrete allowance measurement with specific SEC sensitivity disclosures. Next, connecting the SEC's MD&A critical accounting estimate sensitivity disclosures to the most significant factors that impact the allowance measurement would be important. Aligning these sensitivity disclosures with the significant allowance measurement drivers should provide financial statement users with key CECL insights needed to understand the risk in the credit portfolio and the associated allowance measurement. Additionally, given that R&S forecast changes should impact portfolio segments' allowance differently, additional sensitivity disclosure should be beneficial. Finally, connecting the credit quality indicator(s) disclosures with the allowance measurement and sensitivity disclosures sets the foundation for a better understanding of the allowance. Recognizing the importance of selecting the right credit quality indicators, FASB emphasized that judgment should be used in their selection.<sup>14</sup> Further, given CECL's new measurement requirements, it could be appropriate to change or perhaps increase the number of credit quality indicators from what was useful under an incurred-loss allowance model.

## CECL brings a new level of uncertainty to the most closely analyzed number in banks' financial statements.

Developing the right CECL disclosure approach to meet the “Goldilocks” challenge will likely be the most difficult financial disclosure decision preparers will face during their careers.

Using a disclosure approach that connects all the dots should help bridge the GAAP disclosure framework with the SEC MD&A framework. Absent some linkage between FASB’s and SEC’s disclosures requirements, financial statement users likely will be left to go it alone.

For sure, CECL brings a new level of uncertainty to the most closely analyzed number in banks’ financial statements. The CECL journey thus far has had many twists and turns but they may be modest compared to the post-implementation disclosure journey. Clearly connecting and aligning all the credit and allowance disclosures could pay big “transparency dividends” for companies.



## Endnotes

1. FASB Accounting Standards Boards (FASB) Update No. 2016-13, June 2016 – Measurement of Credit Losses on Financial Instruments, commonly referred to as CECL, Current Expected Credit Losses.
2. Ibid, para. 326-20-50-3.
3. Franklin Templeton letter to FASB dated November 27, 2018, 2018-290, Comment Letter No. 50.
4. Enhanced Disclosure Task Force (EDTF), Enhancing the risk disclosures of banks, October 29, 2012.
5. EDTF, Impact of expected credit loss approaches on bank risk disclosures, November 30, 2015, <https://www.fsb.org/wp-content/uploads/Impact-of-expected-credit-loss-approaches-on-bank-risk-disclosures.pdf>.
6. Ibid, p. 6.
7. Recommendations on a comprehensive set of IFRS expected credit loss disclosures, Taskforce on Disclosures about Expected Credit Losses, November 26, 2018, pp. 9–10.
8. FASB ASU No. 2016-13, para. 326-20-50-2.
9. FASB Accounting Standards Update No. 2010-20, July 2010 – Disclosure about the Credit Quality of Financing Receivable and the Allowance for Credit Losses.
10. FASB ASU No. 2016-13, para. 326-20-50-4 and 5.
11. Ibid, para. 326-20-50-10 and 11.
12. SEC Interpretive Release 33-8350/34-48996, Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations, December 29, 2003.
13. Ibid, Section V.
14. FASB ASU No. 2016-13, para. 326-20-55-16.

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