Herbein
CPAs + Advisors

ASC 326 - CECL - Client Considerations

In determining its estimate of expected credit losses, an entity should evaluate information related to the borrower's creditworthiness, changes in its lending strategies and underwriting practices, and the current and forecasted direction of the economic and business environment.

Historical loss information generally provides a basis for an entity's assessment of expected credit losses. An entity may use historical periods that represent management's expectations for future credit losses. An entity also may elect to use other historical loss periods, adjusted for current conditions, and other reasonable and supportable forecasts. When determining historical loss information in estimating expected credit losses, the information about historical credit loss data, after adjustments for current conditions and reasonable and supportable forecasts, should be applied to pools that are defined in a manner that is consistent with the pools for which the historical credit loss experience was observed.

Historical/Past events

- What is an appropriate time period to look-back and collect historical data?

- Can be internal or external.
  - Internal Example: Was a new product line introduced in last X years?
  - External Example: What factor did COVID-19 play in collection over last 3 years?

Because historical experience may not fully reflect an entity's expectations about the future, management should adjust historical loss information, as necessary, to reflect the current conditions and reasonable and supportable forecasts not already reflected in the historical loss information. In making this determination, management should consider characteristics of the financial assets that are relevant in the circumstances. To adjust historical credit loss information for current conditions and reasonable and supportable forecasts, an entity should consider significant factors that are relevant to determining the expected collectability.

Examples of factors an entity may consider include any of the following, depending on the nature of the asset (not all of these may be relevant to every situation, and other factors not on the list may be relevant):

- Historical losses may not fully reflect an entity's expectations about the future. Consider relevant characteristics of the financial assets.

- Entity ("Lender")-Specific
  - What is the nature & volume of the entity's financial assets?
  - What are the entity's lending policies and procedures, including changes in lending strategies, underwriting standards, collection, write-off, and recovery practices? Current and future - any planned changes?
  - What's the quality of the entity's credit review system?
  - What is the experience, ability and depth of the entity's management, lending staff, and/or other relevant staff?

- Borrower-Specific
  - What are the borrower's operations / what is the borrower's standing in the community? Have they been in the news for anything - good or bad? Any publicized changes in their operations?
  - What is the borrower's financial condition, credit rating, credit score, asset quality, or business prospects?
  - What is the borrower's ability to make scheduled interest or principal payments?
  - What are the remaining payment terms of the financial asset(s)?
  - What's the remaining time to maturity and the timing and extent of prepayments on the financial assets?
  - What is the volume and severity of past due financial asset(s) and the volume and severity of adversely classified or rated financial asset(s)?
  - What's the value of underlying collateral on financial assets?

- Environmental (of borrower & areas in which entity's credit is concentrated)
  - Regulatory, legal, or technological environment to which the entity has exposure.
  - Changes & expected changes in general market conditions - of either geographical area or industry to which entity has exposure.
  - Changes & expected changes in international, national, regional, and local economic and business conditions and developments in which the entity operates, including condition & expected condition of various market segments.

Aggregate financial assets on the basis of similar risk characteristics in order to evaluate financial assets on a collective (pool) basis. This may include one or a combination of the following. This list is not intended to be all inclusive.

- Internal or external (3rd party) credit score or credit ratings
- Risk ratings or classification
- Financial asset type
- Collateral type
- Size
- Effective interest rate
- Term
- Geographical location
- Industry of the borrower
- Age
- Historical or expected credit loss patterns
- Reasonable and supportable forecast periods

Estimating expected credit losses is highly judgmental and generally requires an entity to make specific judgments. Those judgments may include any of the following:

- The definition of default for default-based statistics.

- The approach to measuring the historical loss amount for loss-rate statistics, including whether the amount is simply based on the amortized cost amount written off and whether there should be adjustments to historical credit losses (if any) to reflect the entity's policies for recognizing accrued interest.

- The approach to determine the appropriate historical period for estimating expected credit loss statistics.

- The approach to adjusting historical credit loss information to reflect current conditions and reasonable and supportable forecasts that are different from conditions existing in the historical period.

- The methods of utilizing historical experience.

- The method of adjusting loss statistics for recoveries.

- How expected prepayments affect the estimate of expected credit losses.

- 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 assessment of whether a financial asset exhibits risk characteristics similar to other financial assets.