CECL Overview for the Power Industry

Seattle, WA

September 19, 2019

frv.kpmg.us

CECL overview

CECL – How did we get here?

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Scope - Not just bank loans!

In scope (ASC 326-20)

- **Trade receivables**
- **Contract assets arising from revenue transactions**
- **Net investment in leases recognized by a lessor**
- **Debt securities classified as held-to-maturity**
- Loans receivable
- Loan commitments
- Some guarantee contracts

Out of scope (ASC 326-20)

- **Debt securities classified as available-for-sale***
- **Loans and receivables between entities under common control**
- Equity instruments
- All financial instruments measured at fair value through net income

*** Not within the scope of CECL, however ASC 326-30 makes targeted changes to impairment accounting for AFS debt securities**

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ASC 326 effective dates

Credit losses

The Board tentatively decided to defer the effective dates of its CECL ASU for SEC filers that are smaller reporting companies, non-SEC filers and all other companies. A company's determination about whether it is a smaller reporting company would be based on its most recent filing status prior to the date the proposed ASU becomes final.

Company type	Current effective date for calendar year-end companies	Proposed effective date for calendar year-end companies
SEC filers that are not smaller reporting companies	January 1, 2020	January 1, 2020
SEC filers that are smaller reporting companies	January 1, 2020	January 1, 2023
Public business entities that are not SEC filers	January 1, 2021	January 1, 2023
All other companies, including not-for-profit companies and employee benefit plans	January 1, 2022	January 1, 2023

The SEC defines a smaller reporting company based on the following initial qualification thresholds:

- Public float of less than $250 million; or
- Annual revenues of less than $100 million as of the most recent fiscal year, and either no public float, or a public float of less than $700 million

See KPMG's Defining Issues 18-14 *SEC updates smaller reporting company definition*

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Impact on commercial entitles

Impact of adoption depends on the type and amount of assets an entity holds.

Product	Potential impact	
	Higher	Lower
Short-term trade receivables		✓
Long-term trade receivables	✓	
Investments in HTM debt securities	✓	
Net investment in leases	✓	
Contract assets		✓
Investments in AFS debt securities – non-credit impaired		✓
Investments in AFS debt securities – credit impaired	✓	

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CECL primary areas of change

1. **Lifetime loss estimate**
2. **Requires earlier recognition of credit losses (at origination or purchase date)**
3. **Allowance reduces the amortized cost to amounts expected to be collected**
4. **Need to consider future economic conditions during the reasonable and supportable forecast period**
5. **Considers expected recoveries of amounts written off and expected to be written off**
6. **Applies to HTM debt securities**

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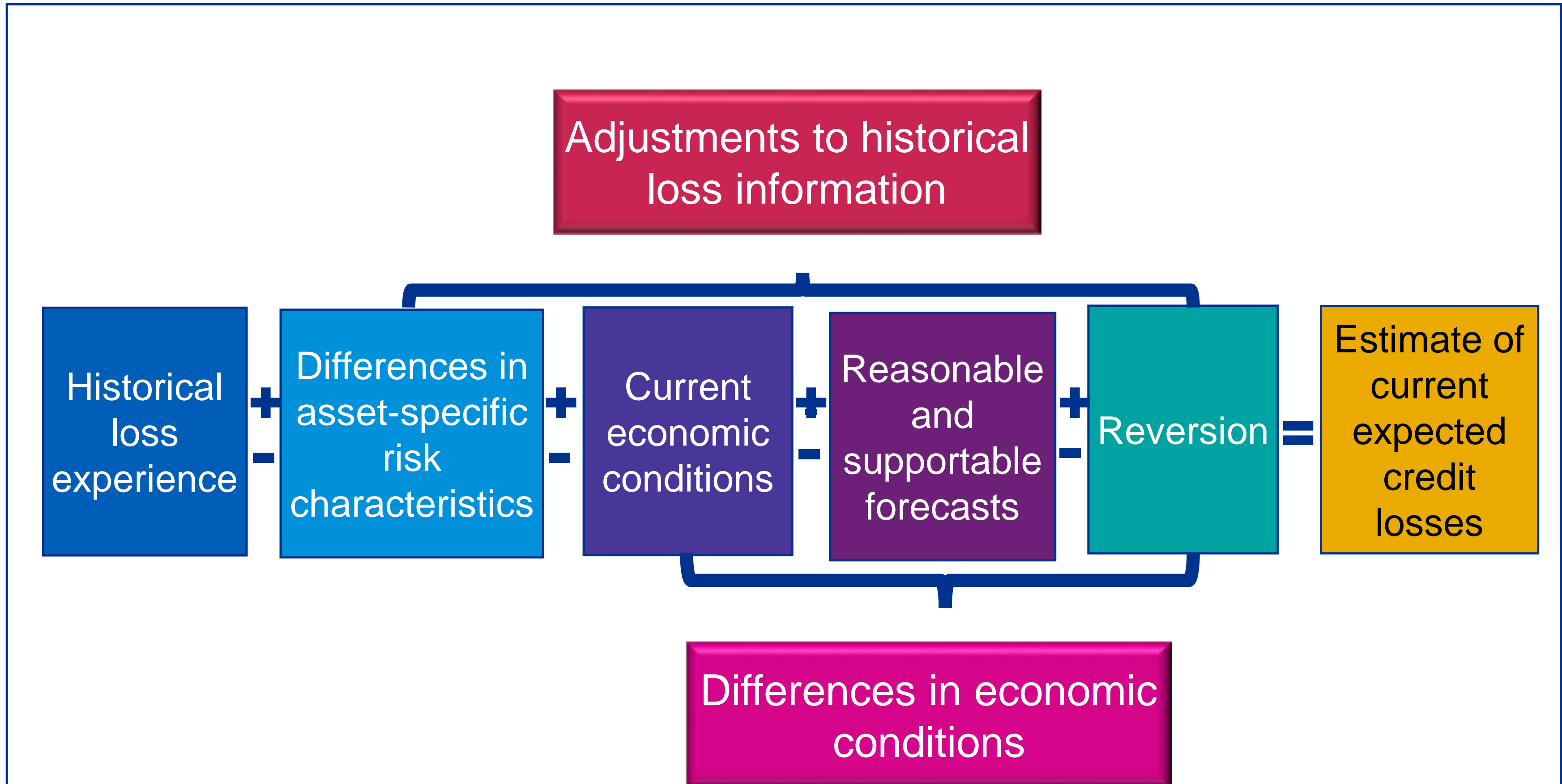
Measuring current expected credit losses



For additional details see chapters 3-8 of the KPMG Credit Impairment Handbook (https://frv.kpmg.us/reference-library/2017/credit-impairment.html)

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CECL measurement considerations

Pool assets with similar risk characteristics.

Do not consider credit losses beyond the stated contractual term.

Consider expected prepayments.

Not required to recognize loss when risk of nonpayment of the amortized cost is zero (generally US government obligations).

Incorporate reasonable and supportable economic forecast(s). Revert to historical loss information beyond forecast period.

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Short-term trade receivables

Impact

— Impact will be more significant for long-term trade receivables compared to short-term trade receivables.
— Generally, all assets will have an allowance even if a likelihood of loss is remote
— Commonly used methods for estimating credit losses on short-term trade receivables continue to be permitted

However, management needs to…

- **Evaluate the historical period used to develop the loss rates**
- **Consider the impact of asset-specific risks, current economic conditions, and reasonable and supportable forecasts of the future (including expected changes in economic conditions) when estimating the allowance**
- **Develop processes and controls over historical data and the development of reasonable and supportable forecasts**

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Example: Short-term trade receivables

Facts:

— Company A extends trade receivables generally due within 90 days.

— Current reserve approach is based on an aging schedule for past-due receivables.

— The historical loss information for its trade receivables is:

- 0.3 percent for receivables that are current
- 8 percent for receivables that are 1–30 days past due
- 26 percent for receivables that are 31–60 days past due
- 58 percent for receivables that are 61–90 days past due
- 82 percent for receivables that are more than 90 days past due

Allowance under current GAAP:

Past due status	Loss rate applied	Applicable balance	Allowance
Current	N/A	**$10,000,000**	**$0**
1–30 days	8%	**$200,000**	**$16,000**
31-60 days	26%	**$50,000**	**$13,000**
61-90 days	58%	**$25,000**	**$14,500**
91+ days	82%	**$12,500**	**$10,250**
Total		**$10,337,500**	**$53,750**

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Example: Short-term trade receivables (continued)

Questions: Assessing Impact of CECL

- Are there differences in the receivables in the historical period compared to the current period (i.e., changes in key terms or customer credit factors)?
- Are the loss rates sensitive to changes in economic conditions?
- If so, what period was used to develop the historical loss rates?
- Is the historical period consistent with current economic conditions?
- Does management believe that the economic conditions will change in the future to a degree that could impact the estimate of expected credit losses?

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Example: Short-term trade receivables (continued)

Entity determines:

— There are no differences in the receivables in the historical period compared to the current period – no adjustment for asset-specific risk characteristics.

— Loss rates are sensitive to changes in economic conditions.

— Current conditions and reasonable and supportable forecast of economic conditions have improved compared to historical information.

— Estimated impact of the change in economic conditions is a 10 percent decrease in the loss rate in each age bucket

Past due status	Historical loss experience	Adjustments for current and forecast economic conditions	Adjusted loss rate	Applicable balance	Allowance
Current	.30%	**-.03%**	0.27%	**$10,000,000**	**$27,000**
1–30 days	8%	**-0.8%**	7.2%	**$200,000**	**$14,400**
31-60 days	26%	**-2.6%**	23.4%	**$50,000**	**$11,700**
61-90 days	58%	**-5.8%**	52.2%	**$25,000**	**$13,050**
91+ days	82%	**-8.2%**	73.8%	**$12,500**	**$9,225**
Total				**$10,337,500**	**$75,375**

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Short-term trade receivables

Do	Don't
— Update loss rates for lifetime expected losses (if lifetime loss rates weren't used already) — Continue to update loss rates that are reflective of current economic conditions (and future economic conditions if changes are expected) — Assign a probability of loss to all trade receivables	— Use long-term average loss rates without reconsideration — Assume there is no allowance (i.e. for current trade receivables)

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Long-term trade receivables

Many considerations will be the same as lending portfolios

Forecast of future economic conditions are more likely to have a significant impact

May not be able to prepare a reasonable and supportable forecast for the entire duration

May need to apply reversion

Could be a bigger difference between loss rates used for incurred loss model and CECL

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Other considerations: Long-term receivables

Reasonable and supportable forecasts

- Apply as a judgment, not a policy election
- Apply a process consistently and ensure that it is well-documented
- Assess ability to make or obtain forecasts of future economic conditions
- Determine the appropriate source for the economic data
- Consider whether length and support differ by economic assumption
- Consider other economic forecasts prepared/used
- Reevaluate the length of the forecast period

Reversion

- Reversion method is an assumption that must be supported
- **May be unnecessary if the reasonable and supportable forecast period is equal to or greater than the contractual life**
- Assumptions can change
  - Need to have a reasonable basis for a change in the assumption
  - Needs to be supported
  - Evaluated similar to other changes in allowance methodology
- Must be representative of the best estimate of expected credit losses

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Interaction with ASC 606

- Credit loss guidance applies to both receivables and contract assets.
  - E.g. long-term construction contracts

- ASC 326 is meant to address credit risk only
  - Price concessions versus credit impairment loss
  - Market risks versus credit risks

- Apply judgment to determine whether revenue guidance or credit loss guidance applies.

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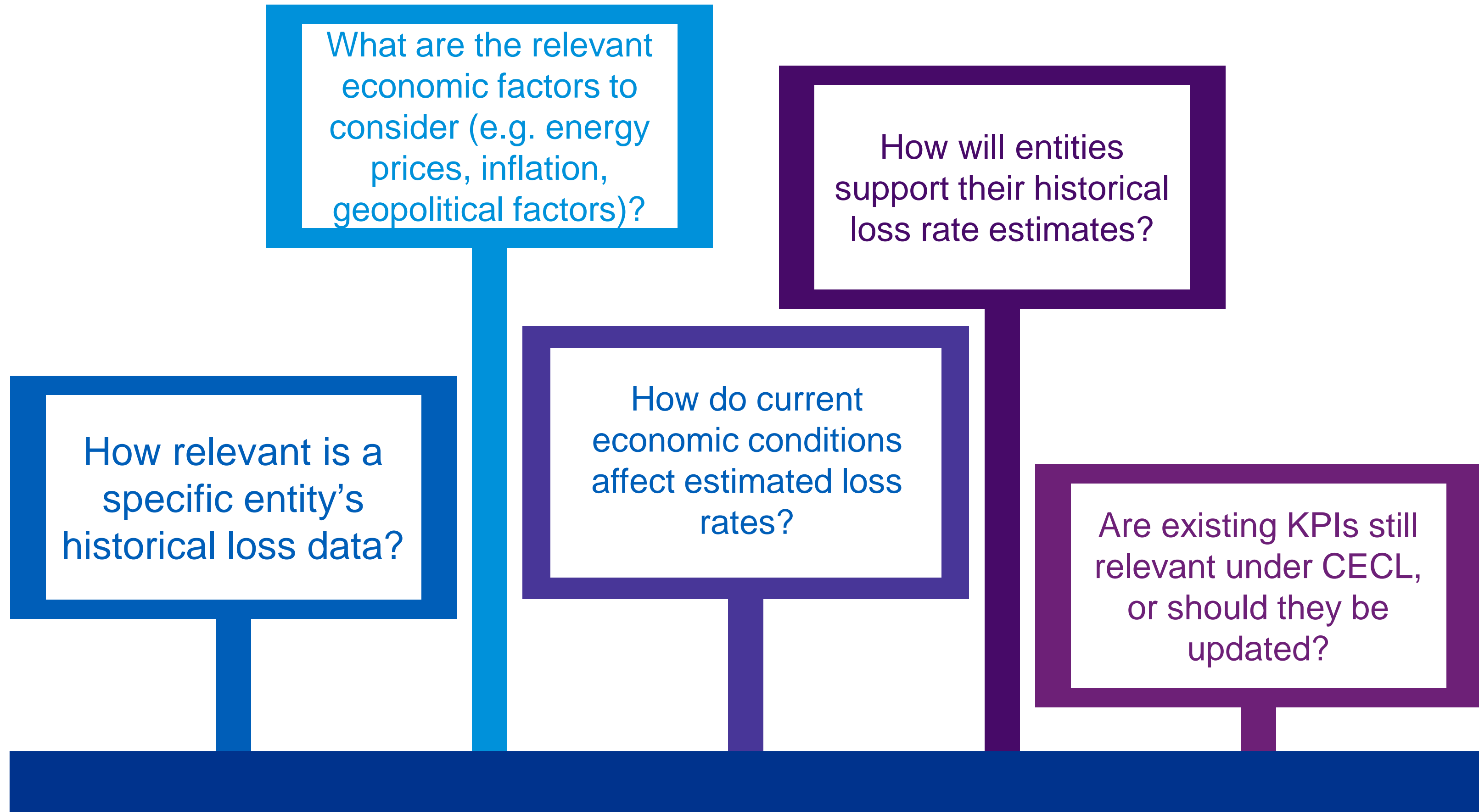
Other considerations for Power and Energy



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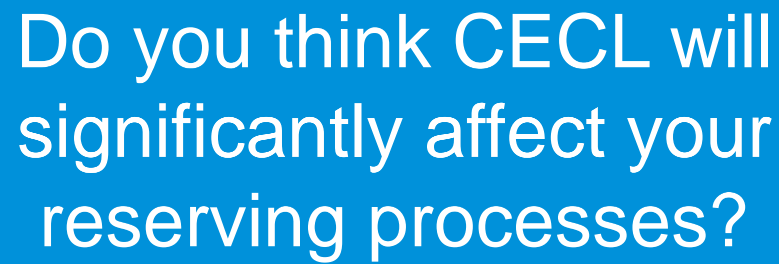
Polling question



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SAB 74 Disclosures

Entities should continue to evaluate the adequacy of their SAB 74 disclosures at each interim and annual reporting period, considering the following questions:

Does the entity's SAB 74 disclosure satisfy all of the components/disclosure categories required by SAB 74 (Topic 11.M)?

Does the disclosure meet the objective of assisting the user in assessing the significance of the impact that the standard will have on the financial statements when adopted?

If the entity is currently evaluating its expected impact of adoption, has the entity disclosed a statement to that effect and provided a timeline to indicate when such determination will be made?

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Internal control considerations (continued)

Entities will likely need to design and implement new internal controls, or modify existing controls, to address risk points resulting from new processes, judgments and data

New process risk points may arise from changes to IT systems and reports that provide data inputs used to support new judgments

Incremental data elements will need to be subject to processes and controls to evaluate the relevance and reliability (completeness and accuracy) of the information – especially if it was not previously collected or it is sourced from systems of record that are outside the financial reporting environment

Further alignment of risk, asset servicing, and financial reporting systems, including internal control considerations, will likely be needed

New judgments and different analyses will require consideration of the skill level, resource capacity, and training needs of employees who will be responsible for new processes and performing the new or modified controls

Processes and related internal controls should be designed and implemented to assess the impact of the application of the new standards

SEC registrants may need to consider the effect of changes in internal controls on management's quarterly and annual disclosures and certifications

SAB 74 disclosures prior to adoption need to be subject to internal controls, including consideration of the SEC Staff Announcement (September 2016)

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Current topics

Recoveries

Deduct (or add) the allowance for credit losses from (to) the amortized cost of financial assets to present the net amount expected to be collected

Recognize writeoffs in the period in which they are deemed uncollectible

Expected recoveries of amounts previously written off and expected to be written off should be considered when measuring the allowance for credit losses

Guidance will not specify which type of recoveries should or should not be included

A negative allowance (contra-liability) may be recorded when measuring the expected credit losses, as long as it does not exceed the aggregate amount of previous or expected write-offs

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Expected Recoveries

Expected recoveries of amounts expected to be written off

- The ASU did not affect how these amounts are considered under ASC 326-20 when estimating the allowance for expected credit losses
- We believe the requirements under ASU 2019-04 are consistent with practice for the majority of financial institutions under the current US GAAP incurred loss model

Expected recoveries of amounts previously written off

- The ASU changes the guidance in ASC 326-20 to **require** an entity to estimate recoveries that it expects to receive from financial assets that have previously been written off
- We believe practice for the majority of companies under the current US GAAP incurred loss model is to recognize these amounts when received. The requirements under ASU 2019-04 will change this practice.

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Polling question

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Other topics

HTM debt securities

Generally an allowance will be recognized (exception for financial assets with a zero loss expectation)

All guidance on measuring expected credit losses applies

Acquired securities need to be assessed to determine if they are purchased financial asset with credit deterioration (PCD)

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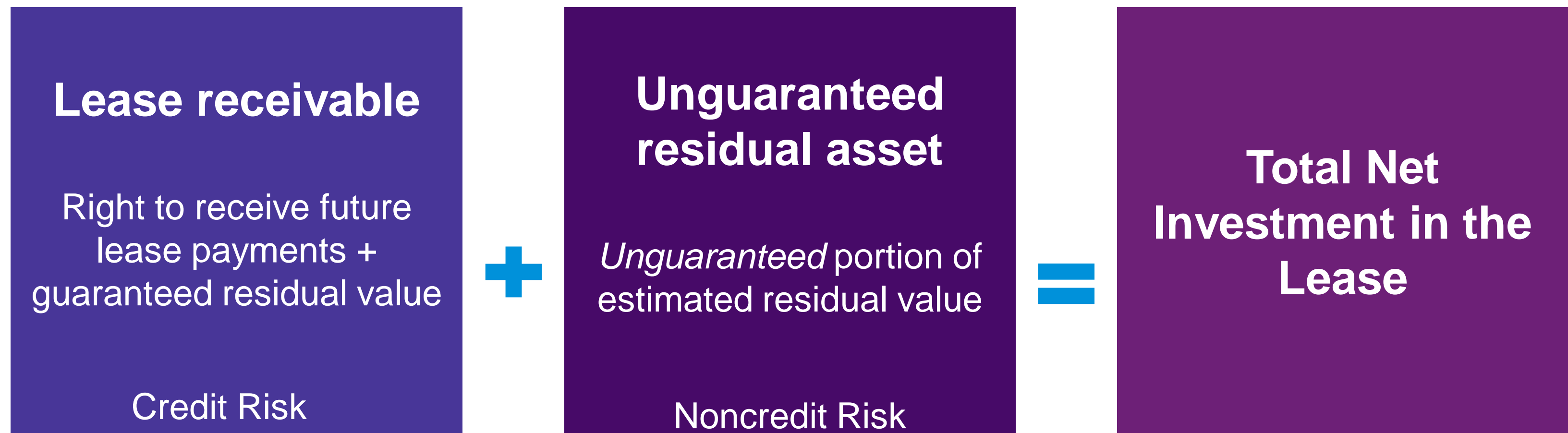
Net investment in a lease



Operating leases are outside the scope of CECL

For additional details see chapter 16 of the Credit Impairment Handbook

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CECL and business combinations

Financial assets purchased with credit deterioration

— Estimate of expected credit losses does not impact net income (instead it increases the amortized cost)

Other financial assets

— Estimate of expected credit losses is recognized in net income (credit loss expense)

Entities will need to evaluate whether acquired assets are purchased with credit deterioration

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AFS debt securities

Limited changes for non-impaired securities

- Cannot consider the length of time the fair value has been less than amortized cost

Significant changes in accounting for credit losses for impaired securities

- Allowance approach
- Credit losses limited to the difference between amortized cost and fair value
- Reversal of credit losses may occur in period of change

For additional details see chapter 12 of the Credit Impairment Handbook

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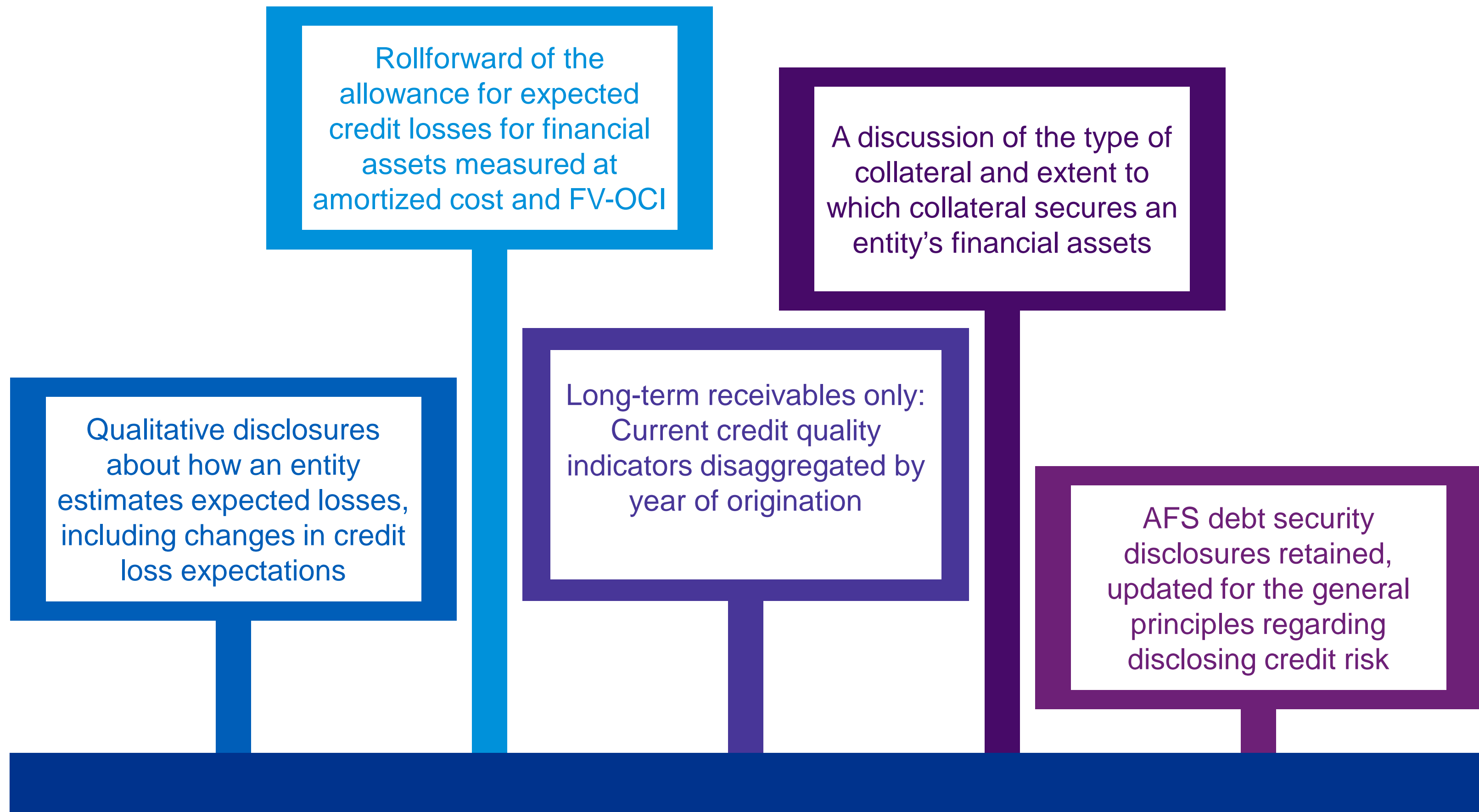

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