JohnsonLambert
cpas + consultants

FEBRUARY 2023

Credit Losses for Nonprofit Organizations

Your Accounting Guide to Adopting Topic 326

Authors:

Lauren Darr, Joshua Keene, and Andrea Wright

Johnson Lambert LLP is dedicated to keeping you current on the impact of the Financial Accounting Standards Board's (FASB) Accounting Standards Codification (ASC) Topic 326 - Financial Instruments – Credit Losses. This white paper presents the most significant changes related to applying ASC Topic 326 to nonprofit organizations.

Background

In June 2016, the FASB issued ASU 2016-13, Financial Instruments – Credit Losses, the first of several ASUs that created and amended ASC Topic 326. The standard requires entities to record the current expected credit loss (CECL) on certain financial assets and other commitments to extend credit that are not recorded at fair value, taking into consideration historical information, current losses and, for the first time, reasonable and supportable forecasts to project expected future losses.

The CECL model addresses perceived shortcomings of the previous incurred loss impairment model by taking into consideration future economic changes (allowing credit losses to be recognized earlier). The model also permits recognition of potential improvements in estimated losses in the statement of activities in future periods, rather than the one-way "permanent impairment" model used prior to this standard.

The standard is effective for calendar years beginning after December 15, 2022 for nonpublic companies.

Financial Assets in Scope

Several financial assets commonly held by nonprofit organizations are subject to the CECL reporting model, including:

CECL Reporting Model

- Trade receivables arising from exchange transaction revenue such as:
  - Tuition income
  - Membership dues
  - Merchandise sales
  - Conference and exhibit registration fees
- Promissory notes receivable
- Loans receivable, including loans to employees, officers and directors
- Contract assets recognized under Topic 606, Revenue from Contracts with Customers (grants receivable following the exchange transaction model)
- Lease receivables resulting from sales-type or direct financing leases
- Off-balance-sheet credit exposures such as loan commitments and financial guarantees

Scope Exceptions

- Financial assets measured at fair value with changes in fair value recorded through the statement of activities
- Contributions (pledges) receivable
- Grants receivable following the contribution model
- **Loans and receivables between entities under common control**
- Receivables arising from operating leases under Topic 842

The CECL model excludes related party loans and receivables between entities under common control based on feedback received during the exposure process. The term common control is mentioned in several codification topics and generally is present when an organization or individual (including immediate family members) controls more than 50% of the voting interest of an organization.

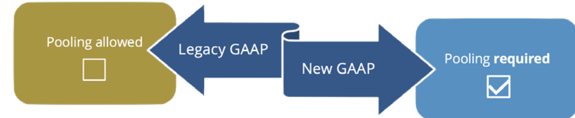
Contracts between entities under common control may include shared service agreements between related parties under common control or loans issued to an affiliate organization. These transactions and related receivables between entities under common control are not subject to the CECL model.

CECL Reporting Model

ASC 326-20 introduces a model for estimating credit losses that generally accelerates the recognition of impairment on financial assets. An organization must estimate expected future credit losses on financial assets in scope and record an allowance, with an offsetting charge through the statement of activities. The allowance (contra-asset) can increase or decrease over time, which is expected to increase volatility in the statement of activities.

Under the CECL model, assets with similar risk profiles are required to be pooled and analyzed collectively to arrive at a lifetime estimated loss rather than waiting for a specific asset to be probable of impairment under the previous incurred loss impairment model.

Under CECL, entities will report financial assets at the net amount the organization ultimately expects to collect over the life of the asset.



Financial Asset Pooling

Financial assets with similar risk characteristics are required to be reviewed collectively as a pool to determine the credit allowance. Similar risk characteristics may include:

- Past due status
- Asset type, size, or term
- Geographic location
- Industry of borrower
- Effective interest rate
- Credit quality or rating
- Year of origination

When a pooled asset ceases to share similar risk characteristics, the asset must be removed from the pool and assessed either with another pool or separately, when no other pools share similar risk characteristics. The organization must review asset pool(s) for similar risk characteristics at each reporting period.

Measurement

Organizations are required to estimate and record a credit allowance against financial assets (or asset pools) in scope at each reporting period. Changes in expected credit losses are recorded each year through the statement of activities. The following information and data may be used in management's analysis:

- Historical data
- Characteristics of the financial assets
- Current economic conditions

Reasonable and supportable forecasts

Qualitative and quantitative aspects of the data are required to be considered. Management should also consider expected recoveries of amounts previously written off or expected to be written off. The expected recoveries cannot exceed the aggregate of amounts previously written off and expected to be written off.

Estimation Methods

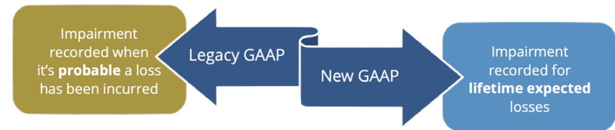
While the guidance does not prescribe a method to estimate the current expected credit losses; it requires management to use a reasonable estimation method. This provides entities the flexibility to choose an estimation method for each financial asset that works for their organization and the available data. Judgment is involved in determining estimation methods that are appropriate under the circumstances.

Management can leverage the same estimation methods used under previous guidance to develop the credit allowance, which may include some or all of the following:

- Aging schedule - considers the length of time an asset has been outstanding; commonly associated with trade receivables
- Discounted cash flow method - projects future principal and interest cash flows
- Loss rate method - calculates the average lifetime rate of loss on a pool of financial assets
- Roll-rate method (or migration analysis) - calculates ultimate losses based on the frequency of assets transitioning from one delinquent stage to another
- Probability-of-default method - estimates the probability a loan in the pool will default based on total exposure

Trade receivables are common financial assets of nonprofit organizations. Many nonprofit organizations may currently use a historical aging schedule to estimate expected losses. Aging schedules may continue to be used to support historical payment patterns, however, management will need to add consideration for current conditions and future expectations.

New inputs into the estimation methods need to be incorporated to reflect the use of reasonable and supportable forecasts in accordance with the CECL model. Organizations are required to consider prospective forecasts for a reasonable period of time that is reasonably available without undue cost or effort. When prospective forecasts cannot be evaluated for the life of the asset, an organization may revert back to historical loss information.



Collateral

An organization is required to consider the effects of a collateral agreement when measuring the credit allowance including the nature of the collateral, potential future changes in the collateral values and historical loss information for financial assets secured with similar collateral.

An organization may elect a practical expedient to measure the allowance for credit losses using the fair value of the collateral at the measurement date without consideration of future changes in the fair value of the collateral. This election is permitted provided the borrower is expected ***to replenish the collateral on a continual basis***. No allowance is required if the fair value of the collateral held and estimated costs to draw upon the collateral exceeds the amortized cost. If the fair value of the collateral is less than amortized cost, the CECL model is applied only to the difference between the fair value of the collateral and amortized cost.

Credit Enhancements

The allowance for credit losses should take into account non-freestanding credit enhancements that mitigate expected credit losses. To be non-freestanding, the credit enhancement must be embedded in the financial asset and cannot be legally detachable or separately exercisable. A freestanding credit enhancement is accounted for as a separate asset.

Disclosures

Appendix A includes a disclosure checklist summary for financial assets subject to the CECL model.

CECL Considerations for Common Financial Assets

The table below lists common financial asset holdings for nonprofit organizations that are subject to the CECL model, and allowance considerations for each:

Trade Receivables

- Required to pool trade receivables provided similar risk characteristics are present, which may include customer credit rating, aging category, the industry of the customer, geographic location of the customer and the product line.
- Historical aging analysis may be used as a starting point to evaluate the allowance for credit losses on trade receivables, adjusted for current conditions and reasonable and supportable forecasts.

Contract Assets

- Required to pool contract assets provided similar risk characteristics are present, which may include type of contract asset, geographic concentration of business and credit ratings.
- Contract assets represent a conditional right to consideration for services transferred when the condition is due to the requirement of satisfying future conditions. Contract assets are recorded when collection of the transaction price is probable.
- Consider credit risk of pools of related receivables when evaluating the allowance for credit losses on contract assets.

Loans Receivable

- Required to pool loans receivable provided similar risk characteristics are present, which may include credit scores, risk ratings, financial asset type, collateral type, size, effective interest rate, term, geographic location, the industry of the borrower and vintage.
- Collateral (ex: house, car) and non-freestanding credit enhancements (ex: co-signer) are considered in the allowance.

Other Considerations

The following items may also apply to financial assets under the CECL model.

Accrued Interest

An organization may make an accounting policy election to exclude accrued interest from the measurement of the allowance for credit losses provided it writes off the uncollectible accrued interest receivable balance in a timely manner.

Zero Allowance

If management deems there is a low risk (or no risk) of credit loss on a specific financial asset, an evaluation must still be performed to support the conclusion. For these cases, it may be reasonable to recognize a zero credit loss.

Financial Assets with Purchased Credit Deterioration

The standard eliminates the legacy model in ASC 310-304 for purchased credit impaired assets for loans. In lieu, a Day 1 accounting model for financial assets with purchased credit deterioration (PCD) was created. The organization recognizes the initial expected credit loss on the asset with PCD through an adjustment to increase the asset's amortized cost and to increase the allowance for credit losses contra-asset account.

Subsequent changes to the allowance for credit losses of PCD assets are the same as for non-PCD assets, with increases or decreases to the allowance for credit losses recorded in changes in net assets.

ASC 326 also clarifies that only non-credit related discounts or premiums may be accreted or amortized to interest income.

Transition

The guidance is required to be adopted using a modified retrospective approach for most financial assets (exception noted below). Nonpublic entities are required to make the following disclosures in the year of adoption:

+ Adoption of the standard
+ Recognize a cumulative effect adjustment to the opening balance of net assets
+ The effect of the change on impacted financial statement line items in the current reporting period and an explanation of significant changes

For PCD assets, entities are required to use the prospective approach. This will result in an adjustment to the amortized cost basis to reflect the addition of the allowance for credit losses at the date of adoption.

Implementation Best Practices

Implementing ASC 326 requires a shift in thinking. The FASB expects organizations to adopt forward-looking forecasts in addition to looking back in time. Additionally, the allowance for credit losses must be revisited at each reporting period which will require organizations to implement tracking mechanisms and additional oversight over the credit loss estimate since it impacts the statement of financial position.

Estimation methods used and policies and practices will vary and can be entity specific. An organization should look at the information available to estimate the credit allowance and determine its appropriateness under the guidance. The CECL model provides flexibility over estimation methods and forecasting data, as long as it is reasonable and supportable.

Regulators, auditors and other users of the financial statements will expect to see consistency of the estimation methods used (including forecasting inputs) from one reporting period to the next.

When judgment is involved and management needs to support consistent application, management is responsible to maintain sufficient, appropriate documentation to support its conclusions.

Documentation should include:

+ Internal controls around gathering the data and inputs in the analysis
+ Risk assessment and characteristics of each asset pool
+ Selection and rationale for estimation methods used
+ Inputs and data (including quantitative and qualitative factors considered)
+ Selection and rationale for forecasts used, specifically how they are reasonable and supportable
+ Calculation of reported credit loss
+ Consistency and/or changes as compared to prior assessments

Additionally, management may need to revisit the organization's impairment policies for its financial assets.

Finally, start on implementation early. It will take additional time in the first year to establish internal controls around the new data sources and forecasting inputs to the impairment model. Once management develops a plan, share it with the auditors early. Expect additional inquiries in the initial year as the auditors gain comfort over the new data sources and forecasts.

Authors: Lauren Darr, Joshua Keene, and Andrea Wright

The content contained herein should not be relied upon as accounting or tax advice as it does not take into account any specific organization's facts and circumstances, nor is every scenario exhaustively covered herein. This publication should not be used as a substitute for consulting authoritative accounting literature, consideration of your organization's specific circumstances, and guidance from qualified professionals.

For more information or to contact us, visit our website: JohnsonLambert.com

© 2023 Johnson Lambert LLP - All Rights Reserved

Appendix A: CECL Model Disclosure Checklist Summary

Credit Quality Information

- [ ] Quantitative and qualitative information by class of financing receivable and major security type about the credit quality of financial assets, including all of the following: credit quality indicators, amortized cost basis by credit quality indicator, and for each credit quality indicator, the date the information was last updated for that credit quality indicator
- [ ] If internal risk ratings are disclosed, provide qualitative information on how those internal risk ratings relate to the likelihood of loss

Allowance for Credit Losses

- [ ] Accounting policy and methodology to estimate the allowance for credit losses by asset pool and major security type, and a discussion of factors that influenced management's current estimate of expected credit losses including: past events, current conditions, reasonable and supportable forecasts about the future
- [ ] Risk characteristics relevant to asset pooling
- [ ] Changes in the factors that influenced management's current estimate of expected credit losses and reasons for those changes
- [ ] Changes to the entity's accounting policies and changes to the methodology from the prior period, its rationale for changes and quantitative effect of changes
- [ ] Reasons for significant changes in writeoff amounts
- [ ] Reversion method is applied for periods beyond the reasonable and supportable forecast period, if applicable
- [ ] Amount of significant purchases of financial assets during each reporting period
- [ ] Amount of significant sales of financial assets or reclassifications of loans held for sale during each reporting period
- [ ] Rollforward of the allowance for credit losses

Other Disclosures

- [ ] For past due amounts, the nature and amount of past due status, disaggregated by class of financial assets and major security type
- [ ] For financial assets on nonaccrual status, amortized cost basis at the beginning of the reporting period and the end of the reporting period, amount of interest income recognized during the period, amortized cost basis of financial assets that are 90 days or more past due but are not on nonaccrual status as of the reporting date, and the amortized cost basis of financial assets on nonaccrual status for which there is no related allowance for credit losses at the reporting date, disaggregated by class of financial assets and major security type
- [ ] For collateral-dependent financial assets when repayment is expected through the operation or sale of the collateral, describe the type of collateral by class of financing receivable and major security type, the extent to which collateral secures its collateral dependent financial assets, and significant changes in the extent to which collateral secures its collateral dependent financial assets
- [ ] For off-balance-sheet credit exposures, the accounting policy, and related methodology the entity used to estimate its liability for off-balance-sheet credit exposures and related charges. Identify factors that influenced management's judgment and the risk elements relevant to particular categories of financial assets.
- [ ] For contracts with customers, credit losses recorded on receivables or contract assets arising from contracts with customers, which the entity shall disclose separately from credit losses from other contracts
- [ ] For purchased assets with credit deterioration, a reconciliation of the difference between the purchase price of the financial assets and the par value of the assets
- [ ] Policy election to exclude the accrued interest from the disclosed amortized cost basis, including time period considered timely, by class of financing receivable or major security-type level