KPMG

CECL and IFRS 9: Preparing today to be compliant tomorrow

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Dual reporters should act now to prepare for both the new U.S. and international credit loss accounting guidance

Banks, insurance companies, and other financial institutions are facing new U.S. and international accounting standards on how the allowance for credit losses is recognized and measured.

Although similar in some requirements, the new U.S. Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS) employ different approaches to measuring expected credit losses for financial assets not measured at fair value with changes in fair value recognized in net income. That means dual reporters will face unique challenges to meet the requirements of both the standards.

Current accounting standards on credit impairment were criticized for delayed recognition of credit losses that were "too little too late" because they were based on incurred losses and had to meet a loss probability threshold before recognition. In response, both the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) have created new accounting standards governing the recognition and measurement of credit losses that focus instead on expected losses over the lifetime of the asset. The new standards strive to provide users with greater transparency on credit risk and a more forward-looking perspective on credit loss recognition that will be more responsive to changes in the credit cycle.

Although different in approach, both standards will likely result in significant changes to quantitative and qualitative models used by organizations to estimate expected credit losses on financial assets not measured at fair value with changes in fair value recognized in net income. Equally important, both standards are expected to result in an increase to the allowance and a corresponding adjustment to retained earnings at initial adoption.

Given that the effective date for the U.S. standard is expected to be two years later than the IFRS standard, organizations may be tempted to focus on the IFRS standard first. However, due to the complexities and differences between both sets of standards, management should focus on implementing methodologies and core processes to address challenges related to both sets of standards concurrently to help ensure a smooth and timely transition to the new standards on their respective effective dates.

01 A second look at the incurred loss model

Following the financial crisis, regulators, standard setters, and investors questioned the effectiveness of existing financial reporting as it relates to recognition, measurement, and disclosures related to credit losses. In 2008, the FASB and the IASB created the Financial Crisis Advisory Group, whose objective was to recommend improvements to financial reporting in order to restore investor confidence in the financial markets. A finding that came out of the study was a limitation on the part of the incurred loss model; under existing accounting rules, reserves are not established for losses unless probable and incurred as of the balance sheet date. As a result, institutions cannot reserve for future expected credit losses.

Ultimately, the IASB and the FASB were unable to reach consensus on a joint converged standard; however, both rule makers continued to develop new credit loss requirements separately. While there are substantial differences between the standards, a forward-looking expected loss model is central to both.

The IASB's IFRS 9, *Financial Instruments,* was issued in July 2014 and is effective January 1, 2018 for most affected companies. The final draft of the FASB's Accounting Standards Update (ASU), Current Expected Credit Loss (CECL) model is expected to be issued in summer 2016 with an effective date of January 1, 2020, for public SEC filing institutions.
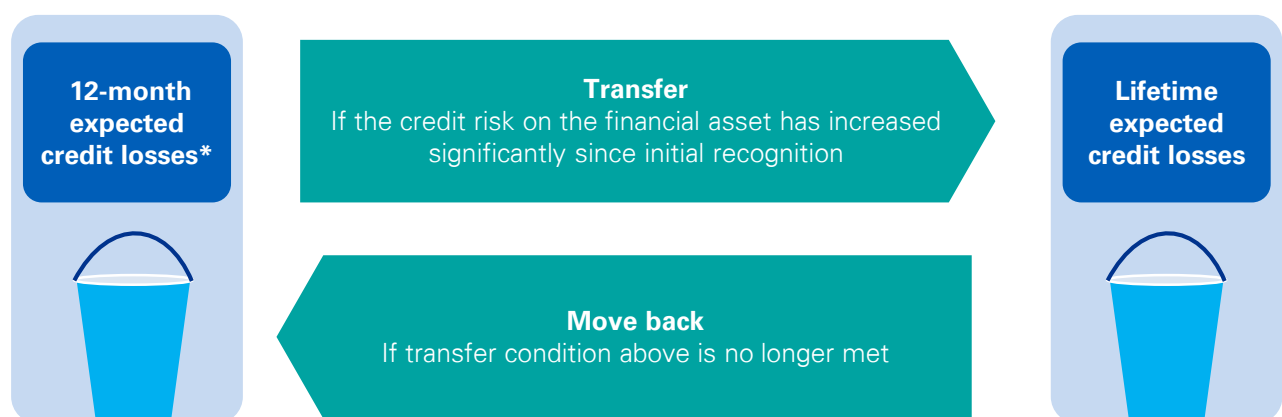
02 A "forward-looking" approach

To address the concerns around the current approach to recognizing credit losses, both the FASB and the IASB concluded that the revised standards should require organizations to shift from the incurred loss approach to a forward-looking expected loss approach. However, some differences exist.

	FASB	IASB
Scope	Loans, trade receivables, debt securities classified as held-to-maturity (HTM), loan commitments, financial guarantee contracts that are not accounted for as insurance or at fair value, and a lessor's net investment in leases are all within the scope of CECL.	All financial assets, loan commitments, and financial guarantees not measured at fair value through profit and loss (FVTP&L) are in scope of the IFRS 9 Impairment Model.
Expected credit loss model	Lifetime expected credit losses are estimated for all originated and purchased assets in scope, regardless of the asset's credit risk, and this assessment is performed on a collective basis for assets that share similar risk characteristics. In determining these expected credit losses, institutions will have to incorporate "reasonable and supportable forecasts" in their evaluations.	Credit loss dual-measurement model where instruments are categorized into credit "stages," under which loss allowance is measured as either: — 12-month expected credit losses for Stage 1 instruments (where no significant increase in credit risk has occurred since origination), or — Lifetime expected credit losses for Stage 2 instruments (where a significant increase in credit risk has occurred since initial recognition).

Both accounting models are designed to be sensitive to changes in credit risk and the company's reasonable and supportable forecasts of future economic conditions.

Whether under IFRS 9 or the FASB's CECL approach, determination of expected credit losses will require a closer collaboration between accounting and credit risk management. Continuous monitoring will be required, driven by changes in both the micro- and macroenvironments that impact future expected credit losses of the company's assets.

12-month expected credit losses*

Transfer
If the credit risk on the financial asset has increased significantly since initial recognition

Move back
If transfer condition above is no longer met

Lifetime expected credit losses

* 12-month expected credit losses are defined as the expected credit losses that result from those default events on the financial instrument that are possible within the 12 months after the reporting date.

03 Next steps for dual reporters

Companies that must comply with both IFRS and U.S. GAAP accounting standards should have already begun the process of implementing IFRS 9. However, because of the complexity of the issues involved, dual reporters should address both the standards simultaneously. In doing so, however, dual reporters should be aware of certain challenges.

Dual reporters will need to calculate expected credit losses under both standards simultaneously. The difference in approach for each standard will likely lead to challenges including:

— A capital impact under U.S. GAAP that is more adverse than under IFRS as lifetime expected credit losses will be greater than 12-month expected credit losses for most assets

— Difficulty of enhancing complicated models to support both IFRS and U.S. GAAP requirements

— The availability of forecast and data components

— Business unit/portfolio-level selection/evaluation of expected credit loss methodology under CECL versus IFRS 9

— Estimating credit losses for future draws on commitments for IFRS and for commitments that cannot be unconditionally canceled for CECL.

When it comes to implementing both IFRS 9 and CECL, meeting the new quantitative requirements is only part of the task. For instance, organizations will have to develop more granular and robust ways to estimate credit risk by incorporating supportable economic variables that could influence expected cash flows of the financial asset. Both standards will require organizational, procedural, technological, and governance changes to the organization's overall ability to produce reasonable and supportable forecasts. Also, given the intricacies of creating forward-looking models, organizations with financial instruments will need to exercise a greater degree of judgment when determining credit risk.

Transitioning to both IFRS 9 and CECL will likely strain an organization's time and resources. One major hurdle will be establishing a process for data discovery to create forward-looking models. Locating credit-related information—and then aggregating and rationalizing or transforming it across multiple platforms—can be a significant undertaking, particularly for institutions that acquire loans after origination, have completed mergers or acquisitions, or use third-party vendors anywhere in the financial asset life cycle.

Another challenge will be the identification of pools with similar risk characteristics, which will require a significant amount of resources to perform data aggregation and analysis. A company will need to evaluate whether its existing pooling methodology accurately captures forward-looking credit exposures that may have been ignored under the incurred loss model.

For smaller companies, there are currently no small-entity expedients or exceptions, meaning they will be required to implement the forward-looking credit losses approach as well. This new requirement may present specific challenges to these smaller organizations, which may have accounting systems that lack the sophistication or modules to model and calculate the expected credit losses.

04 Data gaps

In the process of transitioning to both IFRS 9 and CECL, companies are likely to discover that significant gaps in data are present and that existing data-capturing or storing systems may be inadequate to meet the increased demands. Additionally, organizations may discover they have an insufficient data structure to support modeling requirements under IFRS 9 and CECL.

Besides model data, IFRS 9 and CECL require additional qualitative and quantitative disclosures. As a result of the quantitative changes, different views of the data and additional incremental data will be needed for reporting and presentation purposes.

Although financial institutions have made significant investments in systems, data, and processes in order to meet new regulatory requirements imposed by Basel III, Comprehensive Capital Analysis and Review, and Dodd-Frank Stress Testing, new technology may be required to be able to comply with the accounting and disclosure requirements imposed by the new accounting standards.

In addition, Sarbanes-Oxley (SOX) controls will need to be updated to include processes that support the data gathering and models used to estimate forward-looking expected credit losses.

05 The way forward

Despites these challenges, companies can take a number of steps to facilitate the eventual implementation of the new credit loss standards.

First, an organization should establish a time line for implementation that incorporates both IFRS 9 and U.S. GAAP requirements and deadlines. Next, evaluate current allowance models and determine to what extent existing models can be leveraged to meet new requirements.

Likewise, data inputs will have to be defined under both IFRS 9 and CECL. For example, organizations will have to:

— Refine qualitative factors that include subjective data points such as macroeconomic factors driven by changes in business conditions

— Implement robust data collection and reporting capabilities

— Examine adequacy of historical loss data available and evaluate what additional data may be needed

— Engage firms to create or evaluate expected loss models for compliance with the revised standards.

Implementing both IFRS 9 and CECL will also require a change management strategy. Leaders will need to work with process owners to discuss operations, policies, and assumptions that may affect the expected credit loss model. Furthermore, as the new standards would increase the use of risk data and risk systems, there would be a need to ensure the appropriate controls over financial reporting are implemented over the process. In addition, companies must establish overall governance processes to monitor the establishment and maintenance of its credit loss estimates.

Once these new processes are in place, the accounting function should run parallel models for IFRS 9 and CECL alongside the organization's legacy system to assess the impact of the transition as well as quantify the effect on earnings and capital.

Finally, since forward-looking information will be used in the calculation, consideration should be given to implement processes for ongoing monitoring controls, such as backtesting prior results and model validations to strengthen the process.

06 Final thoughts

With both IFRS 9 and CECL on the horizon, companies will need to make fundamental changes in their approach to credit losses. Given that the expected CECL effective date is at least two years after that of IFRS 9, it may be tempting for dual reporters to delay work on CECL implementation until it is more mature and closer to the effective date to focus on IFRS 9 first. However, that approach would be shortsighted and could potentially lead to duplication of work and extra expense. Forward-looking management should take a comprehensive view of the changing regulations and take steps now to begin implementing the processes and technology to help ensure timely compliance with both CECL and IFRS 9.

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07 How KPMG can help

KPMG can assist dual reporters navigate the new requirements of IFRS 9 and CECL. We can help:

— Determine your readiness to meet the new accounting standards

— Educate your team on the new standards including similarities and significant differences

— Draft position papers and policies and help evaluate options under the standard

— Deploy our proprietary KPMG data layout and transformation tools to execute data discovery, including sourcing, mapping, extraction, transformation, and loading

— Assess your existing risk models used to forecast credit losses and determine the gaps between their existing state and what's required for CECL/IFRS 9 compliance

— Identify the appropriate implementation option when necessary, taking into account your portfolio's composition, your risk appetite, your capital planning, and any regulatory or audit feedback

— Create design and implementation plans tailored to your business model, balance sheet, and capital planning.

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