DECEMBER 2019

# BCMA E~CREDIT NEWS

## BCMA - It is All About You!

December 2019

## This month's topics...

1) Are You Prepared For CECL?

2) Credit Today Forum Discussion: One of my good customers wants us to drop ship our product to one of our past-due customers.

## 1. Are You Prepared For CECL? By David Schmidt

**How your company calculates your bad debt reserve is going to change. That is because the Financial Accounting Standards Board (FASB) has issued new standards that require creditors to implement a Calculated Expected Credit Loss (CECL) methodology starting next year.**

Anytime there is a change like this, it is an opportunity for credit pros to take the initiative. CECL has become a hot topic in the banking arena, but as far as we can tell, has remained under the radar in many other industries. The purpose of this article is to equip credit pros to assume a leading role by introducing you to CECL and the steps you will need to take to implement CECL in your organization.

**What is CECL?**

Accounting Standards Update (ASU) No. 2016-13, Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments was issued June 16, 2016. It replaces the incurred loss impairment approach in current generally accepted accounting principles (GAAP) with a methodology that reflects expected credit losses and entails attention to a wider range of practical information to calculate estimated credit losses.

Currently, bad debts are typically not recorded until incurred. With CECL, the expected credit losses need to be accounted for when the financial instrument, in the case of trade receivables the invoice, is recorded. CECL requires a financial asset (or a group of financial assets) be measured on an amortized cost basis and reflected at the net amount that you expect to collect. The allowance for bad debt is then a valuation account deducted from the amortized cost basis of invoice in order to present the net carrying value at the amount that is expected to be collected.

CECL also requires the consideration of a broader range of risks such as economic, industry, political and environmental. For example, small businesses are largely captive to their local markets and industry trends. Competition and economic trends have a significant impact on small business, but these are seldom accounted for today. Likewise, debt portfolios with concentrations of customers in environmentally sensitive areas -- think California's wildfires, Midwestern flooding, and Gulf and Atlantic Coast hurricanes -- do not currently factor in these risks.

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## 1. Are You Prepared For CECL? (Continued)

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**GOT AN IDEA?**
Would you like to contribute to the BCMA Newsletter? The most important part is your idea. We can handle the polishing. Just write to us at BCMAEditor@ CreditToday.net with your idea!

**Why Did the FASB Feel CECL Was Needed?**
The global financial crisis provided the impetus for CECL. There were concerns because credit losses were being calculated by utilizing backward-looking information to assess an entity's bad debt allowance and on the basis of their own experience. This approach delays recognition until a loss is likely to be incurred, which comports with GAAP's required "incurred loss" methodology.

"The new standard addresses concerns from a wide range of our stakeholders--including financial statement preparers and users--that the existing incurred loss approach provides insufficient information about an organization's expected credit losses," stated FASB Chair Russell G. Golden. (Source: FASB Issues New Guidance on Accounting for Credit Losses, Norwalk, CT, June 16, 2016 New Release)

**Who is Affected?**
Any company that extends credit to its customers is affected. According to ASU #2016-13, CECL covers "loans, debt securities, trade receivables, net investments in leases, off-balance-sheet credit exposures, reinsurance receivables, and any other financial assets not excluded from the scope that have the contractual right to receive cash."

CECL goes into effect next year for public companies and will be rolled out for other entities over the following two years. The specific dates for implementation were addressed in a "Joint Statement on the New Accounting Standard on Financial Instruments - Credit Losses" from the Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, National Credit Union Administration, and the Office of the Comptroller, issued June 17, 2016:

1. **Public business entities (PBE) that are U.S. Securities and Exchange Commission (SEC) filers (SEC filers):** Fiscal years beginning after December 15, 2019, including interim periods within those fiscal years.
2. **Other PBEs (non-SEC filers):** Fiscal years beginning after December 15, 2020, including interim periods within those fiscal years.
3. **Non-PBEs (private companies):** Fiscal years beginning after December 15, 2020, including interim periods beginning after December 15, 2021.

**Differences from Current GAAP Standards**
As previously mentioned, under current GAAP, recognition of the full amount of credit losses is delayed until the loss is imminent. One advantage of CECL is that it eliminates any ambiguity around the probable initial recognition threshold in current GAAP. Instead, CECL reflects a company's current estimate of all expected credit losses.

When credit losses are measured under current GAAP, only past events and current conditions are considered. CECL expands the scope of the data an entity must evaluate in calculating its expected credit loss estimate, but allows receivables or other debt to be measured either collectively or individually. Therefore it is likely the loss probabilities for your largest customers will be individually based, while smaller accounts will be evaluated based on distinct AR portfolio segments.

# 1. Are You Prepared For CECL? (Continued)

By being forward looking, the process imposed by CECL must necessarily incorporate more timely data in the estimate of expected loss. Users of financial statements, your own credit analysts included, will find this advantageous, and will also benefit from more consistency and better risk quantification in the reporting of bad debt reserves.

From a systems implementation perspective, the inputs used to record the allowance for credit losses will typically need to change to appropriately reflect an estimate of all expected credit losses and the use of valid forecasts. The good news here is that an organization can leverage its current systems and processes for recording the allowance for credit losses.

In terms of disclosures, CECL requires that credit quality indicators related to the amortized cost of financing receivables, a current disclosure requirement, will need to be disaggregated by year of origination (or vintage). This vintage information will enable financial statement users to better assess changes in underwriting standards, credit quality trends in debt portfolios over time, and the effect of those changes on credit losses. In other words, credit and financial analysts will be able to access more granular data about portfolio risks and reserve calculations for public corporations. The disaggregation by year of origination will be optional for entities that are not public business entities.

**Call to Action**
The pending enactment of CECL provides credit executives with an opportunity to get ahead of the curve. To do that you must first educate yourself and then engage with your accounting manager, controller and CFO. If they are not already preparing for CECL, you can earn credit for getting the ball rolling. If they are already on top of CECL, you can then provide valuable insight into what it will take from a credit department perspective to fulfill CECL's requirements.

Your preparations for CECL implementation start with identifying all the risks in your AR portfolio: Financial, Industry, Economic, Environmental or Location-based; and if your portfolio includes international receivables, Political and Currency Exchange risks. The next step is to identify the data and information resources needed to forecast these risks. An evaluation of your system needs is also required before you start building a process that addresses CECL's standards. If you have already automated credit and collections, your system needs may be minimal.

As with any other change, CECL comes with its challenges and opportunities. For credit pros, there will be challenges implementing a new process to calculated expected credit losses, but this is not a formidable challenge. In fact, for many credit pros it will not take you far from your comfort zone. The opportunity comes from proving, and even enhancing, your value to your organization by being proactive.
***Thanks to Credit Today.***

## 2. Credit Today Forum Discussion: One of my good customers wants us to drop ship our product to one of our past-due customers.

I am sure someone on this list has run into a similar scenario: Customer "A" is past due, well over 120 days. Customer A is now on credit hold and will be receiving a Final Demand before turning over to our collection agency. Customer "B" is in excellent standing. Customer B has been purchasing our equipment for many years, and recently has begun drop shipping to Customer A.

Has anyone refused to drop ship in a similar situation as leverage to receive payment from Customer A? Are there any legal ramifications? The obvious concern is our relationship with Customer B and the possibility of jeopardizing this relationship by refusing the order, no matter our reason. We are divided on this. Half believes we should withhold the drop ship, half believes if Customer B is paying us, then we are still making a good sale.

As always, the input from this group is appreciated.

Credit and Collections
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If you are aware that Customer B is knowingly assisting Customer A in this act of avoiding his creditors, then that is not a very mutually equitable relationship. I cannot understand why an excellent customer in good standing would expect their vendors to drop ship to B. That does not make sense. I would call them out carefully (probably with the aid and support of the Sales Mgr.). Likely still sell them but not extend the courtesy of the drop ship. This has been something that I have experienced, (where one was helping the other get product) but not to the extent of having to drop ship to the guy that owes money and is about to go to collection.

If Customer A doing some kind of subcontract work for Customer B, then I would let it go as the excellent Mr. B is unaware of the situation, and continue shipping as a complete courtesy to B. This particular scenario I have been involved in and had to let it continue as a service to our good customer who probably had no idea what was going on between the other parties.
**National Credit and A/R Manager**
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Shortly after I started my current position, without my knowledge, our dispatch department entered orders based upon a salesperson's instructions, shipments were billed to “B” (xx day terms), but shipped to "A" (Cash in Advance). When it came time to pay several past-due invoices, "B" said; those are not my orders, your salesperson just wanted to use my account to get the order shipped to "B", go collect from "B.” The salesperson confirmed he allowed this to occur. After climbing down from the ceiling of my office, this problem with sales and order entry was resolved and has not been repeated. It was necessary to credit "B" and invoice "A," increasing the amount owed by

"A" who was already over 120 days past due. "A" filed Chapter 7 BK the following month. It was an expensive lesson, but a great teaching moment.
My policy is I will sell to "B" and ship to "B" or I will sell to "A" and ship to "A" based upon each customer's terms of sale. I will not bill "B" and drop ship to "A." If "B" then wants to sell to "A" then "B" can ship from his store and the transaction is between "A" and "B".
**Credit Manager**
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>> Those are not my orders, your salesperson just wanted to use my account to get the order shipped to "B", go collect from "B." The salesperson confirmed he allowed this to occur. >>

In my first job in credit -- at the J.M. Smucker Co. -- we had something similar happen, but not quite.

We noticed bigger than usual orders going through at the end of a month for a particular grocery chain. Most of them ended up going past due, and when we started our usual past-due letters to collect, we found out from the customer that the salesman (unofficially, probably verbally) had offered them extended terms to place the orders early. He wanted to jam enough through at quarter's-end to make his #s.

Top management took this very seriously and spoke with him.

They concluded he was not sufficiently aware just how bad that was and fired his a**. I got the impression they might have given him a second chance had he been extremely repentant and aware that what he had done was over the top, but that was not their conclusion.
**Rob Lawson, Credit Today LLC**

***Thanks to Credit Today's Senior Credit Executive Forum***

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