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Current Expected Credit Losses (“CECL”)

FASB ASC 326

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Agenda

- Legacy GAAP **vs. NEW GAAP**
- Adoption Dates
- In-Scope **vs.** Out-of-Scope Instruments
- CECL 101
- Disclosures
- Transition Guidance
- Adoption Takeaways

Legacy GAAP vs. NEW GAAP

- **Legacy GAAP – Incurred loss model**
  - *Recognition* – when it is probable that a loss is incurred as of the balance sheet date
  - *Unit of account* – pooling is permitted but not required
  - *Economic conditions* – current economic conditions (“CECs”) are considered
  - *Contractual term* – the asset’s contractual term is not considered
- **NEW GAAP – Expected loss model**
  - *Recognition* – expected lifetime losses, **even if remote**
  - *Unit of account* – pooling is required, if assets share similar risk characteristics
  - *Economic conditions* – CECs plus expectations of future economic conditions
  - *Contractual term* – the asset’s contractual term is considered

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Legacy GAAP vs. NEW GAAP

- **Relevant CECL ASUs**
  - ASU 2016-13 – Measurement of credit losses on financial instruments
  - ASU 2018-10 – Clarified net investments in leases are in scope
  - ASU 2018-19 – Codification improvements
  - ASU 2019-04 – Multiple technical corrections
  - ASU 2019-05 – Targeted transition relief fair value option (FVO)
  - ASU 2019-10 – Effect date changes
  - ASU 2019-11 – Technical corrections
  - ASU 2020-02 – SEC conforming amendments
  - ASU 2020-03 – Codification improvements to financial instruments
  - ASU 2022-02 – Removes TDRs and adds gross write-off vintage disclosures

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Adoption Dates

PBEs that are SEC Registrants <u>and</u> <u>are not</u> SRCs	**PBEs that <u>are</u> SEC Registrants <u>and</u> <u>are</u> SRCs**	**PBEs that <u>are not</u> SEC Registrants or SRCs**	**All other entities**
Have already adopted	**Effective for fiscal years beginning after December 15, 2022 and interim periods therein**		

PBE = Public business entity, as defined in the FASB ASC Master Glossary

SEC = Securities and Exchange Commission

SRC = Smaller Reporting Company, under Regulation S-X, Article 8

Early adoption is permitted

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Adoption Dates

- **Timeline examples (fiscal years beginning after December 15, 2022):**
  - December 31, 2022 year-end
    - Adoption is January 1, 2023
  - March 31, 2023 year-end
    - Adoption is April 1, 2023
  - June 30, 2023 year-end
    - Adoption is July 1, 2023
  - September 30, 2023 year-end
    - Adoption is October 1, 2023

In-Scope

- **Financial assets measured at amortized cost, including:**
  - Financing receivables / loans
  - Held-to-maturity debt securities (“HTM”)
  - Trade receivables (ASCs 605, 606, 610)
  - Repurchase and securities lending related receivables (ASC 860)
- **Lessor** – net investments in leases (ASC 842)
- **Off-balance-sheet credit exposures** – that are not insurance
- **Reinsurance recoverables (ASC 944)**
- **Purchased financial assets with credit deterioration (“PCD”)**

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Out-of-Scope

- **Financial assets measured at fair value through net income**
- **Available-for-sale ("AFS") securities**
  - **Except for** the replacement of the other-than-temporary impairment model
- **Participant loans defined contributed benefit plans**
- **Insurance policy loans**
- **Promises to give (pledges receivable) of a not-for-profit entity**
- **Loans and receivables between entities under common control**
- **Receivables arising from operating lease accounted for under ASC 842**

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CECL 101

- Principles-based
- Provides greater flexibility
- Requires significantly more management judgement and documentation to support conclusions reached
- New disclosure requirements just like ASC 606 and ASC 842

CECL 101 – Amortized Cost

- Combined basis:
  - Outstanding balance (inclusive of write-offs) + accrued interest + (premiums/discounts + foreign exchange adjustments + fair value hedge adjustments)
- Separate basis:
  - Outstanding balance
  - Accrued interest
  - The (other components)
- An entity may make an accounting policy election, at the class of financing receivable or the major security-type level, not to measure an allowance for credit losses for accrued interest if the entity writes off uncollectible accrued interest in a timely manner.

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CECL 101 – Risk of Loss

- Even a **minute risk** of loss should be reflected
  - Low probability of default but potential loss given default
- <u>Unit of account</u>:
  - Pooling of assets that share similar risk (the pools)
    - Evaluate (reassess) the pools at <u>each</u> reporting period
      - More segregation may be necessary
      - Assets could need to move between pools
  - Individually analyze assets with credit deterioration
    - Discounted cash flow method
    - Collateral dependent
  - Refer to ASC 326-20-55-5 for characteristics that may be used to pool assets with similar risk
- **Zero losses** expected on certain investments – look to ASC 326-20-55-48 through 55-50 (for HTM, but may also be relevant when considering AFS)

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CECL 101 – Contractual Life

- Long- vs. short-term receivables
  - When have you historically incurred losses on receivables?
  - Do you extend the same payment terms to all customers or only those you know will pay?
  - What happens when the receivable gets to 30+, 60+, 90+ days past due?
  - What is your receivable turnover rate / days-outstanding?
  - All things to consider in evaluating the contractual term of the receivable.
- Include prepayment expectations but not extensions, renewals or modification
- Looking forward, as opposed to backwards, a 5%, 10%, etc. current expected risk of loss on your receivables could be significant or material to your financial statement users (and/or auditors)

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CECL 101 – Information

- Things to consider:
  - What information do you use now to record reserves and will it be part of the same information used for CECL?
  - How granular is that information and how far back do you have history?
  - Do you need peer or third-party data?
  - What is the nature of the asset, should you make adjustments for differences?
  - Macro- or microeconomic conditions – are they the same or are they different (now vs. then)?
  - **FORECASTS** – Impact will depend on the expected life of the receivable but will need to consider and the more objective ones you can source, the better.
    - Have you been tracking some sort of forecast? Maybe it trends well with your asset and is a great input, maybe not, or maybe you can back-test past data that was published to find the right forecast model?

CECL 101 – Other Items

- Credit enhancements and insurance policies will need to be carefully analyzed to ensure they are properly accounted for
- No changes to recognition of write-offs and recoveries
  - Net write-offs are considered in the CECL estimate
- PCD assets have unique accounting requirements under CECL
- Importance of internal controls
- Documentation is key, including areas that involve management judgement

CECL 101 – Models

- **Loss-rate approaches:**
  - Migration
    - A cumulative loss-rate model freezes all the loans in a segment pool at a particular point in time, then tracks the loss history of those loans over the remaining lives.
    - Cohorts, static pools, or open pools
  - Vintage
    - Considers losses over the full life cycle of various pools
    - A vintage is a group of assets originated in the same time period
  - Weighted-average remaining maturity (WARM)
    - Average annual charge-off rate x Amortization-adjusted remaining life = Lifetime historical charge-off rate

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CECL 101 – Models

- **Roll-rate approach**
  - Uses historical trends to project losses
- **Aging schedules**
  - A loss rate is applied based on how long the receivable has been outstanding
- **Probability of Default (PD) / Loss Given Default (LGD)**
  - PD x LGD x Exposure at Default (EAD) = Expected Losses
- **Discounted cash flow (DCF) model**
  - DCF using effective interest rate
  - May use simple assumptions or another model (i.e., PD/LGD)

Disclosures – John Deere Capital Corp

Credit quality indicators and past-due status based on year of origination, new for the October 31, 2021 Annual Report:

The credit quality analysis of retail notes, financing leases, and revolving charge accounts (collectively, Customer Receivables) at October 31, 2021 was as follows (in millions of dollars):

	Year of Origination							
	2021	2020	2019	2018	2017	Prior Years	Revolving Charge Accounts	Total
Customer Receivables:								
Agriculture and turf								
Current	$ 11,318.1	$ 5,719.1	$ 2,842.5	$ 1,431.0	$ 582.8	$ 119.9	$ 3,620.9	$ 25,634.3
30-59 days past due	34.7	47.5	24.2	13.7	5.9	2.9	13.1	142.0
60-89 days past due	12.8	17.4	8.4	5.1	2.4	.7	3.2	50.0
90+ days past due	.5	.5	.1	.2	.1			1.4
Non-performing	20.1	44.5	26.4	22.3	10.6	12.5	6.4	142.8
Construction and forestry								
Current	2,356.4	1,198.5	573.5	215.6	42.5	5.4	92.3	4,484.2
30-59 days past due	36.6	33.0	21.1	5.8	2.0	.1	2.7	101.3
60-89 days past due	12.5	8.4	5.0	2.6	.5	.2	1.0	30.2
90+ days past due	.1	.4	.9		.1			1.5
Non-performing	21.9	50.0	33.9	15.1	6.3	2.9	.5	130.6
Total Customer Receivables	$ 13,813.7	$ 7,119.3	$ 3,536.0	$ 1,711.4	$ 653.2	$ 144.6	$ 3,740.1	$ 30,718.3

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How it looked in the November 1, 2020 Annual Report:

The credit quality analysis of Customer Receivables at November 1, 2020 was as follows (in millions of dollars):

	November 1, 2020		
	Retail Notes & Financing Leases	Revolving Charge Accounts	Total
Customer Receivables:			
Agriculture and turf			
Current	$ 18,341.2	$ 3,710.3	$ 22,051.5
30-59 days past due	111.4	11.5	122.9
60-89 days past due	47.6	3.5	51.1
90+ days past due	2.0		2.0
Non-performing	172.7	5.4	178.1
Construction and forestry			
Current	3,759.5	92.3	3,851.8
30-59 days past due	82.0	2.4	84.4
60-89 days past due	38.8	1.1	39.9
90+ days past due	1.9		1.9
Non-performing	79.5	.9	80.4
Total Customer Receivables	$ 22,636.6	$ 3,827.4	$ 26,464.0

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CECL rollforward from October 31, 2021 Annual Report:

An analysis of the allowance for credit losses and investment in Receivables at October 31, 2021, November 1, 2020, and November 3, 2019 was as follows (in millions of dollars):

	Retail Notes & Financing Leases	Revolving Charge Accounts	Wholesale Receivables	Total Receivables
2021				
Allowance:				
Beginning of year balance	$ 76.9	$ 42.3	$ 9.9	$ 129.1
ASU No. 2016-13 adoption (see Note 3)	32.5	(12.2)	(.6)	19.7
Provision (credit) for credit losses *	11.8	(17.0)	2.5	(2.7)
Write-offs	(36.7)	(27.8)	(.3)	(64.8)
Recoveries	11.6	35.5		47.1
Translation adjustments	.4		.2	.6
End of year balance	$ 96.5	$ 20.8	$ 11.7	$ 129.0
Receivables:				
End of year balance	$ 26,978.2	$ 3,740.1	$ 5,951.3	$ 36,669.6
2020				
Allowance:				
Beginning of year balance	$ 53.7	$ 39.3	$ 7.6	$ 100.6
Provision (credit) for credit losses	66.2	25.1	(1.9)	89.4
Write-offs	(49.1)	(51.6)	(.9)	(101.6)
Recoveries	6.4	29.5	1.3	37.2
Translation adjustments	(.3)		3.8	3.5
End of year balance	$ 76.9	$ 42.3	$ 9.9	$ 129.1

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Adoption disclosure from October 31, 2021 Annual Report:

Note 3. New Accounting Standards

New Accounting Standards Adopted

In the first quarter of 2021, the Company adopted Financial Accounting Standards Board (FASB) Accounting Standards Update (ASU) No. 2016-13, Measurement of Credit Losses on Financial Instruments, which establishes Accounting Standards Codification (ASC) 326, Financial Instruments – Credit Losses. This ASU was adopted using a modified-retrospective approach. The ASU, along with related amendments, revised the measurement of credit losses for financial assets measured at amortized cost from an incurred loss to an expected loss methodology. The ASU affects receivables, debt securities, net investment in leases, and most other financial assets that represent a right to receive cash.

The Company holds deposits from dealers (dealer deposits), which are recorded in deposits withheld from dealers and merchants, to absorb certain credit losses. Prior to adopting this ASU, the allowance for credit losses was estimated on probable credit losses incurred after consideration of recoveries from dealer deposits. The ASU considers dealer deposits and certain credit insurance contracts as freestanding credit enhancements. As a result, after adoption, credit losses recovered from dealer deposits and certain credit insurance contracts are presented in other income and no longer as part of the allowance for credit losses or the provision for credit losses. The ASU also modified the treatment of the estimated write-off on delinquent receivables by no longer including the estimated benefit of charges to the dealer deposits in the write-off amount (see Note 5). This change increases the estimated write-offs on delinquent financing receivables with the benefit of credit losses recovered from dealer deposits presented in other income. This benefit, in both situations, is recorded when the dealer deposits are charged and no longer based on estimated recoveries.

The effects of adopting the ASU on the consolidated balance sheet were as follows (in millions of dollars):

	November 1 2020	Cumulative Effect from Adoption	November 2 2020
Assets			
Allowance for credit losses	$ (129.1)	$ (19.7)	$ (148.8)
Deferred income taxes	27.1	.7	27.8
Liabilities			
Accounts payable and accrued expenses	$ 922.3	$ (.5)	$ 921.8
Deposits withheld from dealers and merchants	114.8	13.5	128.3
Deferred income taxes	345.9	(5.8)	340.1
Stockholder's equity			
Retained earnings	$ 2,891.6	$ (26.2)	$ 2,865.4

Note 5 contains additional disclosures as well as the Company's updated allowance for credit losses accounting policy.

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Transition Guidance

- Adoption will result in a cumulative-effect adjustment to opening retained earnings as of the beginning of the first reporting period in the year of adoption
  - Example:
    - Adoption year 2023, 12/31 yearend, only have an annual reporting requirement = you will run CECL twice (as of 1/1/23 and as of 12/31/23)
- Comparative financial statements are unchanged (no retrospective adoption of CECL)
- FVO election is optional

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Transition Guidance

- Transition disclosures
  - Nature of the change in accounting principle and explanation of the new principle
  - Method of applying the change
  - Effect of adoption on any line item in the statement of financial position, if material, as of the beginning of the year of adoption
  - Cumulative effect of the change on retained earnings
  - Included in interim and annual financial statements in the year of adoption

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Adoption Takeaways

- CECL can be a very challenging accounting standard to adopt, especially for financial services companies with long-term receivables
- The CECL adoption impact for other industries will vary but don't expect CECL to have no impact
- Documentation and internal controls are keys to success
- There are third-parties who can assist with implementation, modeling (calculations), forecasting, data limitations/gaps, consultation, etc.

Thank you!

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