Internal Audit Considerations for CECL

In June 2016, the Financial Accounting Standards Board (FASB) released the long-awaited standard updating the guidance on recognition and measurement of credit losses for financial assets. Accounting Standards Update (ASU) 2016-13, *Financial Instruments-Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments,* supersedes today's guidance and applies to all entities that hold financial assets not measured at fair value through net income. This has come to be known as the current expected credit loss (CECL) model.

FASB has staggered adoption dates for the standard, with different dates for large and small public business entities (PBE) and all other entities. The new guidance will be effective for PBEs that are U.S. Securities and Exchange Commission (SEC) filers for fiscal years beginning after December 15, 2019, including interim periods, *i.e.*, 2020 for calendar year-end companies. Smaller PBEs—entities that do not meet the definition of an SEC filer—would have an additional year to adopt the standard for annual and interim periods. Entities not meeting the definition of a PBE would fall into a third category for which the new guidance will be effective for annual reporting periods beginning after December 15, 2020, and interim reports beginning after December 15, 2021.

Whether a financial institution meets the new definition of a PBE requires careful analysis and may require consultation with legal counsel and a bank's primary regulator.

The PBE designation means an earlier adoption date, less transition relief and additional disclosure. Banks should double-check the criteria for a PBE designation. If your institution is not an SEC filer, carefully consider:

- *Has your institution issued debt or equity securities traded, listed or quoted on an exchange or over-the-counter (OTC) market? An OTC market includes an interdealer quotation or trading system for securities not listed on an exchange, e.g., OTC Markets Group, Inc., including OTC Pink Sheets and OTC Bulletin Board.*
- *Does your institution have one or more securities not subject to contractual restrictions on transfer—a contractual restriction would exist if sales of securities are subject to management preapproval and, as such, limit the holder's ability to transfer the security—AND is your institution required by law, contract or regulation to prepare U.S. generally accepted accounting principles (GAAP) financial statements (and notes) and make them publicly available on a periodic basis? Publicly available financial statements include those filed with the SEC and other regulatory agencies, but also would include financial statements made publicly available upon request or upon being posted to an institution's website for public access.*

CECL Implementation Dates* (for Entities with Calendar Year-Ends)			
Entity	**2020**	**2021**	**2022**
Public Business Entity (PBE) – SEC filers	Interim & Annual		
PBE – Small (Non-SEC filer)		Interim & Annual	
All Others		Annual	Interim
** Early adoption permitted for all entities for periods beginning after December 15, 2018*			

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CECL Model

FASB has replaced today's "incurred loss model" with an "expected credit loss model." At inception and at each reporting date, entities will recognize an allowance for lifetime expected credit losses for instruments within the ASU's scope. The amount recognized will be based on the current estimate of contractual cash flows not expected to be collected. Subsequent changes in the allowance for credit losses immediately will be recognized through net income. In comparison to an incurred loss model, an expected loss model will result in earlier loss provisions and require significantly more management judgment to estimate future losses.

Entities will have flexibility to develop the methods to estimate and measure expected credit losses as long as they are appropriate, practical and consistent with the guidance's principles. Banks may apply different estimation methods to different groups of financial assets. Smaller institutions are not required to implement complex or costly models when adopting the new standard; however, this will still require substantial changes to policies, procedures and technology to comply with the standard.

Financial institutions should focus on how their current process and systems can be modified or expanded to comply with the new guidance.

Range of Information

FASB broadened the information entities are required to consider in developing their credit loss estimate. Under current GAAP, an entity usually considers past events and current conditions in measuring credit losses. The ASU requires the loss estimate to include relevant information about past events, current conditions and reasonable and supportable forecasts. A bank only needs to consider information reasonably available without undue cost and effort and can use both internal and external information—including qualitative and quantitative factors—to estimate expected credit losses. For periods beyond a bank's ability to make a reasonable and supportable forecast, it would revert to historical credit loss experience.

Individual Versus Pooled Assessment

During the standard's drafting, community banks were concerned they would be required to pool financial assets when measuring expected credit losses. The final standard's language better conveys that smaller institutions can develop credit loss estimates on a pooled basis if the assets share similar risk characteristics—if not, an individual evaluation is appropriate.

Regulatory Expectations

The allowance for credit losses is a bank's most significant estimate and already is subject to detailed scrutiny and second-guessing by regulators and auditors. Shortly after the standard was issued, a group of four banking regulators issued a joint statement with initial supervisory views on the CECL model that included these highlights:

- Benchmark targets or ranges for the change in allowance levels upon CECL's adoption will not be developed by banking regulators.
- Third-party service providers are not required to calculate allowances for credit losses.
- Different estimation methods may be applied to different groups of financial assets.
- Smaller and less complex institutions will not need to implement complex modeling techniques.
- Institutions are encouraged to build strong processes and controls over their allowance methodology.

The regulator's goal is to ensure consistent and timely communication, delivery of examiner training and issuance of supervisory guidance pertaining to the new standard. The agencies will consider the needs of smaller and less complex institutions in determining the nature and extent of supervisory guidance. Detailed guidance from the regulators will be crucial to address scalability and documentation requirements to support the increased judgment required by the new standard. To date, no additional details were provided.

In various speeches, SEC officials highlighted that setting the right "tone at the top" is a critical element of a company's control environment: "Appropriate tone at the top is the foundation for the consistent application of sound judgments required by the new standard. Management should consider whether the existing control environment is adequate to support the formation and enforcement of sound judgments that will be necessary in executing control activities or whether changes are necessary."

In the absence of specific guidance, members of management should educate themselves and the audit committee about the changes, determine which existing processes can be leveraged and review the costs and benefits of the various approaches available under the standard; the approach chosen will have a direct effect on the data requirements. Starting early with the right data will give banks the flexibility to test multiple methodologies before CECL implementation. Appendix A contains the Basel Committee on Banking Supervision's (BCBS) principles on how an expected credit loss credit accounting model should interact with a bank's overall credit risk practices and regulatory framework.

Audit Implications

While the effective date for financial institutions is several years away and regulators are just starting to develop their specific guidance and examination approaches, planning now for new internal controls, data needed and documentation requirements will help ensure a smooth transition.

Internal audit plays a crucial role in the ongoing maintenance and assessment of a bank's internal control, risk management and governance systems and processes. The CECL model likely will change internal audit's risk assessments and audit approach. Due to the estimation uncertainty, materiality of the loan loss provision, level of judgment on key data and assumptions, the new model is likely to give rise to one or more significant risks of material misstatement. Some challenges include:

- Forward-looking view and subjectivity can be challenging to support.
- Complex, material estimates will require strong internal controls, including governing body oversight.
- Increased regulatory scrutiny on management's judgments.
- Estimates will be more volatile, changing from quarter to quarter.
- Volatility and sensitivity will need explanation.

Joanne Wakim, Federal Reserve Board assistant director and chief accountant, highlighted the importance of governance and controls over the CECL implementation process. The audit committee will play a key role in evaluating and monitoring management's implementation plan for CECL. The audit committee should challenge management's process and hold them accountable. CECL implementation is a full institutional effort including not only accounting, but also credit, internal audit, external audit and other stakeholders. Internal audit should be involved early in the process and provide advice but is not responsible for CECL implementation; rather, internal audit should be in a monitoring role.

Data Governance

Data governance is a set of processes that ensures important data assets are formally managed throughout the enterprise. Data governance ensures data can be trusted and people made accountable for any adverse event that occurs due to low data quality. Banks may need to develop or strengthen their processes for data gathering and retention given the need for more data for life of loan and forward-looking CECL calculations. Data governance procedures should be formalized to ensure all data used in the credit loss estimate is consistent, accurate, complete, timely and secure. Data requirements should be well-documented and auditable, and data ownership must be clearly established. Banks should begin to assess where data will come from, how much is enough and how to apply data to a forecast methodology that will provide meaningful and auditable results.

Financial institutions will need to capture and retain more details on their loan portfolios, borrowers and economic factors. With the right data, banks can better defend their CECL calculations to auditors and examiners.

Historical Data

FASB expects the estimate of expected credit losses will be based on historical loss information for financial assets of a similar type and credit risk. Under CECL, annual charge-off data will no longer be relevant. For life of loan credit loss calculations, banks will need to store additional data on a regular basis. Additional loan details to be saved at least quarterly include book balance, risk ratings, interest rate, origination date and transaction detail of charge offs and recoveries. Examiners and auditors will require greater quantitative support for the qualitative factor adjustments.

Forward-Looking Data

Management and internal audit will need to understand the implication of using forward-looking data and assumptions, especially if the data comes from outside sources. Experienced credit experts likely may disagree about the appropriate assumptions for a given circumstance, and even minor differences in assumptions can lead to a large range of loss estimates. Considerations include:

- How many and what scenarios to use
- Probability and weight for each scenario and how it is determined
- Where to obtain the data
- How to factor inputs from various sources
- How to match the data and assumptions with loan maturity

Financial institutions can prepare by analyzing the primary drivers of losses in today's loan portfolio and tracking those items to the most relevant national, regional or local economic data.

Not only will the new standard potentially require the collection and use of a broader range of data than currently required, some new data may be sourced from internal loan systems and external data sources that are not part of traditional accounting systems and were not previously subject to audit procedures. Internal audit will need to determine how to address these systems and data in the audit. Some data sources or assumptions may have a greater effect on the loss estimate than others, *e.g.*, a portfolio of residential mortgages may be particularly sensitive to changes in prepayment or unemployment rates for a geographic region. It may be inappropriate to apply national or global data to a bank's smaller, more diverse lending portfolios. Auditors also should be cognizant of potential management bias.

Controls will be needed to ensure data are completely and accurately pulled from external and internal sources and not tampered with or manipulated. Management should have written criteria for considering the effect of forward-looking data, including the rationale for selecting one data source over another and changing data sources. Factors with an outsized effect on the loss estimate will require a higher risk assessment, supporting documentation and supervisory oversight.

Wes Bricker, SEC's interim chief accountant, said at the American Institute of CPAs National Conference on Banks and Savings Institutions, "Management may need to identify and resolve as part of its application of internal controls over financial reporting (ICFR) significant differences in views regarding collectibility advanced by various business units and other functions within the company, in determining that management's best estimate is reflected in the financial statements."

Forecast Period

Financial institutions will need to determine the appropriate forecast period. Economic cycles tend to have several years of low levels of charge offs followed by short periods of high charge offs. Local and regional recoveries often deviate from national averages. When historical averages are the starting point for loss estimates, large adjustments based on management's judgment likely will be required to arrive at an actual loss expectation. FASB's basis of conclusion notes that recent history may not represent a sound basis for life of loan loss expectations. Banks will need several years of data to support forward-looking calculations.

Reversion to historical average is appropriate for periods beyond an entity's ability to forecast using reasonable cost and effort.

Portfolio Segments

In evaluating loans on a collective basis, aggregation should be on the basis of similar risk characteristics. Management judgment will determine what constitutes a "similar" risk characteristic, but this should be supported by accurate, observable data for regulators and auditors. Management judgments are high-risk areas that require strong internal controls. Examiners also will evaluate if the portfolio segmentation is consistent across the organization.

Management will need to appropriately group credit exposures into portfolio segments with sufficient granularity to appropriately forecast expected credit losses. Having an inaccurate origination or maturity date, interest rate or collateral value in the system today should not significantly affect an allowance estimate. Using an incorrect date for forward-looking allowance estimates could have a material effect on the financial statements. Controls to ensure accuracy, proper updating and data security will have increased importance.

Banks must remove a loan from a pool if its risk characteristics are no longer similar to other loans in the pool, *e.g.*, changes in credit risk, borrower circumstances and recognition of write-offs or cash collections. Management must assess whether the asset should be moved to another pool with similar risk characteristics or if the asset's credit loss measurement should be individually performed. Controls and supporting documentation will need to be developed around the portfolio segmentation process as well as subsequent moves in and out of portfolio segments.

Loan Origination

Internal control requirements over loan origination may expand under CECL. This is generally considered an operational function, but within CECL the loan origination will create a loss expectation and could be considered a new process within the financial audit. Banks will be required to ensure that factors underlying loss expectations are appropriately identified and tracked, *e.g.*, appraisals underlying loan-to-value ratios on collateral.

Commitments

Under current GAAP, the recognition of liabilities for commitment agreements is based on a probable and estimable criteria. Methodologies will need to be adjusted to fully capture the life of contract exposure under CECL. Off-balance sheet credit exposure will need to consider both the likelihood and amount expected to be funded over the commitment's estimated life. Funding probability on the commitment could be based on internal or external data. This data may not be immediately needed, but building up a solid history of detailed data will give banks the flexibility and resources to adjust their models as needed.

Financial institutions would not need to record a liability if the commitments are unconditionally cancelable by the lender.

Conclusion

Successfully implementing the new credit impairment standard will require significant time and cross-functional resources. Upfront planning for data collection and developing and documenting new internal controls around the additional information required will ensure a smooth transition.

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Appendix A

In December 2015, the BCBS issued general guidance on how an expected credit loss credit accounting model should interact with a bank's overall credit risk practices and regulatory framework. These principles do not contradict FASB's standard, but rather provide a helpful framework as implementation projects take shape.

Supervisory guidance for credit risk and accounting for expected credit losses:

Principle 1: A bank's board of directors (or equivalent) and senior management are responsible for ensuring the bank has appropriate credit risk practices—including an effective internal control system—to consistently determine adequate allowances in accordance with the bank's stated policies and procedures, the applicable accounting framework and relevant supervisory guidance.

Principle 2: A bank should adopt, document and adhere to sound methodologies that address policies, procedures and controls for assessing and measuring credit risk on all lending exposures. The measurement of allowances should build upon those robust methodologies and result in the appropriate and timely recognition of expected credit losses in accordance with the applicable accounting framework.

Principle 3: A bank should have a credit risk rating process to appropriately group lending exposures on the basis of shared credit risk characteristics.

Principle 4: A bank's aggregate amount of allowances—regardless of whether allowance components are determined on a collective or individual basis—should be adequate and consistent with the applicable accounting framework's objectives.

Principle 5: A bank should have policies and procedures to appropriately validate models used to assess and measure expected credit losses.

Principle 6: A bank's use of experienced credit judgment—especially in the robust consideration of reasonable and supportable forward-looking information, including macroeconomic factors—is essential to the assessment and measurement of expected credit losses.

Principle 7: A bank should have a sound credit risk assessment and measurement process that provides it with a strong basis for common systems, tools and data to assess credit risk and account for expected credit losses.

Principle 8: A bank's public disclosures should promote transparency and comparability by providing timely, relevant and decision-useful information.