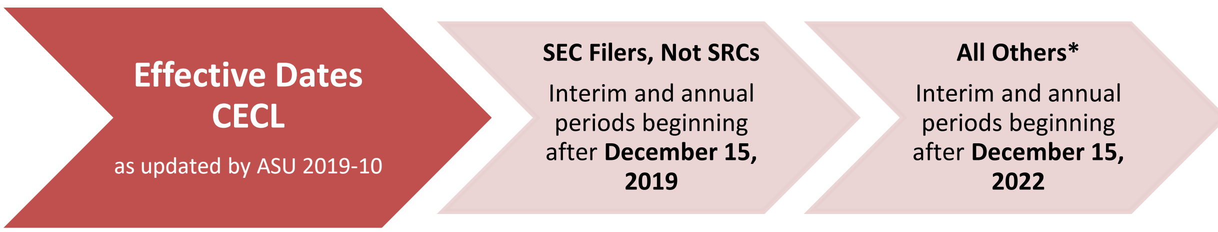
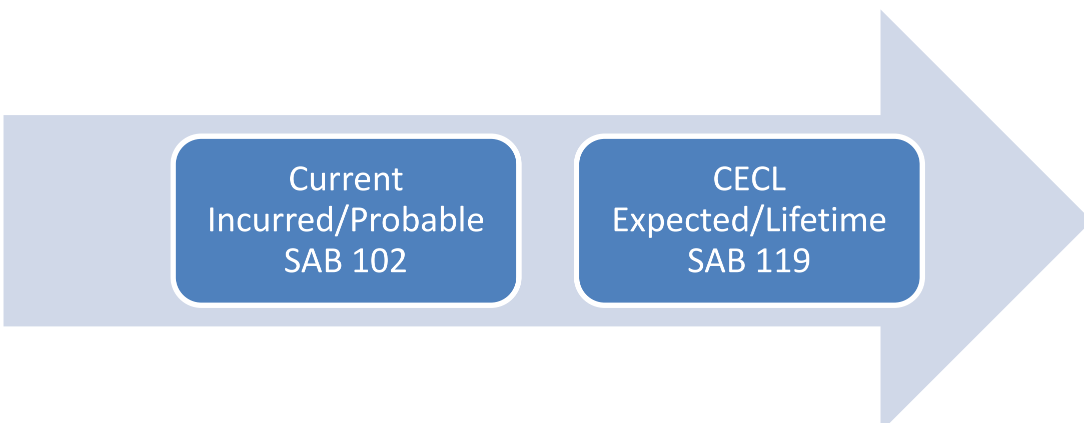
SEC Updates Guidance for CECL

With the effective date for the new credit loss model right around the corner for large public entities, the SEC recently issued [Staff Accounting Bulletin (SAB) 119](), which updates previous guidance to reflect the new credit impairment rules in FASB's Accounting Standards Update (ASU) 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*, commonly referred to as CECL. SAB 119 updates methodologies and supporting documentation requirements for measuring credit losses, focusing on the documentation the SEC staff would normally expect registrants to prepare and maintain to support estimates of current expected credit losses for loan transactions. Entities with a delayed 2023 effective date should continue to use guidance in [SAB 102]().



*Includes all other public business entities (including smaller reporting companies (SRC)), private companies, not-for-profits and employee benefit plans



Scope

SAB 119 applies to all registrants that are creditors in loan transactions that—individually or in the aggregate—have a material effect on the registrant's financial condition. This staff guidance is applicable once a registrant adopts Topic 326. At adoption, the staff guidance in SAB Topic 6, Section L: *Financial Reporting Release No. 28 - Accounting for Loan Losses by Registrants Engaged in Lending Activities*, will no longer be applicable.

Credit Loss Methodology – Development, Governance & Documentation

A registrant should have a systematic methodology to address the development, governance and documentation to determine its provision and allowance for credit losses. The methodology chosen should incorporate management's current judgments about the credit losses expected from the existing loan portfolio, including reasonable and supportable forecasts about changes in the credit quality of these portfolios, on a disciplined and consistently applied basis.

Different models may be used, but the SEC would expect to see the following common elements in any methodology:

- Identify relevant risk characteristics and pool loans based on similar risk characteristics
- Consider available information relevant to assessing the collectibility of cash flows
- Consider expected credit losses over the contractual term of all existing loans (individually or on a group basis), and measure expected credit losses on loans on a collective (pool) basis when similar risk characteristics exist
- Require that analyses, estimates, reviews and other allowance for credit losses methodology functions be performed by competent and well-trained personnel
- Be based on reliable and relevant data and an analysis of current conditions and reasonable and supportable forecasts
- Include a systematic and logical method to consolidate the loss estimates that allows for the allowance for credit losses balance to be recorded in accordance with generally accepted accounting principles (GAAP)

Management should periodically review the appropriateness of its credit allowance methodology. For registrants with audit committees, oversight of the financial reporting and auditing of the allowance for credit losses by the audit committee can strengthen the registrant's process for determining its allowance for credit losses. The SEC expects registrants to adjust their allowance for credit losses balance—either upward or downward—in each period for differences between the results of the systematic methodology and the unadjusted allowance for credit losses balance in the general ledger.

Internal Accounting Controls

Registrants can use a wide range of policies, procedures and control systems in estimating credit losses, which would be tailored to the entity's size and complexity and composition of its loan portfolio. SAB 119 includes the following items for inclusion in written policies and procedures for the systems and controls that maintain an appropriate allowance for credit losses:

- The roles and responsibilities of each department and personnel (including the lending function, credit review, financial reporting, internal audit, senior management, audit committee, board of directors, etc.) who determine or review the allowance for credit losses for financial statement reporting
- Selected methods and policies for developing the allowance for credit losses and determining significant judgments
- The description of the registrant's systematic methodology, which should be consistent with the registrant's accounting policies for determining its allowance for credit losses
- How the system of internal controls for the credit loss allowance process provides reasonable assurance that the allowance for credit losses is in accordance with GAAP

Internal accounting controls for the allowance for credit losses estimation process should:

- Include measures to provide reasonable assurance regarding the reliability and integrity of information and compliance with laws, regulations and internal policies and procedures
- Provide reasonable assurance that the registrant's financial statements are prepared in accordance with GAAP

Documentation for the Allowance for Credit Losses Methodology

A registrant should document the relationship between its detailed analysis of the portfolio's characteristics and credit quality and the credit allowance reported each period and maintain written supporting documentation for the following decisions and processes:

- Policies and procedures over the systems and controls that maintain an appropriate allowance for credit losses
- Credit loss methodology and key judgments, including the data used, assessment of risk and identification of significant assumptions in the allowance estimation process
- Summary or consolidation of the allowance for credit losses balance
- Validation of the allowance for credit losses methodology
- Periodic adjustments to the allowance for credit losses

Written Policies & Procedures

SAB 119 includes the following elements to be included in a registrant's written policies and procedures to demonstrate an effective, disciplined and consistent credit losses methodology:

- How portfolio segments are determined and the methodology used for each portfolio segment
- The approach used to pool loans based on similar risk characteristics
- Documentation of any accounting policy or practical expedient elections made
- The method(s) used to determine the contractual term of the financial assets, including consideration of prepayments and contractual term extensions
- If a loss-rate method is used, the historical data used to develop the components of the loss rate and how that rate is applied to the amortized cost basis of the financial asset as of the reporting date
- The method for estimating expected recoveries when measuring the allowance for credit losses
- The approach used to determine the appropriate historical period for estimating expected credit loss statistics
- The approach used to determine the reasonable and supportable period
- The approach used to adjust historical information for current conditions and reasonable and supportable forecasts
- How the entity plans to revert to historical credit loss information for periods beyond which the entity can make reasonable and supportable forecasts of expected credit losses
- The approach used to determine when a purchased financial asset would qualify to be accounted for as a purchased financial asset with credit deterioration

Methodology Documentation

Regardless of the method used to determine the allowance for credit losses, the SEC expects registrants to substantiate that the loss measurement methods and assumptions used to estimate the allowance for credit losses for its loan portfolio are determined in accordance with GAAP as of the financial statement date. An entity should maintain sufficient, written documentation to support its measurement of expected credit losses under Topic 326, which should reflect the method(s) used to estimate expected credit losses for each portfolio segment and that the loans in each pool have similar characteristics.

Registrants should follow a systematic and consistently applied approach to select the most appropriate expected credit loss measurement methods and support its conclusions and rationale with written documentation. A registrant also should maintain a process to evaluate whether adjustments to the methodology are necessary and, if so, maintain documentation to support adjustments to the methodology used.

The methodology used should produce an estimate that is consistent with GAAP. Before employing an expected loss method, a registrant should evaluate and modify, as needed, the method's assumptions related to the current estimate of expected credit losses. An entity should document the evaluation, the conclusions on the appropriateness of estimating expected credit losses with that method and the objective support for adjustments to the method or its results.

Loss Rates

One method of estimating expected credit losses for a pool of loans is through the application of loss rates to the pool's aggregate loan balances. If an entity uses external data for such a methodology, documentation should support the data's relevance and reliability. The external loss experience data should be for loans with similar credit attributes as the entity's loan portfolio and be consistent with the entity's assumptions on current and forecasted economic conditions.

Discounted Cash Flow (DCF)

If a registrant uses a DCF methodology, documentation should include support for the assumptions and data used to develop the amount and timing of expected cash flows and the effective interest rate used to discount expected cash flows.

Collateral's Fair Value

If the fair value of collateral is used to measure expected credit losses, documentation should include:

- The basis for its conclusion that the loan meets GAAP requirements for measurement of expected credit losses based on the collateral's fair value
- How the collateral's fair value was determined, including policies relating to the use of appraisals, valuation assumptions and calculations, the supporting rationale for adjustments to appraised values, if any, and the determination of selling costs, if applicable
- The recency and reliability of the appraisal or other valuation

Current Conditions & Reasonable & Supportable Forecast Documentation

Regardless of the method used, the underlying assumptions used by registrants to develop expected credit loss measurements should consider current conditions and reasonable and supportable forecasts. A registrant should document the factors used in developing the assumptions and how those factors affected the expected credit loss measurements and should consider the following:

- Levels of and trends in delinquencies and performance of loans
- Levels of and trends in write-offs and recoveries collected
- Trends in volume and terms of loans
- Effects of any changes in reasonable and supportable economic forecasts
- Effects of any changes in risk selection and underwriting standards, and other changes in lending policies, procedures and practices
- Experience, ability and depth of lending management and other relevant staff

- Available relevant information sources that support or contradict the registrant's own forecast
- Effects of changes in prepayment expectations or other factors affecting assessments of loan contractual terms
- Industry conditions
- Effects of changes in credit concentrations

Adjustments

Factors affecting collectibility that are not reflected in historical loss information should be evaluated to determine whether an adjustment is necessary so that the expected credit loss measurement considers those factors. For such adjustments, a registrant should maintain sufficient evidence to support the adjustment's amount and explain why the adjustment is necessary to reflect current conditions and reasonable and supportable forecasts in the expected credit loss measurements. Supporting documentation for adjustments may include relevant economic reports, economic data and information from individual borrowers.

Entities should create a summary of the amount and rationale for the adjustment factor for management review prior to the financial statement issuance. Documentation also should include the nature of the adjustments, how they were measured or determined and the underlying rationale for making the changes to the allowance for credit losses balance.

Registrants should maintain documentation to support the identified range and the rationale used for determining which estimate is the best estimate within the range of expected credit losses. This information should be made available to the registrant's independent accountants. If changes to the credit loss allowance frequently occur during management or credit committee reviews, management should analyze the reasons for the frequent changes and reassess the methodology used.

Documentation to Support the Reported Credit Loss Allowance

The SEC expects sufficient evidence to support the allowance and internal controls over the allowance. Common elements the staff normally would expect to find documented in allowance for credit losses summaries include:

- The reasonable and supportable economic forecasts used
- The estimate of the expected credit losses using the registrant's methodology or methodologies
- A summary of the current allowance for credit losses balance
- The amount, if any, by which the allowance for credit losses balance is to be adjusted
- Detailed subschedules of loss estimates that reconcile to the summary schedule

In general, a registrant's review and approval process for the allowance for credit losses relies on the information provided in these consolidated summaries. After individual or committee reviews, there may be adjustments needed to the loss estimates to provide a better estimate of expected credit losses. These adjustments should be consistent with GAAP and reviewed and approved by appropriate personnel. The summary provided to each subsequent reviewer should include support behind these adjustments. Management should document the nature of any adjustments and the underlying rationale for making the changes. This documentation should be provided to those making the final determination of the allowance for credit losses amount.

Validating a Systematic Methodology

A registrant's allowance for credit losses methodology is considered reasonable when it results in a valuation account that adjusts the net amount of its existing portfolio to cash flows expected to be collected. An entity's systematic methodology should include procedures to assess the continued relevance and reliability of methods, data and assumptions used to estimate expected cash flows. Management should establish internal control policies that are appropriate for the entity's size and the complexity of its loan products and modeling methods. These policies may include procedures for a review—by a party independent of the allowance for expected credit losses estimation process—of the allowance methodology and its application to confirm its effectiveness.

While different procedures may be used in assessing the reasonableness of the design and performance of the credit losses methodology and appropriateness of the data and assumptions used, the procedures should allow management to determine whether there may be deficiencies in its overall methodology. Examples of procedures may include:

- A review of how management's prior assumptions (including expectations regarding loan delinquencies, troubled debt restructurings, write-offs and recoveries) have compared to actual loan performance
- A review of the allowance for credit losses process by a party that is independent and possesses competencies on the subject matter. This often involves the independent party reviewing—on a test basis—source documents and underlying data and assumptions to determine whether the established methodology develops reasonable loss estimates
- A retrospective analysis of whether the models used performed in a manner consistent with the intended purpose of developing an estimate of expected credit losses
- When the fair value of collateral is used, an evaluation of the appraisal process of the underlying collateral, *i.e.*, periodically comparing the appraised value to the actual sales price on selected properties sold

Management should support its validation process with documentation of the specific validation procedures performed, including any findings of an independent reviewer. If the methodology is changed based on the findings of the validation process, documentation that describes and supports the changes would be maintained.

Conclusion

The adoption of the CECL model will be complex and likely will require significant hours to implement correctly. BKD can help educate your team, provide implementation tools and assist with analysis and documentation. If you would like assistance in complying with the CECL standard, contact your BKD trusted advisor. BKD has prepared a library of **BKD Thoughtware**® on this topic. Visit our website to learn more.

Contributor

Anne Coughlan
Director
317.383.4000
acoughlan@bkd.com