Crowe

The Top Five Auditing and Accounting Missteps and How to Avoid Them

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Agenda

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Current banking environment

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CECL and Modifications

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Internal controls over financial reporting

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Information Technology

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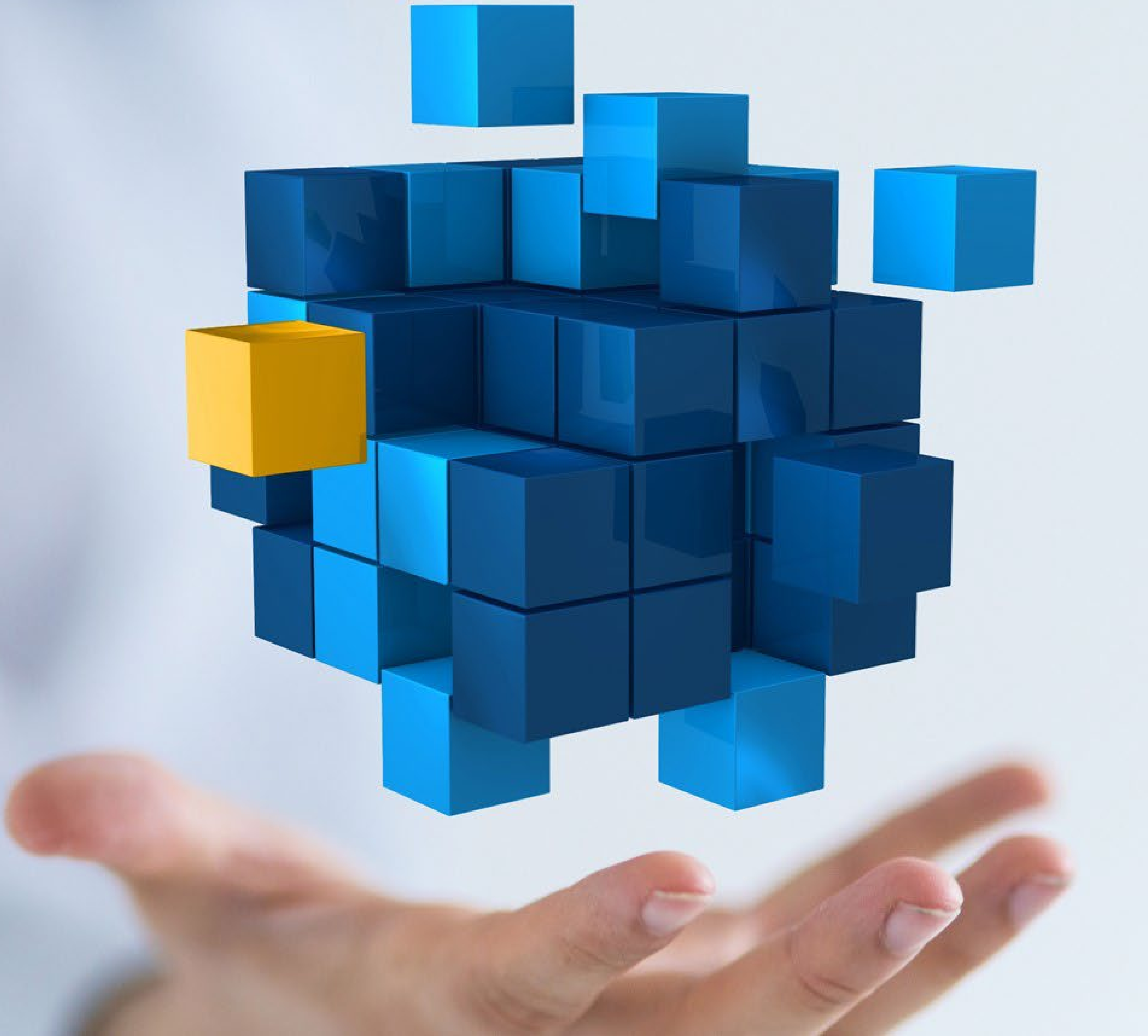
Significant transactions and events

Course objectives

- Identify the most common audit and accounting missteps seen by auditors
- Gain an understanding of why these missteps occur
- Be informed about ways to avoid these missteps
- Understand questions to ask of your management team and/or auditors

Current banking environment



Current banking environment

- Liquidity
- Concentration of members
- Uninsured deposits
- Unrealized losses on securities
- Capital ratios
- Borrowing capacity
- Deposit outflow

Common Missteps - Current Banking Environment

Impact to Credit Union Not understanding how recent bank failures impact the credit union

- Ensure management provides the Committee with proper information to evaluate any impact to the credit union. Possible changes could include change in liquidity plan, use of borrowings, additional monitoring, etc.

Ongoing monitoring Absence of reporting new or key metrics to the Committee

- Ongoing monitoring of those items deemed to be key should continue to be reported to the Committee
- Inquiring minds and questions for management

Regulatory and audit impact Expectation that it will only have an internal reporting impact

- Ask auditors (now) what they are focused on, what additional information they may require, what additional disclosures may be warranted, etc.
- Converse with regulators on expectations for next exam

Current banking environment – Questions for Management

How do you plan to inform the Committee about new developments in the current environment?

What new or expanded evaluations does management perform in light of the current environment?

(Ex: uninsured deposits, top borrowers, liquidity position, etc.)

What is management's plan for discussions with its auditors and what additional information may be required by our auditors?

Current Expected Credit Losses (CECL) and Modifications

CECL Refresher

Estimate losses over contractual term

- Currently, most credit unions base allowance on estimate of 1-year losses
- CECL moves to a life-of-loan estimate of expected losses

Starting point is collective assessment

- Impaired loan classification and related disclosures go away under CECL

Historical loss information is still starting basis and adjustments to historical losses are likely still necessary

- Historical credit loss experience provides basis for expected credit losses, though cannot rely <u>solely</u> on past event to estimate credit losses

Forecasts and reversions are new

- Must consider reasonable and supportable forecast
- For contractual terms extending beyond the time frame of the reasonable & supportable forecast, revert to historical loss experience

Troubled Debt Restructurings - A thing of the past

- ASU 2022-02 eliminates the Troubled Debt Restructurings (TDR) model
  - Requires new disclosures for modifications to borrower experiencing financial difficulties
  - Prospective adoption
  - Will be effective upon adoption of CECL

- General loan modification guidance
  - Terms of the new loan are at least as favorable to the lender as the terms for comparable loans to other members with similar collection risks
  - Modifications to the terms of the original loan are more than minor

Common Missteps - CECL and Modifications

Understanding of model — Overreliance on vendor supplied information

- Management should be able to explain to its auditors and regulators what model(s) were selected, how they work and why they were selected
- Vital to understand how different economic environments will impact the model

Qualitative factors — Factors not supported or did not change from incurred model

- Qualitative factors still play an important role but should be evaluated differently than incurred model.
- Assumption should not be same as last year (SALY)

Potential volatility — Lack of understanding or acceptance of potential volatility

- Acceptance by management and Committee of volatility depending on loan growth, environment, etc.
- Overfunded/unallocated generally removed

Common Missteps - CECL and Modifications (Continued)

Ongoing maintenance — Set it and forget it mentality

- CECL models may change more frequently than incurred models – need to plan by having processes, policies and controls in place
- Model validation as a best practice

Modification Tracking — Perception about what information needs to be tracked

- Ensure management has a process in place to be able to properly disclose in the financial statements – important to get in place now

Disclosures — Underestimation of information required for disclosure

- Ensure management has a plan in place before year-end to ensure all information can be obtained for disclosures
- Ensure process in place to evaluate completeness of disclosures

CECL and Modification – Questions for Management

- Can management explain decisions made on modeling and qualitative factors and do we have appropriate processes and controls in place?
- Does management have a plan for ongoing monitoring and/or model validation?
- Do we have plans/systems in place to track modifications and required disclosure items?

Internal controls over financial reporting

Internal controls over financial reporting

- Identification process
- Controls in key areas
  - Loans
  - Shares
  - Wires
  - Journal entries
- Financial reporting

Common Missteps - Internal Controls over Financial Reporting

Segregation of duties — Lack of segregation of duties due to resources and/or roles

- No one individual should be able to get money out of the credit union. Proper segregation of duties reduces risk.

Documented review — Review occurs, but is not documented – no audit evidence

- Trust, but verify
- Enforce proper documented review, which can reduce audit testing

Sampling risk — Samples are not representative of the population

- Evaluate sufficiency of coverage, not just in total, but by type

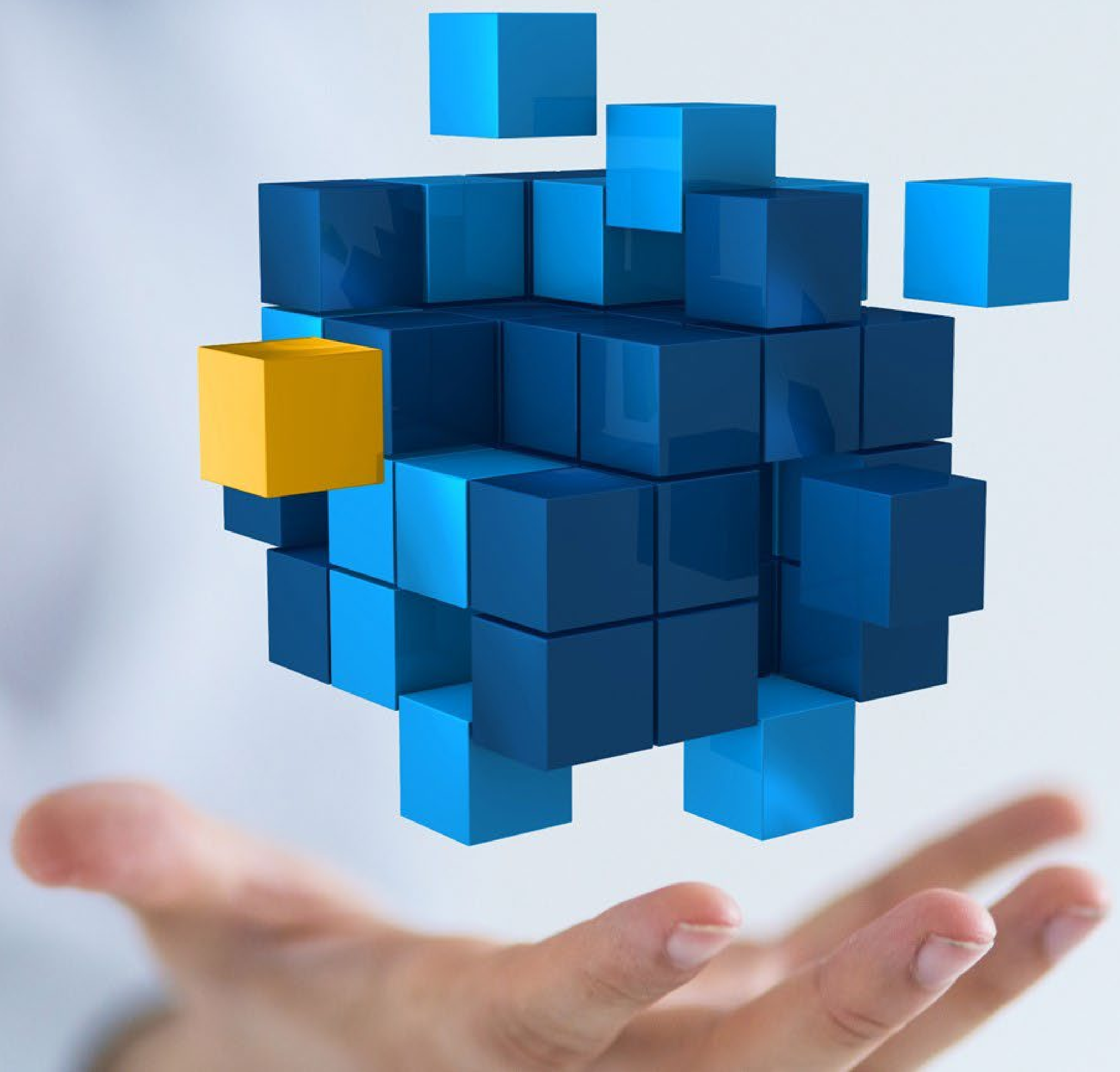
Finding follow-up — Findings are identified, but follow-up to resolution doesn't occur

- Track findings and ensure resolution is documented and presented

Internal Controls – Questions for Management

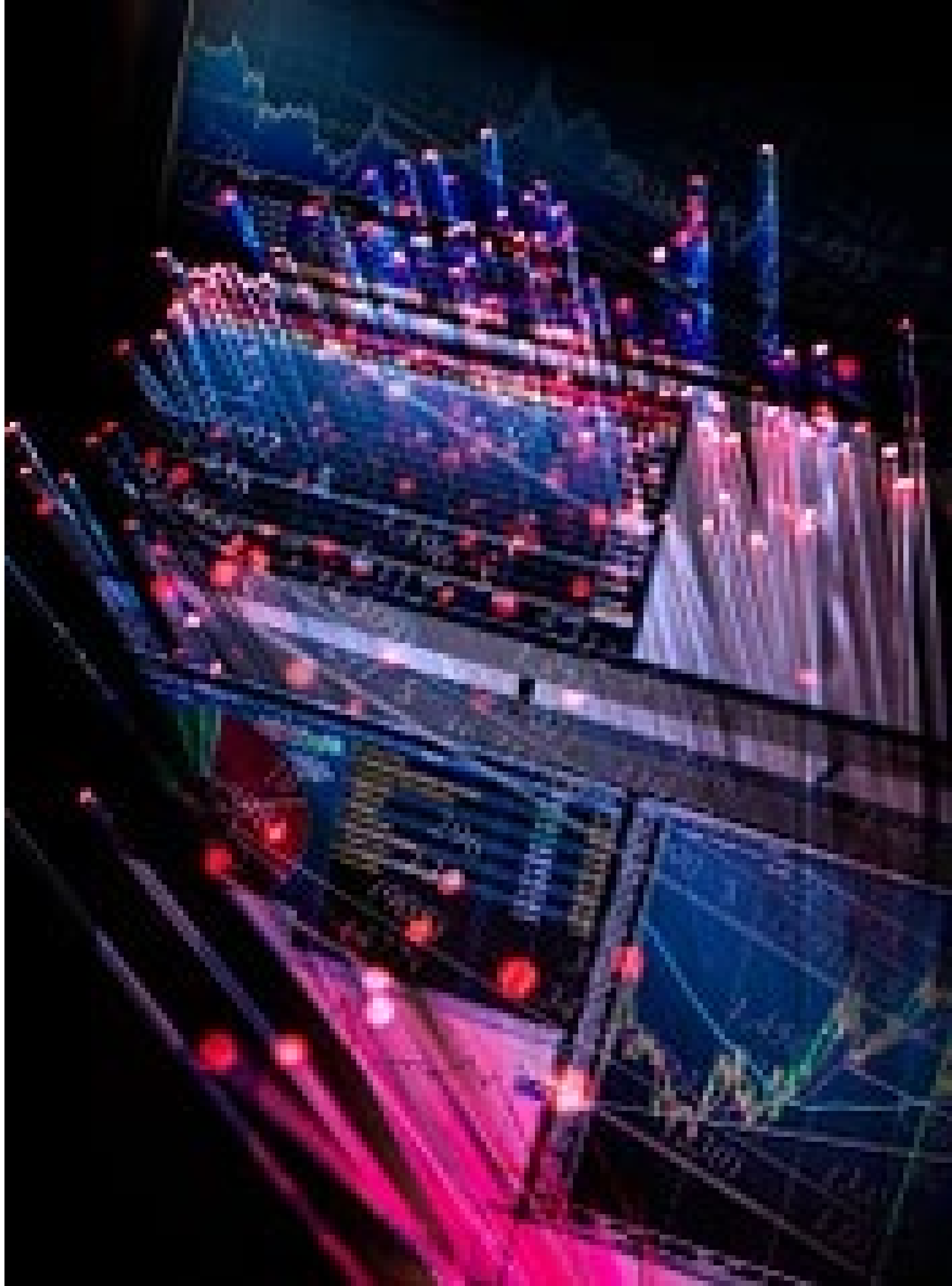
- How do we identify key controls and how are they documented?
- Does management report on key controls to the Committee? Is frequency sufficient?
- What is our process for following up on findings and seeing them to resolution?

Information technology



Key Systems & Controls

- Determination of key systems
- In-house vs. outsourced systems
- Permissions and admin access
- Key controls
  - User Access
  - Provisioning
  - Termination



System and Organization Controls (SOC) Reports

- SOC 1 vs. SOC 2
- Exceptions
- Complementary User Entity Controls (CUECs)
- Bridge/Gap Letter
- Reliance

Common Missteps - Information Technology

Segregation of duties (SOD)

SOD not considered, especially among different systems

- Ensure user roles reviews are performed with a set frequency and performed by individual without access or business owner

Overreliance on systems

Lack of obtaining and/or reviewing SOC report

- Ensure management has a process in place to review SOC reports including exceptions identified, CUECs, gap letter and ultimately reliance on system

Level of importance

Importance of IT systems often overlooked

- Ensure ownership of this area by someone with appropriate knowledge

Information Technology – Questions for Management

- How do we identify key controls and segregation of duties in and among systems?
- Do we obtain SOC reports for all financially significant systems?
- Who is responsible for review and documentation over SOC reports (may be more than one person)?

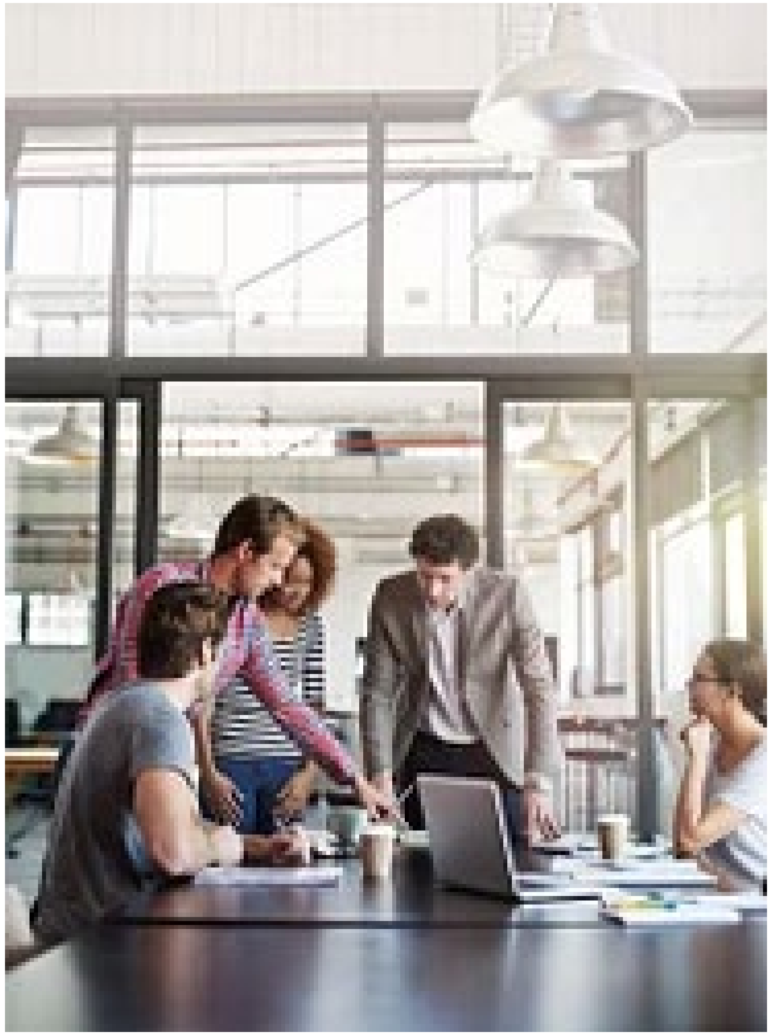
Significant transactions, events or products

Significant transactions, events, or products

- New significant transactions, events or products
  - Examples:
    - Merger or acquisition
    - System conversion
    - New significant asset or liability
    - Regulatory action
    - New significant source of income or expense
      - New product or other source

- Understand accounting implications
  - Often unintended accounting impact

- Auditors have industry knowledge



Credit Union Owned Life Insurance

Recent discussion about a "Guaranteed Investment Protection Rider" that protects against the risk of loss between loan amount and cash surrender value

- Used when loan to employee is non-recourse
- "New" product insures loss exposure, is a long-term term policy owned by the credit union (issued by different insurance company).
  - Q: Should the Credit Union write the loan down to CSV or continue to carry loan at full amount?
  - A: The loan amount should be recorded at the lower of the loan amount or the CSV regardless of the existence of the new policy (from technical inquiry with FASB staff)
- No authoritative guidance to indicate contracts involving different counter parties may be combined into a single unit of account

Emergency Capital Investment Program (ECIP)

- Established by the Consolidated Appropriations Act, US Treasury will make direct investments in CDFIs and MDIs

	C-Corporations	S-Corporations & Mutuals	Credit Unions
Form	Senior preferred stock	Senior subordinated debt	Senior subordinated debt
Regulatory Capital Treatment	Tier 1	Tier 2	Secondary capital (for low-income credit unions only)
Dividends (interest) payable	None for first 24 months; quarterly thereafter	None for first 24 months; quarterly thereafter	None for first 24 months; quarterly thereafter
Dividend (interest) rate	Based on increase in Qualified Lending over Baseline	Based on increase in Qualified Lending over Baseline	Based on increase in Qualified Lending over Baseline
Reporting required	Initial Supplementary Report Quarterly Supplementary Reports	Initial Supplementary Report Quarterly Supplementary Reports	Initial Supplementary Report Quarterly Supplementary Reports

https://home.treasury.gov/policy-issues/coronavirus/assistance-for-small-businesses/emergency-capital-investment-program

Common Missteps - Significant transaction, events or products

Accounting impact

Lack of proper due diligence

- Thorough understanding of significant transaction, event or product
- Deeper discussions with vendors, if applicable

Accounting impact

Do not involve auditors early in process

- Reach out to auditors early and often; benefit from industry knowledge

Subsequent events

Timing and importance not considered in evaluation

- If events occur at beginning of year, evaluate impact on previous year, if any

Significant Transactions, Events or Products– Questions for Management

Do we have any new significant transactions, events or products planned for 2023?

If yes, does management have a thorough understanding of potential accounting impacts?

If yes, have we discussed possible accounting impacts with our auditors?

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Thank You

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