Allowance for Credit Losses
Audit Considerations

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Richards & Associates, CPAs

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Session Description

Supervisory/Audit committees play a crucial financial reporting oversight role in ensuring that the Allowance for Credit Losses represents management's best estimate of credit losses and that information about methods and assumptions that drive the estimate are clearly disclosed in the financial statements.

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Learning Objectives

- Clarify the Supervisory/Audit Committees Role in the Transition to CECL
- Understanding Questions Supervisory/Audit Committees Should Discuss with Management
- Prepare for Communications with External Auditors

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What is CECL

Current Expected Credit Losses (CECL) is a credit loss accounting standard model that was issued by the Financial Accounting Standards Board (FASB) on June 16, 2016. CECL replaces the current Allowance for Loan Loss and Lease Losses ALLL accounting standard. The CECL standard focuses on estimation of expected losses over the life of the loans, while the current standard relies on incurred losses.

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Why CECL

- The financial crisis of 2007-2008 (Great Recession) demonstrated that the then Allowance for Loan and Lease Losses (ALLL) accounting standard/framework did not allow for timely adjustment of reserve levels based on reasonable expectation of future conditions.
- During the crisis, negative outlook of the economy was not explicitly taken into account for ALLL calculations. As a result, reserves were not adjusted for future expected losses.
- The FASB reviewed the standard and replaced it with CECL. CECL requires expected losses to be estimated over the remaining life of the loans, as opposed to incurred losses of the then-current standard.

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What's the Advantage of CECL

- FASB stated that the new standard would improve "financial reporting by requiring timelier recording of credit losses on loans and other financial instruments held by financial institutions and other organizations."
- The Office of the Comptroller of the Currency (OCC) and Federal Reserve predicted that industry allowances would go up by 30% to 50%.

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The Audit Committee’s Role in Oversight

- Audit committees play a crucial financial reporting oversight role in ensuring that the ACL represents management’s best estimate of credit losses and that information about methods and assumptions that drive the estimate are clearly disclosed in the financial statements.
- Audit committees fulfilling their governance responsibilities is a foundational element of implementing FASB ASC 326 appropriately.

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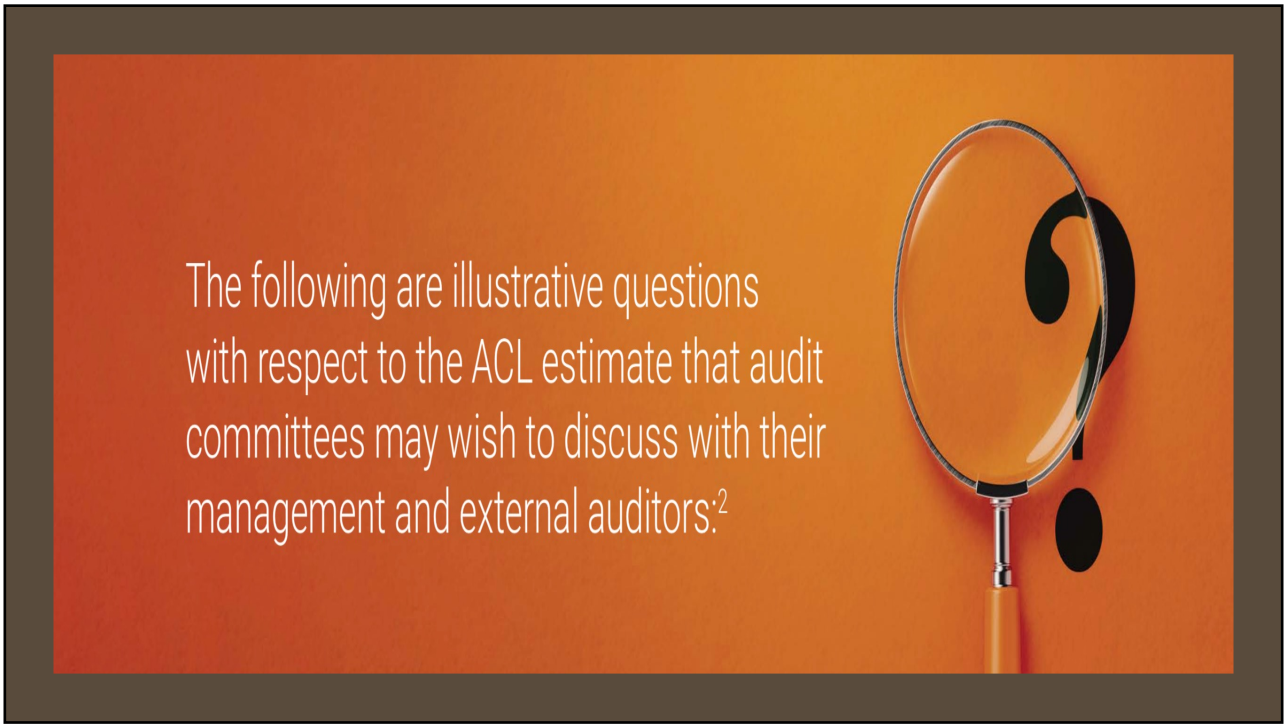

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The Implementation Plan

- How will the audit committee be apprised of status?
- How is management updating the audit committee on the progress of outside constituents who are supporting management in implementation (e.g., internal auditors, IT vendors and outside consultants)?
- Does management need to engage third parties? What are the views of third-party vendors (consultants, etc.) that have been engaged by management regarding the implementation plan, if applicable?

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The Implementation Plan

- What information needs to be collected to implement the new standard, and what is the anticipated level of effort to collect the information?
- Is the Credit Union's CECL parallel run (including methods, models, assumptions, processes, and controls as if the standard was effective) on schedule?
- Are regulatory changes and updates to the standard being monitored?

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Culture and Resources

- Does a strong tone at the top support the effort required to implement the new standard? Is implementation receiving the appropriate resources (in-house and third-party) and priority?
- If third-party resources are being used for implementation, have sufficient internal resources been engaged in the process to take ownership of the implementation of the new standard, as well as the accounting post implementation?
- Does the implementation team have adequate levels of experience and knowledge to understand the new standard's impact? Will significant judgments about implementation be made and approved centrally throughout the Credit Union?

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Systems & Data

- Have data shortfalls (e.g., vintage information, prepayment history) been identified? If so, what is being done to resolve these shortfalls (e.g., outside data resources)?
- Are existing systems adequate to account for credit losses under the new standard?
- Are new systems or improvements to existing systems needed? What is the status of the system implementation, if applicable?
- How is data controlled, stored, and extracted?

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Systems & Data

- Does the Credit Union plan to use in its model any external or internal data not previously subject to internal controls?
- If so, how has management assessed the relevance and reliability of the data?

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Controls

- How is management's assessment of internal control over financial reporting affected?
- Is management appropriately designing and testing the internal controls related to the standard's adoption? How will internal controls related to disclosure of the adoption impact be documented and tested?
- How will changes to controls related to the adoption of the new standard be evaluated to determine whether disclosure is needed?

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Controls

- If manual processes are necessary, what controls are in place to evaluate completeness and accuracy of accounting, including any data inputs?
- Who is responsible for changing, updating, and reviewing processes, controls, and related documentation impacted by the new standard?
- Do existing control deficiencies, including significant deficiencies or material weaknesses, impact control considerations in implementing the new standard?

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Accounting Policy and Significant Accounting Judgments

- Who is responsible for new accounting policy decisions and how does the Credit Union plan to revise written accounting policies?
- How is the Credit Union keeping current on developments from the FASB and SEC? What other resources, such as the AICPA Depository Institutions Expert Panel, and the FASB’s Transition Resource Group, has the Credit Union considered?
- Who has reviewed significant assumptions and judgments? Have significant judgments been documented and communicated to the audit committee? Has management considered alternative assumptions or outcomes? If so, why did management reject them?

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Accounting Policy and Significant Accounting Judgments

- Have accounts been evaluated for appropriate presentation based on the new standard?
- How will the training be rolled out to appropriate personnel?
- How has the internal auditor been involved in the implementation process?

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Modeling and Assumptions

- Has management created robust processes to develop the expected credit loss model and model validation controls to verify the model is performing as expected?
- Has management's risk assessment appropriately considered how assets are pooled and unique risks associated with the asset pools?
- Has management documented the determination of key assumptions and the rationale for including those assumptions in the model? Does the documentation include the source of the data and the controls relevant to its completeness and accuracy?

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Modeling and Assumptions

- Have specialists (internal and external) been identified to assist with the development of the estimate? What controls are there around the data that was provided to the expert and the output given by the expert?
- Have model governance processes and controls been put in place to determine the model is and will remain fit for purpose? Is management sharing the results of these reviews with the audit committee? Has a governance committee been considered?

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Questions for the External Auditors

- How does the Credit Union's external auditor view the impact assessment?
- How has the external auditor been involved and what are the auditor's views on the impact of adopting the standard, changes to critical accounting policies and practices, and the Credit Union's overall readiness?
- What is the external auditor's view as it relates to the implementation plan? Will it satisfy the auditor's plan and timeline to complete the audit in a timely manner?

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Questions for the External Auditors

- Has the external auditor assessed the design and implementation of controls, considering the following:
    - a. Data integrity?
    - b. Reasonableness of assumptions?
    - c. Reasonableness of modeling methodology?
- Has the external auditor reviewed significant judgments (e.g., assumptions used, modeling methodology)? What are the external auditor's perspectives?

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About the Presenter
Michael E. Richards, CPA

Mike Richards has held the position of CEO of Richards & Associates, CPAs since 1978. He joined the firm in 1973 after earning a bachelor's degree in Business Administration from the California State University at Los Angeles and becoming a Certified Public Accountant. In addition to introducing many new services, he is responsible for quality control of all professional services offered by the firm.

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