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ASSURANCE

Internal Audit Considerations for CECL

Financial Institutions

September 2022

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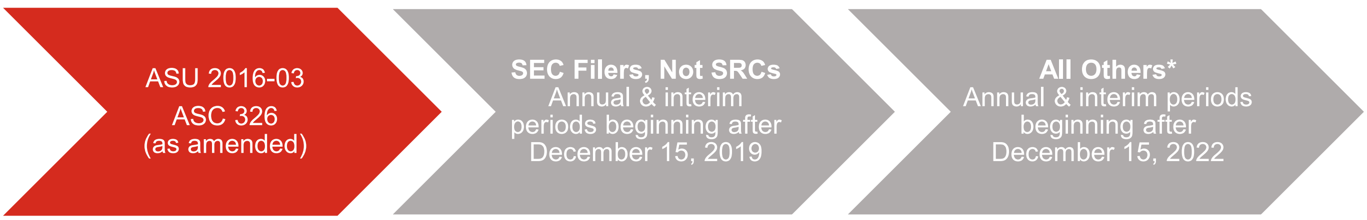
Introduction

Six years have passed since the issuance of Accounting Standards Update (ASU) 2016-13, *Financial Instruments—Credit Losses (Topic 326), Measurement of Credit Losses on Financial Instruments*, commonly referred to as CECL. This standard updates the guidance on recognition and measurement of credit losses for financial assets. Large SEC registrants finalized changes during a global pandemic and the implementation deadline has now arrived for all other entities. This article highlights potential risks in estimated credit losses under the new guidance and some related controls that could be implemented to reduce those risks.

For a comprehensive review of the upcoming changes, see "An Updated Look at CECL – August 2022."



*Includes all other public business entities (including smaller reporting companies (SRC)), private companies, nonprofits, and employee benefit plans

ASC 326 Overview

This guidance is principles-based, which provides greater flexibility in implementation but will require significantly more management judgment and documentation to support conclusions reached and how the updated methodology complies with the new guidance. As with most recent standards, there are substantial new qualitative and quantitative disclosures.

FASB has broadened the information an entity is required to consider in developing its credit loss estimate. Under current GAAP, an entity usually considers past events and current conditions in measuring credit losses. CECL requires the loss estimate to include relevant information about past events, current conditions, and reasonable and supportable forecasts.

At acquisition and 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. 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.

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Audit Implications

Each institution's CECL implementation is unique and will depend on the complexity of the institution's organizational structure, the loan portfolio composition, staff's experience level, and financial reporting requirements.

Internal audit plays a crucial role in the ongoing maintenance and assessment of a bank's internal control, risk management, and governance of 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:

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

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.

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Historical Data

The model requires the expected credit losses estimate to 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. 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 is 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.

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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.

> *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.

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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.*, collateral appraisals underlying loan-to-value ratios.

Commitments

Under current GAAP, the recognition of liabilities for commitment agreements is based on a probable and estimable criterion. 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.

Controls to Consider

The example risks and control activities described below may not be applicable or appropriate for every institution and are not intended to be comprehensive. The following are general examples of risks (what could go wrong) that may arise when estimating credit losses and example control activities that may be employed to reduce those risks.

Implementing CECL will involve significant judgment and development of an accounting estimate based, in part, on forecasting future events. Identifying and documenting control activities for this type of accounting estimate are inherently challenging. Starting with a formal risk assessment by creating a risk inventory of what could go wrong when estimating losses under the incurred loss model is a good place to begin the process of identifying and designing control activities related to CECL implementation.

Shared Risks – Incurred Loss & CECL Models

The example risks below are generally similar under the current standard and the CECL standard. It is possible control activities already in place to mitigate the risks under the incurred loss model may be modified to address the similar risks under CECL. Bank examiners will require institutions to re-evaluate all associated risks and control activities, including those that are generally similar under both models.

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Shared Risks – Incurred Loss & CECL Models	
What Could Go Wrong	**Example Control Activity**
Inappropriate loan classification at inception	Monitoring controls over the accuracy of new loan entry
Inappropriate loan classification at modification	Monitoring controls over the accuracy of modification entry
Inaccurate loan interest accrual status	Monitoring controls over accrual status changes
Inappropriate collateral valuation at inception or during updates	Preventive and review controls over collateral appraisals
Credit quality indicators selected for use in modeling are not highly correlated to loss experience	Management should evaluate whether control activities around selecting credit quality indicators in place for the incurred loss model need to be re-evaluated due to changes in processes related to adoption of CECL models
Historical loss period selection is not relevant or appropriate for use in modeling	Management should evaluate whether control activities in place for the incurred loss model require updates based on models selected and implemented for CECL models
Charge offs are not recorded timely and may create inaccuracies in historical loss rates	Monitoring controls over the accuracy and timeliness of recording charge-off entries
Troubled debt restructuring (TDR) status is not accurate	Preventive and monitoring controls over TDR status changes

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Shared Risks – Incurred Loss & CECL Models	
What Could Go Wrong	**Example Control Activity**
Identification of loans with individual risk characteristics requiring individual analysis may not be accurate or complete and may result in incorrect calculations of reserves	Monitoring controls over the identification of events or conditions that would require loans to be evaluated individually and not collectively NOTE: CECL introduces new criteria for individual loan evaluation
Collateral valuation techniques used to estimate losses on loans with unique risk characteristics, which require individual analysis, may be inaccurate or inappropriate to estimate losses and result in incorrect calculations of reserves	Preventive and review controls over collateral appraisals and other valuation techniques to estimate losses for loans analyzed individually
Data elements housed in system interfaces are inaccurate or incomplete. Examples of a few data elements to consider include: charge-off and recovery amounts and ability to allocate amounts to appropriate loans or loan segments, loan origination balances, loan maturity dates, and as-of date loan balances by period of origination	Preventive and periodic monitoring controls including reconciliations and data validation
Data extraction from core system for use in modeling is inaccurate or incomplete	Preventive and monitoring controls including reconciliations and data validation of extraction
Data importation into the model is inaccurate or incomplete	Preventive and monitoring controls including reconciliations and data validation of importation
Unauthorized or undetected changes are made to data, files, or models	Preventive and periodic monitoring controls including reconciliations and data validation
Inappropriate models or spreadsheet calculations are used	Preventive and monitoring control activities including formula testing and recalculations

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Shared Risks – Incurred Loss & CECL Models	
What Could Go Wrong	**Example Control Activity**
Data requested by the corporate credit team from the line of business is inaccurate or incomplete	Monitoring control activity to periodically evaluate the appropriateness of assumptions and data validation
Data used in developing qualitative factors are unreliable, inappropriate, or insufficient, which could result in the calculation being improperly determined	Monitoring control activity to periodically evaluate the appropriateness of assumptions
Qualitative adjustments are inconsistent with changes in the loan portfolio and economic conditions, which could improperly impact the calculation	Monitoring control activity to periodically evaluate the appropriateness of assumptions
The level of activity disclosed during the period is insufficient or not meaningful to understand the activity in the allowance for credit losses for the period	Monitoring control activity to compare disclosures to applicable requirements and to assess the understandability of disclosures for financial statement users
The level of detail disclosed is insufficient or not meaningful to understand the extent of past-due loans or the credit risk and interest income recognized on financial assets on nonaccrual status	Monitoring control activity to compare disclosures to applicable requirements and to assess the understandability of disclosures for financial statement users

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Shared Risks – Incurred Loss & CECL Models	
What Could Go Wrong	**Example Control Activity**
Financial statement users cannot understand the circumstances that caused changes to the allowance for credit losses and provision reported for the period	Monitoring control activity to compare disclosures to applicable requirements and to assess the understandability of disclosures for financial statement users
Financial statement users cannot understand the method and information used for developing management's estimate of expected credit losses by portfolio segment	Monitoring control activity to compare disclosures to applicable requirements and to assess the understandability of disclosures for financial statement users

Risks Unique to Multiple CECL Models

In addition to performing a risk assessment, creating a risk inventory, and designing and documenting the related control activities during the preliminary implementation phases, institutions also will need to identify, design, and document internal controls to address new risks posed by the new processes and estimation activities resulting from the CECL adoption. Risks related to new data sources and uses, new assumptions used in modeling, new forecasting activities, and new required disclosures will require an evaluation of gaps in existing control activities and a systematic process to design internal control activities used to mitigate the novel risks. Examples of control activities to be considered in this phase of adoption may include the following:

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Risks Unique to Multiple CECL Models	
What Could Go Wrong	**Example Control Activity**
Inappropriate periods are used to develop the CECL calculation determining lifetime loss experience, resulting in errors in estimates	Monitoring control activity to periodically evaluate the appropriateness of assumptions
If the credit quality indicators, loan grading criteria, or terms of the historical loans differ significantly from the current segment being evaluated, the lookback analysis could be improperly applied to the current segment, which could result in errors in estimates	Completion of a data gap analysis to evaluate whether data gathering and storage requirements support data necessary to evaluate historical lookback analysis on a loan-level basis when pool segmentation has changed with CECL adoption
Inappropriate assumptions used to estimate overall life of loans and prepayment rates across diverse loan pools	Monitoring control activity performed periodically to evaluate the accuracy of assumptions
If peer data is used in assumptions, the determination of which companies represent peers is not reasonable or proper, and the use of the improper peer data may adversely impact the results of the analysis	Monitoring control activity to periodically evaluate the appropriateness of assumptions

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Risks Unique to Multiple CECL Models	
What Could Go Wrong	**Example Control Activity**
Economic variable assumptions are not appropriate for use in the forecasting estimates	Monitoring control activity to periodically evaluate the appropriateness of assumptions
Economic variable assumptions obtained from an external source are inaccurate	Monitoring control activity to periodically evaluate the accuracy of model source data
Inappropriate periods are used to develop the expected credit loss calculation, *e.g.*, reasonable and supportable forecast period, reversion to historical loss information period, and post-reversion period	Monitoring control activity to periodically evaluate and challenge the appropriateness of the period selected for use in the model and the level and quality of documentation supporting the rationale used for selections
Inappropriate or missing management adjustments for changes in trends, conditions, or other relevant factors	Monitoring control activity to evaluate the appropriateness of assumptions used in the model and forecasting
Adjustment factors to account for differences in the lookback period, *e.g.*, real estate market or unemployment rate changes, when compared with current conditions could be improperly determined	Monitoring control activity to evaluate the appropriateness of assumptions used in the model
Models do not reflect the best estimate of expected credit losses considering available internal and external data not captured by the model	Monitoring control activity to evaluate the results of the model calculations for reasonableness, directional consistency, and inclusion of relevant data
Identification of loans with individual risk characteristics requiring individual analysis under the new definition may not be accurate or complete and may result in incorrect calculations of reserves	Monitoring controls over the identification of events or conditions that meet the new CECL definitions; requiring loans to be evaluated individually and not collectively

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Risks Unique to Multiple CECL Models	
What Could Go Wrong	**Example Control Activity**
Loans that do not have individual risk characteristics requiring individual analysis are inappropriately excluded from loan segments	Monitoring controls over the identification of events or conditions that meet the new CECL definitions requiring loans to be evaluated individually and not collectively
Historical recoveries may not be properly identified and associated with the proper loan and period. This could result in the calculation being improperly determined	Monitoring control activity to evaluate the accuracy and appropriateness of assumptions used in the model
Estimates used to account for unfunded commitments under the new standard may not include an assessment of the likelihood funding will occur	Monitoring control activity to evaluate the accuracy and appropriateness of assumptions used to estimate losses on unfunded commitments

Risks Unique to Specific CECL Models

The new guidance does not mandate any specific estimation process. Financial institutions should use judgment to develop estimation techniques that are consistently applied over time. Selecting an appropriate model or even multiple models for different portfolios will be a critical management decision. Considerations include:

- The entity’s size and complexity
- Models/methods currently used
- Auditor, regulator, and stakeholder expectations
- Data limitations
- Future growth plans
- Portfolio composition

While many of the risks listed above are applicable to the mostly used common models, the example risks listed below are more tailored for specific methodologies.

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Risks Unique to Specific CECL Models	
What Could Go Wrong	**Example Control Activity**
Weighted-Average Remaining Maturity (WARM)	
If pay-down activity estimates used to project the amortized cost of loan segments improperly include charge-off activity, the calculation could result in errors in CECL estimates	Completion of a data gap analysis to evaluate data gathering and storage requirements to support the models selected and monitoring control activity to periodically evaluate the accuracy of source data used in the model
If pay-down activity estimates used to project the amortized cost of loan segments are improper or inaccurate, the calculation could result in errors in CECL estimates	Monitoring control activity to evaluate the appropriateness of assumptions used in the model
If the underwriting process is not executed correctly, *e.g.*, liens are not perfected or collateral appraisals are not performed, then the institution may not have adequate claim to underlying collateral. If the institution does not have adequate claim to collateral, then the calculation could result in errors in CECL estimates	Preventive and review controls over collateral appraisals and lien perfection activities

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Risks Unique to Specific CECL Models	
What Could Go Wrong	**Example Control Activity**
Discounted Cash Flow	
If the analysis includes an improper discount factor, the calculation could result in errors in CECL estimates	Monitoring control activity to evaluate the appropriateness of assumptions used in the model
If the analysis does not consider available information relevant to collectability of identified cash flows, the calculation could result in errors in CECL estimates	Monitoring control activity to evaluate the appropriateness of assumptions used in the model

Risks Unique to Specific CECL Models	
What Could Go Wrong	**Example Control Activity**
Probability of Default – Loss Given Default	
If the definition used to identify a "default event" does not follow the definition prescribed in the new standard, the calculation could result in errors in CECL estimates	Monitoring control activity to periodically evaluate the appropriateness of calculations in adherence with definitions introduced in the new standard
If recoveries are not properly excluded from defaults in the quantitative analysis (versus addressing this in the qualitative analysis), the calculation could result in errors in CECL estimates	Detective control activity that defines activities necessary to analyze the data available for use in modeling

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Risks Unique to Specific CECL Models	
What Could Go Wrong	**Example Control Activity**
Probability of Default – Loss Given Default	
If confirmed losses are not charged off timely and not properly reflected in loss rates, the calculation could result in errors in CECL estimates	Monitoring control activities over the identification of events requiring a charge off to be recorded, and the related approval activities and policies/procedures requiring the timely recognition of approved charge offs
If the underwriting process is not executed correctly, *e.g.*, liens are not perfected or collateral appraisals are not performed, then the institution may not have adequate claim to underlying collateral. If the institution does not have adequate claim to collateral, then the calculation could result in errors in CECL estimates	Preventive and review controls over collateral appraisals and lien perfection activities

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 can help ensure a smooth transition. Beginning the process of identifying and documenting internal controls necessary to mitigate the risks associated with adopting the new standard will require the focus and attention of your institution's managers and board. Embedding the identification and documentation of internal controls into your institution's CECL approach from the earliest stages of implementation will allow for a more comprehensive risk mitigation and control environment than starting this process after implementing the operational and accounting changes necessary to adopt the new standard.

The adoption of the CECL model will be complex and likely will require significant hours to implement correctly. **FORVIS** can help educate your team, provide implementation tools, and assist with analysis and documentation. If you would like assistance complying with the CECL standard, contact a professional at FORVIS.

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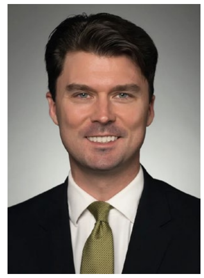

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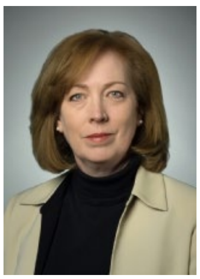

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