AICPA

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AICPA CECL Task Force Auditing Subgroup

April 29, 2019 - Meeting Takeaways

Overarching Themes

- Methodologies and models should be well documented and supported. Appropriate governance processes and controls are critical. Management must have an appropriate model selection/validation process and cannot solely rely on vendors (and any validation/SOC reports they may have).
- Transparency into 3rd party models is important for both the entity's internal controls and for external audit purposes.
    - Expectations are the same for In-house developed models and vendor models. Vendors need to provide sufficient documentation to enable Management to demonstrate appropriate understanding and controls to External parties (e.g., regulators and auditors)
- Qualitative adjustments should be (1) designed to compensate for limitations of the model, (2) supportable and quantifiable, (3) applied consistently over time, and (4) adequately documented.
- Although CECL models may make greater use of quantitative data than incurred-loss ALLL models today, qualitative judgments and adjustments are foundational to arriving at a reasonable estimate of expected credit losses.
- Controls around data (including 3rd party provided) should address the (1) reliability (completeness and accuracy), (2) relevancy, and (3) consistency of the data.
- Vendor feedback is that some entities are not as prepared as hoped and behind on transition. There is a concern that in some cases, management may be over relying on the vendors and not taking an appropriate level of ownership of their models and related ECL estimates.
- CECL is a "fresh start" from the incurred loss model.
    - CECL model estimates will be evaluated against ASC 326, not anchored to incurred loss model estimates.
    - Management may find it useful in the context of validating their CECL model to understand what drove changes from ALLL levels today to ACL estimates under ASC 326. However, management should be aware of potential anchoring, confirmation, availability bias that might occur when implementing the new standard.
    - While categories of qualitative factors may be similar, model limitations requiring adjustments will likely have little if any other connectivity given the different measurement objectives of incurred vs. expected loss.

Role of Management

- Management may outsource model development activities, but not overall responsibility for the appropriateness of the model
    - That is, the expectations of an auditor are the same, regardless of how the model is developed. Management should still have a full understanding of their models and should both document and be able to explain the inputs and assumptions in their models and methodology.
    - Vendors will likely play an important role in support (including training management in both the standard and the workings of the model), but management cannot rely solely on the vendor. Management should own the model and have a clear understanding of how the model works and the data utilized in their model.

Internal Controls over Financial Reporting

- SOC 1 reports done at the vendor level will be helpful
    - For vendor selection and internal control over financial reporting (ICFR) evaluation by management
    - For auditors in their testing of management's ICFR and in the auditor's risk assessment
- Management should have controls over full model development/validation process – even if they use a vendor-supplied model
    - Initial model development
        - vendor model selection process
        - how they know that the vendor used sound model development practices
    - Ongoing monitoring of model performance (tolerances, etc.) – if vendor has tolerances, management must understand them and determine if they are appropriate for their purposes.

Model Evaluation (Both Development and Ongoing)

- Management should have a robust model validation program regardless of whether a CECL model is internally developed or provided by a vendor
    - 3rd party model validation of vendor-supplied model may be helpful, but will likely not be sufficient in and of itself – models are often adapted to their circumstances
    - Management will need to evaluate whether the model selected is appropriate for the specific portfolio for which it is being implemented
        - Transparency into vendor models is of paramount importance
        - Vendor models may have structural differences in the data characteristics and segmentation as compared to what may be relevant for the bank that is using the vendor model. Management needs to be aware of these differences and consider whether they constitute a material difference or not for the purpose of the CECL loss reserve estimate. Any adjustments that may be required must be appropriately controlled and supported.

      If limitations exist regarding the entity's access to the model and/or the data used by the model, consideration should be given to if those limitations prevent the entity from designing and implementing appropriate internal controls over the model. These limitations may also preclude the external auditor from obtaining sufficient, appropriate audit evidence, which may result in a scope limitation on the financial statement audit.

Model Evaluation (Both Development and Ongoing), continued

- Qualitative Adjustment Factors
  - Conceptually, qualitative adjustments are intended to compensate for known limitations of the model. A less sophisticated model will likely require more qualitative adjustments and those adjustments may be greater in magnitude. Conversely, a more sophisticated model will likely require fewer qualitative adjustments and those adjustments may be less in magnitude.
  - Due to fundamental changes in the model, nature and magnitude of the qualitative adjustments in the CECL model should be independently generated and not anchored to, or grounded in, the qualitative adjustments used in the current incurred loss model .
  - Management must be able to support not only that the change in qualitative factors quarter-over-quarter is directionally consistent, but also the amount of the adjustment itself
    - Management should not pre-determine the magnitude of the adjustment and then produce documentation to support it – the amount should be determined by a rigorous, repeatable, well documented process with appropriate internal controls around that process.
  - Qualitative factors should have an established framework where management challenges their own assumptions in whole and period over period to ensure they are reasonable and supportable under the CECL model.
  - Adjustments to historical information and forecasts could be negative, positive, or no change. Regardless, it's important for management to understand, document, and support their rationale in all three scenarios.

- Retrospective Reviews (aka "back-testing")
  - Discussions around when retrospective reviews are useful how it should be performed
  - Comparing actual results to previously forecasted or estimated items may be helpful in refining the methodology and inputs utilized in future forecasts.
  - Due to the complexity of the loss estimation process and multitude of variables, an outcome that is different than previously estimated does not necessarily mean that the previous estimate was incorrect or that there were errors in the estimation process.

Forecasting/Reversion

- Forecasting
  - Reasonable and supportable forecasts should be objectively supported, analyzed and appropriately updated in a timely manner.
    - Adjustments should be determined through a concrete sequential thought process (rather than calculated and backed into).
    - Transition from reasonable and supportable forecasts to reversion techniques should be specific to the circumstances (i.e. reversion period and method may change, depending on economic conditions).
  - Should represent management's view
  - Should be developed by parties with relevant expertise
  - Should have internal controls in place over the selection of forecasted data and source

Forecasting/Reversion, continued

- Forecasted economic data utilized should be relevant to the portfolio (i.e. data specific to lending market may be more relevant than general, country-wide data). Multiple scenarios
  - No requirement to consider multiple scenarios but may be helpful
  - Need robust support for the weighting used, which may be challenging.

- Reversion
  - Not an accounting policy election, but rather is a component of the overall estimate

Data

- Data used in models should be subject to controls that are designed to ensure completeness, accuracy and relevance to the portfolio (i.e., similar economic conditions, loan structure and underwriting. Data will also need to be available to external auditors for substantive testing
- Data should be evaluated for consistency – is the data consistent period over period (i.e., definition of default)
- Data aggregated by vendors may not have previously been subject to traceable internal controls. Vendors, Management, Auditors and other interested parties must consider how to address such industry limitations prior to standard implementation.

If management is not able to validate the data (relevance, reliability and consistency), that data may be difficult to use in the financial reporting process.

Other:

- Discussion over Subsequent Events speech by Kevin Vaughn: https://www.sec.gov/news/speech/speech-vaughn-121018