



AICPA CECL Task Force Auditing Subgroup

April 29, 2019 and June 27, 2019- Vendor Meeting Takeaways

Overarching Themes of the Meeting(s)

- 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). Management should consider all aspects of this document as it applies to them and not solely rely on one section or the other.
- Transparency into 3rd party models is important for both the entity's internal controls and for external audit purposes.
 - SOC 1 Type 2 reports will be helpful and are considered a best practice. Auditors during the meeting expressed recommendations for this report in timely fashion given the nearing adoption date for certain entities.
 - 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)
- Management will need processes to identify process risk points and controls that can be evaluated by auditors. Amongst other things, that would include understanding the flow of data as well as understanding models, model output, financial reporting, and what management has done to design and implement controls in order to identify underlying assumptions and risk points.
- 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 relevant to address short-comings in the quantitative estimate.
- 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. ASC 326 does not require a reconciliation between incurred and expected credit losses.

However, management should be aware of potential anchoring, confirmation, and 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.
- The magnitude of qualitative adjustments under CECL should not be anchored to the magnitude of qualitative adjustments under an incurred loss model.

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.
 - Vendors may validate how the allowance calculation works, but the underlying model assumptions and decisions are management's responsibility.
- Management needs to understand and document how their model(s) function. A best practice exercise discussed included the development of a roadmap for their model(s). This road map may include the optionality of the model, options available for each potential decision, outcomes from each decision, and the selection of the option including support for their reasoning.
- Management assumptions are separate from management's estimate. Management assumptions should be well documented and supported.
- Management must have appropriate user controls that work in conjunction with vendor controls. Conclusions on the design and operating effectiveness of the combination of vendor and management controls are the responsibility of management.

Internal Controls over Financial Reporting

- SOC 1 Type 2 reports issued at the vendor level will be helpful and are considered a best practice:
 - (1) For internal control over financial reporting (ICFR) evaluation by management and (2) For auditors in their testing of management's ICFR and in the auditor's risk assessment
 - Management should not consider the SOC 1 report as "check the box." Management should pay close attention to the scope of the SOC 1 and the related user control considerations (UCCs) involved to ensure appropriate relevance and reliability of the report.
 - SOC 1 reports should cover the entirety of the process and include, when applicable, internal and external data (including change controls) utilized by methods and models within management's ACL estimate.
 - SOC 1 reports should be evaluated for any possible limitations. Gaps between vendor SOC 1 reports and necessary internal controls need to be addressed.

- Vendors may be considered specialists and do not alleviate the need for management to test controls developed, including end user controls.
- SOC 1 reports can be as of an interim date. In such case, roll forward procedures for year-end would be needed.
- SOC 1 reports will need to be supplemented with an understanding and testing of how the model was implemented by the reporting entity (i.e., a SOC 1 report is likely not sufficient in and of itself).
- Management should have controls over full model development/validation process – even if they use a vendor-supplied model, including controls over:
 - initial model development
 - vendor model selection process
 - how management knows that the vendor used sound model development practices
 - ongoing monitoring of model performance (e.g., tolerances) 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:
 - Model validation with a wide applicability is not acceptable. Model validations should be tailored to individual institutions.
 - 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 such as but not limited to data characteristics and segmentation as compared to what may be relevant for the institution 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 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, management should consider 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.

- Validating the model is “fit for purpose” is an important step. Given optionality offered by vendors, management should support that the choice and assumptions made are appropriate and that the model is working as intended. Management should be support for why “why A” was selected and “not B.”
- Decisions such as economic scenarios, weighting, etc. can heavily impact the allowance estimate. As such, a governance function to challenge assumptions is critical.

- Management will need to review their governance framework and oversight processes (as well as enhance or create internal controls) in keeping with CECL's requirements for processes, changes in financial reporting, and the new data.
 - Forecasting for CECL vs. forecasting for budget estimates may serve a different purpose and have different financial reporting and related internal controls considerations.
 - There is a difference between model validation and governance function challenging assumptions. Models should be run through model validation. Qualitative framework should go through an appropriate governance process, which may include evaluation through the model validation process. This is a logical progression as the need for adjustments made outside of models are determined to be required as a result of the model validation process.
- 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, the 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 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 is important for management to understand, document, and support their rationale in all three scenarios.
- Retrospective Reviews (aka "back-testing")
 - Retrospective reviews can be useful in certain circumstances.
 - 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.
 - Backtesting may need to be performed at different levels of the estimate (e.g., as a whole, the modelled outcome pre-adjustments, the forecast, the qualitative adjustments, etc.). Management should determine the appropriate process and controls based on each institutions facts and circumstances.

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 and well controlled 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
 - 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 that must be subject to appropriate controls.
 - Should be evaluated each reporting period.

Data used in Models

- Management should utilize data that is relevant, reliable, complete and accurate instead of utilizing pools of data or other resources that are not. Management should continue to build their internal data resources over time and be aware of possible cognitive availability bias.
 - Historical data may not necessarily have been subject to the controls process under the incurred loss model. As such, management needs to demonstrate that historical data used for CECL is complete and accurate.
 - If vendors are used for data and/or models, it is critical to understand the data being provided by the vendor, including its relevancy, reliability, completeness and accuracy.
 - Data from in-house economists and outsourced vendors used for modeling will require internal control considerations.
- 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.
 - Controls over the accumulation of data is crucial, as is the completeness, accuracy, relevance, and reliability of data used. These elements are needed to be able to use the data for financial reporting purposes.
 - Management/vendors also need to think about data lineage and data flow to model.
 - Back-testing can also assist in support for the data used. However, if management has a small sample of data, back-testing may not be as meaningful.
- 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.

Overall

- Management must have a well controlled process to take a step back and evaluate whether the methodology implemented (all components of the estimate) produced the allowance estimate anticipated by management.

Other:

- Discussion over Subsequent Events speech by Kevin Vaughn: <https://www.sec.gov/news/speech/speech-vaughn-121018>
- Discussion on interaction between preparers and vendors incorporated into AICPA Practice Aid *Allowance for credit losses – audit considerations* found at <https://www.aicpa.org/creditlosses>