September 13, 2019

Sherry Hazel
American Institute of Certified Public Accountants
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Re: Proposed Statement on Auditing Standards – Audit Evidence

Dear Ms. Hazel:

The American Bankers Association (ABA\textsuperscript{1}) appreciates the opportunity to comment on the Proposed Statement on Auditing Standards – Audit Evidence (the Proposal). We are commenting on this Proposal due to the potential implications the final standard may have on audits of banks. Along with the recent auditing standard that was approved by the International Auditing and Assurance Standards Board on Auditing Estimates and Related Disclosures (ISA 540), the Proposal addresses key issues that banks will face from auditors as a result of the Current Expected Credit Loss (CECL) accounting standard for the measurement of credit losses.\textsuperscript{2}

By requiring the measurement of lifetime expected credit losses, CECL changes both the timing and size of the estimated allowance for credit losses. Vastly different historical data, newly gathered from various operational administration systems, will be used to support CECL estimates and, unlike any other topic in generally accepted accounting principles, a highly subjective forecast of the future will be performed that does not conform to “market-based” assumptions. In short, CECL changes the nature of the bank audit and will put to the test many of the basic concepts discussed in the Proposal and in ISA 540. As the expected nature and extent of documentation that may be required for auditing purposes can change a bank’s configuration of its CECL estimation system, arriving at a common understanding of practical requirements between auditors and banks will be critical. It is through this lens that ABA views this Proposal.

ABA recognizes that this Proposal is intended to address private company audits, which are not subject to the standards set by the Public Company Accounting Oversight Board (PCAOB). However, the Proposal integrates the “professional skepticism” concepts of ISA 540 into the assessment of audit evidence, as well as directly addresses the issues in using external information, which we believe will be integral to CECL. These issues are not yet addressed in PCAOB standards in nearly the level of detail as presented in ISA 540 or the Proposal. Therefore, we believe that, until they are, the guidance in the Proposal will set the expected practice as to PCAOB-regulated auditing practitioners. As such, though the implementation of

\textsuperscript{1} The American Bankers Association is the voice of the nation’s $18 trillion banking industry, which is composed of small, regional, and large banks that together employ more than 2 million people, safeguard $14 trillion in deposits, and extend more than $10 trillion in loans. Learn more at www.aba.com.

\textsuperscript{2} The Financial Accounting Standards Board (FASB) issued the “Current Expected Credit Loss” accounting standard (Accounting Standards Update 2016-13) in June 2016 and is effective for SEC registrants on January 1, 2020.
CECL for private companies could be delayed until 2023,\(^3\) expectations for 2020 audits will likely be consistent with the tenets detailed in this Proposal.

**The AICPA Should Request a Delay to CECL until Standards and Guidance Are Finalized**

ABA observes that the American Institute of CPAs (AICPA) has just published a Technical Practice Aid related to the auditing of CECL, and an Audit and Accounting Guide is scheduled for the second half of 2020. While there have been final drafts of papers addressing certain specific issues documented by the CECL Transition Resource Group and the Depository Institutions Expert Panel, there is little to no guidance in regards to many issues, especially those related to the topic of the Proposal – Audit Evidence. Indeed, in the three years since CECL was issued, ABA has observed contradictory statements from FASB members, regulators, and auditors in regards to various key aspects of a CECL audit. With that in mind, no audit should be performed until there is a generally accepted understanding of the key issues and how such issues should be addressed. Starting the auditing process at this point is setting up banks and/or auditing firms for failure. Since new auditing guidance, including guidance in the Proposal, is targeted toward challenging management assumptions in making estimates, it is reasonable to believe that bank CECL processes (no matter the size of the institution) may need to change, depending on how the auditing firm integrates such guidance into its audits. Indeed, many stakeholders have commented on an expectation of evolving practice, and we agree that practice may evolve. However, depending on the extent of “ evolution” required, banks may need to make subsequent changes that can be costly and take years to remediate fully. That all said, we do not believe there is sufficient time for the Technical Practice Aid or any aspects of this Proposal to be socialized and banks to integrate any related issues in time for the January 1, 2020, effective date. As a result, ABA recommends that the AICPA request a delay to implementing CECL for all banks until an auditing and accounting guide, integrating finalized guidance from the Proposal, is issued.

We are aware that the International Auditing and Assurance Standards Board, the New York-based organization that issues auditing standards that normally result in U.S.-based standards, recognizes the challenge of auditing smaller entities and has issued a discussion paper, “Audits of Less Complex Entities: Exploring Possible Options to Address the Challenges in Applying the ISAs (International Auditing Standards)” to gather feedback. We believe this further supports a delay to the CECL standard, as auditing bodies are recognizing the challenge that new auditing standards will have on smaller entities.

While FASB has proposed a delay to the CECL effective date for SEC registrants that are “smaller reporting companies” and for other smaller entities, it is difficult to differentiate the level of sophistication and complexity of banks between those that qualify and those that do not qualify for the delay. ABA has observed a wide range of messaging from auditing firms, related to CECL complexity and data requirements, and we believe that the quality of audits for those

\(^3\) While the CECL effective dates for non-SEC registrants are currently scheduled to occur between 2021 (public business entities that are not SEC registrants) and 2022 (non-public business entities), an outstanding proposal by FASB may roll both of these dates back to 2023.
smaller institutions that do not qualify for the delay could be questioned. Therefore, instead of relying on the limited CECL delay, the AICPA should request a delay for all entities.

The Final Standard Should Address Audits of Smaller Institutions

While banking regulators and FASB have noted that implementation of the CECL accounting standard can be scaled to the size and complexity of the financial institution, we know of no guidance explaining what that means to an auditor or to the specific judgments an auditor of a smaller institution will exercise. With this in mind, there is no mention in the Proposal to address audit evidence during an audit of smaller entities. ISA 540, the recently issued auditing standard addressing accounting estimates, acknowledges that processes at smaller entities may be “uncomplicated because the business activities are simple or the required estimates may have a lesser degree of estimation uncertainty.” However, neither circumstance is necessarily true at a small bank. In fact, contrary to what many assert, community bank loan portfolios are often more complex than those of larger banks because of the unique and personalized terms that they are able to provide their customers. Additionally, due to their small portfolios, the lack of precision inherent in a credit loss estimate for smaller institutions will often not only be multiples of materiality,4 but multiples of those inherent in a large bank. While a smaller organization is expected to have less complex internal controls, it is unclear as to how an auditor will take this into consideration, since financial statement “materiality” thresholds should not be different.

Within this backdrop, the CECL standard elevates the role of subjectivity in accounting, noting that “estimating expected credit losses is highly judgmental.”5 The Proposal (as well as ISA 540), however, newly emphasizes auditing processes that address the “risk of bias.” In this light, it is easy to see that audits of small financial institutions will see significant changes to the nature and extent of work required. While some may say that the same challenge exists today, CECL significantly changes not only the “size of the playing field” (from annualized metrics to lifetime), but also the timing of it by years. In an industry dependent on the stability of regulatory capital levels, such a change is expected to transform how credit loss estimates are audited and how capital is managed,6 especially for the smaller bank.

As a result, many community bankers are confused as to the application of the CECL accounting standard to their individual institutions and the kinds of evidence they will need to provide to their auditors – particularly to the extent they will need to provide quantitative support for their estimates, including the “qualitative adjustments” made to initially modeled results, as well as for the final provision amount. For example, on the one hand, messaging from certain parties indicates “qualitative adjustments” need little to no quantitative support. On the other hand,

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4 Per paragraph A125 of ISA 540, when an auditor decides to perform an independent estimate, “The size of the auditor’s range may be multiples of materiality for the financial statements as a whole, particularly when materiality is based on operating results (for example, pre-tax income).”


6 As it will change how capital is managed, it will change decisions on dividends. While some believe that CECL is merely a “capital issue”, bank investors tell ABA that CECL puts significantly more risk into their forecasting process because of its impact on year to year earnings (and, thus, available dividends).
messaging from other parties, as well as the emphasis on “professional skepticism” in both ISA 540 and the Proposal, implies that significant quantitative support and governance processes will be required.\(^7\)

The nature and extent of the evidence smaller banks believe they will need to provide will highly influence how they will configure not only their CECL estimate models but also the operational systems that feed into their models. ABA believes that CECL implementation efforts by smaller banks should not proceed unless there is general agreement as to how smaller banks will be audited under CECL. At this point, community bankers generally find that guidance documents on governance and internal controls related to CECL have not been helpful, because they have either been presented with insufficient detail for the community bank\(^8\) and/or are appropriate only for larger organizations.\(^9\) Addressing smaller banks, therefore, should be a priority in an Accounting and Auditing Guide. However, just as with what has been proposed regarding “professional skepticism,” we believe this issue should also be directly integrated into future auditing standards, such as this one.

**More Guidance Is Needed to Address Auditor’s Bias and Qualitative Adjustments**

Paragraph A33 addresses auditor’s bias, laying out four different ways such biases can affect professional skepticism during an audit. ABA believes that “Anchoring bias,” which involves making assessments by starting from an initial numerical value and then adjusting insufficiently away from that initial value in forming a final judgment, could be a significant issue during many CECL audits. ABA does not question the legitimacy of anchoring bias. However, in context of the CECL accounting standard, more clarification, including an example, is needed. Based on the models and historical data that are used, for example, adjustments from the modeled outputs can be significant. In fact, ABA is hearing from certain CECL implementation consultants that “qualitative adjustments” can often make up 80-90% of the final forecasted loss. In other words, the “modeled amount” can often be an insignificant aspect of the final estimate, compared to the “qualitative adjustment.”

\(^7\) It is generally accepted that “qualitative adjustments” will often be made to initially modeled results, and the nature of documentation supporting the need for a qualitative adjustment is understood. However, documentation supporting the quantitative amount of the adjustment is not well understood. While some believe that CECL processes will be similar to current practice, the common understanding of a “lifetime” credit loss for both recognition and measurement provides an anchor that does not exist in an “incurred” loss. Therefore, the processes and expectations for quantitative support are expected by many to be significantly different.

This difference in understanding was evident during the recent AICPA National Conference on Banks and Savings Institutions, as statements from FASB staff indicated no difference in such processes from current practice while auditors separately affirmed the very challenging aspect of supporting such CECL adjustments.

\(^8\) See the Center for Audit Quality’s “Preparing for the New Credit Losses Standard: A Tool for Audit Committees.”

\(^9\) See Financial Executives Institute’s “ICFR: Insights, Issues, and Practices: A guide to implementing internal control over financial reporting (ICFR) for the current expected credit loss (CECL) standard.”
Bankers are also concerned, however, that, as a result of the definition within the Proposal, auditors will address anchoring bias through unwarranted audit effort on those aspects of the CECL estimation processes that represent adjustments made to the initial model output. Bankers believe the wording of the definition implies that the initial output from the models will be “accurate” and represent a higher form of persuasiveness, thus requiring less skepticism than the related adjustments. In real life, adjustments from the initially-modelled estimates will be just as important as the model. As a result, we believe further clarification as to the term “anchoring” is needed to avoid confusion. More guidance clarifying how modeled output should be considered is needed in this respect.

More immediately, however, is that “anchoring” has become a separate technical term used by CECL implementation consultants employed by accounting firms. In this context, they are communicating to CECL adopters that qualitative adjustments made to initial model outputs must be anchored to life of loan portfolio loss expectations, as opposed to annualized charge-off-based incurred loss calculations. In other words, qualitative adjustments must have some quantitative basis. Clarification in the final standard may be needed to avoid confusion between these two concepts.

**Expectations on the Use of External Information for Estimates Needs Clarification**

ISA 540, which is related to accounting estimates, emphasizes obtaining and evaluating “contradictory evidence” equally with “corroborating evidence” in order to enhance “professional skepticism” and mitigate management bias in the estimation process. With this in mind, there will likely be a wealth of external credit loss information that will be available for audits of CECL credit loss estimates. For example, Fannie Mae and Freddie Mac provide certain loan-level historical data free of charge (or for nominal cost) and different vendors have similar data, gathered from securitization activity across various other loan products on a granular basis, available to be purchased.

Auditors have reason to believe that, during audits of community banks, external data will be inherently more reliable (because it typically will include more observations than internal history) and less subject to management bias than internal data. As a result, considering the need for an auditor to obtain and assess “contradictory evidence,” ABA believes use of external data will become commonplace. Auditing firms and banking regulators, however, while acknowledging external data may be needed within the CECL process, have generally been silent on whether such information will be important.

If such external information may be important to auditors assessing the reasonableness of a credit loss estimate, community banks should know that now, because the configuration of their CECL estimation systems could change significantly. Consequently, we believe the Board should better connect the dots between the accounting estimates auditing standard (ISA 540) and this proposal by more fully discussing how external information can be used in context of a highly judgmental accounting estimate (in other words, CECL). Guidance in ISA 540 related to

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10 International Auditing Standard 540 (which is expected to be approved by the Auditing Standards Board for audits of private companies in the U.S.) and PCAOB Release No. 2018-05 (for audits of public companies) both address auditing accounting estimates, of which many aspects of the CECL accounting standard would apply.
external information sources (paragraphs A127 to A129) appears to address fair value measurements, but not other estimates. Fair value measurements have a vastly different measurement “anchor” (the exit price obtained in an arm’s length transaction) than do CECL estimates (which are not based on any assumed transaction but on historical experience). Therefore, discussion related to credit loss estimates in regards to external information is sorely needed.

**More Guidance on “Relevance” Is Needed in Light of CECL**

In light of the CECL accounting standard, banks are facing a profound change in the kind of historical experience that will be used as a basis for its credit loss estimates (lifetime-based loss information, as opposed to information informing current impairment). Among other things, forecasted future economic conditions can significantly change the relevance of specific credit loss historical data. For example, loss experience during certain stages of an economic cycle is likely more relevant than experience that represents an entire economic cycle or experience that represents the immediately previous few years. Such experience may then often, based on the relevant part of the economic cycle, need to be disaggregated, based on the credit quality of borrowers, loan terms, etc.

Depending on how “relevance” is interpreted, these examples can change how an audit is conducted, especially in instances in which external data are used. External data sources for credit loss history can provide information that is significantly more granular than the granularity initially planned by many community banks. ABA is concerned, however, that messaging from certain auditing firms during the CECL implementation process indicates very little of this. As a result, we believe many community banks may be configuring CECL systems that will eventually need to change once they become subject to audit.

A common understanding of “relevance” is critical in CECL prior to the effective date. For example, FASB staff has released guidance on how companies consider “reasonable and supportable forecast periods” and “reversion techniques” in light of expected closings of certain local businesses and a factory. Because such events, if considered significant, are often catastrophic to a community, ABA believes that auditors may initially question the relevance of much of the historical loss information maintained by the company, unless that information was captured during periods that also included significant business closures. This is not to say that the FASB Staff guidance was wrong. However, it does emphasize the need to “get on the same page” in evaluating the relevance of the information on which estimates are based on. As we previously noted, a bank could make significant changes to its CECL support systems depending on expectations of the audit process.

As a result, ABA recommends that the final standard address how auditors will assess the relevance of data in a CECL-like environment. This would include addressing levels of detail, how automated data techniques could assist in the process, and how to assess varying levels of relevance that can change throughout an economic cycle. For example, historical data related to credit losses on commercial real estate (CRE) loans are relevant to a credit loss estimate. However, data that differentiate, for example, between those loans for municipal hospitals from those for hotel construction would be more relevant, since collectability on hotel loans are often
more sensitive to economic factors. During certain parts of an economic cycle, certain historical experience within the hotel construction segment would also likely be more relevant than experience covering other periods. Auditors will need to assess how such differences can be quantified for materiality purposes, and such guidance would be highly useful.

**Internal Controls at External Information Providers May Need Testing**

The implementation of CECL will often require the use of external information. Most commonly, independent economic forecasts will often be used as a basis in determining reasonable and supportable forecasts of future conditions, and detailed, loan-level proxy credit loss data, gathered from securities, will often be used as a basis for credit loss estimates.

ABA is observing various arrangements in which external information may be obtained. For example, a service provider that offers database, analysis, and modeling capabilities can also be the originator of certain economic forecasts or may supply to the bank the same forecasting information that was acquired from the originating forecasting company. Similar situations can apply to the loan-level proxy credit loss data. However, database providers may also accumulate certain credit loss information from their clients and supply summarized data for use by their bank customers. In each of these cases, we believe that none of these situations preclude the information used from be considered “external,” which implies a higher level of reliability and lower level of management bias.  

The appendix in the Proposal provides a robust set of “considerations regarding the use of external information sources.” Absent from the considerations, however, is a discussion on the need of a Systems Organization and Control (SOC-1) audit report. As a result of this absence, bankers are assuming that much of the available external information that will be used will be considered “reliable” without significant further internal control testing by the bank.

With these things in mind, we believe examples addressing these kinds of situations would assist in the application of the audit responsibility in considering external information. We are aware that there are auditing firms currently working with a group of CECL service providers in order to coordinate audit expectations. Anything learned during those discussions should be integrated into the final standard. That said, we are unaware of any similar effort to address issues at service providers that accumulate and summarize prepayment activity, and we believe that similar insights should be provided.

In closing, the CECL accounting standard presents a significant challenge to banks and bank auditors alike. While some may believe that the recommendations could all be addressed neatly within an Accounting and Auditing Guide, the collision of CECL (an accounting standard that greatly increases subjectivity) with the new auditing standards (that seek to mitigate it) provides an opportunity for the AICPA to avoid much confusion in the practice of any accounting estimate. In other words, addressing the CECL issues will be critical to an auditor of any

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11 This concern was also evident during the recent AICPA National Conference on Banks and Savings Institutions, as a panel discussion indicated that auditors on the AICPA Depository Institutions Expert Panel are still unsure of the level of “validation” procedures that will be needed when external information is used.
company that has significant estimates in its financial statements and to the company itself that must implement controlled systems that perform them.

Thank you for your attention to this matter and for considering our requests. Please feel free to contact me (mgullette@aba.com; 202-663-4986) if you would like to discuss this further.

Sincerely,

Michael L. Gullette