CECL: Lessons Learned and Future Challenges

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Today's Presenter

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Nely has over 12 years of experience in public accounting, specializing in financial institution audits. She participates in financial and operational audits with related management recommendations for enhancing internal controls and efficiency improvements for public and private companies. She also has experience with material loss reviews conducted by the Inspector General of the NCUA to review and report on failed credit unions.

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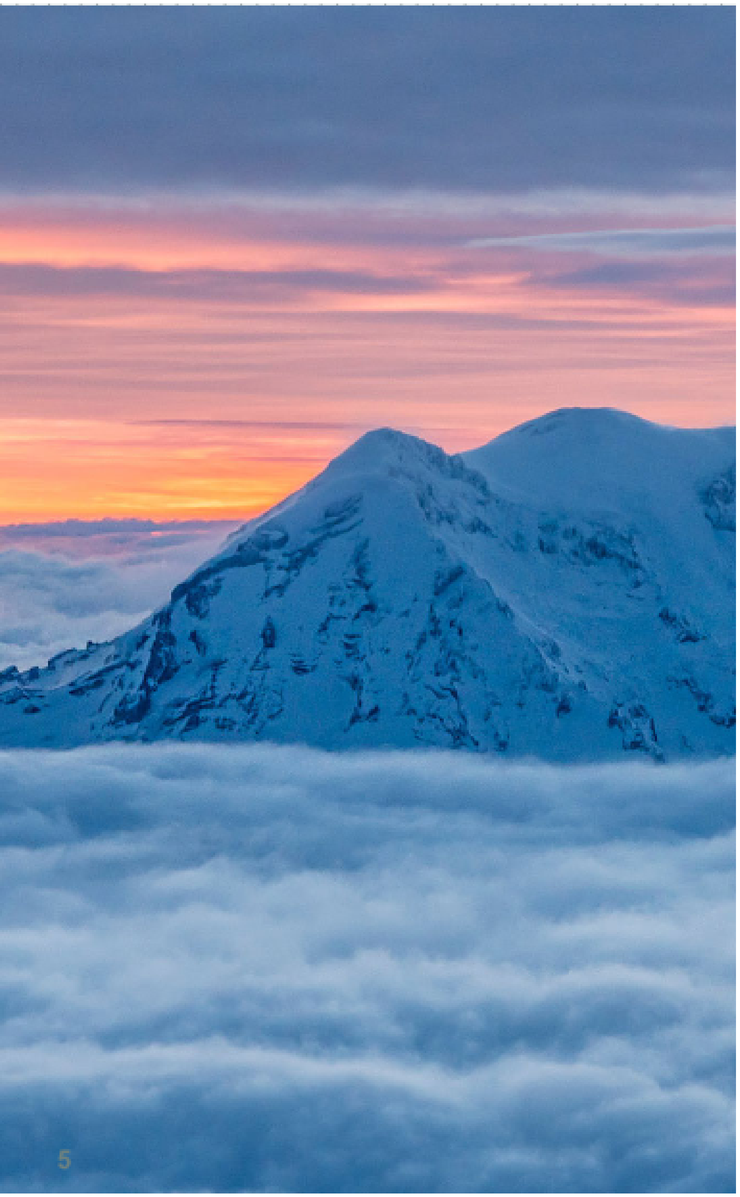


Agenda

1) Internal Controls Refresher

   Outline of internal control purposes and the specific types of internal controls

2) CECL Risk Assessment

   Viewing the CECL control environment from a “what could go wrong?” lens

3) Post-Adoption CECL Lessons Learned

   Top 5 CECL internal control deficiencies, ramifications, and example key controls to address

4) CECL Internal Controls Best Practices

   Establish a sound CECL environment for repeatable success

5) Summary and key takeaways

Poll Question

What area of the financial institution do you work?

A. Finance/Accounting
B. Lending/Loan Operations
C. Credit Administration
D. Internal Audit / Risk and Compliance
E. Other

Internal Controls Refresher

What is an internal control?

“A process, effected by an entity’s board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives related to operations, reporting, and compliance.”

In other words, **internal controls are procedures that provide comfort that things are working correctly.**

– Committee of Sponsoring Organizations of the Treadway Commission (COSO)

Internal Controls Refresher

Internal controls are not sexy

We often hear that internal controls….

1) **SLOW THE BUSINESS DOWN**
2) **ARE NOT ALIGNED WITH BUSINESS OBJECTIVES**
3) **PROVIDE A FALSE SENSE OF COMPLIANCE**
4) **WASTE SIGNIFICANT TIME AND RESOURCES FOR PERSONNEL**
5) **DO NOT CONSIDER CHANGES IN THE BUSINESS OVER TIME**

In reality, when things go wrong, the cost/time/effort to assess damages and remediate is much greater than if the time was taken to put a thoughtful control framework in place

Internal Controls Refresher

Which control categories and types are best?

PREVENTATIVE MANUAL CONTROL
Charge-offs of $100k+ are reviewed by CCO prior to posting.

DETECTIVE MANUAL CONTROL
Charge-offs of $100k+ are provide to CCO for review for appropriateness after posting.

PREVENTATIVE AUTOMATED CONTROL
Charge-offs of $100k+ are flagged within the loan system for CCO approval prior to posting.

DETECTIVE AUTOMATED CONTROL
Charge-offs of $100k+ are flagged within the loan system after posting for CCO review after posting.

Poll Question

What is the optimal control type and category?

A. Preventative manual control
B. Detective manual control
C. Preventative automated control
D. Detective automated control

CECL Risk Assessment

What could go wrong?

➢Risk assessment is foundational to identify risks of material misstatement within the CECL estimate and the actions management should take to mitigate the identified risks.

➢The risk assessment **requires reevaluation on a continuous basis** as the risks of material misstatement within the CECL estimate may change.

➢Result of proper risk assessment is the design and operation of control activities to address identified risks.

CECL Risk Assessment

Start high-level, move to more granular

Examples of key high-level risks are as follows:

METHODOLOGY SELECTION AND APPROPRIATENESS

- Has the model changed since adoption of CECL?
- Do credit risks within the loan portfolio remain the same?
- Is management and those charged with governance comfortable with the methodology?

MANAGEMENT BIAS

- Are significant assumptions well documented?
- Is data being utilized the most relevant for the intended purpose?
- Does the methodology anchor to a specific result for CECL as a percent of loans?

MANAGEMENT'S SPECIALISTS/THIRD PARTIES

- Is post-adoption monitoring "due diligence" needed?
- Have we reassessed the use of the specialist/third party?
- Are controls established by the specialist/third party sufficient to rely on information (SOC 1)?

ESTIMATION UNCERTAINTY

- Where are sources of estimation uncertainty?
- Has a loss driver analysis been completed?
- What were the results of back-testing/retrospective review?

CECL Risk Assessment

Get more granular to assess control systems

Management should…

1. *Consider elements of the estimate*

   (Completeness and accuracy of inputs, method selection and techniques, uncertainty, management bias)

2. *Assess objective inputs*

   (Current loan data, historical losses, prepay rates, contractual terms)

3. *Assess subjective inputs*

   (Management adjustments for current conditions/forecasts, discount rates, or cash flow assumptions, recovery estimates, definition of default)

4. *Ensure integration of IT general controls and the ACL*

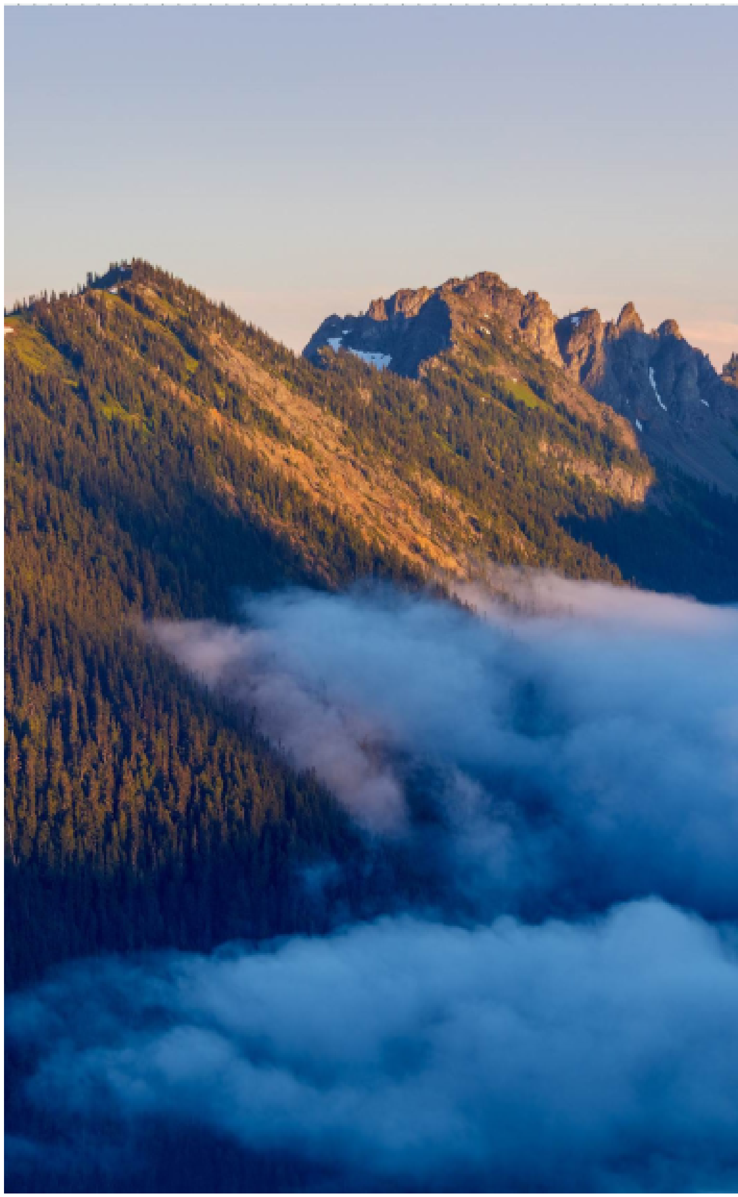
   (Management adjustments for current conditions/forecasts, discount rates, or cash flow assumptions, recovery estimates, definition of default)

CECL Risk Assessment

Transition from risk assessment to control activities

At the conclusion of an effective risk assessment exercise, action items are as follows:

- Compare identified risks to current control activities
- Identify control gaps or enhancements needed
- Assess desired precision vs resources available
- Put together an action plan
- Ensure all relevant stakeholders are part of the process



Poll Question

In your first audit after adoption, how many CECL related control deficiencies were noted from your auditors?

A. Material weakness/significant efficiency… we have a bit of work to do
B. A few findings, but manageable
C. No findings or internal control deficiencies that I recall
D. We adopted years ago!

Post-Adoption CECL Lessons Learned

Top 5 CECL internal control deficiencies and ramifications, and example key controls

1. Lack of documentation to support critical assumptions
2. Significant changes to the CECL methodology that are not substantiated
3. Overreliance on vendors/systems
4. Unsupported reserve levels in excess of model calculated reserves
5. Loan data not complete and accurate within the CECL calculation

CECL Control Deficiency #1

Lack of documentation to support critical assumptions

Examples of what we see…

- *Qualitative adjustments and/or changes of adjustments from prior periods with no related documentation*
- *Decision points (peer group selection, loss rate lookback periods, prepayment speeds, etc.) with no basis for the conclusion*

Ramifications for what could go wrong…..

- *Increased scrutiny from auditors or regulators*
- *Shift of focus moves to management rather than methodology*
- *In a period of credit quality shifts, there's no baseline for decision points for prior conclusions*

Key Control Activity Examples to Address Control Deficiency

"Management prepares a monthly/quarterly memorandum outlining the CECL results, including each critical assumption or change thereto, with evidential documentation to support the conclusion."
"For changes to critical assumptions as defined within the CECL Policy, supporting documentation is presented to the CECL Committee for review and approval."
"Qualitative adjustments and supporting analysis are reviewed and approved by the CFO prior to finalizing the calculation, as documented within the minutes."
"Periodically, the CECL methodology, including all critical assumptions are reviewed by CFO, and approved by the Audit Committee." (LESS PRECISION)

CECL Control Deficiency #2

Significant changes to the CECL methodology that are not substantiated

Examples of what we see…

- *Change in methodology selection within existing CECL provider or change in CECL provider with minimal documentation surrounding the change or reason for change.*
- *Material new information obtained that existed upon adoption of CECL but factored into the methodology on a go-forward basis, with no consideration of prior reporting period effects.*

Ramifications for what could go wrong…..

- *Potential for management bias*
- *Prior financial statements could be materially misstated*
- *Additional deficiencies may result depending on the cause, which may require additional work/costs*

Key Control Activity Examples to Address Control Deficiency

"As outlined within the CECL policy, changes to CECL providers and methodology changes, including the supporting documentation for reasons for change and retrospective review to compare methodology results, are presented to the Audit Committee for review and approval."

"Proper due diligence is conducted for critical vendors surrounding significant estimates and presented to the Audit Committee for approval."

"Changes to significant estimates resulting from new information obtained are considered for a potential correction of an error, which may warrant restating previously issued financial statements."

"Significant changes to the CECL methodology are reviewed and approved by the Audit Committee." (LESS PRECISION)

CECL Control Deficiency #3

Overreliance on vendors/systems

Examples of what we see…

- *Management is unable to explain, even at a high level, the CECL methodologies utilized by the institution, and key loss drivers.*
- *Management does not review the SOC 1 reports for the CECL provider, or periodically test any calculations or outputs of the CECL model.*

Ramifications for what could go wrong…..

- *Errors may not be identified timely or at all*
- *Management cannot adequately set expectations or assess results of the calculation*
- *Methodologies or key inputs within the methodologies might not be appropriate for the underlying loan segments*

Key Control Activity Examples to Address Control Deficiency

"Upon adoption of significant accounting standards (CECL), management researches and documents the implementation, including critical assumptions, key decisions, and effects on financial reporting."
"Periodically, management performs a loss driver analysis to assess the validity, completeness and accuracy of data, and appropriateness of key loss drivers within the CECL methodology."
"Annually, management obtains the SOC 1 report covering the reporting period, and reviews for deficiencies affecting the CECL methodology. Complimentary user entity controls are mapped to the institutions control activities and documented accordingly."
"Annually, management obtains an independent model validation on the CECL methodology."

CECL Control Deficiency #4

Unsupported reserve levels in excess of calculated reserves

Examples of what we see…

- *CECL calculation and analysis do not agree to the recorded balance in the general ledger, with no supporting documentation for the difference.*
- *Management has a qualitative adjustment recorded to maintain a 1.5% level of ACL to loans.*

Ramifications for what could go wrong…..

- *Management bias called into question*
- *Actual expected credit losses are not accurately reflected for financial reporting*
- *CECL methodology is not nimble enough to increase recorded reserves when forecasting points to increase in expected credit losses*

Key Control Activity Examples to Address Control Deficiency

"Quarterly, management prepares a memorandum in conjunction with the CECL calculation, concluding on calculated reserves, qualitative adjustment, and the overall recorded ACL reserve."

"Recorded ACL reserves are maintained at a level within 10% of calculated ACL reserves, which is in accordance with policy thresholds set forth by the Board of Directors."

"Qualitative adjustments and supporting analysis are reviewed and approved by the CFO prior to finalizing the calculation, as documented within the minutes."

CECL Control Deficiency #5

Loan data not complete and accurate within the CECL calculation

Examples of what we see…

- *CECL calculation did not incorporate certain acquired loans not maintained within the loan subledger.*
- *Certain loan purpose/call report codes were modified, but not updated within the CECL methodology.*

Ramifications for what could go wrong…..

- *Actual expected credit losses are not accurately reflected for financial reporting*
- *Financial statement disclosures are inaccurate*

Key Control Activity Examples to Address Control Deficiency

"Reconciliation by CECL loan segment to the loan subsidiary ledgers and general ledger is completed to ensure that loans are accurately reflected within the CECL methodology, and the internal loan data used to calculate the ACL is complete."

"When loan call report, purpose, active status, or accrual status codes are changed, management notifies the CECL provider to ensure current and historical information is updated accordingly."

"Annually, on a sample basis, key loan attributes are tested against the CECL methodology to ensure information used to calculate the ACL is complete and accurate."

CECL Internal Control Best Practices

Establish a sound CECL control environment for repeatable success

1. Embrace internal controls
2. Ensure all parties know their role
3. Develop a proper risk assessment
4. Utilize control flowcharts or narratives
5. Find a balance of granular and higher-level controls
6. Proper documentation is paramount

CECL Internal Control Best Practices

1. **Embrace internal controls**
   - Successful organizations have a culture to lean in to controls and the control environment and understand the value they provide.
2. **Ensure all parties know their role**
   - CECL is a cross-institutional process, with information coming from multiple areas of an organization. When people understand how their work product fits into the process, there is a better understanding of what could go wrong, and fewer errors.
3. **Utilize a proper risk assessment**
   - Focusing on risks identifies the areas of focus for control activities. Start with higher level risks (management bias, estimation uncertainty, 3rd parties, etc.) And move to more detailed risks (elements of the model, subjective/objective inputs, IT general controls, etc.).

CECL Internal Control Best Practices

4. **Utilize control flowcharts or narratives**
   - A cradle to grave process documented for the entire CECL process ensures completeness and helps identify both control gaps and areas for precision
5. **Find a balance of granular and higher-level controls**
   - CECL is complex and has a lot of moving parts, but CECL control process owners need to do their day job, so controls should be in place to an acceptable risk tolerance, focusing on critical control activities. Internal controls should be effective to provide comfort to stakeholders but should not drive the bus
6. **Documentation is more important than ever**
   - "If you don't document it, it didn't happen." Not exactly, but with the subjective nature of CECL estimation and significant assumptions, it is imperative that conclusions are supported.

Poll Question

How are you feeling leaving this session on CECL controls?

A. I feel good about CECL controls at my institution
B. There were a couple helpful takeaways to consider
C. I understand the importance of risk assessment and internal controls
D. We have some work to do on CECL controls
E. I can't believe we are still talking about CECL

Key Takeaways

1. Preventative automated controls are the strongest, and detective manual controls are the weakest. Personnel expertise, capacity, and IT largely drive the ideal break out of control types for CECL.

2. A CECL risk assessment should be done in a normal cadence, with a focus on risks for "what could go wrong?"

3. The ACL is management's estimate, which may include reliance information/processes from 3rd parties, and controls at 3rd parties (SOC 1, validations, due diligence documentation) must be scoped in.

4. Given the subjective and ever-changing nature of CECL, supporting documentation for conclusions surrounding key assumptions or changes within the methodology is critical.

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