Preparing for the new credit loss model

Introduction

The FASB’s new credit losses standard changes the accounting for credit losses for certain instruments. The new measurement approach is based on expected losses, commonly referred to as the current expected credit loss (CECL) model, and applies to financial assets measured at amortized cost, including loans, held-to-maturity debt securities, net investment in leases, and reinsurance and trade receivables, as well as certain off-balance sheet credit exposures, such as loan commitments. The standard also changes the impairment model for available-for-sale debt securities.

For SEC filers, the standard is effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. All other entities, including certain not-for-profit and employee benefit plans, have an additional year.

For entities with extensive activities involving financial assets, such as banks and insurance companies, the implementation of the CECL model may present challenges. As management begins to think through changes that may be necessary to their processes, systems and controls in order to implement the CECL model, they should also consider the evidence and documentation that a robust governance and internal control framework should produce to support their estimates. The support for estimates will be an area of continued focus by stakeholders such as the SEC and other regulators.

External auditors will also look to the evidence and documentation used by management in preparing the expected loss estimate. Given the inherent judgment required to apply the CECL model, a frequent topic of discussion among preparers has been around what auditor’s will expect to see. In this paper we outline ways in which management can support the judgments and analysis that support their
estimation process. We also describe how the requirements of the auditing standards are typically applied to accounting estimates.

Management’s process

One of the challenges of implementing the CECL model is the requirement to estimate expected credit losses (ECL). Accounting estimates that incorporate forward-looking information are common in the preparation of today’s financial statements (e.g., fair values, other-than-temporary impairment, impairment of long-lived assets and tax valuation allowances). As such, management should have a starting point for developing policies and processes to support the new expected credit loss estimates.

Management’s process to establish estimates normally consists of the following common elements (which are also relevant to estimates of ECL):

- Identifying the relevant factors that may affect the accounting estimate
- Accumulating relevant, sufficient and reliable data on which to base the estimate
- Developing assumptions that represent management’s judgment of the most likely circumstances and events
- Determining through appropriate governance processes the estimate based on the assumptions and other relevant factors
- Determining that (1) the accounting estimate is presented in conformity with applicable accounting principles and (2) disclosure is adequate

As part of the audit of the financial statements, auditors will obtain an understanding of management’s processes, typically through a combination of inquiry, observation and inspection of documentation, to assess the risk of material misstatement in the development of accounting estimates. To make their risk assessment, the auditor will consider:

- Complexity and subjectivity associated with the process
- Degree of uncertainty associated with the assumptions
- Availability and reliability of relevant data
- Number and significance of assumptions that are made
- Risk of material misstatement
Based on its risk assessment, the auditor will assess the reasonableness of management’s accounting estimates using one or more of the following approaches:

1. Directly test the process used by management to make the estimate
2. Independently develop an expectation of the estimate to corroborate the reasonableness of management’s estimate
3. Review subsequent events or transactions occurring prior to the date of the auditor’s report

Historically, in auditing estimates of credit losses for financial assets measured at amortized costs, auditors typically tested the process used by management. This is likely to be the most frequent approach under the CECL model.

When performing an integrated audit, the auditor is required to test management’s controls relevant to material estimates. Management’s documentation of its judgments is integral to maintaining effective internal control over financial reporting. The FFIEC\(^1\) and SEC staff\(^2\) have guidance regarding the expected level of supporting documentation over management’s loan loss allowance, which should be considered in supporting estimates of ECL. Management’s written supporting documentation should include support for the following decisions, strategies and processes:

- Policies and procedures over the systems and controls that maintain the estimate as well as the methodology
- Summary or consolidation of the balance
- Validation of the methodology
- Periodic adjustments to the estimates process

Together, all of this documentation facilitates review of the estimates, builds discipline and consistency into the process, and helps ensure that all relevant factors are appropriately considered in the analysis. Management’s current processes that support other estimates, such as fair value or impairment, may be an effective place for management to start in determining the processes, controls and documentation to support estimates of ECL.

With this backdrop, let’s further consider two specific areas of frequent discussion in the implementation of the CECL model: (1) the precision of estimates and ranges and (2) reasonable and supportable forecasts.

### Precision of estimates and ranges

The CECL model does not provide prescriptive guidance regarding how to develop an estimate of ECL. Therefore, the selection of a modelling methodology is one of the key decisions in adopting the CECL model.

Given the range of possible methodologies, management will want to document its rationale (including commentary on alternatives considered and rejected) for its selection. This will provide a record to help address questions from regulators,

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\(^1\) Interagency Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions, July 2001

\(^2\) Securities and Exchange Commission; Staff Accounting Bulletin No. 102
including those raised in connection with banking regulator examinations or SEC staff comment letters. Such documentation will also aid the audit process.

In evaluating the reasonableness of an accounting estimate developed under a selected methodology, management’s process should focus on the factors and assumptions that are:

- Significant to the accounting estimate
- Sensitive to variation
- Deviations from historical patterns
- Subjective and susceptible to misstatement and management bias

Documentation of the key factors and assumptions are important to maintaining an effective and robust control structure. The auditor will typically focus on the key assumptions.

The extent of analysis performed and documentation will be influenced by the objectivity of the inputs. For example, an estimate based on the company’s historic loss data on a portfolio of similar loans is likely more objective than a forecast of future credit card delinquency rates in response to macro-economic factors such as unemployment. As a result, the estimate based on history may require less analysis. But even when using historical data, there is still judgment involved when choosing the look-back period and determining whether adjustments are needed to reflect current conditions and risks. In this regard, auditors will want to understand how management’s judgments impact the estimation of ECL.

When the auditor tests management’s process, they may develop a reasonable range to evaluate management’s point estimate. Auditing standards require that the auditor narrow the range, based on audit evidence available, until all outcomes within the range are considered reasonable.

The auditing standards indicate that “ordinarily, a range that has been narrowed to be equal to or less than performance materiality is adequate for the purposes of evaluating the reasonableness of management’s point estimate.” However, the standard also cautions that narrowing the range to that level may not always be feasible, particularly for certain industries and estimates. An inability to narrow a wide range may indicate that the accounting estimate is a significant risk because of measurement uncertainty. This would require the auditor to perform additional procedures to conclude on the reasonableness of management’s estimate. Management can expect auditors to ask about how management:

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3 AICPA AU-C 540.A100
Reasonable and supportable forecasts

The estimate of ECL should consider historical information, current conditions, and “reasonable and supportable” forecasts, as well as estimates of prepayments. The standard does not prescribe a specific method to make the estimate, and does not provide a definition of “reasonable and supportable.”

With respect to forecasts, management should consider whether:

- Adequate controls are in place over data used to formulate the assumption and to evaluate its reasonableness
- Assumptions or forecasts are internally consistent when the same or similar assumption is used for other accounting estimates, risk or other management analysis

  *For example, management may consider whether prepayment and default assumptions used in an accounting estimate of ECL for held-to-maturity private label residential mortgage-backed securities are consistent with the prepayment and default assumptions used to determine the fair value disclosures of those same securities.*

- Assumptions are supported by historical data or industry research

  *For example, management may consider the availability of other external sources to corroborate the information, whether the historic look-back period over which the data is collected is suitable and whether the historic data is comparable with the current estimation period.*

Management can expect their auditor to test management’s processes around these elements. Given the significance of judgments and the potential for bias in the process, auditors will consider whether there is contradictory information. For example, if the entity uses credit models related to the same credit products for other purposes, such as fair value estimates or regulatory capital analyses, management should be prepared to address whether assumptions or forecasts specific to the credit product differ between models and, if so, whether such differences are reasonable. Likewise, auditors may consider whether there is contradictory information related to management’s assumptions. For example, if there are conflicting research reports regarding unemployment forecasts, auditors may ask how management determined which report was appropriate.

Related standard setting developments

The PCAOB has active projects related to auditing estimates and the use of specialists. It expects to release proposed auditing standards related to each project in the second quarter of 2017.
The International Auditing and Assurance Standards Board (IAASB) released for public comment a revised standard on auditing estimates in April 2017. The proposed amendments to the audit standard are in part influenced by the IASB’s IFRS 9, *Financial Instruments*, issued in July 2014. While there are fundamental differences in the new IFRS and US GAAP accounting models related to credit losses, they both require that estimates be made of credit losses. As a result, many of the auditing considerations are likely to be similar.

Once finalized, these auditing standards are likely to impact the auditors testing of credit losses. Accordingly, companies may want to monitor the developments in the PCAOB and IAASB standard setting processes.