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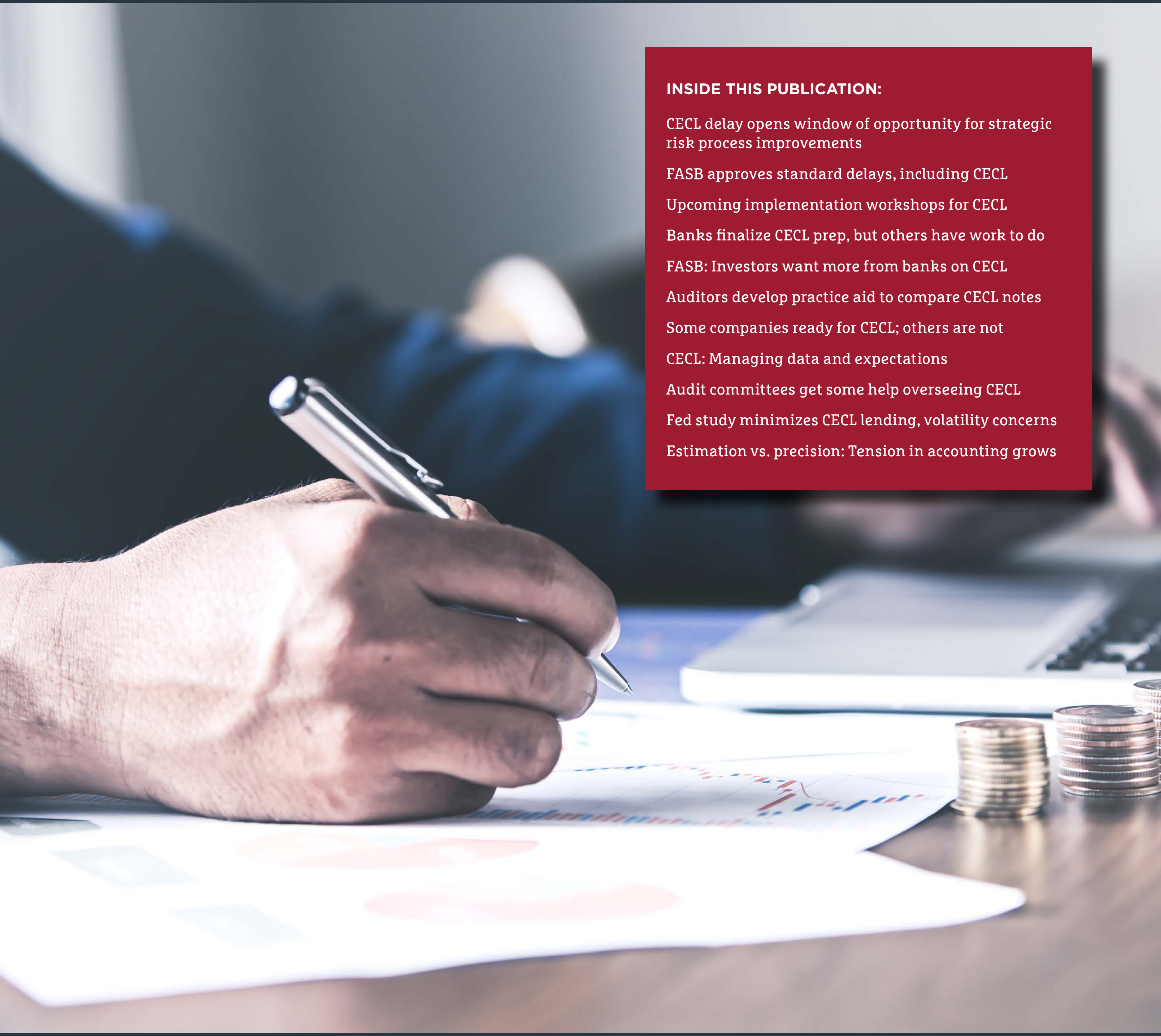

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CECL | Don’t get left behind on FASB’s credit loss standard

An e-Book publication sponsored by Wolters Kluwer EQUIFAX

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Inside this e-Book

CECL delay opens window of opportunity for strategic risk process improvements

By **Will Newcomer**, VP — Business Development & Strategy, Wolters Kluwer

The prospect of a delay in implementing the FASB's new CECL (Current Expected Credit Losses) accounting model has been lauded by many industry practitioners and observers keen to see the emerging standard modified or repealed. But it appears that under the proposed "two-bucket approach", much of the former Wave 1 institutions will remain to be compliant by 2020, making it imperative for financial institutions to continue apace with their preparations.

And while the proposed second bucket, which now includes all former Wave 2 and 3 and smaller reporting companies (SRCs), will almost certainly be pushed back to 2023, this gives these institutions the opportunity to optimize their approaches to the regulation.

The FASB'S latest proposed Accounting Standards Update (ASU) would grant private companies, not-for-profit organizations, and non-SEC filing public companies additional time to implement CECL, and encouraged stakeholders to comment on its proposal by September 16. As such, it appears likely that the decision to delay CECL, whose original specification was issued by the FASB in June 2016, will be ratified within the next two months.

To date, industry concerns about the CECL standard have been focused on a limited portion of the CECL process, with a focus on two of its six major steps. Specifically, these relate to CECL's requirements around economic forecasts and the ECL calculation itself which is expected to create unnecessary volatility. Whether that's the case is open to debate, but it's nonetheless important to note that most core elements of the process are consistent with current industry best practices and therefore worthy of implementing regardless of CECL's final form.

Furthermore, it's clear that auditors and regulatory examiners have accepted the remaining four of CECL's six steps (Data Management and Process Governance, Credit Risk Assessment, Accounting, and Disclosure and Analytics) and will not ignore them in future audits and exams. Financial institutions that choose to keep their pre-CECL process for these steps do so at their own peril, falling behind competitors, or increasing costs in a late rush to compliance. Instead, strategically minded institutions are forging ahead with those aspects of CECL that have been identified as consistent with best practice.

With a delay from FASB looking almost certain, institutions can move forward with confidence in their strategic plans for risk management, regardless of the final form CECL takes. Accepted wisdom suggests that firms should continue work on improving their capabilities in risk and finance, leveraging the work they've already completed while addressing the fundamental challenges in complying with CECL. They should monitor industry and regulatory developments in this space, particularly during this period of uncertainty, to keep abreast of how best to prepare for dealing with CECL or whatever comes next.

As the marketplace pauses ahead of the FASB's guidance on CECL next steps, financial institutions have a unique opportunity to move beyond the contentious areas of the CECL calculations and focus on creating strategic benefit by adopting positive elements of the standard. By building on the best practices elements of the standard, firms' investment in CECL to date can be leveraged to create business value in a number of ways.

First, by adopting CECL practices they can improve their risk assessment and mitigation strategies, and grow the business while balancing risk and return. But more widely, institutions can align execution across the organization, at the same time engaging management and shareholders.

Further to these tangible business benefits, institutions can use their CECL preparations to establish end-to-end credit risk management framework within the organization. By taking this approach, financial institutions can enjoy strategic, yet incremental improvements across a range of functions, improving decision making and setting the stage for preparations for future standards.

This can yield benefits in a number of areas:

DATA MANAGEMENT AND QUALITY

Firms starting to build their data histories with credit risk factors now can improve their current ALLL (Allowance for Loan and Lease Losses) processes and ensure the successful implementation of CECL when it comes into effect. Financial institutions frequently underestimate the time and effort required to put in place the data and data management structures required, particularly with respect to granularity and quality. The message is: for higher quality data, source data now.

INTEGRATION OF RISK AND FINANCIAL ANALYSIS

This can strengthen the risk modeling and provisioning process, leading to improved understanding and management of credit quality. It also results in more appropriate provisions under the standard and can give an early warning on the potential impact of compliance. Meanwhile, improved communication between the risk and finance functions can lead to shared terminologies, methods and approaches, thereby building governance and bridges between the functions.

ANALYTICS AND TRANSPARENCY

Firms can run what-if scenario analysis from a risk and finance perspective, and then slice and dice, filter or otherwise decompose the results to understand the drivers of changes in performance. This transparency can then be used to drive firms' business scenario management processes (see below).

AUDIT AND GOVERNANCE

Firms can leverage their CECL preparations to adopt an end-to-end credit risk management architecture (enterprise class and cloud-enabled) capable not only of handling quantitative compliance, but also able to address qualitative concerns, enabling institutions to better answer questions from auditors, management and regulators. This approach addresses weaknesses in current processes that have been discovered by audit and regulators.

BUSINESS SCENARIO MANAGEMENT

Financial institutions can leverage the steps detailed above to identify the impact of CECL on their business before the regulatory deadlines, giving them competitive advantage as others try to catch up. By mapping risks to potential rewards, firms can improve returns for the firm.

Given the last month's issuance of the ASU, the FASB will likely offer its guidance on CECL within the coming weeks. Notwithstanding any delay, firms can benefit from CECL best practices now, since they are equally applicable to the current incurred loss process. By implementing them now, firms can continue to build on their integration of risk and finance, improving their ALLL processes as they do. At the same time, institutions can build a more granular and higher-quality historical credit risk database for the transition to the new CECL standards, whatever the timeframes. This ensures a smoother transition to CECL, regardless of the form it ultimately takes, minimizing the risk of nasty surprises along the way. ■

FASB approves standard delays, including CECL

The Financial Accounting Standards Board approved delays to effective dates for some companies on its standards on derivatives and hedging, CECL, and leases. FASB Chair Russ Golden acknowledged a need for more time. **Kyle Brasseur** explores.

The Financial Accounting Standards Board has voted to approve a previously proposed delay to its upcoming rule change for credit losses, in addition to standards for hedging and leasing.

The board affirmed its decisions on the amendments following a public comment period that ended Sept. 16. Affected are Accounting Standards Codification Topic 326 (credit losses, or Current Expected Credit Loss), Topic 815 (derivatives and hedging), and Topic 842 (leases).

The board will next draft a final Accounting Standards Update on the amendments for vote by written ballot.

ASC 326 requires companies to adopt a "current expected credit losses" approach. Public business entities (PBEs) that are Securities and Exchange Commission filers, excluding entities eligible to be smaller reporting companies (SRCs) as currently defined by the Commission, will still be expected to comply for fiscal years beginning after Dec. 15, 2019, and interim periods within those fiscal years. For calendar-year-end companies, the effective date is Jan. 1, 2020.

All other public business entities and private entities will have the date delayed from January 2021 to fiscal years beginning after Dec. 15, 2022, including those interim periods within those fiscal years.

Accounting Standard Codification 815 on hedging, already in effect for PBEs as of December 2018 (January 2019 for calendar-year-end companies), will be deferred an additional year for all other entities other than public business entities to fiscal years beginning after Dec. 15, 2020 (Jan. 1, 2021, for calendar-year-end), and interim periods within fiscal years beginning after Dec. 15, 2021 (Jan. 1, 2022, for calendar-year-end).

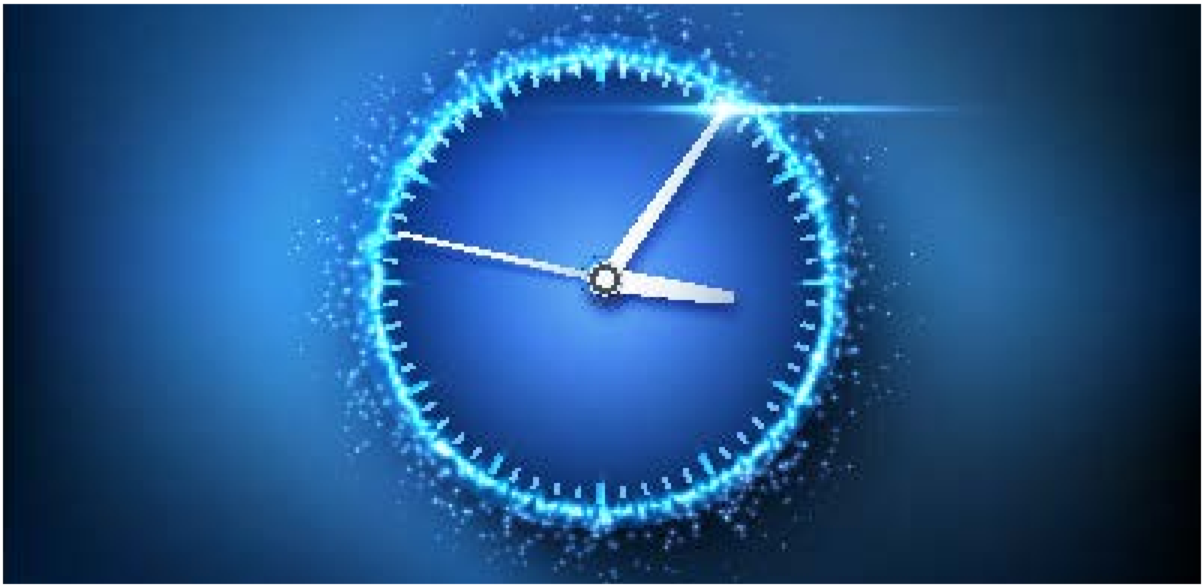
ASC 842 on leases, which is also already in effect for all PBEs, not-for-profit conduit bond obligors, and employee benefit plans that file or furnish financial statements with the SEC, will be deferred an additional year for all other entities—similar to ASC 815.

Early adoption on ASC 815 and ASC 842 will continue to be allowed. FASB's CECL delay notably does not let large SEC filers off the hook despite a universal plea from banks of all sizes to delay the standard so its effects on the economy can be further studied.

The controversial standard has even been a target for lawmakers, with Sen. Thom Tillis (R-N.C.) and Rep. Blaine Luetkemeyer (R-Mo.) each referencing CECL in legislation proposed to subject FASB standards to additional scrutiny before being implemented.

Russ Golden, chairman of the Financial Accounting Standards Board has acknowledged that private companies, not-for-profit organizations, and smaller public companies would benefit from having more time to implement major changes in accounting, with availability of resources, the timing and sources of education in the new standards, and the development or acquisition of technology among factors providing hardship.

This was originally published on Oct. 17. ■



Upcoming implementation workshops for CECL

After giving its approval for changing effective dates on some of its standards, including CECL, FASB has implemented workshops to help guide the process. **Jaclyn Jaeger** has more.

The Financial Accounting Standards Board has announced upcoming workshops designed to help community banks and credit unions of all sizes implement the standard on current expected credit losses.

The CECL Implementation Workshops are a series of 90- to 120-minute interactive sessions presented by FASB at various conferences and venues around the country. The workshops focus on credit loss reserve estimation techniques, including the Weighted Average Remaining Maturity (WARM) method; answers to frequently asked questions; and other common implementation issues banks may face.

Dates include Oct. 28 in Monterey, Calif.; Nov. 19 in Philadelphia; and a Webinar that will be held Dec. 19. New sessions will be announced on FASB's Website as more information becomes available.

"The FASB is committed to ensuring community banks, credit unions, and lending institutions of all sizes can successfully implement the credit losses standard," said FASB Chairman Russell Golden. "To support their success, FASB staff experts are taking our CECL Implementation Workshops to conferences and other gatherings of these institutions throughout the United States. It's yet another way we're promoting a smooth transition to the standard for all."

This was originally published on Oct. 22. ■

Banks finalize CECL prep, but others have work to do

Major banks are moving forward with FASB's credit loss standard; small banks are still thinking through it, writes **Tammy Whitehouse**.

Big banks are making progress in preparing for the new accounting requirements around credit losses, but non-bank operating companies are likely to face a heavier lift.

Bank of America has either validated its new models for recognizing credit losses under a "current expected credit losses" approach or is in the process of validating them, said Chris Lynch, senior vice president, at a recent American Institute of Certified Public Accountants banking conference. "We're running our CECL process in real time to make sure it can do it at game speed," he said. "It's been a great experience."

Public business entities (PBEs) that are Securities and Exchange Commission filers will still be expected to comply for fiscal years beginning after Dec. 15, 2019, and interim periods within those fiscal years. For calendar-year-end companies, the effective date is Jan. 1, 2020. All other public business entities and private entities will have the date delayed from January 2021 to fiscal years beginning after Dec. 15, 2022, including those interim periods within those fiscal years. The new standard tells entities to use some historic experience along with some forecasting to estimate their lifetime credit losses and book upfront allowances, doing away with the current approach whereby losses are reported as they occur.

The American Bankers Association and other major banks have lobbied for a delay in the CECL standard so the macroeconomic effects of booking larger upfront reserves can be further studied before being implemented. CECL critics say the standard will diminish the availability of credit when economic conditions deteriorate, although a recent Federal Reserve study pokes holes in that position.

Meanwhile, major banks are moving forward with implementation activities, preparing for the scheduled effective date. Doug Smith, senior vice president and head of credit risk administration at Wells Fargo, said the company has made "a tremendous amount of progress" preparing for the new accounting. In the first quarter the company completed dry runs of its new models, which were developed by leveraging comprehensive capital analysis and review requirements of the Federal Reserve.

"We are thinking through the validation process and getting that completed and moving to final documentation," said Smith. "If you think of all the activities together, end to end, we're very far down the line from a timeline perspective, but we still have quite a few activities bunched into the third and fourth quarters."

Lynch said Bank of America faces some year-end activities to finalize its preparations as well. The entity needs to finalize its documentation of internal controls over financial reporting to be ready for Sarbanes-Oxley Section 404 reporting, and it needs to complete its risk management validations, he said. "We also have to finalize our disclosures for the first quarter," he said. "We have initial drafts, but there's more to be done. I'm cautiously optimistic about where we are now."

Smith said he would also characterize his view of Wells Fargo's readiness as "cautiously optimistic," although he agreed his company faces a great deal of work to be fully prepared.

At Bank of Oklahoma, which is part of the regional BOK Financial Corp. based in Tulsa, Okla., Brent Saffell says he's also cautiously optimistic. Saffell is senior vice president in charge of credit risk management, reporting, and administration.

The firm has performed parallel runs in the third quarter that include all the controls, committee approvals, and documentation that will be required under CECL, said Saffell. "We are getting people through a lot of work that they haven't done internally before," he said, adding the company is probably on par with what has been achieved to date at bigger banks.

A recent KPMG poll suggests that although financial firms are making progress preparing for the standard, they are still not providing a great deal of specific detail about the expected effects. "The progress has been insufficient to lead financial statement preparers to have a comfortable idea of what their CECL impact might be," KPMG reported. "This uncertainty is evidence by the fact that few respondents were able to provide their CECL impacts at a product level."

Sagar Teotia, chief accountant at the Securities and Exchange Commission, said he and his staff in the Office of the Chief Accountant have seen "much progress to date on implementation" of the new CECL approach. "OCA has had many productive discussions with stakeholder, including financial institutions, other regulators, audit firms, and industry groups," he said.

A sound implementation of CECL requires adequate time, said Teotia. The Financial Accounting Standards Board issued the standard in 2016, although companies faced equally big changes in revenue recognition in 2018 and leases in 2019. "Time is necessary to develop new accounting policies and internal accounting controls, execute systems changes, and form well-reasoned judgments," he said.

Teotia said OCA can be expected to play fair when it comes to exercising judgments after companies have completed their filing. "OCA has consistently respected and not objected to well-reasoned judgments that entities have made in applying new accounting standards, and we will continue to do so in credit losses and in other areas," he said.

While the CECL effect is expected to be most significant in the financial services sector, non-bank public firms are also subject to the standard and may also have assets on their balance sheet that fall within the scope of the new rules. The standard applies not only to loans, but to items like trade receivables, debt securities that are being held to maturity and are available for sale, financial guarantees, and lease receivables.

Chris Chiriatti, audit managing director at Deloitte & Touche, says many companies outside of financial services were just starting to get engaged on CECL as summer ended and companies returned from the Labor Day holiday. "Even if there's not a heavy impact, every company is affected by the standard," he said.

Jonathan Prejean, managing director at Deloitte, said it has been tempting for companies that will not see a material effect under CECL to give it less attention. "From a financial statement impact, it may not be that big of a deal," he said. "But from a global company perspective, getting everyone on the same page, getting people trained, developing processes, that's going to take some time and effort. From a process and controls perspective, they need to get it done."

This was originally published on Sept. 19. ■

FASB: Investors want more from banks on CECL

A member of the Financial Accounting Standards Board says investors want more details form leading banks on how CECL will impact financial statements. **Tammy Whitehouse** has more.

Investors are frustrated they are not getting more information from leading banks over how financial statements will be affected by the adoption of the new CECL accounting rules on credit losses.

That's what Hal Schroeder, a member of the Financial Accounting Standards Board, said to a conference of bankers at the American Institute of Certified Public Accountants. FASB is hearing from investors who say they expect more numerical disclosure under Staff Accounting Bulletin No. 74 regarding how leading banks will be affected by the new current expected credit losses approach to reporting.

"During our outreach, investors have told us they're frustrated at having to work on their 2020 estimates with little to go on, other than a few high-level estimates," said Schroeder.

The CECL standard takes effect for public firms beginning Jan. 1, 2020. As many banks finalize their processes for arriving at more forward-looking loss estimates that are largely expected to increase reserves on balance sheets, Schroeder is advising them to use the remainder of 2019 and the early days of 2020 to work out their messaging. "Help your debt and equity holders readjust their eyesight," Schroeder said.

Although some are still holding out hope CECL will be delayed, Schroeder said FASB has no basis for believing entities are struggling to meet the time line for the new accounting based on any confusion or uncertainty over the standard.

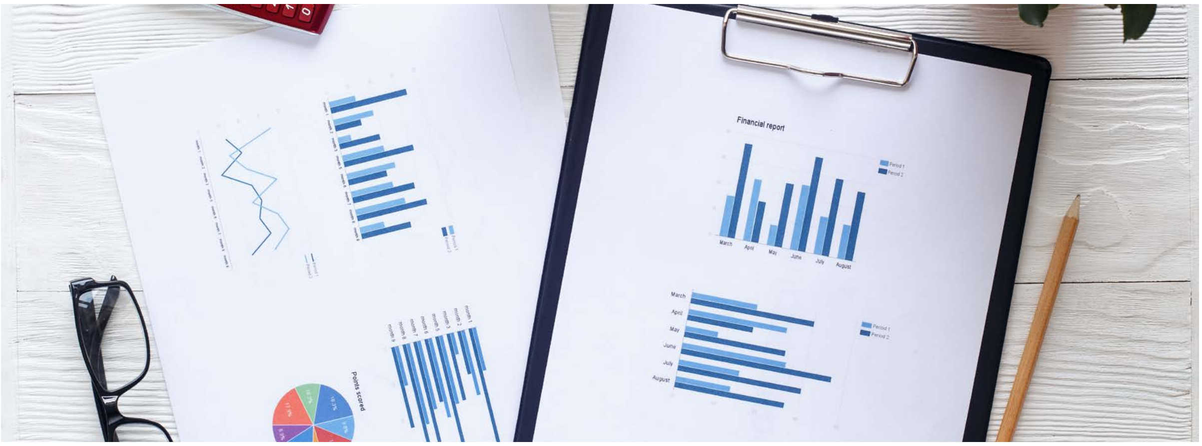
"In the past year, the staff has received very few questions, many of which could be quickly answered by referring directly to the guidance," he said. "Considering that our technical inquiry service is free and accessible online, the limited number of questions is at odds with the view some have voiced that there are many unanswered questions, and therefore, CECL should be delayed."

Schroeder referred to a few pieces of legislation in Congress, one in the House and another in the Senate, that would require FASB to defer CECL while its economic effects can be further studied. "Those advocating stop-and-study allege dire consequences from CECL's so-called procyclical effects on lending," he said. "However, independent studies already conducted do not support such concerns."

> "OCA has had many productive discussions with stakeholders, including financial institutions, other regulators, audit firms, and industry group, and I encourage everyone to stay engaged as we approach the standard's effective date."
>
> Sagar Teotia, Chief Accountant, SEC

Sagar Teotia, chief accountant at the SEC, said at the same conference he and his staff in the Office of the Chief Accountant "have observed much progress" on implementation. "OCA has had many productive discussions with stakeholders, including financial institutions, other regulators, audit firms, and industry groups, and I encourage everyone to stay engaged as we approach the standard's effective date," he said.

This was originally published on Sept. 9. ■



Auditors develop practice aid to compare CECL notes

The American Institute of Certified Public Accountants has developed guidance for auditors to use when communicating with audit committees on CECL. **Tammy Whitehouse** explores.

Auditors are comparing notes on how they will interact with audit committees and management regarding a new accounting approach to credit losses, and they've produced a guide that might be informative to preparers.

The American Institute of Certified Public Accountants has developed non-authoritative professional guidance intended to help auditors when communicating with audit committees regarding the Financial Accounting Standards Board's "current expected credit losses," or CECL, standard.

The guide says auditors expect practice to "evolve over time" with expectations of regulators and auditors changing along the way. "As such, questions, examples, and risks listed in this practice aid should not be considered exhaustive," the report says. "Auditors, management, and those charged with governance need to stay abreast of developments and consider the implications of those developments."

The practice aid is intended to give auditors information that may help them improve the efficiency and effectiveness of their audits, said Jason Brodmerkel, AICPA senior technical manager, in a statement. The aid is based on existing professional material plus input from the AICPA expert panels on depository institutions and insurance and AICPA member firms.

The guide summarizes the key provisions of the new standard and addresses some key considerations for auditors as they audit allowances companies develop for credit losses following the new guidance. It walks auditors through obtaining an understanding of the entity, assessing risks, identifying controls relevant to the audit, designing an audit response, performing audit procedures, and evaluating the audit and disclosure considerations.

Mike Lundberg, a partner at audit firm RSM and chair of the AICPA CECL auditing subgroup, says the guidance is primarily written for auditors, but lenders might want to have a look. "We believe this practice aid will be directly beneficial to lenders preparing to implement the new standard," Lundberg said.

This was originally published on Sept. 13. ■

Some companies ready for CECL; others are not

Citigroup raised its expected loan loss reserves under CECL as it prepares for parallel testing of its methodology, but plenty of organizations have barely started, writes **Tammy Whitehouse**.

When Citigroup assessed how its loan loss reserves would be affected by new accounting requirements soon taking effect, the company disclosed to investors reserves would increase by 10 percent to 20 percent.

Now that the company is deeper into its implementation activity, it is getting a better understanding of how the accounting works—and it has learned the reserve will actually be much bigger.

"This quarter, we moved to the 20 to 30 percent range as our models are getting finalized," said Linda Bergen, director and head of external affairs and Securities and Exchange Commission reporting at Citigroup, at a recent conference hosted by Deloitte & Touche and Bloomberg.

Like all calendar-year, publicly held companies, Citigroup is preparing for Jan. 1, 2020, when Accounting Standards Codification Topic 326 takes effect. ASC 326 is the accounting rule that requires companies to transition from the current approach of recognizing credit losses when they are virtually assured of occurring to a "current expected credit losses" approach.

Under the new accounting, companies will use a more forward-looking approach to recognize credit losses, leveraging some combination of historic experience and market data to estimate losses they will experience in the future and book those losses as soon as those items are added to the balance sheet.

While the new accounting is only a little more than a half year away, at least one member of Congress is still hoping to block implementation.

Representative Blaine Luetkemeyer (R-MO) is hearing from constituents that the economic consequences of the new accounting will be catastrophic for those looking to access credit, especially during market downturns, when increasing reserves will incentivize banks to reduce their exposure to risky loans. He's worried banks not only will reduce lending during downturns but also raise the cost of borrowing to cover their increased reserves.

"It scares the heck out of me," said Luetkemeyer. "A lot of people suddenly can't afford to buy a home. It's a bipartisan problem."

Luetkemeyer introduced a bill in late 2018, just before the Congressional season ended, but the bill went nowhere. He says that the work is now underway both in the House and Senate to renew the legislative effort.

Hal Schroeder, a member of the Financial Accounting Standards Board, which wrote the new accounting rule, says the concerns are overblown. "Reports of CECL's destructiveness have been greatly exaggerated," he said. "In fact, I strongly believe that CECL achieves the FASB's mission," which is to give investors a fair picture of a company's financial position, including advance warning of signs of trouble.

"Better information should contribute to improved pricing and capital allocation decisions," said Schroeder. "And, by extension, a safer financial system and a more resilient economy."

While Congress and CECL experts debate its possible effects on the economy, organizations like Citigroup are moving forward preparing for the rule to take effect. Banks in particular have recognized the amount of work CECL represents and started early in gathering data and developing models to determine how they would comply.

Organizations like Citigroup are arguably on the leading edge of compliance. Given the size of their debt-related portfolios, they had to take it seriously and start early.

Citigroup is in the process of testing user acceptance and began preparing for parallel runs in the third quarter, said Bergen. That means it will calculate its loan loss reserves under both the current accounting and under the new standard to test how its new modeling is working in producing figures that are ready for reporting in financial statements.

"Better information should contribute to improved pricing and capital allocation decisions ... and, by extension, a safer financial system and a more resilient economy."

Hal Schroeder, Member, FASB

Citigroup's wholesale group is a little further along in preparing its CECL reserve than its retail group, said Bergen. The wholesale group was able to leverage work the company has undertaken in other countries where International Financial Reporting Standards apply. The international rule on recognizing loan losses—similar to, but also different from, CECL—is already in effect.

The retail group at Citgroup is more dispersed, said Bergen, with the company operating in some 100 countries. Retail is also home to some of the more complex CECL issues, she said, because it includes credit cards.

Figuring out a CECL model for revolving loan balances like those associated with credit cards proved tricky. "Cards is probably the most difficult product banks have to try to evaluate under CECL," she said.

Early on, banks considered some different approaches to recognizing losses for credit cards, which were met with different reactions from banking regulators and the Financial Accounting Standards Board. Ultimately, most financial services firms have determined they will follow a "pay-down methodology," looking at payment history for accounts that are not routinely paid off each month.

As it turns out, the pay-down approach provides for a credit card receivable with a much longer life span than other methods that were considered, said Bergen. "The lesson learned: You need an awful lot of data and data not previously used for other purposes," she said.

The company created a data warehouse for accumulating and testing all the data it would need to comply with CECL to assure it would be fit for financial reporting purposes. "If the data is not good, the output for the model is not going to be any good either," said Bergen.

Citigroup also had to work out how far into the future it would take its forecasting. The company adopted different forecast horizons based on product. For credit cards, for example, the company determined 13 months was a reasonable and supportable forecast period. "Anything beyond that will be done through reversion to historical experience," said Bergen. For mortgages, the forecast period is 40 years, she said.

"Most losses are in the early years," said Bergen. "The further out you go with forecasts, the less reliable it becomes."

Not all banks are taking the same position. At least one major bank is taking the view it can only forecast reliably for one year, said Bergen.

While banks are making steady progress to prepare for the new accounting, some organizations outside of financial services still may not recognize they are also affected by the new accounting. "Don't think you're escaping this standard just because you're not a financial services institution," said Catherine Ide, managing director of professional practice at the Center for Audit Quality. "If you don't think this applies to you, think again," she added.

Jerry Trieber, director of audit services and support at HEI Hotels & Resorts, says his organization is exploring the extent to which it might be exposed to greater loan loss reserves as a result of credit card fraud. The company used to be able to rely on payment from credit card transactions, but rising levels of identity theft and credit card fraud produce greater risk of charge-backs, or reversed transactions due to fraud, he said.

"Most of our customers pay by credit card, and some pay by automated clearing house or wire transactions. It's this area of risk from our perspective that needs to be addressed," he said.

Deloitte and Bloomberg's on-site survey would suggest that plenty of organizations still have much work ahead of them to prepare for the new accounting. In fact, only a little more than one-third said they had developed a model for recognizing credit losses under CECL, and roughly a quarter said they were developing internal controls and processes for their new accounting. More than 20 percent said they hadn't yet undertaken any preparations.

This was originally published on May 8. ■

"Most of our customers pay by credit card, and some pay by automated clearing house or wire transactions. It's this area of risk from our perspective that needs to be addressed."

Jerry Trieber, Director of Audit Services and Support, HEI Hotels & Resorts

The main features and capabilities that financial institutions should look for in identifying a solution that can support their CECL related needs.

Financial Services Solutions

CECL: Managing data and expectations

BUYER'S GUIDE

The best hope for implementing the standard effectively and avoiding the pitfalls is to introduce or affirm certain operational practices, particularly those that enhance cross-department cooperation. That cooperation is essential, and it will need to be continual, not occasional.

The accounting standard, which requires banks to calculate expected credit losses and incorporate resulting provisions into its P&L statements, calls for a flexible, adaptable technology solution that will enable closer collaboration among finance, risk and reporting functions.

CECL: Managing data and expectations

If you're an executive at a bank that follows U.S. generally accepted accounting principles (U.S. GAAP), you may be watching the scramble by firms in much of the world to implement a new accounting standard – IFRS 9 Financial Instruments, a brainchild of the International Accounting Standards Board (IASB) – and thanking your lucky stars that it's not you. But it will be you soon enough.

The deadline to introduce Current Expected Credit Loss (CECL), the equivalent protocol from the Financial Accounting Standards Board (FASB) for predicting the extent and impact of credit impairments, is determined by a business's fiscal year, whether it is a Securities and Exchange Commission filer and whether it meets the definition of a public business entity (PBE). It will be the first day of the fiscal year beginning after December 15, 2019, for financial companies that have publicly held equity and that meet the definition of a U.S. SEC filer (January 1, 2020, for calendar-year entities). All others will have a year after that to get the job done.

That means the leaders of institutions that adhere to U.S. GAAP will have to start thinking about the changes they will need to make between now and then to their technology and their activities overall. If they run global enterprises that answer to the FASB and IASB in different jurisdictions, moreover, they are likely to find that the race to implement IFRS 9 has been merely the first of two heats.

When senior executives embark on their CECL projects, they could be in for a daunting experience. Indeed, the American Bankers Association, dispensing with any urge for sugarcoating, called it "the biggest change in the history of bank accounting." The challenges of getting CECL right, in particular devising the most appropriate impairment model, and executing it in a way that is transparent, efficient and repeatable, are great and many – often more than for other supervisory regimens – and the consequences of getting it wrong are severe.

The best hope for implementing the standard effectively and avoiding the pitfalls is to introduce or affirm certain operational practices, particularly those that enhance cross-department cooperation. That cooperation is essential, and it will need to be continual, not occasional.

While other procedures, such as the Federal Reserve's Comprehensive Capital Analysis and Review (CCAR), are periodic exercises, CECL practices must be conducted constantly, in real time. To support such a taxing, yet collegial, endeavor, institutions should employ a technological solution that fosters flexibility, adaptability and consistency in the use of data, most notably by facilitating its deployment for multiple purposes.

Leaders of institutions that adhere to U.S. GAAP will have to start thinking about the changes they will need to make between now and December 2019 to their technology and their activities overall. If they run global enterprises that answer to the FASB and IASB in different jurisdictions, moreover, they are likely to find that the race to implement IFRS 9 has been merely the first of two heats.

A running estimate that never stops

The primary task for an organization under the CECL standard is to estimate, and update frequently, the losses that are likely to result from impairments to assets over their lifetimes on the balance sheet. While IFRS 9 calls for the calculation of expected losses for individual assets that are then cobbled together into portfolios with similar risk characteristics, CECL allows for more collective assessments from the start.

Various methodologies underpinning the impairment model will be permitted under CECL, and institutions will be able to mix and match them to achieve what works best in particular circumstances, for instance for each loan pool. They include:

- **Transition matrix.** This involves tracking changes in risk characteristics, measured by risk ratings, credit scores or delinquencies, say, in a given batch of loans from one period to the next. It is a way to gauge changes in probability of default (PD).

- **Net flow rate.** This type of model is often used to forecast losses in retail portfolios. Debt is divided into buckets that vary in credit quality based on delinquency status or other factors. An estimate is then made of the percentage of the amount in each bucket that will deteriorate to the point that the debt must be moved into a bucket with worse credit characteristics, say from 30 days past due to 90. Expected losses are calculated by measuring the rates at which debt is moved to the charge-off bucket – the end of the line – from each of the others.

- **Net charge-off rate.** This is a fairly simple approach in which net charge-offs over a certain period are divided by total starting exposure. This historical charge-off rate is used to estimate future losses. What this method has going for it in terms of simplicity, however, it tends to lose in unreliability. Forecasts are highly dependent on the chosen look-back period, and data compilation is necessarily delayed by the gap between the starting point and when debt is ultimately charged off.

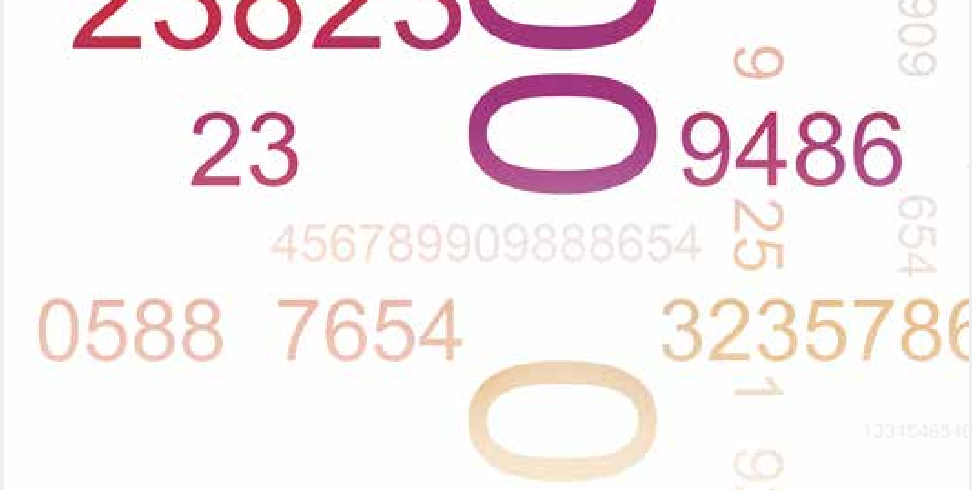
- **Vintage analysis.** Loans are typically grouped based on their maturities and years of issuance. A portfolio of six-year loans, for instance, will be divided into six piles, each with loans maturing in different years – so loans made five years ago that mature next year, loans made four years ago that mature in two years, and so on. For each of these groups, known as vintages, an expected-loss figure will have to be calculated for each of the six years that they will be on the books. That will create a grid of 36 loss estimates – six years of life times six years of issuance.

Whichever methods are used, loss calculations will be based on historical data about the loans themselves, overlaid with macroeconomic forecasts and other bits of context. How an institution crunches the numbers will depend on the model it has created. The point of the analysis is to allow patterns to emerge in the data that then can be used to inform other types of analysis beyond loss provisioning.

The overriding aim of the standard, though, is to come up with a sketch of an institution's exposure to credit losses. Most important, the estimated losses must be reflected immediately in the profit-and-loss statement, which is likely to add volatility and, especially just after implementation, decrease reported earnings. That gives the CECL calculation a tangible, meaningful heft; it's not just hypothetical spit-balling.

Déjà vu all over again

Although the expression "Current Expected Credit Loss" might seem confusingly oxymoronic to the uninitiated, the work involved in following the standard and the broad goal of seeing the future today will be familiar to anyone who is acquainted with financial supervision over the last decade and has seen how improved risk management practices have steadily made their way into post-crisis regulatory reporting. They can be seen in such protocols as the Basel capital adequacy rules, and in CCAR and other stress testing regimens included in the Fed's Enhanced Prudential Standards (EPS). In the aftermath of



the global credit crisis, several aspects of the supervisory architecture were widely judged to have been responsible for failing to prevent the crisis or provide any warning of its approach.

The means for assessing credit risk relied too heavily on a rigid incurred-loss methodology that limited the ability to assess and adjust to conditions as they were evolving. Evaluating operating conditions was harder in the first place because the partitioning into silos that characterized banks at the time – and that still does to too great a degree – limited communication among departments that might have revealed the danger. An additional factor is that even if bankers could see conditions changing, the existing supervisory system left them powerless to do much about it; management was not encouraged sufficiently, under accounting rules in use at the time, to adapt its thinking or practices to try to counter looming threats.

Regulatory regimes and accounting standards have undergone considerable evolution of their own since then. Much of it involves persuading executives to shift their viewpoint further into the future so that they can anticipate developments and then have freer rein to rely on their judgment about them. The preferred approach now is to observe principles rather than follow hard and fast rules so that institutions are better positioned to make adjustments to forestall negative events or at least to lessen their impact should they occur.

The CECL standard is but one manifestation of this trend. Its close cousin IFRS 9 is another, as is Consultative Document BCBS 311, the Basel Committee on Banking Supervision's somewhat dour set of guidelines to banks for crafting stress scenarios that has served as a wellspring for post-crisis regulatory frameworks worldwide.

Tomorrow's losses today

Under CECL, an organization must estimate credit losses that will accrue for most assets, including loans and debt securities, due to default or similar events from the moment that each is recognized on the balance sheet and for as long as it is expected to remain there. CECL is something of a blunt instrument; the treatment of expected losses is the same for all assets of all types and credit qualities, stable and risky alike.

CECL calculations are derived from the expected shortfall in cash flows alone, with a fair degree of leeway given to rely on practical expedients, based on historical precedent, to determine the relevant figures. IFRS 9 encourages the incorporation of additional prospective factors into the equivalent calculations, most notably projections of operating conditions arising from macroeconomic forecasts.

These discrepancies notwithstanding, CECL and IFRS 9 are broadly similar in their intentions and in the principles and practices that they call on institutions to adopt. That means businesses that have implemented IFRS 9, or are well on the way there, and that will then have to get to work on CECL will not be starting from scratch. The ones that only have to worry about CECL, meanwhile, can still benefit from the widely reported teething problems that peers have experienced implementing IFRS 9 and the solutions they have found for them.

In any case, two full years remain before CECL complaint models and its supporting processes must be in place (although it is permissible to use the standard as early as the start of 2019), leaving plenty of time to get it right. Just remember that getting it right will be a formidable task even in the best of circumstances, so it would behoove the personnel directing the implementation process not to take too long to get down to business.

When it comes to creating the CECL model, the FASB invokes the other main feature of post-crisis financial supervision: an emphasis on management judgment. CECL is a principle-based, rather than a rule-based, standard. Institutions are encouraged to develop models that work best for their mix of activities and the places where they do business. As the FASB said when it announced the final CECL procedures in 2016, the details should be left up to each organization, with each model broadly "based on historical experience, current conditions, and reasonable and supportable forecasts."

With great power comes great responsibility

A regimen that counts on adherents to draw up their own rules is a double-edged sword. It offers a lot of freedom, but the onus is entirely on them to construct models with appropriate rules and then to execute these models in the right way. Whatever practices an institution follows, it must be able to defend them.

This is another reason that data reusability is so important; while the resulting efficiency will help institutions crank out facts and figures with greater regularity than will be needed under any other supervisory protocol they are likely to encounter, the consistency it affords will limit errors, not to mention awkward questions from regulators and investors. And, of course, calculations and analysis must be consistent not just among the various CECL tasks, but between results obtained under the standard and those produced for other frameworks.

Just how formidable a challenge an institution will face in putting CECL into effect depends substantially on how far along the road it has gone toward integrating key departments, particularly risk, finance and reporting, and following the other guidelines set by the BCBS and the accounting standards boards, such as adopting a more forward-thinking approach and greater flexibility in decision making. If material progress has already been made in these areas, then preparing for the new standard will be mainly an engineering problem. Such well positioned businesses will have to upgrade and/or reconfigure systems to calculate impairment allowances and their impact on the profit-and-loss statement, capital requirements and other key metrics, and to produce the relevant disclosures for supervisory authorities.

For institutions that still have a compartmentalized, siloed organizational structure in place, a more thorough, comprehensive overhaul will be in order, and sooner rather than later. Enhancing communication and cooperation among a bank's key functions is emphasized by regulators and

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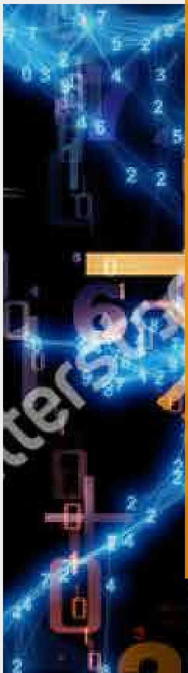

accounting standard setters across the board. The need to heed that advice may be most acute, however, when it comes to implementing CECL.

The procedures mandated by IFRS 9 and other frameworks may have many of the same adverse consequences, but they are probably more egregious under CECL due to the standard's unique features. Because CECL requires the estimation of losses for the lifetime of every asset on the balance sheet, impairment allowances are frontloaded to the maximum. That could produce a severe hit to P&L, significantly heightened capital requirements and other unpleasant effects, ratcheting up the pressure to devise the right model.

Explaining, if not avoiding the bad news

Even if the most negative effects prove unavoidable, close coordination of the risk and finance departments, along with auditors, compliance and reporting officers and senior executives, should allow them at least to frame the impact in the most palatable terms and explain it – perhaps with some warnings along the way on what, and how much, is to come – to key figures inside and outside an institution. They can emphasize, for example, that the initial damage to key metrics, though potentially great, is likely to dissipate once it has made loss calculations for existing assets.

But the need to explain and defend results will be a continual effort. Whereas other supervisory frameworks provide a snapshot of an institution at one or a few points in the year, CECL is more like a movie that tells the story of its life, warts and all. Especially the warts, in fact, considering the extreme provisioning procedures under the lifetime-loss rule.

It's not an obscure art house film that few people will ever see, either. CECL calculations involve forecasts and educated guesses, but this is no mere what-if exercise. The results will determine real-world provisions and therefore real-world profits under ordinary operating conditions.

Compliance with the standard, therefore, is akin to producing a documentary, albeit one where viewpoints are often presented as facts, and not a fictionalized account. It's one that will be scrutinized by a wide and influential audience – in the boardroom, at agencies like the Fed and the SEC, and on Wall Street – that will not hesitate to offer judgments on an organization's management, particularly regarding its use of capital.

Assembling the team

Creating such a work requires a topnotch crew pulling together behind the scenes. Incorporating CECL into existing operations and technological infrastructure will require a thorough integration of an institution's key functions.

Given the critical role that the standard will play not just in regulatory compliance but in risk management and financial performance, many departments will be involved in developing, testing and evaluating the expected-loss model, and then using it after the implementation phase. Data management, reporting, disclosures and other significant aspects of an entity's operations also will require closer cooperation.

Veteran financial executives may think they have heard all this before, but they should take care to avoid overconfidence as they prepare to get their programs off the ground. CECL requires finance, risk and reporting to come together more closely than under any supervisory rubric that they are likely to have dealt with.

Financial and accounting elements typically have been walled off from details related to risk, but they are tightly bound under CECL due to its blending of historical data with forecasts. The somewhat improvisational nature of a system that asks institutions to adhere to broad principles but counts on them to write their own rules also plays a role. It is also important not to underestimate how discordant the practices mandated under CECL are likely to seem to the accounting staffs that will have to use the standard. Accountants are used to working with hard, historical facts, not making forecasts and estimates or otherwise winging it.

Perhaps the greatest need for cooperation when drawing up an implementation plan lies in the fact that calculating losses and their impact will not be an occasional event, compared to the CCAR process, which requires banks to perform an exercise once or twice a year, but a core activity with duties to be performed quarterly, monthly or even daily. Having such frequent risk management and accounting chores – especially ones that depend on compiling current and historical data, adding estimates for events in the near and distant future, and then doing perennial updates – makes efficiency, as well as accuracy and consistency, paramount.

Calling a spade a spade and not a shovel

Achieving these aims depends on repeatable processes and procedures. That is the cornerstone of cross-department collaboration. Each function must understand how each other one works so that all can operate the same way at every point of contact. Practices must be identical, and for that to happen, identical names and ideas must be used.

Any given data category must be called the same thing throughout the organization, for instance. And while that may seem obvious, and obviously beneficial, getting to that point will mean overcoming the tendency for each part of an enterprise to be certain that its terminology and way of handling that data category are best. That means that someone will have to make tough calls, even if they are only tough because some groups are bound to dislike them.

That someone is likely to be a senior finance official. The direct road from CECL to loss provisions to the P&L statement argue for finance to take the lead in developing, implementing and trying out the model, and in issues related to data governance. Regulatory reporting, risk and information technology specialists will contribute input in the early going, and compliance and audit personnel will join at a more advanced stage. This is different from IFRS 9 and most regulatory frameworks; it is more sensible, given the heavy risk management elements, for risk officers to guide their implementation and use.

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After the tough calls are made, they must be written down. Fully and faithfully documenting the decisions made in CECL implementation is essential for the team spearheading it and for those who will have to work with the standard – and the myriad other processes that it will affect – later on.

Doing so will help get the project moving back in the right direction should it go awry. Even if it goes smoothly from the start, the need to explain and defend rules, procedures and calculations to regulators, investors and other stakeholders makes such rigorous documentation a sound habit to get into. Strong documentation procedures will help to form the solid foundation that is especially important for a CECL program because the principle-based nature of the standard assures that it will be supporting what could be some experimental and potentially fragile architecture above it.

A story that adds up, even if the numbers might not

It is important, of course, to build a CECL model that reflects as precisely as possible an institution's best estimate of future credit losses. But precision isn't all it's cracked up to be. The need to explain and defend results can make it even more vital to develop a narrative underpinning the model choices and how they are applied.

Why does the model use a technique for aggregating loans that spreads risky ones among pools of good credits in a particular way, for instance? Officials will need to be able to show their thinking to regulators and perhaps, if things go far off the rails, in court and to make a persuasive argument that these methods were the best available at the time. It may not be fair or just, but an organization with a more transparent, believable story is likely to come off better than a rival that has a better model but a comparative inability to explain and justify it.

This highlights what might be thought of as a temporal irony of CECL. The standard will employ predictions to create a statement about conditions today that will be presented as hard facts. But it can make sense for institutions to come up with a tale to lend credence to the guesswork about the future that gets them there.

This is another occasion that demands close companywide cooperation. Staff members who work intimately with CECL, the people precariously straddling the present and future, must all agree upon a compliance framework. It is important to remember that there is no right model, just the truth as senior officials see it – and can explain and justify it.

When an undertaking is so complex, the technology supporting it must be correctly designed to handle the requirements efficiently and accurately.

Many moving parts, constantly in motion

CECL is an exercise that relies on calculating, compiling, collating and analyzing immense quantities of data swiftly and all the time by many members of an organization working to achieve the same mission but with myriad roles and responsibilities. When an undertaking is so complex, the technology supporting it must be correctly designed to handle the requirements efficiently and accurately.

Users must utilize the system via interfaces tailored to their needs. At the same time, retrieving information should not be a cumbersome or time-consuming ordeal, especially given the frequency with which many operations must be performed.

That makes good data management – methods for gathering, cleaning up and storing it – the foundation of a CECL solution. It should feature a data model designed with all factors and attributes that an impairment model is going to be built on. It should be accessible to all users and present information in a common language and format. That will ensure that the system is most flexible and adaptable and will allow data to be used and reused, facilitating the performance of any quantitative financial, risk or regulatory requirement or analysis.

Wherever and however a firm does business, having a solution that is designed with multiple users and multiple supervisory frameworks in mind, while managing data in a way that presents a single version of the truth, will ensure consistency, enhance productivity and keep compliance and reporting costs as low as possible.

Data reusability, indeed, is likely to pay dividends especially for big, international institutions that need to implement both major accounting standards in various parts of their realms. The ability to reuse and repurpose data will also come in handy for a range of other requirements and procedures related, for example, to asset-liability management, Basel capital adequacy compliance and general regulatory reporting.

While the stakes for designing an accurate, effective CECL model are high and the data management needs are great, the model requirements for IFRS 9 are generally more complicated. An institution that has implemented IFRS 9 ought to be able to adapt its model to CECL with some judicious tweaking of the factors used in the expected-loss calculations, assuming its data management is up to scratch.

Some institutions are reporting, by contrast, that the systems they use for CCAR stress tests are not completely able to be recalibrated adequately to perform CECL functions. CECL horizons are much longer and the calculations will be run on a business as usual basis, not just once or twice per year. It may seem paradoxical, but the smaller a bank is, the more work it is likely to have to do to develop its CECL capability, running stress test and CECL processes separately, for instance.

Wherever and however an organization does business, having a solution that is designed with multiple users and multiple supervisory frameworks in mind, while managing data in a way that presents a single version of the truth, will ensure consistency, enhance productivity and keep compliance and reporting costs as low as possible. These are worthy objectives in meeting the requirements of any supervisory protocol, but the frequency and volume of calculations under CECL heighten their importance.

Harmonizing staff members and their tools

A unified database also will aid the cause of cooperation across departments that enhances the implementation and performance of CECL, creating a virtuous circle. Presenting data in a common, universally understood format will encourage employees who perform disparate functions to work more collaboratively because they will be inhabiting the same universe of facts, figures and processes.

The flexibility and adaptability built into OneSumX CECL manifest themselves in several ways that help it to act as the glue that binds an institution's operations and people together. It is one of the rare solutions in the marketplace that bring the functional requirements of finance, risk and reporting under a single platform. Having one process leveraging others eliminates waste and, with the help of its rules and accounting engines, maximizes compatibility with different sets of standards and regulations.

To facilitate implementation, OneSumX CECL is a modular system designed to mesh with an organization's existing tech as much or as little as needed. It can serve as a point solution to cover existing gaps or as a strategic platform for end-to-end CECL compliance. From segmentation of assets, credit assessment, stress testing and scenario management through the actual ECL calculations to ledger postings and disclosures, it provides full data visibility and auditability in open architecture that integrates easily into an entity's legacy systems and others provided by third parties.

Institutions will have to perform a gap analysis to gauge which elements of their existing technology will meet CECL requirements, and how well, and what new infrastructure will be needed. The analysis will have to determine how adaptable their systems are to quantitative modeling and the grouping of credit instruments. It will also have to decide how well their existing systems will prepare them to defend their model and its calculations and whether their data management capabilities are up to the challenge of holding and processing massive amounts of historical information and applying frequent updated forecasts to it.

Even the most diligent and astute gap analysis will have gaps of its own, however, because CECL remains a work in progress. The BCBS has lamented discrepancies in the procedures for various regulations and accounting standards. It has said that it would prefer harmonization to ensure a level playing field, yet after more than a year since the FASB published its CECL procedures, it is unclear if, when and how the supervisory landscape will be altered.

This uncertainty should encourage institutions to place an even greater premium on flexibility and adaptability as they work through their CECL implementation. That should help them avoid the tendency to scrap or overhaul systems and procedures each time a significant regulatory change is introduced. In fact, managers of a glass-half-full disposition may be inclined to view CECL as an opportunity to refresh and streamline their overall data infrastructure, adding functionality where appropriate, say to handle liquidity requirements, and eliminate redundancy.

As they set about implementing CECL, that prospect should force bankers to contemplate another hypothetical: What if a model that is poorly thought out or poorly executed, or perhaps data management processes that are not up to the daily grind of CECL calculations, gets it wrong and generates provision forecasts that are too low or too high when regulators and the stock market demand that they be just right? Goldilocks isn't the only one known to have had unpleasant experiences with bears.

With so much on the line, a firm's personnel will have to work together as never before, with all functions, particularly finance, risk and reporting, performing in concert. They will have to be of like minds and speak with a common voice. And they will need tools that are organized the same way, as a fully integrated solution that doesn't just conform to the desired holistic organizational structure, but strengthens it.

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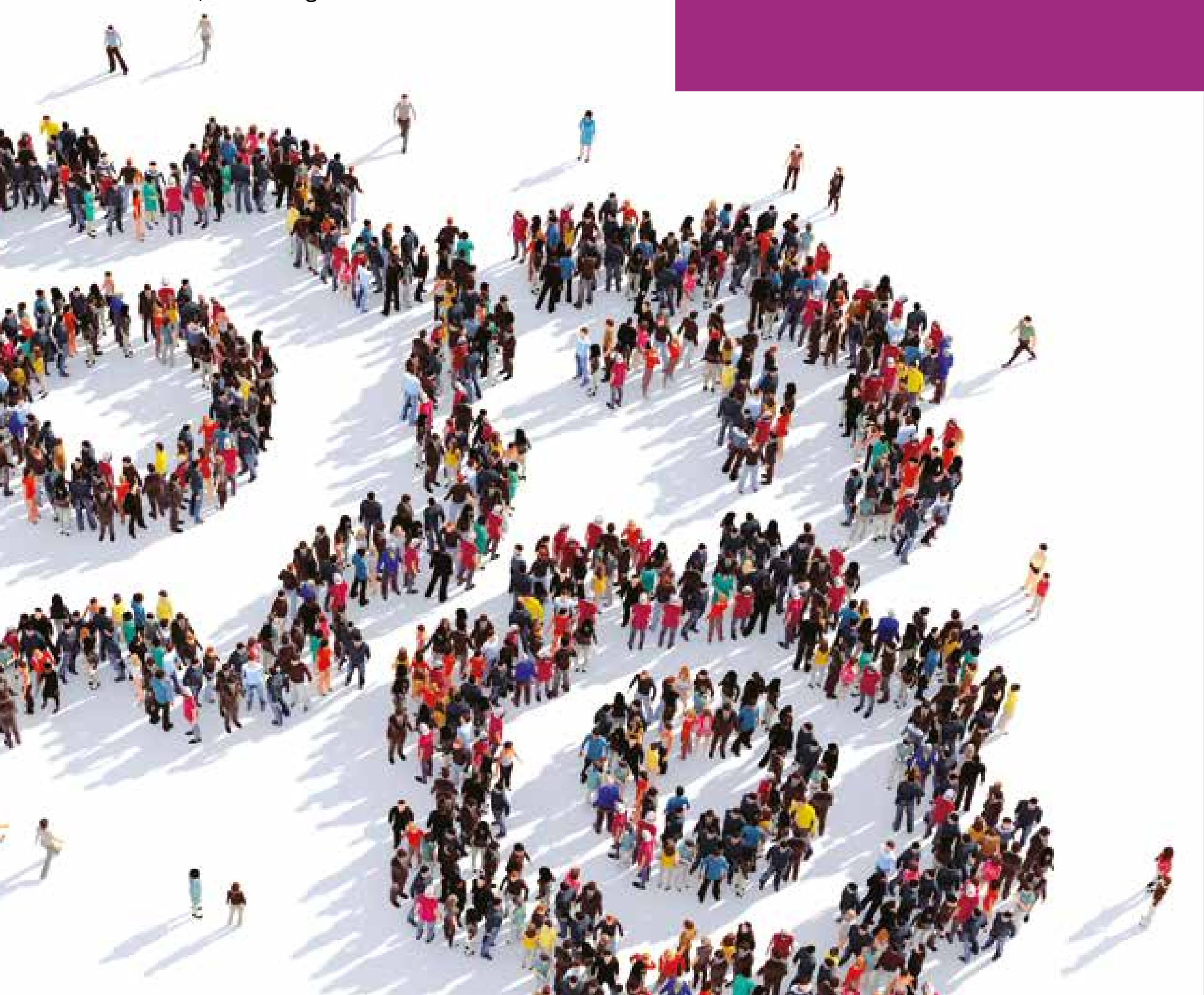

A hypothetical for the real world

Much of post-crisis financial supervision has asked institutions to consider what-if scenarios, often bleak ones: What would the condition of the bank be if something close to the worst were to happen? CECL deals with a what-will-be scenario and may produce more anxiety for it.

CECL will require institutions to come up with their best estimate of credit impairments using their best predictions of the operating environment that they will face. They will have to supply much of this information daily. And the results will not be regarded merely as the outcome of a hypothetical exercise; they will be factored into the financial statements presented to regulators, the board and investors and treated as a testament to their credit risk and capital management prowess.

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The need to be right, right at the start and in the most efficient and economical – in time and money – way, means that institutions should put their best people on the job. They, in turn, will need the support of specialists that offer the best technology, experience and expertise. Together they can implement a CECL solution that is flexible, adaptable, consistent and, perhaps most important, durable so that it will be able to perform a range of complex operations simply and elegantly, and then perform them repeatedly.

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Audit committees get some help overseeing CECL

The CAQ is giving audit committees a hand overseeing credit loss standard mplementation. **Tammy Whitehouse** reports.

Public companies are required to begin complying with the current expected credit losses model under Accounting Standards Codification Topic 326 beginning Jan. 1, 2020. As overseers of financial reporting and auditing, audit committees ultimately are responsible for oversight of the implementation of the new accounting standard.

A new CAQ tool gives audit committees guidance on how to exercise that oversight duty. It provides a brief overview of the core principles of the standard and suggests questions audit committees should be asking to properly evaluate how effectively the company has assessed the impact of the new accounting.

The tool also helps audit committees evaluate management's implementation plan. It gives audit committees some additional issues to consider, such as transition methods and disclosure requirements, and it provides tips on additional resources that will be helpful to audit committees.

While financial services firms have been engaged on CECL for some time leading up to the effective date, the standard's effect outside of that is not as well recognized or understood. Audit committees outside of financial services "probably have a little work to do," said Catherine Ide, managing director of professional practice at the CAQ, at a one-day Deloitte-Bloomberg conference on CECL. "There's a little fatigue in the system," she said, due to big changes companies have already endured with respect to revenue and leases.

"There's a misperception that the standard is only going to impact financial institutions," said Ide. Any company that holds financial instruments that are not marked to market, or measured at fair value, will be affected in some way, she said.

> "There's a little fatigue in the system. There's a misperception that the standard is only going to impact financial institutions."
>
> Catherine Ide, Managing Director of Professional Practice, Center for Audit Quality

That means audit committees at those entities need to be engaged with the process those firms put in place to evaluate how it will be affected by the standard and what internal controls are needed for implementation and the new accounting, Ide said.

Audit committees also are responsible ultimately for assuring the company is meeting its disclosure obligations both in connection with the new accounting and in the financial reporting periods leading up to implementation. The Securities and Exchange Commission's Staff Accounting Bulletin No. 74 requires companies to give investors advance warning of changes that are coming in accounting.

This was originally published on May 7. ■

Fed study minimizes CECL lending, volatility concerns

A new analysis out of the Federal Reserve suggests concerns over the expected economic effects of CECL, the new rule on credit losses, may be overstated. **Tammy Whitehouse** reports.

A new analysis out of the Federal Reserve suggests concerns regarding expected economic effects of a new rule on credit losses may be overstated.

Two board members of the Federal Reserve studied how a current expected credit losses approach to recognizing credit losses in financial statements would have affected the period leading up to the financial crisis of 2008. The CECL approach, required by the Financial Accounting Standards Board under Accounting Standards Codification Topic 326, is set to take effect Jan. 1, 2020, for calendar-year public companies, although FASB has voted to approve a delay for smaller reporting companies and other non-public entities.

A large number of banks, including the American Bankers Association (ABA), have called on FASB to delay CECL for all companies, concerned it may have a "procyclical," detrimental effect on the economy. They believe the increased reserves banks will need to hold to cover for life-of-loan loss estimates under CECL will make it more difficult for borrowers to get loans, especially as the economy heads toward a period of stress. They are predicting volatility both for reserve requirements and for reported income.

Banks have even petitioned Congress to intervene, and they have won the ear of some members, although bills introduced there so far have not gained enough support to move through the legislative process.

The study by Fed board members Bert Loudis and Ben Ranish suggests the concern is not as great as big banks think. Using data to create a model of how CECL would have affected bank lending from 1998 through 2014, the study says CECL will "modestly affect bank lending in a way that dampens fluctuations."

During the period before the financial crisis in 2008, for example, had CECL been in effect, banks would have reduced lending leading up to the crisis and increased lending during the recovery. That would have had the effect of "modestly decreasing the volatility of lending growth," the study concludes.

The findings are consistent with what FASB heard from stakeholders as it worked over several years to develop the new model, says FASB Chairman Russ Golden. "I'm pleased but not surprised by the general conclusions of this objective study of CECL," he said. The board is committed to continuing its engagement with preparers, auditors, and others, he said, answering questions and providing assistance, all aimed at "helping ensure a smooth, effective implementation of CECL."

The ABA is not as confident in the newest study. "In the real world, banks will forecast credit losses in light of supervisory expectations that are grounded in stress tests and are subject to auditing standards designed to minimize earnings management," said Mike Gullette, senior vice president of tax and accounting at the ABA.

Those factors are not captured in this study from Fed board members, he says. Still needed, says Gullette, is "a robust, quantitative impact study of the standard's potential effect, particularly on lending."

In the meantime, financial institutions continue their march to compliance with CECL beginning on Jan. 1, 2020, for calendar-year entities. Because the standard shifts banks from reporting losses as they are incurred to projecting lifetime losses and reporting them upfront, experts have generally expected banks to report increases in reserves.

A recent analysis by Audit Analytics shows only a handful of entities have so far disclosed how they expect to be affected by the standard. JPMorgan said it will increase its credit loss reserves on its $150 billion credit card portfolio by some $4 billion to $6 billion, and Citigroup's reserve across its portfolio is expected to rise $400 million to $600 million.

Two major organizations disclosed some unexpected effects, however, reporting their reserves will actually decline when they adopt the new accounting. Wells Fargo said its reserves on short-term commercial loans will drop by as much as $1 billion, and its reserve for residential mortgages could fall by $1.5 billion. Synchrony Financial also said it expects the new standard to reduce its regulatory capital.

Larry Smith, senior managing director at FTI Consulting and a former member of FASB, says he wasn't expecting to see instances where banks would reduce reserves given the change from an incurred loss model to one projecting lifetime losses and recognizing them at the inception of an instrument. "I don't think there were many board members expecting reserves to go down," he says.

It's possible some entities may have reserves that are overstated under current GAAP, says Smith. Perhaps as a result of a conservative approach to satisfy banking regulators, some banks may be recording reserves on "an incurred-plus loss basis," he says.

It's also possible, says Smith, a reduced reserve could be rooted in the interplay between accounting rules and banking regulatory requirements with respect to the write-off and eventual recovery of bad loans. CECL will generally accelerate the recording of expected recoveries compared with current GAAP, he says, which would affect reserves.

Yet another factor, says Smith, is how a given financial institution treats loans it expects to roll over, or renew. "Under CECL, you don't look at future loans or loans that are expected to renew," he says. "You only look at current loans."

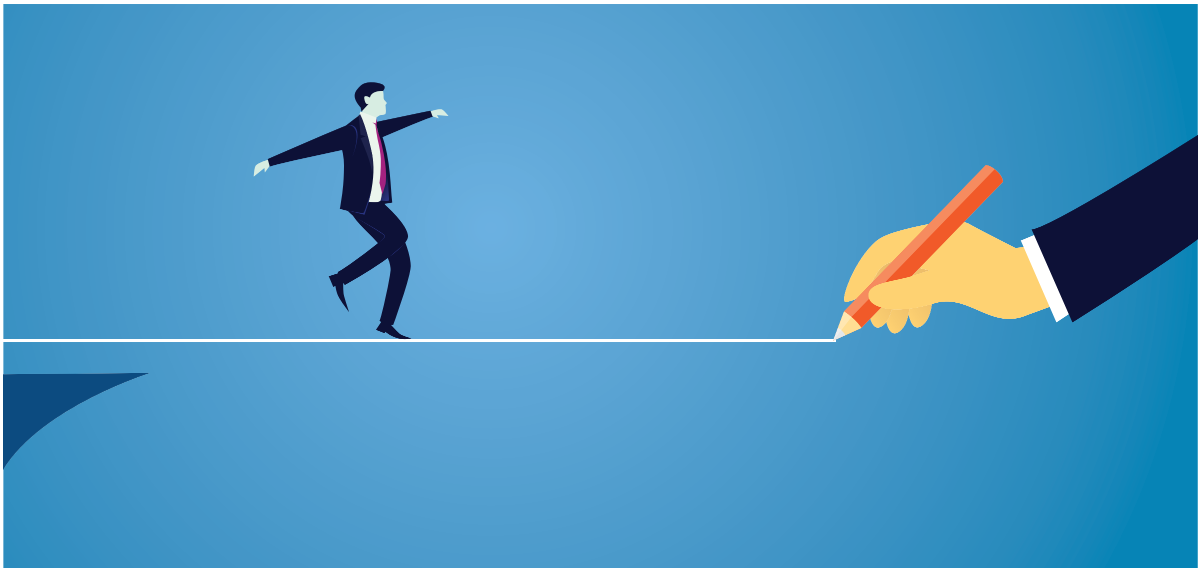
Jonathan Howard, senior consultation partner at Deloitte, says the standard's requirement to focus on the contractual life of a loan could lead to smaller reserves for certain types of instruments, such as credit cards or revolving instruments, for example. During consultation with FASB's Transition Resource Group, accountants were told CECL prohibits companies from establishing allowances on unfunded lines of commitment where the entity has unilateral authority to shut it down. "It wouldn't surprise me if we saw instances of credit losses declining," he says.

As entities get deeper into preparing for the new accounting, it's still difficult to predict systemically what will happen to reserves, says Howard. It will depend on any given entity's asset mix as well as economic conditions at the time of reporting, he says.

This was originally published on Aug. 16. ■

"In the real world, banks will forecast credit losses in light of supervisory expectations that are grounded in stress tests and are subject to auditing standards designed to minimize earnings management."

Mike Gullette, SVP of Tax & Accounting, ABA



Estimation vs. precision: Tension in accounting grows

It's more than big change prompting major deferrals for pending accounting rules. It's also about the growing tension between estimation and precision. **Tammy Whitehouse** has more.

Major deferrals in pending accounting standards reflect not only the enormity of change that's occurring. They also represent a symptom of the growing tension in financial reporting between estimation and precision.

The Financial Accounting Standards Board is pushing the pause button on some major accounting changes, including Current Expected Credit Loss, or CECL, for smaller reporting companies, as the system tries to catch up with huge change in recent years and prepare for more change still to come. CECL requires companies to shift from reporting losses on debt-based instruments as they occur to developing projections under a "current expected credit losses" model. The standard requires entities to use a combination of internal and external data massaged by judgments and estimates to arrive at expected losses to be reported in financial statements. Large banks are well on their way to complying with the new approach, and some are saying they will make sizable increases to their loan loss reserves as a result.

Smaller banks and other public companies are generally further behind, and now FASB is proposing to give smaller reporting companies and non-public companies an extension. As the board consults with its advisory groups and studies what transpired with the revenue recognition adoption in 2018 and the lease accounting adoption in 2019, board members recognize smaller companies are last in line for scarce resources and need more time to prepare.

"In some regards, it's general fatigue," says Graham Dyer, a partner at Grant Thornton. "That's one element."

Another element, says Dyer, is continued tension over how to develop a model that complies with the standard, which does not prescribe an exact method but tells companies to use judgment based on their own circumstances to estimate future losses. The availability of data to feed into a proposed model, not to mention the quality and the reliability of that data, are matters of ongoing debate.

Scalability of the standard to smaller organizations is still a point of confusion, says Thomas Barbieri, a partner at PwC. "Less sophisticated institutions are wondering to what extent they need models to satisfy the standard. There's a lot of noise in the system relative to how far you need to go."

Therein lies the tension between estimation and precision. CECL is an estimate, but how precise must it be to satisfy regulators, auditors, and investors?

As FASB opened the discussion, staff issued new guidance on CECL to try to address that tension. The guidance answers questions around the standard's requirement for companies to use reasonable and supportable forecast information to develop their loss reserves.

Especially from smaller organizations and those that are not on the leading edge of CECL preparations, FASB staff has fielded questions about how to arrive at "reasonable and supportable" forecast data and where historical information can be used, says FASB member Sue Cosper.

In an effort to combat continued "misinformation," the new staff guidance is meant to provide some granular clarity about how to apply the standard, particularly for smaller financial institutions and credit unions, says Cosper. "It helps them understand what they need to do and what they don't need to do," she says.

FASB staff also plans to roll out a series of workshops, perhaps in the fall, to help smaller organizations in particular understand how to apply the standard. "The methodology smaller banks can apply very much leverages the practices and methodologies they use today," Cosper says.

The workshops will be meant for practitioners and auditors alike, she says, "to help get the word out about what this is and what this isn't," said Cosper. "We're trying to really help them understand that they can really leverage what they're doing today."

Mike Gullette, senior vice president of tax and accounting at the American Bankers Association, which has lobbied Congress to block CECL so it can be more closely studied and possibly revised, is circumspect. "It's a complicated process inherently," he says.

To appropriately develop models under CECL, financial services firms have to look at all aspects of credit risk, says Gullette, and they have to be able to explain that to auditors and investors. "That's very comprehensive," he says. "To say you can use simple models vastly underestimates how much preparation needs to occur, but also how much data you need and what kind of quality that data needs to be."

Auditors, for example, are under ongoing scrutiny from their regulators—the Public Company Accounting Oversight Board—to exercise more skepticism and to look more closely at how management arrives at its estimates and assumptions, says Gullette. "New auditing standards are telling them to be skeptical," he says. "They're going to ask why you didn't arrive at their different estimates. They're going to use peer information and third-party data. You have to be able to answer their questions. Simple models will not answer all their questions."

In their preliminary modeling, banks are finding they get their best reserves under CECL and can explain period-to-period changes more easily when they begin with granular facts and data and then bring it to a higher level, says Gullette. Beginning at a higher level is problematic, he says. "You might find you have overlooked data you need if you do things starting from a high level."

FASB's extension of the CECL timeline for smaller reporting companies and non-public companies will give the system time to sort that out. With the earliest of effective dates to be deferred approaching on Jan. 1, 2020, "we need to act expeditiously," says Cosper.

This was originally published on July 18. ■

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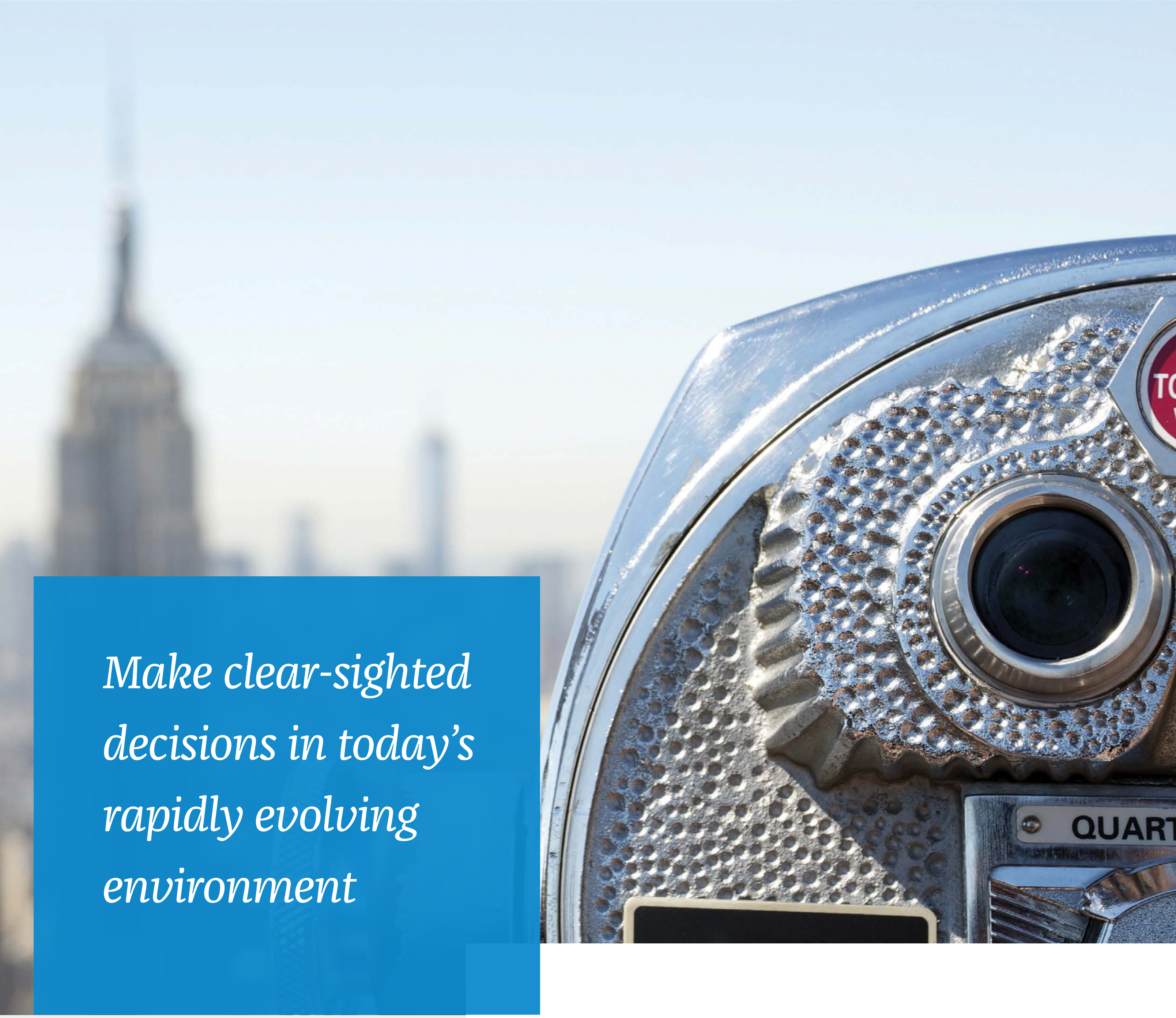

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