Brought to you by the publishers of COMPLIANCE WEEK

INSIDE THIS PUBLICATION:

AICPA proposes papers on credit loss interpretations

Deloitte: CECL 2019: Finish strong, with confidence

SEC will watch for SAB 74 disclosure leading to CECL

FEI group provides guides on leases, CECL controls

Preparing for the New credit loss rules

An e-Book publication sponsored by Deloitte.

About us

COMPLIANCE WEEK

Compliance Week, published by Wilmington plc, is an information service on corporate governance, risk, and compliance that features a weekly electronic newsletter, a monthly print magazine, proprietary databases, industry-leading events, and a variety of interactive features and forums.

Founded in 2002, Compliance Week has become the go to resource for public company risk, compliance, and audit executives; Compliance Week now reaches more than 60,000 financial, legal, audit, risk, and compliance executives. http://www.complianceweek.com

Deloitte.

Deloitte provides industry-leading audit, consulting, tax and advisory services to many of the world's most admired brands, including more than 85 percent of the Fortune 500 and more than 6,000 private and middle market companies. Our people work across more than 20 industry sectors to make an impact that matters — delivering measurable and lasting results that help reinforce public trust in our capital markets, inspire clients to see chal-lenges as opportunities to transform and thrive, and help lead the way toward a stronger economy and a healthy society. Deloitte is proud to be part of the largest global profes-sional services network serving our clients in the markets that are most important to them.

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee ("DTTL"), its network of member firms, and their related entities. DTTL and each of its member firms are legally separate and independent entities. DTTL (also referred to as "Deloitte Global") does not provide services to clients. In the United States, Deloitte refers to one or more of the US member firms of DTTL, their related enti-ties that operate using the "Deloitte" name in the United States and their respective affili-ates. Certain services may not be available to attest clients under the rules and regula-tions of public accounting. Please see www.deloitte.com/about to learn more about our global network of member firms.

Inside this e-Book

AICPA proposes papers on credit loss interpretations

The AICPA is digging into credit loss rules, suggesting some implementation approaches with two draft documents. **Tammy Whitehouse** has more.

The accounting profession is digging into the new accounting standard on credit losses and suggesting some implementation approaches with two draft documents.

The American Institute of Certified Public Accountants has formed a task force to explore implementation issues that are arising particularly in the financial services and insurance sectors as they prepare to adopt Accounting Standards Update No. 2016-13. That's the new standard on reflecting credit losses in financial instruments, which requires companies to follow a "current expected credit losses" model for determining how to reflect debt instrument performance in financial statements.

The new CECL model, codified in Accounting Standards Codification Topic 326, replaces the current "incurred loss model" by telling companies to take a more forward-looking approach to booking loan losses. The idea is to give investors earlier warning when instruments may be headed for trouble.

Companies must estimate the potential for losses using a combination of their own historic data and market or industry data, and they then must estimate and book possible losses from the inception of a given instrument, even when it is fully performing. Financial institutions, which are the most heavily affected by the new standard, are reporting challenges in preparing for the new accounting.

FASB formed a Transition Resource Group to field questions and concerns as they arose through implementation activities, and it recently determined it will extend the effective date for non-public business entities due to some uncertainty over how to comply with transition provisions. FASB has issued a proposed amendment to the standard to clarify its intent with respect to transition for those entities.

The AICPA has formed a task force as well to work through questions arising in the profession, and it is developing draft documents for review and public comment to try to build some consensus in terms of how the requirements are being interpreted and observed. The task force has developed nearly 40 issues that are being developed into similar working draft documents, and it has issued two so far for public review and comment.

> "This is a way for us to help folks say here's what we identified as potential zero credit losses based on our facts and circumstances now, and here's why."
>
> Jason Brodmerkel, Staff Member, Accounting Standards Group, AICPA

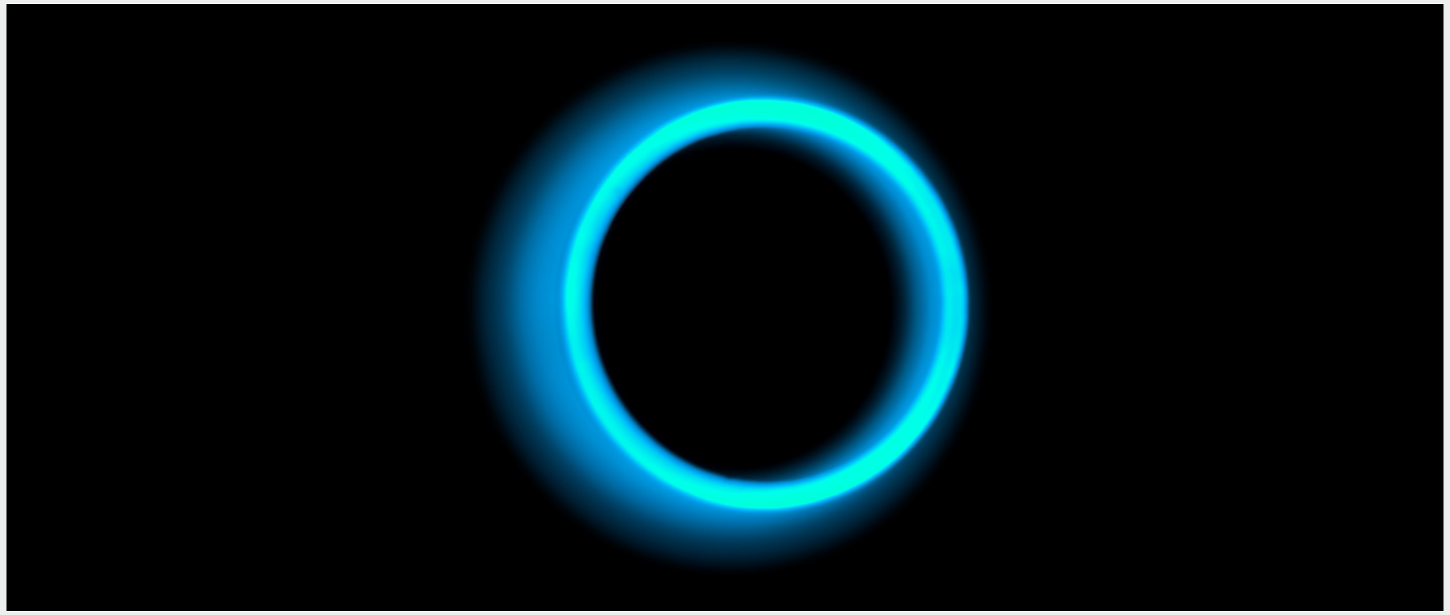
The first focuses on zero expected credit losses, or where an entity can reasonably estimate and report that it expects no credit loss to occur. The standard does not preclude the possibility that an instrument will perform perfectly, leading to no loss, but it also doesn't make it easy for entities to assume as much.

"Under CECL, a measure of expected credit losses is required even if the expected risk of credit loss is remote," the AICPA writes in its working draft. "However, the ASU goes on to state that no measure of expected credit losses is required for a financial asset or group of financial assets if historical credit loss information, adjusted for current conditions and reasonable and supportable forecasts, results in an expectation of non-payment of the amortized cost basis of zero."

The working draft presents a series of indicators that entities might consider as it determines whether it can support a zero expected credit loss on a given instrument. "This is a way for us to help folks say here's what we identified as potential zero credit losses based on our facts and circumstances now, and here's why," says Jason Brodmerkel, a staff member in the accounting standards group at the AICPA.

The second paper is focused on the reversion method companies would apply under the new standard. The standard says companies can revert to historic loss information under certain circumstances, and that has produced questions on whether that would constitute a change in accounting principle or a change in accounting estimate, for example. The paper explores the relevant guidance and seeks to help entities understand how to consider the questions based on their own facts and circumstances. ■

Deloitte.



CECL 2019: Finish strong, with confidence

10 ways to gain clarity—and confidence—about CECL readiness

Is your company on a straight line to go live with the new current expected credit loss (CECL) standard when it takes effect January 1, 2020?[1] What measures are being taken to increase the certainty of that?

As companies evaluate their CECL readiness and complete the implementation, the calendar can be their most precious asset. As a result, the importance of conducting "parallel run" testing that is sufficient, effective, and informative cannot be overstated. Also imperative is an investor communication strategy that provides adequate transparency and enhances comparability between companies. Both require ample time to prepare—time that many companies are shrinking to save on costs.

To understand the scope of your CECL efforts in 2019, many companies can benefit from conducting a CECL readiness assessment now. It can serve to sharpen your organization's focus and help identify potential gaps that may lead to costly and disruptive last-minute issues. It can also increase confidence that your CECL implementation program can deliver a timely, end-to-end CECL-compliant process.

Based on Deloitte's end-to-end CECL implementation model and lessons learned in two years of client engagements, the following are actionable review steps companies can consider as they assess their CECL program and start the final sprint toward CECL adoption.

1. The Financial Accounting Standard Board's (FASB's) CECL standard takes effect for entities that are US Securities and Exchange Commission filers for fiscal years beginning after December 15, 2019.

1. Know where you are now, where you're going, and whether you're on track. The 2019 segment of your CECL journey will likely have many new twists and turns:

- Evaluate the status of your program management capabilities.
- Conduct an in-depth readiness assessment as you might do for a merger announcement.
- Determine whether sufficient contingency time is built into the plan prior to your company's CECL adoption or "go live" date.
- Confirm that CECL program- and process-related roles are well defined.

Since the June 2016 issuance of the CECL standard, implementation efforts have raised many questions, including those about open accounting, that will likely challenge 2019 implementation efforts. An in-depth assessment can point toward implementation plan adjustments that can improve confidence that the adoption date can be met without unnecessary and costly last-minute changes. Since moving your go-live date is not an option, be sure to include adequate contingency time in the development program.

2. Assess your CECL allowance governance framework. CECL's allowance estimation model is complex, and errors and control weaknesses could easily occur:

- Review the framework governing your new CECL methodology.
- Conduct a governance committee review of key CECL decisions.
- Review the parallel run plan, including scope, timing, and resources.
- Engage with your external auditors on accounting, controls, and modeling.

Existing allowance oversight could be inadequate for many companies under the CECL standard. Your allowance governance committee is likely to need additional, more robust information for allowance decisions and preparation of external CECL communications. A clear understanding of provision drivers for each period and the sensitivity of the estimate to the various assumptions driving loss, such as forecasts, are essential for effective disclosure and investor communication. Additionally, a well-designed parallel run can boost management confidence in the implementation, with the design effort itself highlighting potential program issues earlier. Remember the pivotal role of your company's external auditor in 2019; last-minute issues that arise because the auditor wasn't engaged earlier in the process may challenge your company's ability to respond in a timely and cost-effective manner.

3. Review models carefully. Simple or complex, they are the cornerstone of compliance:

- Conduct a CFO/CRO-level model review and brief your company's audit committee on the results.
- Conduct model review workshops with the modelers, accountants, and credit management group.
- Review model results in multiple reasonable and supportable (R&S) forecast scenarios.
- Define model production processes and assess operational efficiency and the ability to meet accounting close timelines.

Given the importance of the CECL estimate, a CFO/CRO-level model review can provide a basic understanding of model performance attributes and facilitate investor dialogue. It can also reveal potential overlaps in factors being considered both within the models and through qualitative factors. Internal communications about model development can be challenging, so cross-functional workshops can provide transparency and clarity. Sensitivity analysis derived from multiple R&S forecasts can also provide a clearer understanding of model performance and volatility. Carefully planned production-processing cycle times can provide sufficient time to run multiple scenarios and conduct scenario reviews. Additionally, it's important to assess how to address data lags that may result from using information other than quarter-end information in the CECL calculation.

4. Identify key data gaps. Remediation efforts could be complicated and costly:

- Assess historic data set completeness, internal controls, and processes.
- Evaluate the data gap remediation plan for reasonableness and modeling impact.
- Review production data management decisions and processes.
- Confirm that data update procedures are well-controlled.

Whether you use simple or complex models, well-controlled data that reflects a full credit cycle is essential for CECL compliance. Data remediation decisions should not be left to modelers alone and should be reviewed by allowance governance leadership. Production data acquisition and management, including exposure at default (EAD) data, is often overlooked in CECL planning and it can take a significant effort to integrate it into the CECL model calculation.

5. Complete model validation and performance measurement soon. Late model changes are likely to be troublesome:

- Conduct model validation reviews early and assess their model design impact.
- Include model validation in your parallel run.
- Define the scope of model validation as part of the overall allowance governance.
- Define ongoing quarterly and annual performance monitoring, process scope and timing.

Model validation input and associated remediation can impact final model design, so receiving timely model validation feedback, including executive review, should be a top priority. Additionally, soliciting model validation feedback during parallel processing will be critical to obtaining timely final executive approval. Processes for performance monitoring of ongoing business as usual (BAU) models should be defined early and include quarterly internal control considerations. Companies should also decide whether model validation will have an expanded role in overall allowance governance beyond its role in model review and governance.

6. Test and retest R&S forecast decisions. Many options are available:

- Test R&S forecast inputs and period length for loss sensitivities.
- Verify that R&S forecasts are considered in the context of other internal economic forecasts.
- Evaluate design of the ongoing BAU R&S forecast update process and governance.
- Consider R&S forecast uncertainty in either a quantitative or qualitative adjustment.

Accounting and regulatory R&S forecast guidance continues to evolve. However, starting 2019 without near-final R&S forecast conclusions, such as R&S forecast duration, is likely to put pressure on parallel run timelines. A well-thought-out approach to whether, when, and how R&S forecast assumptions may evolve given changing circumstances should be an important part of your ongoing Business as Usual CECL process. Another important governance consideration is the consistency of R&S forecasts relative to other internal economic forecasts. Measuring the allowance component of R&S forecast uncertainty as a qualitative adjustment may be appropriate for many companies.

7. Carefully evaluate qualitative allowance adjustments. Double-counting between quantitative and qualitative allowance components could result in restatements:

- Conduct workshops to align quantitative and qualitative allowance components to reduce the risk of double-counting reserves.
- Assess whether qualitative components have sufficient quantitative support.
- Review production cut-off processes and procedures for needed qualitative adjustments.
- Confirm that "relevant information" is considered in the qualitative adjustments.

Establishing separate allowance components for the same risk as part of both the quantitative and qualitative components of your allowance may lead to financial statement errors. The introduction of more complex models may increase the possibility that their theoretical application encompasses a risk that might have been simultaneously considered in a qualitative adjustment. Every effort, across all disciplines, will be necessary to ensure that risks are not considered multiple times. Many companies likely calculate the allowance estimate prior to quarter end, updating that estimate for certain critical factors.Factors such as changes in loan balances, loan risk grade migration, portfolio segment shifts, and changing R&S assumptions should be assessed as of quarter end in a robust and regimented manner subject to appropriate governance. Additional qualitative adjustments also may be required. This will ensure consideration of relevant information that is reasonably available without undue cost. This requirement may result in additional qualitative adjustments.

8. Thoroughly review the end-to-end production process. Challenges and complexities are likely to emerge:

- Conduct a broad review of the target operating model (TOM).
- Perform systems integration testing early.
- Confirm that the parallel run plan will thoroughly test the end-to-end process.
- Review the CECL production cycle and how it will integrate with the various closing cycles.

CECL is more complicated than today's incurred loss model. Define the TOM early and it can serve as the road map for a solid production design. Also, conducting tabletop reviews or walkthroughs of the end-to-end production process with representatives of all impacted functions may assist in identifying issues early and avoiding costly fixes late in the implementation. These walkthroughs should cover many management reviews and governance in addition to technology and control reviews. Using the results of a readiness assessment to help refine the scope of the parallel run testing effort will likely help confirm that potential risk areas have been are effectively tested. Further, detailed production processing design is essential for a smooth quarterly production process that is integrated with existing quarterly systems processing.

10. Carefully review internal controls. Control deficiencies can be a major CECL risk:

- Perform a full walkthrough of control and governance procedures.
- Confirm that well-designed and precise internal controls are in place and clear evidence of effectiveness is available.
- Assess segregation of duties throughout the process.
- Determine that the second and third lines of defense conduct timely reviews.

The standard for measuring whether an internal control deficiency is a material weakness for financial reporting purposes is whether a deficiency or combination of deficiencies could result in a material misstatement of the company's financial statements. Developing appropriate internal controls, from modeling to external reporting, including data used in model development, should be one of the top objectives of companies' CECL implementation plans. Since modeling is often a team effort, a critical step is confirming that adequate segregation of duties and internal controls over access exist in model development and production. Late feedback from second and third lines of defense could lead to potential control deficiencies.

9. Develop an investor communications strategy early. CECL's flexibility and complexity increase the communications challenge:

- Prepare the adoption communications plan now, not later.
- Develop the required pre-adoption disclosure approach early.
- Draft financial reporting disclosures including supporting "describe or discuss" information.
- Develop the investor relations strategy and consider a pre-adoption education session with investors.

Establishment of the communication and disclosure components of CECL compliance is often positioned toward the end of the program. However, early focus on it can help drive engagement decision-making and understanding of the CECL outcome. A key CECL disclosure consideration for public companies is the required "describe or discuss" narrative disclosures that are designed to help financial statement users understand the circumstances driving the period-over-period changes in the allowance balance. Companies should determine that adequate data is derived to inform the necessary narrative disclosures. Conducting a pre-adoption education session with investors may be valuable and help improve investor understanding of results that could yield benefits in April 2020 and beyond.

Final thoughts

Clarity, focus, and confidence are crucial as CFOs and other senior executives educate the board of directors, engage in leadership conversations, and communicate with investors about the final stage of CECL implementation. As you look toward 2019, these final considerations can help you enhance your company's CECL implementation efforts:

- Confirm that strong program management capabilities, transparency into the status of your company's implementation plans, and adequate contingencies exist to deal with inevitable CECL uncertainties.
- Define a detailed parallel run plan that can demonstrate that everything and everyone involved in implementation are working together efficiently, offer insights into the CECL calculations, and build the necessary skills to carry on with the CECL program after the go-live date.
- Develop a robust communication strategy that can provide useful preadoption information, help investors understand your company's CECL methodology and results, and prepare investors to better understand the company's allowance.

Let's talk

Deloitte's CECL implementation services can help you stay ahead of fast-approaching deadlines and the many complexities of CECL implementation. Contact us to learn more.

Corey Goldblum
Principal | Deloitte Risk and Financial Advisory
Deloitte & Touche LLP
+1 404 220 1432
cgoldblum@deloitte.com

Gregory Norwood
Managing Director | Deloitte Risk and Financial Advisory
Deloitte & Touche LLP
+1 571 766 7804
grnorwood@deloitte.com

Jonathan Prejean
Managing Director | Deloitte Risk and Financial Advisory
Deloitte & Touche LLP
+1 703 885 6266
jprejean@deloitte.com

Troy Vollertsen
Partner | Audit & Assurance
Deloitte & Touche LLP
+1 703 885 6356
tvollertsen@deloitte.com

Peter Wilm
Managing Director | Deloitte Risk and Financial Advisory
Deloitte & Touche LLP
+1 215 246 2446
pwilm@deloitte.com

www2.deloitte.com/us/en/pages/financial-services/articles/us-current-expected-credit-losses-cecl.htm

The services described herein are illustrative in nature and are intended to demonstrate our experience and capabilities in these areas; however, due to independence restrictions that may apply to audit clients (including affiliates) of Deloitte & Touche LLP, we may be unable to provide certain services based on individual facts and circumstances.

FEI group provides guides on leases, CECL controls

FEI's corporate reporting group has developed its own guides for preparers on how to assure sound controls with major new accounting adoptions. **Tammy Whitehouse** reports.

Taking the internal control bull by its horns, the preparer community has assembled itself and developed its own guidance on how to assure sound controls with respect to new accounting adoptions.

The Committee on Corporate Reporting at Financial Executives International issued two guides to address internal control considerations as companies prepare to implement new accounting standards on leases and on credit losses. The committee wanted to put its own stamp on the formation of insights and best practices that might help preparers develop and apply internal controls as they transition to the new accounting requirements.

Public companies with a calendar year-end are in the final stages of adopting Accounting Standards Codification Topic 842 on leases, which takes effect Jan. 1, 2019. ASC 842 brings virtually all assets and liabilities associated with leasing out of financial statement footnotes and on to the face of the balance sheet, grossing up balance sheets by trillions of dollars.

ASC 326 on credit losses introduces the "current expected credit losses" approach to recognizing signs of stress in debt-related portfolios. The CECL standard, moving companies away from the current focus on incurred losses to a more forward-looking approach to reporting, takes effect for calendar-year public companies on Jan. 1, 2020. FEI's documents are meant to provide a support system to help companies of various sizes execute successful implementations utilizing effective internal control over financial reporting.

"Internal controls must be top of mind for management at all times, but especially as new standards are operationalized and new systems and processes are implemented," said Mick Homan, chairman of the FEI committee and vice president in charge of corporate accounting at Procter & Gamble.

"These ICFR guides represent the collaborative efforts of leading preparers with input from their auditors. We believe this will help refresh the dialog between management and its auditors, leading to process improvements and better internal controls." ■

"We believe this will help refresh the dialog between management and its auditors, leading to process improvements and better internal controls."

Mick Homan, Chairman, FEI Committee & VP, Corporate Accounting, Procter & Gamble

SEC will watch for SAB 74 disclosure leading to CECL

Tammy Whitehouse explores the Securities and Exchange Commission's next moves on CECL.

Consistent with the adoption of other major accounting standards, regulators will be watching closely for increasingly detailed disclosures to investors about the expected effects of moving to a new method for recognizing credit losses.

Wesley Bricker, chief accountant at the Securities and Exchange Commission, told bankers at a recent conference that disclosures explaining transition to the new "current expected credit losses," or CECL model for reflecting performance in credit-based financial instruments, will need to be specific enough to help investors understand the change that is coming. "Nobody likes surprises," he said.

All public companies, but financial institutions in particular, will see changes to their balance sheets as they adopt Accounting Standards Codification Topic 326 to adopt a more forward-looking approach to recognizing signs of trouble in their loan portfolios or accounts payable balances. The standard takes effect on Jan. 1, 2020, for public companies, a year after companies complete their adoption of new lease accounting requirements.

Leading up to the adoption of major new accounting standards, the SEC staff has reminded companies early and often to be sure they give investors plenty of fair warning about what is going to change, as required under SEC Staff Accounting Bulletin No. 74. "Transition disclosures enable investors to understand the anticipated effects of the new standard," Bricker said.

Companies that report under International Financial Reporting Standards have already adopted a similar but not identical standard for recognizing loan losses under IFRS 9. Their reporting has informed the thinking at the SEC about what companies should consider disclosing, said Bricker, who suggested some specific concepts for companies to keep in mind.

Forewarning disclosures under SAB 74 should contain "easy-to-understand explanation of new terms and key concepts," Bricker said, along with "specific descriptions of the methodology and significant judgments made by management." Companies should even consider tabular presentation of the economic assumptions they are relying on as they arrive at their loan loss provisions, as well as quantified effects of moving from the current incurred loss approach to the new expected loss approach, he said. In fact, those effects should be disaggregated, or presented separately, for each lending portfolio, Bricker said.

Audit committees need to be engaged as well, said Bricker, overseeing the implementation plans, progress, and any changes that are necessary to internal control over financial reporting as a result of the transition. "The audit committee plays a vital role in overseeing a company's financial reporting, including implementation of new accounting standards," he said.

With respect to the ongoing work to adopt the new standard, Bricker reminded companies to be sure they keep good books and records, establish sufficient internal controls, and document their methodology for determining loan losses each reporting period. ■