Grant Thornton

New Developments Summary

Highlights of the 2018 AICPA National Conference on Banks & Savings Institutions

Impact and implementation of the current expected credit losses standard

Summary

The 2018 AICPA National Conference on Banks & Savings Institutions, held in Washington, D.C. on September 17-19, featured speakers from the SEC, the FASB, federal banking regulators, audit firms, and financial institutions. The conference focused on accounting and financial reporting challenges facing financial institutions, particularly issues related to implementing the new current expected credit losses (CECL) standard.

This publication provides a summary of the key matters discussed during the conference. The Appendix provides links to publically available speeches and other referenced materials.

Contents

A. Conference overview

The 2018 AICPA National Conference on Banks & Savings Institutions, held in Washington, D.C. on September 17-19, featured speakers from regulatory and standard-setting bodies, as well as industry professionals. The conference began with remarks from SEC Chief Accountant Wes Bricker, who stated that “CECL is alive and well,” setting the tone for the conference. Subsequent speakers echoed this sentiment, including staff from the SEC’s Office of the Chief Accountant (OCA) and Division of Corporate Finance (CorpFin); representatives from the Financial Accounting Standards Board (FASB); and the Chief Accountants of the federal banking agencies. Their presentations largely focused on summarizing new developments related to the adoption and implementation of the credit loss standard, ASC 326, *Credit Losses*.

B. SEC

Mr. Bricker’s opening remarks for the conference focused on three themes:

- CECL
- Digital currencies
- The amendment to the auditor’s opinion for SEC filers to include a description of critical auditing matters

CECL

Mr. Bricker suggested that many entities already have experience related to ASC 326 as a result of evaluating potential mergers or acquisitions of entities with significant credit exposures, such as financial institutions, or pricing significant credit exposures. These types of transactions frequently involve making an estimate of lifetime expected credit losses, which incorporates reasonable and supportable forecasts of future conditions, aligning closely to key aspects of ASC 326.

SAB Topic 11.M disclosures

Mr. Bricker emphasized that issuers might need to communicate to investors the anticipated impact of adopting ASC 326 by including disclosures required under SEC Staff Accounting Bulletin (SAB) Topic 11.M, *Disclosure of the Impact that Recently Issued Accounting Standards will have on the Financial Statements of a Registrant when Adopted in a Future Period*. He noted that the following information might help investors understand the anticipated effects of CECL:

- Easy-to-understand explanation of new terms and key concepts
- Specific descriptions of the methodology used to develop the estimate and significant judgments made by management
- Tabular presentation of the economic assumptions utilized
- Quantified effects of moving from incurred to expected credit losses, disaggregated by lending portfolio

Internal control over financial reporting

Mr. Bricker also emphasized the need for entities that hold assets subject to CECL to have processes and controls in place over both of the following phases of their implementation efforts:

- Assessing the appropriateness of their implementation efforts regarding the new standard
- Assessing the impact of new standards to provide timely disclosure of the anticipated effects

In addition, he noted that entities also need a well-documented, systematic, and well-controlled methodology to estimate the allowance for credit losses (ACL) under ASC 326. Mr. Bricker emphasized that, in designing their processes and controls, entities should consider SAB 102, whose principles for documentation of processes and controls will continue to be relevant under CECL. Mr. Bricker did state that SAB 102 will be updated and amended once ASC 326 becomes effective to reflect the new accounting and that the principles of sound documentation will remain.

Marc Panucci and Sagar Teotia, Deputy Chief Accountants from OCA, encouraged open communication between entities and their auditors during the ASC 326 implementation process. They suggested that each party ask "what can go wrong" when implementing a new accounting standard, particularly in regard to the design of process and controls both during and after implementation.

Grant Thornton insight: Considerations for processes and controls during and following implementation

As noted above, the SEC believes it is critical that entities and auditors engage in active discussions regarding implementation decisions as they progress toward the effective date of ASC 326. While the SEC's comments focus on issuers, we believe that it may be valuable for all entities to consider "what could go wrong" throughout their implementation efforts to ensure that there are sufficient and appropriate controls around their disclosures during implementation and around their estimation of the opening balance-sheet (Day 1) adjustment upon adoption of ASC 326. Additionally, many of the processes and controls related to implementation disclosures and Day 1 adjustments will likely be leveraged as part of an entity's post-implementation processes and controls.

However, the processes and controls over the post-implementation estimates of the ACL will need to be modified or expanded beyond those necessary to estimate the Day 1 adjustment for most entities. In many cases, entities will need to modify the processes and controls to make them operational on an ongoing basis.

Mr. Panucci and Mr. Teotia also noted that the SEC has observed continued reliance on management review controls to support assertions of the operational effectiveness of internal control. While noting that management review controls may be effective, with attributes that appropriately make them key controls in an entity's overall control environment, they should not, in most cases, be the sole control relied upon to prevent or detect a material misstatement.

Precision of management review controls

Controls around the allowance for loan and lease losses (ALLL) (or, under CECL, the ACL) should be designed by the entity to prevent and detect a material misstatement, and should occur at a sufficient level of documented precision. Review controls can enhance the control environment around the ALLL. For example, a company may utilize a quarterly allowance meeting, comprising a small group of individuals with relevant experience from across the entity, to discuss the outcome of the ALLL estimation process and to approve the quarterly ALLL estimate. An entity might determine that this meeting is a management review control and it is a key control, but it is unlikely that this type of control alone is sufficient to provide reasonable assurance that the allowance estimate in its entirety conforms to Generally Accepted Accounting Principles (GAAP).

As Mr. Bricker noted, an entity's processes and controls should

- Maintain books, records, and accounts that accurately reflect the transactions of the entity. These functions should be designed so that the information used to estimate ALLL or the ACL is accurate and well documented; and
- Provide reasonable assurance that the estimate is in accordance with GAAP, meaning that the entity has documented how it assessed that its processes and judgments are consistent with the relevant accounting standard.

As Mr. Panucci and Mr. Teotia noted, it is unlikely that a management review control, by itself, would cover all of these elements or operate at a sufficient level of precision to achieve each of these objectives. However, a management review control might have attributes that make it a key control, particularly with regard to assessing the appropriateness of management's judgments, presuming it operates at a sufficient level of precision.

Consultation with the SEC

Michael Berrigan, Professional Accounting Fellow in OCA, John Nolan, Senior Assistant Chief Accountant, and Stephanie Sullivan, Associate Chief Accountant with CorpFin, discussed consultations related to implementing CECL. They reported that early questions focused on the scoping of assets for implementation, while current consultations focus more on specific interpretive issues of the new standard. Aided by Mr. Bricker's role as an observer of the FASB's Transition Resource Group (TRG) for Credit Losses, the SEC believes that it is well positioned to continue to answer consultation questions from issuers regarding the implementation of ASC 326.

CorpFin consultation example

Ms. Sullivan provided an example of a consultation received on implementing ASC 326 for pools of residential mortgages. The guidance in ASC 326 requires loans to be pooled based on certain risk characteristics for purposes of estimating the ACL. The new guidance also requires an entity to consider its historical loss experience when developing an estimate of the ACL. This issuer provided a fact pattern for a pool of residential mortgages where the borrowers had filed for bankruptcy. Based on the bank's historical experience, 75 percent of such borrowers continue to perform, despite their bankruptcy status, and they generally do not default until another weakness develops, such as a missed payment or an increase in the loan-to-value ratio. The issuer did not believe it was appropriate to charge off the loans once the borrower had filed for bankruptcy, because its historical evidence suggested that the loans were collectible. Instead, the institution indicated it intended to charge off individual loans once an additional weakness or other identified negative trend was identified, at which point, it would consider the loans uncollectible.

The CorpFin staff observed that the pool of loans given to bankrupt borrowers would have shared risk characteristics and should therefore be considered for an allowance collectively. Presuming appropriate loan segmentation, the staff did not object to the conclusion that the issuer should charge off loans only after the loans exhibited an additional weakness, consistent with its historical experience.

The federal banking agencies have also issued guidance for handling residential loans when the borrower has filed for bankruptcy protection, which regulated entities may wish to consider.

Digital currencies

Commenting on the constant evolution of blockchain technology, Mr. Bricker noted that entities must consider the following principles if they have material exposure to these new technologies:

- Financial statement assertions, including books and records and internal accounting controls
- Fair value measurement and related-party disclosures
- Loss contingencies
- Dealing with potential illegal acts
- Audit committee considerations

Mr. Bricker said that it is critical that management appropriately account for such holdings and provide meaningful and appropriate disclosures about them to investors. Additionally, he indicated that it is also the audit committee's responsibility to engage advisers, including auditors, who understand the complexities of these instruments and the activities of the entity.

Critical audit matters

Members of the SEC staff, including Mr. Bricker, are encouraged by the collaborative efforts of issuers, audit committees, and auditors in performing "dry runs" under the new PCOAB ruling requiring auditors to disclose "critical audit matters" (CAMs) in their audit report. The SEC believes this three-way dialogue is critical to ensure that the auditor's report is more informative and relevant to users of the financial statements. The new CAM reporting will be required beginning in 2019 with large accelerated filers.

Grant Thornton insight: CAM dry-duns

We encourage all audit committees of issuers who are subject to this new standard to consult their auditors to determine which matters may be considered critical to the audit. Issuers may want to ensure during the dry run process that their MD&A disclosures mirror those matters identified by the auditor as a "critical audit matter." This might include a discussion about whether any matters may recur in each period, given their significance to the audit of the institution on a recurring basis, or if a matter is specific to an audit of a given year.

C. FASB

FASB Board member Hal Schroeder and Shayne Kuhaneck, Assistant Director of Technical Accounting Activities at the FASB, addressed a variety of relevant concerns focusing on both ASC 326 and the new hedging standard.

CECL standard

Mr. Schroeder and Mr. Kuhaneck began their discussion of CECL by addressing a Board decision to clarify the implementation date of ASC 326 for entities that are not public business entities (non-PBEs). This amendment would provide separate and staggered effective date requirements for public business entities filing with the SEC, public business entities not filing with the SEC, and all other entities, by requiring that all other entities adopt the proposed amendments in fiscal years beginning after December 15, 2021 and in interim periods within those fiscal years. As originally issued, ASU 2016-13 requires all other entities to adopt this new guidance in fiscal years beginning after December 15, 2020 and in interim periods within fiscal years beginning after December 15, 2021. This update will become effective once the proposed ASU is finalized.

During the question and answer session, Mr. Schroeder told attendees about a meeting that occurred at Missouri Congressman William Luetkemeyer's office that involved FASB and SEC representatives, as well as federal banking regulators and select practitioners who are seeking additional relief from recording lifetime losses on financial assets held at amortized cost under the new CECL standard. Mr. Schroeder noted that this meeting was yet another opportunity for the FASB to hear stakeholders' concerns, and encouraged any participants who want to request modification of the standard to submit an agenda request through the FASB's website. If participants submit a paper related to the issues discussed at the Congressman Luetkemeyer meeting, FASB Chairman Russ Golden is committed to holding those discussions in a public forum.

Hedging

The FASB staff noted that some entities have chosen to early adopt the amendments in ASU 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*, in order to reclassify certain securities from held-to-maturity to available-for-sale. The ASU allows entities to elect a one-time option at the adoption date to transfer debt securities classified as held-to-maturity that are eligible to be hedged under the last-of-layer method in accordance with the standard to available-for-sale without tainting the remainder of the held-to-maturity portfolio. Under the guidance, an entity need not plan to apply a last-of-layer hedging strategy to utilize the election. This election may allow an entity to exclude certain debt securities from the provisions of the CECL guidance, as available-for-sale securities have a separate impairment model in ASC 326-30. Those electing early adoption of ASU 2017-12 should make certain that the securities transferred from held-to-maturity to available-for-sale are, in fact, eligible assets to be hedged under a last-of-layer methodology in accordance with the guidance. Entities may risk tainting their portfolio inadvertently if this determination is incorrect.

D. Federal banking agency

Federal Reserve Bank

Joanne Wakim of the Federal Reserve Board addressed regulatory efforts related to education and implementation of ASC 326. Ms. Wakim emphasized that regulators should not take the place of financial statement preparers or standard setters, because it is not the regulator's role to tell entities what to do or how to interpret the standard. Rather, the regulator's goal is to educate both examiners and the entities they regulate, and to establish a range of acceptable practices under ASC 326 for these regulated entities.

Ms. Wakim reiterated that there is no one-size-fits-all answer for developing and applying a CECL methodology. Further, as entities evaluate their portfolios and data availability, management may consider many different methods to estimate the ACL for their various loan portfolios. The estimation method that management selects should be the one that best estimates lifetime losses for the loan portfolio. Ms. Wakim warned against selecting a method that yields the highest or lowest estimate because it best fits management's goals for the estimated amount. Once a method has been selected, continuing to evaluate multiple methods and selecting the most preferred answer is inappropriate, she noted. Ms. Wakim pointed out that if, upon adopting ASC 326, an entity's allowance levels declined, such an entity would be expected to have a well-documented reconciliation between the allowance levels before and after the adoption of ASC 326.

Lastly, Ms. Wakim stated the agencies will continue their outreach efforts with stakeholders by attending outreach events, hosting webinars for examiners and bankers, and issuing interagency frequently asked questions.

During the question and answer portion of the Chief Accountant Panel, the agencies acknowledged that, similarly to the SEC's SAB 102, the *Interagency Policy Statement on the Allowance for Loan and Lease Losses* remains relevant, and entities should consider its principles when implementing the new CECL standard.

Office of the Comptroller of the Currency

Sydney Menefee of the Office of the Comptroller of the Currency (OCC) discussed risk in the banking industry, as discussed in the OCC's "Semiannual Risk Perspective," focusing on three areas: complacency, competition, and change.

Regarding complacency, Ms. Menefee noted that risk builds, inevitably leading to the next downturn, when times are good economically and the industry is generally thriving.

The OCC's most recent "Semiannual Risk Perspective" documented increased risk within loan portfolios, focusing on the "layering" of risk. Layering of risk is when an entity allows for more than one concession on the same loan (for example, a rate, a term, or an amortization period) when any one of those concessions on its own would have generally been within the entity's risk tolerance. The document also noted that on the liability side of the balance sheet, depositors, particularly younger ones, are currently less rate-sensitive and more "application" sensitive, meaning that they differentiate institutions based on convenience (such as the availability of a smartphone application) rather than on rate alone. Ms. Menefee questioned whether community banks are capable of competing for this desired level of convenience.

The last theme addressed change, specifically changes related to adopting ASC 326. OCC-supervised entities were asked a series of questions during quarterly periodic monitoring during the second quarter of 2018 regarding their implementation progress. Approximately one-third of respondents are still unsure if they would develop their CECL estimation processes and controls internally or with the help of a third-party service provider. Ms. Menefee stressed the urgency of developing a comprehensive CECL implementation plan, as well as the importance of having a sound vendor evaluation and management program if an entity chooses to utilize a third-party service provider to assist with its CECL implementation.

Federal Deposit Insurance Corporation

Robert F. Storch of the Federal Depository Insurance Corporation discussed the agencies' notice for proposed rulemaking allowing entities to transition the Day 1 impact to retained earnings as a result of the adoption of ASC 326 to capital over three years. Mr. Storch noted that comment letters on the proposed rule are presently being considered in development of the final rule. Additionally, the call report will be updated for both the proposed CECL capital transition relief and the expanded assets within the scope of ASC 326.

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For additional information on topics covered in this bulletin, contact your Grant Thornton LLP professional.

Appendix

Links to relevant materials

The following table provides links to multiple external documents and speeches that have been referred to in this publication.

References
Remarks by Wes Bricker, Chief Accountant of the SEC, before the 2018 AICPA National Conference on Banks & Saving Institutions
SAB 102
Interagency Policy Statement on the Allowance for Loan and Lease Losses
Interagency Frequently Asked Questions on the New Accounting Standard on Financial Instruments – Credit Losses
OCC Semiannual Risk Perspective
ASU 2016-13, *Financial Instruments – Credit Losses*
ASU 2017-12, *Derivatives and Hedging*
FASB Transition Resource Group (TRG) for Credit Losses
PCAOB Release 2017- 001, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* (Critical Audit Matters)
Grant Thornton Summary of ASU 2016-13
Grant Thornton Summary of the June 12, 2017 TRG for Credit Losses Meeting
Grant Thornton Summary of June 11, 2018 TRG Meeting