

# FORVIS

## **2023 Adopter CECL Implementation Road Map Series: Impact of CECL on Internal Controls**

January 10, 2023

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# Meet the Presenters



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# Agenda

- Discuss the importance of the control environment
- Discuss best practices related to the internal control implementation of ASC 326
- Discuss the documentation necessary to support key controls



# Risk Assessment

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# Significant Risk of Material Misstatement Indicators

Estimation uncertainty

Materiality of the loan loss provision

Level of judgement on key data & assumptions

# Likely Challenges

Complex material estimates will require strong internal controls, including governing body oversight

Forward-looking view & subjectivity can be challenging to support

Increased regulatory scrutiny on management's judgments

Estimates will be more volatile, changing from quarter to quarter

Volatility & sensitivity will need explanation

# Identifying Risks – What Could Go Wrong?

**Take a fresh look at your risks & controls!  
While some risks & controls identified may overlap with your old incurred loss model, a common pitfall is trying to fit your new ACL process into your old incurred loss model framework**

**What Could Go Wrong =  
"WCGW"**





# Identifying Risks – What Could Go Wrong?

- **What is a “what could go wrong” risk?**
  - Any condition that could allow misstatements to enter the system or allow data to lose integrity
  - Can also include risk of unauthorized acquisition, use, or disposition of assets that could result in a material misstatement

# Identifying Risks – What Could Go Wrong?

- **Things to consider when identifying WCGW risks**

How data enters the system

How data is stored within the system; how it's accessed or transferred

Where in the process data is summarized, accumulated, subject to calculation, or manipulated

Manual process that affects the data

Management review processes over the data; how data maintains integrity

Judgments made by management in determining whether to make adjustments & the amount of adjustment(s)

How data is affected when it's summarized for financial reporting purposes

# Identifying Risks – What Could Go Wrong?

- **Implementation WCGW Examples**

- Key stakeholders not adequately involved in implementation & decision making
- Identification of inappropriate credit quality indicators used to segment loans for modeling
- Models selected are excessively difficult to implement due to missing or inaccurate loan data

# Identifying Risks – What Could Go Wrong?

## ▪ **ACL Model WCGW Examples**

- Unauthorized or undetected changes are made to data, files, or models
- Data requested by the corporate credit team from the line of business is inaccurate or incomplete
- Data importation into the model is inaccurate or incomplete
- Economic variable assumptions are not appropriate for use in the forecasting estimates
- Qualitative factors are unsupported

# Documenting Your ACL Process

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# Narratives & Flowcharts

**“Cradle to Grave” documentation of the process for both**

**Implementation  
Process**

**Ongoing ACL  
Process**

# Narratives & Flowcharts

- **Documented through collaboration with multiple stakeholders**
  - Accounting/Finance Team
  - Credit Team
  - Information Technology Team
  - Audit Committee
  - Those Charged with Governance

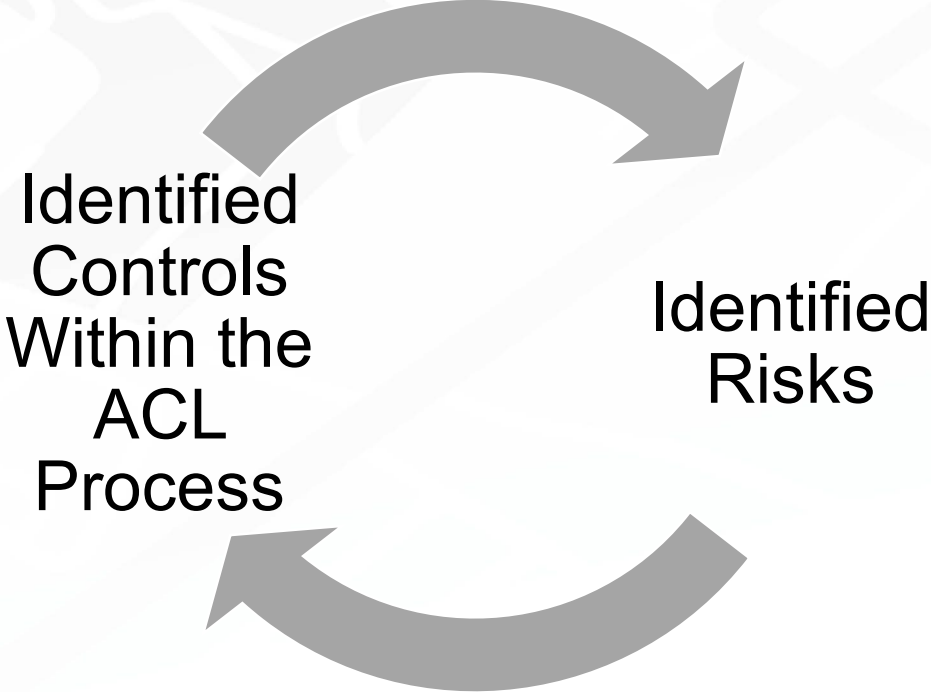
# Narratives & Flowcharts



One common pitfall to avoid is documenting the “best case scenario” of the ACL process rather than what is actually happening in practice



# Circling Back to Risks



# Common ACL Risks & Controls

- The example risks & control activities on the following slide may not be applicable or appropriate for every institution & are not intended to be comprehensive. The following are general examples of risks (what could go wrong) that may arise when estimating credit losses & example control activities that may be employed to reduce those risks

# Common ACL Risks & Controls

## Risks

Data used in the model is incomplete or inaccurate

## Controls

Preventive & monitoring controls including reconciliations & data validation

# Common ACL Risks & Controls

## Risks

Calculations within the ACL model or spreadsheet are inaccurate

## Controls

Preventive & monitoring controls including formula testing, recalculations, or model validation

# Common ACL Risks & Controls

## Risks

Inappropriate loan classification at inception

## Controls

Preventive review controls over the accuracy of new loan entry

# Common ACL Risks & Controls

## Risks

Economic variable assumptions obtained from external source are inaccurate

## Controls

Review control to periodically evaluate the accuracy of model source data

# Common ACL Risks & Controls

## Risks

Loans that do not have individual risk characteristics requiring individual analysis are inappropriately excluded from loan segments

## Controls

Monitoring controls over the identification of events or conditions that meet the new CECL definitions requiring loans to be evaluated individually & not collectively

# Common ACL Risks & Controls

## Risks

Qualitative factor adjustments are inconsistent with changes in the loan portfolio or economic conditions &/or management's determination of adjustments are not well-documented

## Controls

Review controls over data used to develop qualitative factor adjustments or lack thereof & robust documentation of management's process for determining the adjustments



# Documentation Best Practices

## Key elements of documentation

Who performed  
the control

When did they  
perform the  
control – was it  
performed timely?

Procedure-level  
documentation –  
often risk-based

Retention of  
reports used in  
the operation of  
the control

# Documentation Best Practices

- Review Controls
  - Often will require additional documentation to evidence the precision of the review
  - Documentation of the reviewer's thought process when performing the review
    - + What are the expectations?
    - + What would constitute a deviation?
    - + How are exceptions or issues handled?

# Documentation Best Practices

- Committee-Level Controls – common for the ACL process
  - Many individuals involved
  - Often where key assumption decisions are made or where the final approval of the ACL calculation takes place
  - Documentation is often kept in the form of meeting minutes
  - Consideration of materials reviewed by the Committee for completeness & accuracy – supports the precision of the control

# Documentation Best Practices

- Qualitative factor adjustments
  - Highly subjective & difficult to support if poorly documented
  - Importance of documenting the qualitative factor determination process
    - + Period to period change
    - + Overall amount
  - Documentation of the completeness & accuracy of the data used in the qualitative factor determination process

# Documentation Best Practices

## Report/Spreadsheet Inventory & Retention

ACL model or spreadsheet

Loan trial balance

Studies used to support assumptions

Individually evaluated loan assessments

Charge-off & recoveries report

Loan reconciliation

Economic forecast reports

Reports used in determination of qualitative factors

Reports used to determine loan segmentation

Committee minutes

# Final Thoughts

- A fresh look at your risk assessment will help identify ACL controls needed & those you may be missing
- The ACL process involves many stakeholders at your financial institution &, in some cases, third-parties
- Documentation is key!

# Other Webinars

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# 2023 Adopter CECL Implementation Road Map Series

- December 8, 2022 recording: Q-Factors in a CECL World
- August 23, 2022 recording: Debt Securities & Unfunded Commitments
- July 14, 2022 recording: Documenting Your CECL Adoption
- April 28, 2022 recording: Regression & Correlation – What It Is & How It's Used in CECL
- December 8, 2021 recording: CECL Methodologies & Selection Process



# Questions?

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