



# Allowance for credit losses — audit considerations

With a focus on loans measured at amortized cost for depository and lending institutions as well as insurance companies



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# Notice to readers

This practice aid has been developed to help auditors in their communications with both management and audit committees as they address FASB Accounting Standards Update (ASU) No. 2016-13, *Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*. As management, regulators, and auditors gain more experience with FASB Accounting Standards Codification (ASC) 326, *Financial Instruments – Credit Losses*, additional challenges and insights may emerge. The practice is expected to evolve over time and the expectations of both regulators and auditors may change along with it. As such, questions, examples, and risks listed in this practice aid should not be considered exhaustive. Auditors, management, and those charged with governance need to stay abreast of developments and consider the implications of those developments.

This practice aid is intended to provide auditors with information that may help them improve the effectiveness and efficiency of their audits and practices. It is based on existing professional literature, the experience of members of the AICPA Depository Institutions Expert Panel (DIEP), the AICPA Insurance Expert Panel (IEP), and information provided by certain AICPA member firms to their own professional staff. This information represents the views of AICPA staff based on the input of the members and has not been approved by any senior committee of the AICPA. The auditing portion of this practice aid is an *other auditing publication* as defined in AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*,<sup>1</sup> and is intended to provide guidance to auditors. The guidance in this document is meant for auditing standards in effect as of June 30, 2019. Preparers of financial statements might find this helpful in developing their accounting estimates and the controls over the estimates. Other auditing publications may help the auditor understand and apply generally accepted auditing standards and PCAOB standards but have no authoritative status. In applying the auditing guidance included in an other auditing publication, the auditor should, exercise professional judgment and assess the relevance and appropriateness of such guidance to the circumstances of the audit.

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<sup>1</sup> All AU-C sections can be found in AICPA *Professional Standards*.

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# Foreword

In 2016, FASB issued Accounting Standards Update (ASU) No. 2016-13, *Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*. This ASU has an extensive reach as it applies to all entities and most financial assets that are not measured at fair value through net income. Although the scope of the ASU<sup>1</sup> covers a variety of financial assets, this practice aid is focused on measuring credit losses for loans and other long-term receivables; however, the concepts may be applicable to other financial assets such as Day 2 accounting for purchased credit deteriorated (PCD) assets. Audit considerations that may be applicable to purchased loans with credit deterioration, investment securities, and other financial assets are not included in this practice aid.

The intent of this practice aid is to summarize key provisions of FASB *Accounting Standards Codification (ASC) 326, Financial Instruments – Credit Losses*, and to address key considerations in auditing the allowance for credit losses (ACL) related to loans under ASU 326-20<sup>2</sup> and disclosure considerations. This practice aid highlights key areas within the auditing process, including obtaining an understanding of the entity, assessing the risks, identifying the controls relevant to the audit, designing an audit response, performing audit procedures, and evaluating the audit results.

Management, those charged with governance,<sup>3</sup> and auditors need to focus significant efforts on the implementation of FASB ASC 326-20 to ensure that, among other considerations,

- a. management is prepared to adopt FASB ASC 326 by the effective date.
- b. management has identified the credit loss model or models it will use, understands how the model or models work, and assessed the historical data needed.
- c. inputs and assumptions used in the model or models are reasonable.
- d. financial statement disclosures prior to the effective date of FASB ASC 326 properly address the anticipated effects of FASB ASC 326<sup>4</sup>.

Similar to FASB ASC 606, *Revenue from Contracts with Customers*, as entities implement FASB ASC 326, they may need to change existing (or develop new) systems and processes used to gather and archive relevant data, make required estimates, and provide required disclosures. Internal controls over those processes may need to be changed or developed. Inadequate or ineffective design or implementation of changes to systems, processes, and controls can pose heightened risks of material misstatement, including the risks of material misstatement due to fraud (fraud risks).<sup>5</sup>

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<sup>1</sup> See paragraphs 2 and 3 of FASB ASC 326-20-15 for an understanding of which items are included and excluded when applying FASB ASC 326-20.

<sup>2</sup> Available-for-sale debt securities as noted in ASC 326-30 are not discussed in this Practice Aid.

<sup>3</sup> Those charged with governance may include the loan committee, audit committee, supervisory committee, board of directors, and other committees of the board. The term *audit committee* is used throughout this practice aid to refer to those charged with governance.

<sup>4</sup> SEC filers only.

<sup>5</sup> Page 2 of Staff Audit Practice Alert No. 15, *Matters Related to Auditing Revenue from Contracts with Customers* (PCAOB Staff Guidance, sec. 400). All PCAOB Staff Audit Practice Alerts can be found in PCAOB Standards and Related Rules.

## General Considerations Pertaining to Auditing the Adoption of FASB ASC 326-20

Management is responsible for the preparation and fair presentation of its financial statements and for the design, implementation, and maintenance of internal control over financial reporting. If the internal control over financial reporting requirements of the Federal Deposit Insurance Corporation Improvement Act or the Sarbanes-Oxley (SOX) Act, as amended, are applicable, management is responsible for assessing the effectiveness of its internal control relative to financial reporting. Therefore, management should have an established process, including an appropriately designed system of internal controls, to ascertain whether its loans are appropriately accounted for in accordance with the applicable financial reporting framework, including FASB ASC 326 (this may include processes and controls over inputs and assumptions used in the estimation processes, planned use of vendors, and other considerations).

An entity's adoption of FASB ASC 326-20 will likely have a significant impact on the audit. The adoption of new accounting policies relating to FASB ASC 326-20 will affect the auditor's evaluation of whether the overall presentation of the financial statements, including the related disclosures, is in accordance with the applicable financial reporting framework.<sup>6</sup>

The auditor is required to assess the risk of material misstatement and design and perform audit procedures based on the assessed risk.<sup>7</sup> During the risk assessment process, an auditor may identify factors that need to be addressed during the audit, including new risks of material misstatement. Therefore, an entity's implementation of an inherently different credit loss model causes an auditor's audit procedures to change and be tailored to address the new or different risks identified.

The auditor is required to conclude whether sufficient appropriate audit evidence has been obtained.<sup>8</sup> In forming a conclusion, the auditor should consider all relevant audit evidence, regardless of whether it appears to corroborate or contradict the assertions in the financial statements. FASB ASC 326-20 requires management to exercise significant judgment with respect to assumptions, such as portfolio segmentation, the determination of an appropriate historical loss period, adjustments for current asset-specific risks, reasonable and supportable forecasts, and reversion methods.

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<sup>6</sup> Paragraph .26 of AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*. All AU-C sections can be found in *AICPA Professional Standards*.

<sup>7</sup> As defined in AU-C section 330.

<sup>8</sup> Paragraph .28 of AU-C section 330.

With the adoption of FASB ASC 326-20 and related accounting policies, a key consideration of the auditor is the effectiveness of internal control over the expected credit loss estimation process and the financial reporting of loans in accordance with FASB ASC 326-20. Other elements of internal control implemented by management may be responsive to risks in the following areas:

- Determination of applicability and adoption of new accounting policies
- Determination of the methodologies, assumptions, and data needed to establish the estimate of the ACL.
- Validation and conclusion of the results of the calculation of the ACL.

Lastly, the implications for public business entities (PBEs) and non-PBEs, although generally similar, are different, including financial reporting requirements. A public business entity that is an SEC filer is required to disclose in its Form 10-K and Form 10-Q the expected impact to the entity upon adoption and, further, whether disclosures of any changes in internal control warrant disclosure in accordance with SEC rules in accordance with Staff Accounting Bulletin 74.<sup>9</sup> Although non-PBEs have additional time prior to adoption under FASB ASC 326 and do not have the same disclosure requirements in the transition period as PBEs that are SEC filers, the implementation period may take just as long, if not longer, for non-PBEs. Ultimately, determining the expected impact on the entity and beginning the implementation process early will be critical for ensuring an appropriate and effective implementation of FASB ASC 326 for both PBEs and non-PBEs.

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<sup>9</sup> See SEC Staff Accounting Bulletin No. 74 codified as SAB Topic 11-M, *Disclosure of the Impact that Recently Issued Accounting Standards Will Have on The Financial Statements of the Registrant When Adopted in a Future Period*.

# Chapter 1

## Introduction and procedures



### Background

FASB *Accounting Standards Codification (ASC) 326, Financial Instruments – Credit Losses*, has arguably created the single most significant change in the history of financial reporting for entities involved in lending activities. Prior to the effective date of FASB ASC 326, U.S. generally accepted accounting principles (GAAP) requires an “incurred loss” methodology for recognizing credit losses that requires loss recognition when it is probable a loss has been incurred. FASB ASC 326-20 requires an entity to measure expected credit losses for financial assets measured at amortized cost and held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts. Management is required to consider forward-looking information in its determination of an allowance for credit losses (ACL).

For financial assets held at amortized cost, FASB ASC 326-20 eliminates the probable incurred recognition threshold in current GAAP and, instead, requires an entity to reflect its current estimate of all expected credit losses over the contractual term, adjusted for prepayments of these assets. The ACL is a valuation account that is deducted from, or added to, the amortized cost basis of the financial asset(s) to present the net amount expected to be collected on the financial asset in the applicable financial reporting framework.

### Effective Dates

FASB ASC 326 includes effective date provisions as follows:

- For fiscal years beginning after December 15, 2019, including interim periods within those years, for public business entities (PBEs) that are SEC filers
- For fiscal years beginning after December 15, 2020, including interim periods within those years, for other PBEs
- For fiscal years beginning after December 15, 2021, including interim periods within those years, for non-PBEs
- For fiscal years beginning after December 15, 2018, including interim periods within those years, early adoption is permitted for all entities

**Note:** At its July 17, 2019, Board meeting, FASB voted to adopt a two-bucket approach designed to stagger effective dates for major standards. Bucket one includes SEC filers (as defined in GAAP), excluding smaller reporting companies (SRCs) as currently defined by the SEC. Bucket two makes up all other entities, including the following:

- All other PBEs, including SRCs
- Private companies
- All not-for-profit organizations, including not-for-profit entities that have issued, or are conduit bond obligors for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market
- All employee benefit plans, including employee benefit plans that file financial statements with the SEC

FASB decided that FASB ASU No. 2016-13 will be effective for PBEs that are SEC filers, excluding SRCs as currently defined by the SEC, for fiscal years beginning after December 15, 2019, and interim periods within those fiscal years. The determination of whether an entity is an SRC will be based on an entity's most recent assessment in accordance with SEC regulations. For all other entities, FASB decided that FASB ASU No. 2016-13 will be effective for fiscal years beginning after December 15, 2022, including interim periods within those fiscal years. For all entities, early adoption will continue to be permitted; that is, early adoption is allowed for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years (i.e., effective January 1, 2019, for calendar-year-end companies).

The FASB Board's tentative decisions can be found under the "Meetings" tab at [fasb.org](http://fasb.org). FASB notes that all reported conclusions are tentative and may be changed at future Board meetings. Decisions become final only after a formal written ballot is voted on to issue an ASU or a Statement of Financial Accounting Concept.

## Management's Responsibility

Management has a responsibility for developing, maintaining, and documenting a systematic, disciplined, and consistently applied process for determining the ACL in accordance with GAAP. To fulfill that responsibility, management is expected to design, document, and implement policies, procedures, internal controls, systems, and models that result in the development of management's best estimate of the ACL.

The implementation of FASB ASC 326-20 introduces new challenges related to the relevance, reliability, and availability of credit risk data. In addition to ensuring that the model management plans to use is fit for its intended purpose, management needs to also ensure that its expected credit loss model makes appropriate use of inputs and assumptions. The implementation of FASB ASC 326-20 will often require the collection and tracking of information not previously used in the incurred loss modeling or existing regulatory capital approaches. In some cases, this data may not have been previously subjected to internal controls. Management will need a detailed plan to address these challenges and to ensure the availability of complete and accurate data and development of appropriate models. The resources and time needed to effectively adopt the standard may be substantial.

Estimating expected credit losses is inherently subjective and involves management making judgments about collectibility and the estimation of losses. Management's judgments are influenced by historical information, current conditions, and reasonable and supportable forecasts. It is critical that the ACL methodology incorporate management's current judgments about credit quality of the loan portfolio through a systematic, disciplined, and consistently applied approach.<sup>1</sup>

<sup>1</sup> SEC Staff Accounting Bulletin No. 102, *Selected Loan Loss Allowance Methodology and Documentation Issues, and the Interagency Policy Statement on the Allowance for Loan and Lease Losses*, set forth the SEC staff's and regulators' expectation that registrants develop and document a systematic methodology to the estimate of credit losses through a disciplined and consistently applied process.



Management’s methodology for estimating credit losses should be well documented, including assumptions made, with clear explanations of the supporting analysis and rationale for the judgments made. In addition, if alternatives are considered by management, they should also be well documented with clear explanations of the supporting analysis and rationale for the judgments made. When management engages a third party to assist in the development of the assumptions used in management’s estimate of credit losses, those assumptions, become management’s assumptions. Management needs to consider those assumptions in the same manner as management’s other assumptions when designing and implementing internal control over the reasonableness of the estimate (that is, when management engages a specialist, management is still responsible for the appropriateness of the specialist’s methodology, as well as both inputs and outputs relevant to the estimate).

### The Audit Committee’s Role in Oversight

Audit committees (and their equivalents) play a crucial financial reporting oversight role in ensuring that the ACL represents management’s best estimate of credit losses and that information about methods and assumptions that drive the estimate are clearly disclosed in the financial statements. Audit committees fulfilling their governance responsibilities is a foundational element of implementing FASB ASC 326 appropriately. Effective and regular two-way communication between the auditor and the audit committee throughout the audit process is essential. To assist entities with the adoption of the new standard, the Center for Audit Quality (CAQ) identified the following questions that audit committees may wish to consider. A key aspect of successful implementation will be those charged with governance monitoring and working with management. Entities should develop an implementation plan and communicate it to the audit committee. In turn, audit committees should consider asking management questions regarding management’s implementation plan.

The following are illustrative questions with respect to the ACL estimate that audit committees may wish to discuss with their management and external auditors:<sup>2</sup>



### **The Implementation Plan**

1. How are milestones established/monitored? Are the milestones appropriate?
2. How will the audit committee be apprised of status? Audit committees may want to consider requesting a quarterly progress report from management.
3. How is management updating the audit committee on the progress of outside constituents who are supporting management in implementation (e.g., internal auditors, outside legal counsel, IT vendors and outside consultants)?
4. Does management need to engage third parties? What are the views of third-party vendors (consultants, etc.) that have been engaged by management regarding the implementation plan, if applicable?
5. How does the entity's implementation plan compare to other companies' best practices based on the audit committee member's experience, if applicable?
6. What information needs to be collected to implement the new standard, and what is the anticipated level of effort to collect the information?
7. Is the entity's CECL parallel run (including methods, models, assumptions, processes, and controls as if the standard was effective) on schedule?
8. Are regulatory changes and updates to the standard being monitored?

### **Culture and Resources**

9. Does a strong tone at the top support the effort required to implement the new standard? Is implementation receiving the appropriate resources (in-house and third-party) and priority?
10. If third-party resources are being used for implementation, have sufficient internal resources been engaged in the process to take ownership of the implementation of the new standard, as well as the accounting post-implementation (including data and models)?
11. Does the implementation team have adequate levels of experience and entity knowledge to understand the new standard's impact? Will significant judgments about implementation be made and approved centrally (e.g., at corporate headquarters) or throughout the entity (e.g., at a business-unit level)?

### **Systems and Data**

12. Have data shortfalls (e.g., vintage information, prepayment history) been identified? If so, what is being done to resolve these shortfalls (e.g., outside data resources)?
13. Are existing systems adequate to account for credit losses under the new standard?
14. Are new systems or improvements to existing systems needed? What is the status of the system implementation, if applicable?
15. How is data controlled, stored, and extracted?
16. Does the entity plan to use in its model any external or internal data not previously subject to internal controls? If so, how has management assessed the relevance and reliability of the data?

<sup>2</sup> Center for Audit Quality, *Preparing for the New Credit Losses Standard*, May 2019, pp. 10–12 [thecaq.org/preparing-for-the-new-credit-losses-standard-a-tool-for-audit-committees/](https://thecaq.org/preparing-for-the-new-credit-losses-standard-a-tool-for-audit-committees/).

## Controls

17. How is management's assessment of internal control over financial reporting affected?
18. Is management appropriately designing and testing the internal controls related to the standard's adoption? How will internal controls related to disclosure of the adoption impact be documented and tested?
19. How will changes to controls related to the adoption of the new standard be evaluated to determine whether disclosure is needed?
20. If manual processes are necessary, what controls are in place to evaluate completeness and accuracy of accounting, including any data inputs?
21. Who is responsible for changing, updating, and reviewing processes, controls, and related documentation impacted by the new standard?
22. Do existing control deficiencies, including significant deficiencies or material weaknesses, impact control considerations in implementing the new standard?

## Accounting Policy and Significant Accounting Judgments

23. Who is responsible for new accounting policy decisions and how does the entity plan to revise written accounting policies?
24. How is the entity keeping current on developments from the FASB (e.g., ASU updates) and SEC? What other resources, such as the AICPA Depository Institutions Expert Panel, and the FASB's Transition Resource Group, has the entity considered?
25. Who has reviewed significant assumptions and judgments? Have significant judgments been documented and communicated to the audit committee? Has management considered alternative assumptions or outcomes? If so, why did management reject them?
26. Have accounts been evaluated for appropriate presentation based on the new standard?

## Modeling and Assumptions

27. Has management created robust processes to develop the expected credit loss model and model validation controls to verify the model is performing as expected?
28. Has management's risk assessment appropriately considered how assets are pooled and unique risks associated with the asset pools?
29. Has management documented the determination of key assumptions and the rationale for including those assumptions in the model? Does the documentation include the source of the data and the controls relevant to its completeness and accuracy?
30. How do significant modeling methodologies and assumptions used compare to other business units within the entity, to peers, and to competitors? What controls has management put in place to evaluate internal consistency where appropriate? If not, consistent, has management documented why?
31. Have specialists (internal and external) been identified to assist with the development of the estimate? What controls are there around the data that was provided to the expert and the output given by the expert?
32. Have model governance processes and controls been put in place to determine the model is — and will remain — fit for purpose? Is management sharing the results of these reviews with the audit committee? Has a governance committee been considered?

## Involvement of Stakeholders

33. How has an internal communication plan been established (such that key stakeholders are aware of how the new standard will impact the entity)? Are key decision-makers aware of the judgments and process/control changes that need to be made at a business-unit level?



34. How will the training be rolled out to appropriate personnel?
  35. What is the plan to communicate the impact of the adoption of the new standard to investors? In addition to robust transition disclosures, how will the entity manage investor expectations?
  36. Are other stakeholders impacted that should be considered (e.g., federal or state regulators, underwriters)?
  37. How has the internal auditor been involved in the implementation process?
- Questions for the External Auditor**
38. How does the entity's external auditor view the entity's impact assessment? How has the external auditor been involved and what are the auditor's views on the impact of adopting the standard, changes to critical accounting policies and practices, and the entity's overall readiness?
  39. What is the external auditor's view as it relates to the implementation plan? Will it satisfy the auditor's plan and timeline to complete the audit in a timely manner?
  40. Has the external auditor assessed the design and implementation of controls, considering the following:
    - a. Data integrity?
    - b. Reasonableness of assumptions?
    - c. Reasonableness of modeling methodology?
  41. Has the external auditor reviewed significant judgments (e.g., assumptions used, modeling methodology)? What are the external auditor's perspectives?

# Chapter 2

## Internal Control and Governance

### Introduction

Management is responsible for the preparation and fair presentation of its financial statements and for the design, implementation, and maintenance of internal control over financial reporting. If the internal control over financial reporting (ICFR) requirements of the Federal Deposit Insurance Corporation Improvement Act or the Sarbanes-Oxley (SOX) Act are applicable, management is responsible for assessing the effectiveness of its internal control relative to financial reporting. FASB *Accounting Standards Codification (ASC) 326, Financial Instruments – Credit Losses*, introduces additional complexity and subjectivity into management’s estimate of an allowance for credit losses (ACL), which will likely result in a high level of estimation uncertainty with potentially enhanced data requirements, including existing data not previously subject to financial reporting controls. Therefore, entities will likely need to enhance existing controls or implement additional controls.

Entities’ ACL judgments and the related financial statement disclosures will be based on certain foundational elements such as the following:

- Accounting policies
- Operational procedures
- Information systems and data

- Estimation method, models, and assumptions
- Internal control over financial reporting

The auditor’s identification and assessment of the risks of material misstatement in audit of financial statements include obtaining an understanding of the entity’s internal control, as defined by the audit standards.<sup>1</sup>

### COSO Framework

The 2013 *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO framework) is one possible internal control framework used by entities to perform an assessment of internal control. As management and audit committees evaluate the ACL estimation process, they should consider this framework or another suitable framework. Under the COSO framework, there are five components of internal control, as follows:<sup>2</sup>

- Control environment
- Risk assessment
- Control activities
- Information and communication
- Monitoring activities

<sup>1</sup> Paragraph .04 of AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*. All AU-C sections can be found in AICPA *Professional Standards*.

<sup>2</sup> ©2019 Committee of Sponsoring Organizations of the Treadway Commission (COSO). All rights reserved. Used by permission. See [coso.org](https://www.coso.org).

## Control Environment

The control environment is the base of the internal control structure. The audit committee and management set the “tone at the top” regarding expectations related to the internal control environment and, with respect to the ACL, implement appropriate corporate governance. Management identifies the necessary resources and the skills and expertise needed to develop an appropriate estimate of credit losses under FASB ASC 326-20. The control environment sets the tone for accounting policies and disclosures that are transparent and free from inappropriate bias.

## Risk Assessment

Management’s risk assessment process is the foundation for the identification of risks of material misstatement within the ACL estimate and the actions management plans to take to mitigate the identified risks. The risk assessment requires reevaluation on a continuous basis as the risks of material misstatement within the estimate may change.

An entity’s preliminary consideration of the risks associated with the implementation of FASB ASC 326 may be helpful in anticipating and minimizing issues that may be identified in the transition and going-forward accounting process. Additional lead time in anticipating and addressing these issues will likely create a smoother and more efficient implementation for entities and auditors.

Principles 6 and 7 in the COSO framework are “The organization specifies objectives with sufficient clarity to enable the identification and assessment of risks relating to objectives” and “The organization identifies risks to the achievement of its objectives across the entity and analyzes risks as a basis for determining how the risks should be managed,” respectively. They relate specifically to an entity’s recognition and response to risks of financial reporting. Entities are expected to update risk assessments as a result of considering the effect of FASB ASC 326-20 on an

entity’s internal control over financial reporting and financial reporting objectives. Because this is a major change in accounting guidance for many entities and principle 9, “The entity identifies and assesses changes that could significantly impact the system of internal control,” relates to management responding to changes, it is likely that the change in the ACL accounting create new financial reporting risks. The entity may identify and subsequently design controls to address the new financial reporting risks.. This also relates to the design of controls in principles 10, “The organization selects and develops control activities that contribute to the mitigation of risks to the achievement of objectives to acceptable levels,” and 12, “The organization deploys controls activities through policies that establish what is expected and in procedures that put policies into action.” Through the risk assessment process and the resulting financial reporting risks that are identified, the absence or weakness in design or implementation of an entity’s control over financial reporting risks may often indicate a “gap” in the controls’ design or effectiveness, resulting in a control deficiency of some magnitude.

During the transition to FASB ASC 326-20, most entities will establish controls to ensure complete and accurate financial reporting of the ACL both during implementation and post-adoption. Such controls can help control audit costs of testing the data used and satisfying the assertions regarding the ACL.

As management performs its risk assessment and designs and implements controls, management considers elements within the ACL estimate such as the following:

- Relevance and reliability, including completeness and accuracy of inputs such as data and assumptions
- The selection and application of methods and techniques or models used to generate the estimate
- Information systems

- Potential for management bias (intentional or unintentional)
- Estimation uncertainty
- Transparency and clarity of related ACL disclosures

Risks related to inputs may depend on the source and whether they are objective or subjective inputs. For example, objective inputs may include the following:

- Data related to the unamortized cost basis
- Historical loss data
- Prepayment rates
- Contractual terms
- Payment structure

Examples of subjective inputs may include the following:

- Management adjustments for prepayment estimates, asset-specific differences, expected cash flows, discount rates (for discounted cash flow models), current conditions, or reasonable and supportable forecasts of economic conditions
- Determination of historical loss period
- Estimation of recoveries (for example, captured in period of recovery or mapped to period of charge-off)
- Definition of default

The selection and application of management's method or methods for estimating the ACL may give rise to risks of material misstatement. When estimating the ACL, certain assumptions are made during the estimation process. Management should design and implement controls to ensure assumptions are consistent with the objectives of FASB ASC 326-20. If an assumption is not consistent with an explicit requirement of FASB ASC 326-20, then the entity should demonstrate that such

inconsistency is not intentional.<sup>3</sup> Furthermore, the entity should demonstrate that any unintentional deviations are not material, both at adoption and on an ongoing basis, in evaluating the impact of the current year misstatement and control deficiency. Other risks with respect to the application of the method may include the mathematical accuracy of the model, whether the model is fit for its intended purpose and use, and the appropriateness of inputs and assumptions for the method (for example, will an adjusted effective interest rate result in a more precise estimate of ACL when using a discounted cash flow method when there are material loan purchase accounting adjustments?).

Information systems are used for various purposes including capturing, processing, and retaining an entity's business transactions. Information systems may include being a source of internal data as well as the vehicle used to process the ACL estimate. Risks related to the information systems include whether all transactions are captured and whether those transactions are captured accurately. There are also risks related to maintaining the integrity of the data once the information is captured by the system.

Due to the significant judgments necessary to estimate the ACL, management should identify risks to the development of a reasonable estimate related to unintentional management bias. Additional consideration should be given to elements of the ACL estimate that may give rise to fraud risk factors. Among others, risks related to fraud may include intentional<sup>4</sup> bias and management override of controls. For example, management bias may be present in the selection and application of accounting policies, among other areas of the ACL estimate.

The ACL is an estimate that relies on a number of different management judgments, including judgments related to forward-looking events. Due to these judgments and the nature of ACL, the ACL is

<sup>3</sup> Statement of SEC Staff Accounting Bulletin No. 99, *Materiality*.

<sup>4</sup> See preceding footnote.

likely to have a high level of estimation uncertainty. As management considers estimation uncertainty in its risk assessment, management should identify those factors that increase estimation uncertainty. For example, management might identify assumptions that are highly sensitive to minor variations as an element that results in estimation uncertainty.

The risk assessment process should also capture management's identified risks related to financial statement disclosures. Risks related to disclosures are those risks that may affect the transparency and reliability of the disclosure. Examples may include disclosures related to the credit risk inherent in the loan portfolio, how management monitors those identified risks, management's estimate of the ACL, and key drivers of changes in the estimate of the ACL during the period.

### **Control Activities**

Control activities should be designed to prevent or detect misstatements arising from risks identified within the risk assessment process. Control activities include policies and procedures designed to contribute to management's achieving its objectives that, in the case of the ACL, relate to reporting a reliable and reasonable estimate of credit losses and presenting transparent and reliable financial statement disclosures. To achieve the objective, it is expected management would formally document its policies and procedures related to the ACL. Management's policies should include how management's estimation process meets the requirements of FASB ASC 326-20, including the key decisions, judgments, and interpretations made by the entity. For example, the policy should address management's identification and selection of the assumptions, data, and methods used in the estimate. Other control activities may include information technology general controls (ITGC) for identified information systems that store and process the data for the ACL estimate. They also relate to automated controls and manual controls over various components of the ACL estimate. For example,

controls may include the following:

- Segregation of duties
- Approval-type controls, such as approval of charge-off activity
- Verification controls, such as tracing loan data back to signed notes
- Reconciliation-type controls, such as reconciling loan data from the ACL system to the core loan system
- Management review controls, such as a "review" of adjustments for reasonable and supportable forecasts

See chapter 3, "Audit Objectives," of this practice aid for other control considerations related to the components of the ACL.

### **Information and Communication**

Controls over information and communication address risks related to how the entity gathers and uses relevant and quality information and how this information is disseminated both internally and externally within the entity's system of internal control. In the context of the ACL, the use of relevant, quality information is critical to addressing the risks of material misstatement due to the potential sensitivity in the ACL estimate from data, assumptions, and techniques used in the estimation process. Controls generally address risks related to the production or evaluation of quality information. The COSO framework states the quality of information is dependent on accessible, correct (accurate and complete), current, projected, retained, sufficient, timely, valid, and verifiable information. Controls should address both internal and external information. For example, internal data may include historical loss information subjected to internal control to ensure the completeness and accuracy of that information. External data may include economic forecasts subjected to an evaluation of whether the forecast is relevant and reliable, reasonable and supportable.

## Monitoring

The monitoring component of the COSO framework is the process to evaluate the effectiveness of the internal control system in achieving its objectives. The monitoring process includes evaluations of internal control at all levels of the entity by management and the audit committee. The risks presented by the ACL require increased oversight by management and the audit committee in periods both before and after the initial adoption of FASB ASC 326.

During the implementation phase, the monitoring by management and the audit committee should generally focus on risks related to management readiness to implement FASB ASC 326-20 using a systematic, disciplined, and consistently applied approach. The audit committee should understand the risk assessment performed by management and consider whether additional risks are present.

The monitoring and timeliness of how management is responding to the identified risks are critical to the successful implementation of the ACL. Similar risks are present post-implementation. For example, management and the audit committee may focus on monitoring controls related to availability, competency, or limitation of resources, ongoing evaluation of the model, management bias, and overall reasonableness of the ACL estimate, which includes assumptions as appropriate used.

In order to effectively monitor the process, controls over the ACL estimate should be in place both during the implementation phase and subsequent to the effective date of FASB ASC 326-20. The entity's system of internal control should address the following, as appropriate:

- a. Relevance and reliability, including completeness and accuracy of such data (for example, historical information, including information sourced from outside the entity)
- b. The assumptions, method, and techniques used to generate the estimate, including the appropriateness of accounting policies, and the methodology to comply with the entity's accounting policies
- c. Information systems (for example, controls over completeness and accuracy of information produced by the entity)
- d. The identification and mitigation of potential management bias
- e. Accounting estimates with high degree of estimation uncertainty
- f. The transparency and clarity of related ACL disclosures
- g. How management identifies the need for and applies specialized skills or knowledge related to the accounting estimates, including the use of a specialist, as applicable

## Control Deficiencies

A failure in any element of internal control, including the audit committee's oversight, represents a control deficiency that may rise to the level of a significant deficiency or material weakness in the entity's internal control structure.

Questions pertaining to internal control and governance are included throughout chapter 3: "Audit Objectives and Procedures" of this practice aid.

# Chapter 3

## Audit Objectives and Procedures

### Overview

During the adoption period for FASB *Accounting Standards Codification (ASC) 326, Financial Instruments – Credit Losses*, it is important that the auditor understands his or her client's progress toward adoption to understand whether the client will be prepared to implement timely and will have appropriate controls over transition disclosures. The auditor may perform procedures to gain an understanding of the controls that exist during the pre-adoption period, including controls related to the determination of the entity's disclosures related to the anticipated impact upon adoption.

Upon adoption, the objective of the auditor's evaluation of the allowance for credit losses (ACL) is to obtain sufficient appropriate audit evidence to evaluate the reasonableness of management's estimate and the adequacy of the financial statement disclosures in accordance with FASB ASC 326-20.<sup>1</sup> AU-C section 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, addresses the auditor's responsibility to evaluate the reasonableness of management's estimate and requires the auditor to undertake one or more of the following audit approaches, taking into account the nature of the accounting estimate:<sup>2</sup>

- a. Determining whether events occurring up to the date of the auditor's report provide audit evidence about the accounting estimate.

- b. Testing how management made the accounting estimate and the data on which it is based. In doing so, the auditor should evaluate whether
  - i. the method of measurement used is appropriate in the circumstances,
  - ii. the assumptions used by management are reasonable in light of the measurement objectives of the applicable financial reporting framework, and
  - iii. the data on which the estimate is based is sufficiently reliable for the auditor's purposes.
- c. Testing the operating effectiveness of the controls over how management made the accounting estimate, together with appropriate substantive procedures.
- d. In testing management's estimate, developing a point estimate or range to evaluate management's point estimate. For this purpose,
  - i. if the auditor uses assumptions or methods that differ from management's, the auditor should obtain an understanding of management's assumptions or methods sufficient to establish that the auditor's point estimate

<sup>1</sup> Paragraph .06 of AU-C section 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*. All AU-C sections can be found in AICPA *Professional Standards*.

<sup>2</sup> Paragraph .13 of AU-C section 540.

or range takes into account relevant variables and to evaluate any significant differences from management's point estimate.

- ii. if the auditor concludes that it is appropriate to use a range, the auditor should narrow the range, based on audit evidence available, until all outcomes within the range are considered reasonable.

Due to the subjectivity, complexity, and estimation uncertainty inherent in the ACL estimate, testing management's process to develop the estimate may be the most effective audit approach. Due to the nature of the ACL estimate, an evaluation of subsequent events in isolation likely would not provide sufficient appropriate audit evidence.

Regardless of the audit approach, the auditor is required to understand the entity and its internal control related to management's process for developing the ACL. The auditor's understanding should include<sup>3</sup>

- a. the requirements of the applicable financial reporting framework relevant to accounting estimates, including related disclosures.
- b. how management identifies those transactions, events, and conditions that may give rise to the need for accounting estimates to be recognized or disclosed in the financial statements. In obtaining this understanding, the auditor should make inquiries of management about changes in circumstances that may give rise to new accounting estimates or the need to revise existing accounting estimates.
- c. how management makes the accounting estimates and the data on which they are based, including

- i. the method or methods, including, when applicable, the model used in making the accounting estimate;
- ii. relevant controls (including those over completeness and accuracy of data, such as information produced by the entity, and the precision level of key management review controls);
- iii. whether management has used a specialist;
- iv. the assumptions underlying the accounting estimates;
- v. whether there has been or ought to have been a change from the prior period in the method or methods, or assumptions, used in making the accounting estimates and, if so, why; and
- vi. whether and, if so, how management has assessed the effect of estimation uncertainty.

The auditor is required to obtain sufficient appropriate audit evidence about whether the disclosures in the financial statements related to accounting estimates are in accordance with the requirements of the applicable financial reporting framework.<sup>4</sup> This includes obtaining sufficient appropriate audit evidence about whether management's accounting policies are complete and are in accordance with the applicable accounting requirements. Financial statement disclosures, including accounting policy disclosures should include a sufficient level of detail so that users of the financial statements can identify the key decisions, judgments, and interpretations made by the entity. Complete accounting policies enable mapping to the underlying principles of FASB ASC 326-20. Clear and comprehensive evidencing by the entity is an important element in ensuring the completeness and appropriateness of the accounting policies.<sup>5</sup>

<sup>3</sup> Paragraph .08 of AU-C section 540.

<sup>4</sup> Paragraph .19 of AU-C section 540.

<sup>5</sup> Global Public Policy Committee, *The Auditor's response to the risks of material misstatement posed by estimates of expected credit losses under IFRS 9*, July 2017, par. 2.2.2, [iasplus.com/en/publications/global/other/ifrs-9-impairment-banks-2](https://iasplus.com/en/publications/global/other/ifrs-9-impairment-banks-2).

During the auditor's process to understand management's methodology, common questions the auditor may ask management include the following:

- Why did management select this methodology?
- What alternative methodologies did management consider and why were they discarded?
- How did management determine the relevant data (internal and external) and assumptions?
- What disconfirming or contrary information has management identified? How has management considered this information?
- What risks did management identify in its process? How have these risks been addressed?
- What types of information systems did management use?
- How did management ensure relevance and reliability (completeness and accuracy of internal data) of the data used in the estimate?
- How has management responded to management-identified risks? What controls address those risks?
- What system or model limitations were identified? What (if any) adjustments compensate for system or model limitations?
- What data limitations were identified? What (if any) adjustments compensate for data limitations?
- What skills and expertise does management have?
- How did management evaluate and consider the sufficiency of its skills and expertise?
- How has management ensured that the necessary skills and expertise were available to the entity?

- If gaps were identified, how did management compensate (for example, training, hiring, engaging a specialist, engaging a third-party service provider)?

The auditor's understanding of the entity and its environment, including its internal control, provides the basis for the auditor's identification and assessment of the risks of material misstatement at the assertion level. The auditor is required to design and perform further audit procedures whose nature, timing, and extent are based on, and are responsive to, the assessed risks of material misstatement at the relevant assertion level<sup>6</sup> to conclude on the reasonableness of the ACL estimate in accordance with FASB ASC 326-20, the financial statements taken as a whole, and the related financial statement disclosures. The assessment of the risks of material misstatement at the financial statement and assertion levels provides the basis for the audit responses.

The auditor is required<sup>7</sup> to determine whether any of the risks identified are, in the auditor's professional judgment, a significant risk. Significant risks identified should be at a level granular enough to clearly understand and link to a necessary audit response. Significant risks identified with the ACL will most likely be specific aspects of the ACL determination rather than the calculation as a whole. If the auditor determines there is a significant risk, the auditor is required to obtain an understanding of the entity's controls, including control activities, relevant to that risk and, based on that understanding, evaluate whether such controls have been suitably designed and implemented to mitigate such risks. In addition, the auditor is required<sup>8</sup> to perform substantive procedures that are specifically responsive to that significant risk. When the approach to a significant risk consists only of substantive procedures, those procedures should include tests of details.

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<sup>6</sup> Paragraph .06 of AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*.

<sup>7</sup> Paragraph .28 of AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*.

<sup>8</sup> Paragraph .22 of AU-C section 330.

Finally, for accounting estimates that give rise to significant risks, in addition to other substantive procedures performed to meet the requirements of AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, the auditor's evaluation should include how management has considered alternative assumptions or outcomes and why it has rejected them or how management has otherwise addressed estimation uncertainty in making the accounting estimate.<sup>9</sup>

## Sources of Risks of Material Misstatement

The auditor's assessment of the risks of material misstatement at the assertion level relative to the estimate of credit losses may consider factors such as the following:

- Portfolio segmentation (pooling)
- Modeling
- Relevance and reliability of data
- Adjustments to historical loss information
- Adjustments to reasonable and supportable forecasts
- Implementing reversion
- Evaluating estimation uncertainty
- Consideration of elements susceptible to management's bias
- Use of management's specialists and other third parties

## Portfolio Segmentation (Pooling)

### Management Considerations

FASB ASC 326-20 requires management to measure expected credit losses on a collective (pool) basis when similar risk characteristics exist. When similar risk characteristics do not exist, management should evaluate the loan individually.<sup>10</sup> FASB ASC 326-20 also requires disclosure of expected losses by portfolio segment for loans.<sup>11</sup> On an ongoing basis, management is required to evaluate whether a loan in a pool continues to exhibit similar risk characteristics as the other loans in the pool.<sup>12</sup> Management's determination of the loan pools, or decision to evaluate a loan on an individual basis, is highly judgmental<sup>13</sup> and should be reflective of management's identification and evaluation of similar risk characteristics. Management may consider the following potential risk characteristics in FASB ASC 326-20-55-5 when identifying pools:<sup>14</sup>

- Internal or external (third-party) credit score or credit ratings
- Risk ratings or classification
- Loan purpose
- Collateral type
- Size
- Effective interest rate
- Term
- Geographical location
- Industry of the borrower
- Vintage
- Historical or expected credit loss patterns
- Reasonable and supportable forecast periods.

<sup>9</sup> Paragraph .15a of AU-C section 540.

<sup>10</sup> FASB *Accounting Standards Codification (ASC)* 326-20-30-2.

<sup>11</sup> FASB ASC 326-20-50-3.

<sup>12</sup> FASB ASC 326-20-35-2.

<sup>13</sup> FASB ASC 326-20-55-6i.

<sup>14</sup> The list of risk characteristics included in FASB ASC 326-20-55-5 may not be relevant to every situation, and other factors not on the list may be relevant such as loan purpose, occupancy, property types, and initial loan-to-values.

The determination of loan pools may affect the model chosen by management to estimate expected credit losses and any related qualitative adjustments. For example, if management has determined that their 1–4 family mortgage loans share similar risk characteristics, and therefore constitute a pool for purposes of estimating the ACL, and management has further identified the year of origination as a primary risk characteristic for 1–4 family mortgage loans, management may determine that the most appropriate model to measure expected losses for this pool is a vintage-based model.<sup>15</sup> Further, if management determines not to disaggregate 1–4 family mortgage loans by rate structure (that is, variable rate vs. fixed rate), management may determine that it is necessary to adjust the historical loss information for differences in the mixes of rate structures. See the following section on qualitative factor adjustments to historical loss information, which discusses adjustments to the historical loss information for differences in current asset-specific risk characteristics. Further, it is important to understand whether pools are reasonable not only because they impact decisions on models as described earlier, but they may also help determine which loss data to use and which economic variable to forecast.

Management’s control considerations may include the following:

- a. Completeness and accuracy of data used to determine segmentation (For example, is the system data complete and accurate?)
- b. Sensitivity analysis of alternative risk characteristics
- c. Review controls over the selection of risk characteristics
- d. Review controls over the reevaluation to determine if a loan no longer shares risk characteristics with the other loans in the pool (for example, if the loan needs to migrate to a different pool or be evaluated individually)

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<sup>15</sup> FASB ASC 326-20-55-17, example 3.

### **Auditor’s Considerations**

In accordance with AU-C section 315, the auditor is required to identify and assess the risks of material misstatement. In an ACL estimate, this includes risks of material misstatement related to management’s loan segmentation process. The auditor develops audit procedures that are responsive to those risks. The auditor may consider factors that could affect whether management has appropriately and consistently applied the loan segmenting requirements of FASB ASC 326-20 such as the following:

- Completeness and appropriateness of the pool classification of the loan segment
- Appropriateness of the entity’s data, classifications and methods from prior periods
- Consideration of alternative risk characteristics
- Relevance and reliability of the entity’s data used to segment the portfolio

The following paragraphs include illustrative inquiries that the auditor may perform in understanding management’s method and techniques to segment the portfolio and to identify the related risks of material misstatement.

The auditor may ask questions to address completeness and classification of management loan segments such as the following:

1. How did management determine the pool classification of loan segments?
  - a. If management bases the segmentation on call report codes,
    - i. how did management determine the risk characteristics in the segment are appropriately reflected within the relevant call report code?
    - ii. how did management evaluate that the call report segments are reasonable and sufficiently precise to result in a reasonable estimate?

2. What are the potential risk characteristics in the portfolio?
3. How did management determine which risk characteristics were relevant?
  - a. Did management determine whether the examples in FASB ASC 326-20-55-5 were applicable to its portfolio?
  - b. Did management consider other risk characteristics not included in FASB ASC 326-20-55-5?
  - c. If not, how did management determine that its population of risk characteristics applicable to its portfolio were complete and appropriate?
4. For the loans management evaluates individually, how did management determine those loans did not share similar risk characteristics?
5. How did the pooling affect the method selected and data used to determine the expected credit losses for each loan pool?

The auditor may ask questions to address the ongoing appropriateness of management's segmentation of the loan portfolio and to address changes, if any, in the method from the prior period such as the following:

1. How did management determine that the framework to segment loans is appropriate?
2. How does management monitor the risk characteristic changes in a loan segment?
  - a. How does management determine whether a change in a loan segment is necessary?
  - b. How does management evaluate changes to pools, if applicable, period over period?
  - c. How does management determine whether a loan in a pool has changed such that it shares risk characteristics with a different pool or no longer shares risks characteristics with any pool?

- d. How does management reassess those loans that are evaluated individually to determine whether in subsequent reporting periods the loan should be evaluated collectively as it now shares risk characteristics with other loans?
3. Has the entity documented its loan segmentation process and conclusions?

The auditor may ask questions to address alternative assumptions such as the following:

1. Is there other information, such as risk characteristics, management considered but determined was not applicable?
2. Did management consider other relevant information but instead used alternative information?
3. How did management consider publicly available information?
4. How did the entity consider further aggregation or disaggregation of the pools?

The auditor may ask questions to understand management's use of data and identify risks related to the completeness and accuracy of that data (see additional considerations in the data section) such as the following:

1. What data is relevant to the pooling conclusion (for example, loan type, vintage, risk rating, term)?
2. What is the source of the data? What are the relevant information systems?
3. How did the entity evaluate that data for completeness and accuracy?
4. What assumptions were made to adjust for missing or incomplete data due to system limitations or other factors? For example, management may consider and conclude it is appropriate to further disaggregate its loan segments but, due to system limitations, sufficient data may not exist or may not be reliable.

Potential risks of material misstatement in the area of portfolio segmentation may include the following:

1. Loan segments that do not represent loans with similar risk characteristics, resulting in an ACL or changes to credit loss provisions that do not reflect the risks within the loan portfolio
2. Changes in loan portfolio characteristics that over time (or due to events) may result in pool risk characteristics changing such that they no longer align to the pools used to determine historical loss information
3. Loan attributes (for example, loan type, vintage, risk rating, term) used to determine the loan segmentation that are not relevant, complete, and accurate, resulting in an ACL that does not reflect the risks within the loan portfolio
4. Segmented loan balances that are not complete and accurate, resulting in a miscalculated and (as a result) misstated ACL
5. Loans that require evaluation of expected credit losses on an individual basis (i.e., do not share similar risk characteristics with other loans) are not timely or accurately identified, causing inaccurate assumptions related to pooled asset performance and ultimately resulting in misstatement of the provision for credit losses and ACL

## Modeling

### **Management's Considerations**

FASB ASC 326-20 requires an entity to recognize expected credit losses; however, FASB ASC 326-20 does not require a specific method to determine this estimate. Although multiple methods are available, no one method is required, and multiple methods may be used to arrive at the final ACL estimate. As stated in FASB ASC 326-20-55-7, the method(s) used to estimate expected credit losses may vary on the basis of the type of financial asset, the entity's ability to predict the timing of cash flows, and the information available to the entity. Management's

methodology describes the overall estimation approach for the ACL and includes rules or principles governing the relationship between the variables in the estimate. As part of management's method for developing the ACL, management may use a model. As described in Office of the Comptroller of the Currency Bulletin 2011-12, "Sound Practices for Model Risk Management: Supervisory Guidance on Model Risk Management,"

a *model* is a quantitative method, system, or approach that applies statistical, economic, financial, or mathematical theories, techniques, and assumptions to process input data into quantitative estimates. A model consists of three components: an information input component, which delivers assumptions and data to the model; a processing component, which transforms inputs into estimates; and a reporting component, which translates the estimates into useful business information.

To determine an appropriate model, management should consider the risks within its portfolio segments and choose a model or models for each pool that can provide a reasonable estimate of expected credit losses based on the identified risks. Because multiple models could be appropriate, management is expected to document both its rationale for the initial model selection and the subsequent evaluation of whether the selected model or models remain appropriate.

Management is responsible for evaluating whether the model designed is appropriate to meet the objectives of FASB ASC 326-20 and for evaluating whether each model individually and as a whole operates in accordance with its intended purpose.

Management is also responsible for establishing and implementing policies, procedures, and controls relevant to financial reporting over these objectives. Management's policies, procedures, and controls over the model or models may vary based on the entity's size, nature and complexity of the model, and the extent and sophistication of the entity's use of models and should take into consideration the following objectives:

- a. The entity's model validation process should include<sup>16</sup>
  - i. evaluation of the conceptual soundness and mathematical integrity of the methodology, including the appropriateness of parameters and sensitivities.
  - ii. ongoing monitoring including
    - validation process prior to usage,
    - period reviews to ensure that it continues to be suitable for its intended use, and
    - consistency and completeness of the model's inputs with objectives of the financial reporting framework and whether the appropriate inputs are available for use in the model.
  - iii. outcome analysis, a comparison of model outputs to corresponding actual outcomes.
- b. Appropriate change control policies, procedures, and access security controls are in place.
- c. The model is appropriately changed or adjusted on a timely basis, when necessary.
- d. The model is periodically calibrated, reviewed, and tested for validity by a separate and objective function.

- e. The model maximizes the use of relevant objective inputs and minimizes the use of subjective inputs when not anchored to objective evidence.
- f. The model, including the model's intended applications and limitations, and its key parameters, required data, results of any validation analysis performed, and any adjustments made to the output of the model are adequately documented.

The nature and extent of model validation activities will vary depending on the complexity and extent of model use by the entity. These considerations apply whether management has developed an internal model, outsourced the development to a third party, purchased an off-the-shelf model, or used a service provider's model. The use of a third party can provide the requisite specialized skills; however, management is still responsible for understanding the model. Additional challenges may arise from use of a third party, such as the use of a third party's proprietary information. See the specialist section that follows for further discussion on this topic.

### **Auditor's Considerations**

The auditor is required<sup>17</sup> to obtain an understanding of how management determines the estimate and obtains the inputs (including data and assumptions) on which the estimate is based. This understanding includes the method or methods used, including, when applicable, the model used, in making the accounting estimate.

The auditor's understanding of the model includes understanding management's validation process. Among the components of management's validation process listed earlier is the evaluation of the conceptual soundness of the model. As part of the auditor's evaluation of the conceptual soundness, the

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<sup>16</sup> See Office of the Comptroller of the Currency (OCC) Bulletin 2011-12, "Sound Practices for Model Risk Management," for additional considerations.

<sup>17</sup> Paragraph .08c of AU-C section 540.

auditor obtains an understanding of management's judgments related to the development of the model and how those judgments were applied in the modeling. This includes, for example, what judgments or assumptions were made in how the model handles

- the contractual life of a loan,
- elements of amortized cost other than unpaid principal balance,
- recoveries,
- prepayments,
- reasonably expected troubled debt restructurings (TDRs),
- unconditionally cancellable extension options/renewals,
- averaging (simple average, weighted average), and
- forward-looking information.

The requirement of FASB ASC 326-20 to evaluate the ACL on a pool basis when similar risk characteristics exist may result in management's deploying more than one model in estimating the ACL. The auditor is required to gain an understanding of the models and assess the risks of material misstatement.

In understanding the risks of material misstatement at the assertion level with respect to management's model, the auditor may consider the potential risks with respect to the aforementioned requirements.

This may include risks related to the following:

- Model capabilities and limitations
- Model development and implementation
- Adjusting models over time
- The model not being suitable for its intended use
- System integration
- Output reviews
- Incentives to provide effective challenges to models

**Risks related to the model's conceptual soundness may include, for example, the following:**

1. The model may have fundamental conceptual errors, which include but are not limited to the following examples, resulting in inaccurate outputs when viewed against the requirements of FASB ASC 326-20.
  - a. Model output for credit loss rates that are not supported by historical experience over the life of the portfolio.
  - b. Estimates based on average lives may omit consideration of risk of loss over the entire life of the portfolio.
  - c. Changes in estimates based on average scores for some credit risk metrics (FICO, for example) may not reflect the nonlinear relationship of changes in expected loss to changes in credit scores. These relationships can change from period to period in collateralized lending and credit card portfolios.
  - d. Inappropriate reversion techniques from reasonable and supportable forecast period to unadjusted historical experience may produce unreasonable results.
2. Mathematical theories may be misapplied when designing and maintaining the model.
3. The data and assumptions are not evaluated appropriately or supported.

**Risks related to model development and implementation may include, for example, the following:**

1. The individuals responsible for modeling lack the skills and expertise to design and implement the model.
2. The individuals responsible for modeling have not appropriately documented evidence in support of all model choices, including the overall theoretical construction, assumptions, data, and specific mathematical calculations.

3. The model has not been sufficiently stress-tested (that is, management has not sufficiently evaluated how changes in inputs and parameter values affect outputs) prior to being placed in production to ensure the model will perform appropriately under a variety of economic conditions.
4. The model is not performing as intended.
5. Management does not perform checks to test that all model components are functioning as designed.
6. There are no controls or procedures in place covering who has access to the model during development. There is a risk that unauthorized individuals can make changes to the model and that these changes are not being tested.
7. The underlying theory of the model is not conceptually sound and not generally accepted for its intended purpose under FASB ASC 326-20.
8. Individuals responsible for modeling make recurring qualitative adjustments to better align outputs with expectations, or to adjust the model for known events, rather than imbedding these assumptions in the model.
9. Modeling limitations identified in the development phase are not assessed over time or addressed through overlays or other means.
10. The individuals responsible for modeling do not consider external information and events (for example, contrary evidence from historical loss rates indicated in external data).

**Risks related to adjusting models over time may include, for example, the following:**

1. Prior to each use, management does not consider whether to reevaluate the model, and the methods and assumptions used in the development of the model.

2. Once the model has been placed in production, management does not implement processes or controls for further maintenance.
3. Model changes are not tracked, evaluated, and approved by the responsible parties, resulting in unauthorized changes to the model.
4. Validation procedures do not occur timely on an ongoing basis.
5. The individuals responsible for modeling do not consider benchmarking steps (that is, a comparison of a given model's inputs and outputs to estimates from alternative internal or external data or models<sup>18</sup>).

**Risks related to the model not being suitable for its intended use may include, for example, the following:**

1. Entities may not fully consider the differences between portfolio segments and may inappropriately default to using the same model to estimate expected credit losses for all loan segments.
2. Entities may inappropriately use the same model to predict the effect macroeconomic factors (for example, unemployment, housing price indexes) have on all loan segments.
3. Management does not evaluate which estimation method, including model, is better suited to predict expected credit losses.
4. The model is not being used as intended.
5. Entities may inappropriately use the same model when there have been changes to generally accepted accounting principles or regulatory requirements.
6. Entities may inappropriately use a model or method designed for a purpose other than estimating credit losses in accordance with FASB ASC 326-20.

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<sup>18</sup> See OCC Bulletin 2011-12.

**Risks related to system integration may include, for example, the following:**

1. The information used in the model may come from other sources and may not be complete and accurate.
2. The data flow is not occurring in a controlled environment.
3. The model has not been accurately implemented, including aspects of system integration.

**Risks related to model output reviews may include, for example, the following:**

1. Management does not compare model outputs (prior period estimate) to corresponding actual outcomes in the current period.
2. Management does not review discrepancies, including investigating the root cause, between model outputs, expectations, external information, and benchmarking.
3. Management overrides model outputs without proper analysis and documentation (see the sections “Adjustments to Historical Loss Information” and “Adjustments for Reasonable and Supportable Forecasts”).
4. Management does not review reports or outputs derived from the model for completeness and accuracy.
5. Management does not summarize model results in a way that is relevant and helpful to the users of the financial statements (that is, management does not contemplate reporting, which translates the estimates into useful business information).
6. Management does not have the skills and expertise to appropriately challenge model outputs that may be more complex compared to those used under the superseded incurred loss methodology.

**Risks related to incentives to provide effective challenges to models include the following:**

1. There may not be a separation between individuals designing and implementing the model and those reviewing and validating it (for example, objectivity).
2. Individuals reviewing the models do not have the necessary skills or expertise.
3. Senior management does not appropriately challenge the decisions made by the individuals responsible for modeling.

**Other examples of risks may include the following:**

1. Loans are incorrectly included in both collective and individual assessments of expected credit losses, resulting in a misstatement of the provision for credit losses and ACL.
2. Expected extensions, renewals, and modifications that are included in the original or modified contract at the reporting date and are not unconditionally cancelable by the entity are incorrectly considered in the determination of the contractual term of loans when a TDR is not reasonably expected, resulting in a misstatement of the provision for credit losses and allowance.
3. Loans are inappropriately identified as having an expectation that nonpayment of the amortized cost basis is zero, resulting in a misstatement of the provision for credit losses and ACL.
4. The method used to attribute gross charge-offs and recoveries to portfolios, economic events, or other relevant credit metrics is not appropriate.
5. The method to estimate prepayments is not appropriate, resulting in the use of inappropriate prepayments within the ACL estimation process.

For each assessed risk of material misstatement at the assertion level, the auditor is required to develop audit procedures that are responsive to the risk.

## Relevance and Reliability of Data

### **Management's Considerations**

Because FASB ASC 326-20 requires estimates of expected credit losses over the entire contractual term of a pool of loans, data reflecting expected credit losses across a wide range of risk factors will generally be required, potentially including data not previously used in developing the allowance for loan losses under the probable incurred loss method. For example, if an entity has a segment of a loan portfolio with 30-year mortgages, the entity should consider the relevant data derived over the entire contractual life including prepayments of the loan in their ACL estimate. Therefore, it is expected that entities will need to capture a large volume of data when implementing the new standard. With respect to the use of relevant quality information, the 2013 *Internal Control – Integrated Framework* issued by COSO states that

[m]aintaining quality of information is necessary to an effective internal control system, particularly with today's volume of data and dependence on sophisticated, automated information systems. The ability to generate quality information begins with the data sourced. Inaccurate or incomplete data, and the information derived from such data, could result in potentially erroneous judgments, estimates, or other management decisions.

The reasonableness of an ACL estimate is highly dependent on the use of relevant and reliable data and the application of this data using a consistent method. As such, management needs to consider the relevant data its information systems are capturing, relevant data not being captured that may be necessary to reasonably estimate expected credit

losses (gap assessment), and the controls over the completeness and accuracy of this information.

Management should use relevant and reliable data (regardless of its source) within its model. Management's consideration of the reliability of data from its information systems includes an evaluation of the completeness and accuracy of the historical data that resides in the system. In determining the completeness and accuracy of the data, management may consider the past operating effectiveness of controls over data input and data integrity. For situations in which the data was not previously subject to a control, the control was ineffective, the control was not sufficiently precise for use in the ACL estimate, or the effectiveness of the controls is unknown; management should consider implementing a control to retrospectively evaluate the completeness and accuracy of the historical data, for example, by agreeing with relevant historical data to original source documents. For situations in which the data was previously subject to an effective control, management might include in the ACL documentation the following:

- Why prior period controls are relevant based on how the data is used in the ACL estimate.
- How the effectiveness of prior period controls addresses the reliability of the data used in the ACL estimate. For example, if management is relying on controls from 2010 to support the completeness and accuracy of certain data used in the ACL estimate as of January 1, 2020, how has management considered the risk of the data being modified from the time of the 2010 control operation and the data's use in the January 1, 2020, ACL estimate?
- What evidence does management have in the current period supporting the design and operating effectiveness of the prior period controls?

- What the impact is of prior period controls on the design of the current period controls in the implementation period has had over the completeness and accuracy of data.

Additionally, management should implement controls over data input and data integrity as appropriate and should review the design effectiveness of said controls on a continual basis.

The consideration of information systems also includes an evaluation of the transfer of data from system to system. For example, loan data may be manually exported from a source system to the ACL system or transferred via automated system interfaces. Manual transfers of data introduce different and additional risks as compared to automated interfaces. Management's determination of the completeness and accuracy of relevant data should also extend to the transfer of data between systems.

Management's consideration of data also includes externally sourced data such as macroeconomic data and loan-level data relating to an acquired entity's loans to assist in the preparation of certain disclosures, as applicable. When evaluating the relevance and reliability of externally sourced data, management may consider factors such as the following:

- The nature and authority of the external information source (For example, a central bank or government statistics office with a legislative mandate to provide industry information to the public is likely to be an authority for certain types of information.)
- The objectivity of the source (for example, the inability of management to influence the information obtained through relationships between the entity and the information source)
- The competence and reputation of the external information source with respect to the information, including whether, in

the auditor's professional judgment, the information is routinely provided by a source with a track record of providing reliable information

- Past experience with the reliability of the information provided by the external information source
- Evidence of general market acceptance by users of the relevance or reliability of information from an external information source for a similar purpose to that for which the information has been used by management
- Whether the entity has in place controls to address the relevance and reliability of the information obtained and used
- Whether the information is suitable for use in the manner in which it is being used and, if applicable, was developed taking into account the applicable financial reporting framework
- Alternative information that may contradict the information used
- The nature and text of disclaimers or other restrictive language relating to the information obtained
- Information about the method used in preparing the information and how the methods are being applied including, where applicable, how models have been used in such application, and the controls over the methods
- When available, information relevant to considering the appropriateness of assumptions and other data applied by the external information sources in developing the information obtained

Management's control considerations may include the following:

- a. Information technology general controls (ITGCs)
- b. Completeness and accuracy of information input into the system and historical information maintained in the system
- c. System data processing controls
- d. Controls over the completeness and accuracy of the output from the information system (for example, reports)
- e. Controls over the transfer of data between systems
- f. Review relevance and reliability of data received from external information sources or third parties

### **Auditor's Considerations**

The auditor is required to consider the relevance and reliability of the information used in obtaining audit evidence. For example, if management uses call report codes to determine its loan pools, not only should the auditor test the accuracy of the data used to classify loans into the appropriate call report code (that is, reliability), but the auditor should also challenge whether using only the call report code is appropriate for the circumstances (that is, relevance).

In evaluating the reliability of data used as audit evidence, the auditor considers the nature and the source of the data. When using information produced by the entity such as historical loan data, the auditor tests the completeness and accuracy of information or tests the controls over the completeness and accuracy of that information.<sup>19</sup> Tests of completeness and accuracy may include tests such as comparing data from or to original source documents. For externally sourced information, the auditor may evaluate similar factors as outlined above in management's considerations.

Through the risk assessment process, the auditor may identify risks of material misstatement related to management's use of data, including risks related to completeness and accuracy. When developing audit procedures responsive to the identified risks, the auditor should consider whether substantive procedures alone cannot provide sufficient appropriate audit evidence to address the identified risk. If substantive procedures alone cannot provide sufficient appropriate audit evidence, the auditor is required to test controls.<sup>20</sup>

Controls relevant to the data used in the ACL estimate may include controls over (1) the completeness, relevance, and accuracy of data used to develop the accounting estimate and (2) the review and approval of the assumptions or inputs used in its development.<sup>21</sup> Due to the expected large sets of data, it is possible that:

- a. testing relevant controls over certain data will likely be the most efficient and effective approach to achieve sufficient appropriate audit evidence over the completeness and accuracy of data, and
- b. substantive procedures alone may not provide sufficient appropriate audit evidence to conclude on the completeness and accuracy of data.

Management may incorporate data that has not previously been subjected to internal controls over financial reporting or audit procedures. For example, management may determine loan-to-value is a relevant data point to estimate expected credit losses under the new standard. As part of the auditor's requirement to obtain an understanding of the control in accordance with paragraph .13 of AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, the auditor should gain an understanding of newly determined

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<sup>19</sup> Paragraph .09 of AU-C section 500.

<sup>20</sup> Paragraph .08b of AU-C section 330.

<sup>21</sup> Paragraph .A26 of AU-C section 540.

relevant data and gain an understanding of how management has implemented appropriate internal control over that data. In such circumstances, the auditor is required in accordance with paragraph .09 of AU-C section 500, *Audit Evidence*, to evaluate whether the information is sufficiently reliable for the auditor's purposes to when using information produced by the entity.<sup>22</sup>

Management may incorporate data that has been previously subjected to internal controls over financial reporting or audit procedures. When the auditor intends to use information obtained from the auditor's previous experience with the entity and from audit procedures performed in previous audits, the auditor should determine whether changes have occurred since the previous audit that may affect the information's relevance (and reliability) to the current audit.<sup>23</sup> Further, if the auditor plans to use audit evidence from a previous audit about the operating effectiveness of specific controls, the auditor should perform audit procedures to establish the continuing relevance of that information to the current audit. The auditor may consider a number of factors to determine the evidence needed during the current-year audit to support the auditor's control risk assessment such as the following:

- Whether the lack of a change in a particular control poses a risk due to changing circumstances
- The risks of material misstatement and the extent of reliance on the control
- The nature and materiality of misstatements that the control is intended to prevent or detect
- The inherent risk associated with the related accounts or assertions
- Whether there have been changes in the volume or nature of transactions that might adversely affect control design or operating effectiveness
- Whether the account has a history of errors
- The effectiveness of entity-level controls that

the auditor has tested, especially controls that monitor other controls

- The nature of the controls and the frequency with which they operate
- The degree to which the control relies on the effectiveness of other controls (for example, the control environment or ITGCs)
- The competence of the personnel who perform the control or monitor its performance and whether there have been changes in key personnel who perform the control or monitor its performance
- Whether the control relies on performance by an individual or is automated (An automated control would generally be expected to be lower risk if relevant ITGCs are effective)
- The complexity of the control and the significance of the judgments that must be made in connection with its operation
- The planned degree of reliance on the control
- The nature, timing, and extent of procedures performed in past audits
- The results of the previous years' testing of the control
- Whether there have been changes in the control or the process in which it operates since the previous audit

Relevant data may include, for example, the following:

- Amortized loan cost
- Prepayment data
- Loan extension, modification, and renewals
- Loan attributes used to determine portfolio segments
- Loan attributes used to adjust for current asset-specific risk characteristics
- Historical loss information
- Economic data supporting current, reasonable, and supportable forecasts
- Borrower data
- Collateral values

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<sup>22</sup> Paragraph .09 of AU-C section 500.

<sup>23</sup> Paragraph 14 of AU-C section 330: Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained.

The following paragraphs include some questions the auditor may consider in understanding relevant data and identifying the related risks of material misstatement.



**Questions related to data sources and availability include the following:**

1. Is the data sourced from systems outside traditional accounting systems such as those used for regulatory reporting (for example, call reports and stress testing risk management or credit systems)? If so, how is that data used in the ACL estimation process? Are sufficient and appropriate controls in place around those systems?
2. Is the data internally sourced or developed (for example, loan-level characteristics, historic and forecasted charge-offs, recoveries, prepayments, and lending projections)?
3. How does management use and consider externally sourced data, including use of specialists?
  - a. Is forward-looking data (for example, macroeconomic information such as GDP forecasts, unemployment forecasts, interest rate forecasts, and housing trend forecasts) sourced from credit or regulatory agencies or developed by third parties?
4. What judgments are made to adjust for missing or incomplete data?

**Questions related to consistency include the following:**

1. What is the rationale for changes in sources of data or types of data between reporting periods?
2. Is the data being used consistently across ACL estimates and for the various loan segments?
3. Is the data being used consistently with other functions of the entity such as other forecasting, reporting, or budgetary purposes? Why or why not?

4. Is the data being used consistently within the entity in determining other accounting estimates, such as goodwill impairment or deferred tax asset valuation?

**Questions related to relevancy and sufficiency include the following:**

1. Is the data relevant to the portfolio for which the ACL is being estimated (that is, how is it relevant for estimating credit losses for the loan segment being evaluated)? For example,
  - a. Does the data reflect the prepayment adjusted contractual term of the loan?
  - b. Does the data reflect the specific segment risk characteristics?
  - c. Does the data capture loan data and loss history related to previous mergers, if applicable?
2. Does the data include all periods relevant to establishing the estimate?
3. What relevant data did management consider and determine not to use?
4. How does management use or consider external data (for example, economic forecasts or loss experience) across the various loan segments?

**Questions related to completeness and accuracy (reliability) include the following:**

1. How does management evaluate whether the data reconciles across multiple systems, including data flow from the source systems to the ACL model?
2. How does management determine the reliability of externally sourced data?

### Questions related to controls over data include the following:

1. Are the systems from which data is being obtained subject to the entity's ITGCs?
2. How does management implement ITGCs over the systems in which data is located?
3. How does management implement controls over the completeness and accuracy of internal data?
4. How does management implement controls over determining the reliability of external data?
5. How does management implement controls to address the relevance of the data, such as independent validation?
6. How does management implement controls to address the relevance and sufficiency of the data related to assumptions such as developing, analyzing, and updating economic scenarios?
7. How does management implement controls to address the financial statement impact of adjustments made to data to compensate for system limitations?
8. How does management address prior period completeness and accuracy controls over data relied on in the current period including:
  - a. the determination of both relevance and reliability of the design and operating effectiveness these controls?
  - b. management's planned implementation of these controls?

As a result of the auditor's evaluation, the auditor may have identified risks of material misstatement.

Potential risks of material misstatement related to relevant and sufficient data may include the following:

1. The selection of data resulting from management bias.
2. The historical loss period is not relevant to the current portfolio of financial assets.
3. There is insufficient data that is relevant and reliable in the historical loss period.

4. When management uses third-party information, the information is not relevant and fit for purpose.
5. The forecast is not relevant or sufficiently supported to apply to the loan segmentation, resulting in the use of an inappropriate forecast within the ACL estimation process.

Potential risks of material misstatement related to reliable data may include the following:

1. Gross charge-offs and recoveries included in the historical loss rate are not complete and accurate (that is, the timing and amount), resulting in ACL estimates that do not reflect the risk characteristics of the portfolio.
2. Data included in the development of the qualitative factor adjustments (for example, unemployment rates, property values, commodity values, delinquency) is not reassessed on a timely basis and is not complete and accurate, resulting in ACL estimates that do not reflect the risk characteristics of the portfolio.
3. Historical loan data is not validated for completeness and accuracy.

### Adjustments to Historical Loss Information

#### **Management's Considerations**

FASB ASC 326-20-30-8 states that historical credit loss experience of financial assets with similar risk characteristics generally provides a basis for an entity's assessment of credit losses.

FASB ASC 326-20-30-8 states that an entity should consider adjustments to historical loss information for differences in current asset-specific risk characteristics, such as differences in underwriting standards, portfolio mix, or asset term within a pool at the reporting date or when an entity's historical loss information is not reflective of the prepayment adjusted contractual term of the financial asset or group of financial assets.

FASB ASC 326-20-30-9 also requires an entity to consider the need to adjust historical loss information to reflect the extent to which management expects current conditions to differ from the conditions that existed for the period over which historical information was evaluated. The adjustments for current conditions may be qualitative in nature and should reflect changes related to relevant data, such as changes in unemployment rates, property values, commodity values, delinquency, or other factors that are associated with credit losses on the financial asset or in the group of financial assets.

FASB ASC 326-20-55-4 provides an illustrative list of significant factors for management's consideration when evaluating whether historical information is different from or representative of asset-specific risk characteristics and current conditions. These factors include the following:

- The borrower's financial condition, credit rating, credit score, asset quality, or business prospects
- The borrower's ability to make scheduled interest or principal payments
- The remaining payment terms of the financial asset or assets
- The remaining time to maturity and the timing and extent of prepayments on the financial asset or assets
- The nature and volume of the entity's financial asset or assets
- The volume and severity of past-due financial assets and the volume and severity of adversely classified or rated financial assets
- The value of underlying collateral on financial assets in which the collateral-dependent practical expedient has not been used
- The entity's lending policies and procedures, including changes in lending strategies, underwriting standards, collection, write-off, and recovery practices, as well as knowledge

of the borrower's operations or the borrower's standing in the community

- The quality of the entity's credit review system
- The experience, ability, and depth of the entity's management, lending staff, and other relevant staff
- The environmental factors of a borrower and the areas in which the entity's credit is concentrated, such as the following:
  - Regulatory, legal, or technological environment to which the entity has exposure
  - Changes and expected changes in the general market condition of either the geographical area or the industry to which the entity has exposure
  - Changes and expected changes in international, national, regional, and local economic and business conditions and developments in which the entity operates, including the condition and expected condition of various market segments

Other examples of adjustments that an entity should consider may include recoveries, prepayments, and reasonably expected TDRs.

The adjustments to historical loss information for current asset-specific risk characteristics and for current conditions (adjustments for current conditions) are used to compensate for what is referred to in practice as "steady-state" assumption. A steady state is one in which the baseline credit loss model assumes that loss rates will be the same as they have been in the past because the basis of the model is historical loss information. Similar to the incurred loss model, the expected credit loss model requires adjustments to capture expected differences from the historical loss information.

To identify adjustments for current asset-specific risk

characteristics and current conditions, management generally begins the process by developing the methodology or methodologies applied and the segmentation of loans within each methodology or methodologies. Once an entity understands its methodology and loan pools, it can begin to evaluate the assumptions inherent in its approach and the potential need for adjustments.

As an example, management assumes a steady-state with respect to loan onboarding. Despite this assumption, there may be differences in the current asset-specific risk characteristics of the loans being originated, which in turn may have a different credit risk profile. As such, expected credit losses of the newly originated loans may differ from the credit losses on the historical pool. The goal of management's evaluation in this example is to evaluate differences in the nature of the loan pools that might indicate that the expected future performance will differ significantly from the historical performance.

For some entities with alternative approaches, such as entities whose estimation process relies on the use of peer or acquired market data, the process would be similar. Management understands the assumptions inherent in using historical loss information, which would often start with the belief that the loan pool using such historical loss information will behave similarly to the peer or acquired industry data pool. Then, management evaluates the significant relevant factors that may or may not result in the need for adjustments to that peer or acquired market data.

### **Qualitative Adjustments to Historical Information**

Qualitative adjustments to historical information are inherently subjective and complex and can result in a high degree of estimation uncertainty. These adjustments should be grounded in a methodology that is subject to appropriate governance, challenge, and periodic controlled

reevaluation. Such methodology will generally require significant management judgment. The information used to support management's adjustments may be publicly available information, information specifically developed for the entity via management's specialist (internal or external), or other relevant and reliable information. Due to the level of judgment being applied by management, management should expect to have adequate documentation supporting management's collection and evaluation of that data to demonstrate its basis for its adjustments. The less objective and more qualitative in nature the adjustment is (meaning it has less quantitative support), the greater the need for robust documentation. In all cases, it is expected that management will document the relevant factors and related adjustments, especially qualitative adjustments, that it considered and include in the documentation objective evidence to support the amount of adjustment (or why there is no adjustment) and an explanation about why (or why not) an adjustment is necessary.

### **Auditor's Considerations**

The auditor is required to determine whether management has appropriately applied the requirements of the applicable financial reporting framework relevant to the accounting estimate.<sup>24</sup> This includes whether the assumptions (including qualitative adjustments) used in determining the ACL are consistent with FASB ASC 326-20. Further, if the auditor is testing management's process of determining the accounting estimate, the auditor is required to evaluate whether the assumptions used by management are reasonable in light of the measurement objectives of the applicable financial reporting framework.<sup>25</sup> Considerations by the auditor may include the following:

- a. The appropriateness of the methodology for developing the adjustment to historical data
- b. The nature of the assumptions (for example, if

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<sup>24</sup> Paragraph .12a of AU-C section 540.

<sup>25</sup> Paragraph .13b of AU-C section 540.

the assumptions are supported by quantitative evidence or primarily subjective in nature)

- c. How management assessed whether the assumptions are relevant and complete and internally consistent
- d. The completeness and accuracy of the data used to support the assumption
- e. The nature and extent of management's documentation supporting the assumptions

Determining whether management has appropriately applied the requirements of FASB ASC 326-20 to the ACL estimate includes evaluating whether management's documentation supports management's assumptions to comply with FASB ASC 326-20.

When implementing FASB ASC 326-20, management may make certain assumptions intended to simplify the process to estimate the ACL. Management should evaluate the impact of these assumptions individually and in the aggregate. If the impact of these assumptions is inconsistent with FASB ASC 326-20 and results in an unreasonable estimate, then management should reconsider the use of these assumptions.

Audit procedures to evaluate management's assumptions are performed in the context of the audit of the entity's financial statements. The objective of the audit procedures, therefore, is not to obtain sufficient appropriate audit evidence to provide an opinion on the individual assumptions themselves. Rather, the auditor performs procedures to evaluate whether the assumptions are appropriate in developing a reasonable estimate of expected credit losses in the context of an audit of the financial statements as a whole.

Identifying those assumptions that are significant to the ACL estimate requires the auditor's professional judgment. The auditor focuses attention on the significant assumptions identified. Generally, significant assumptions cover matters that could materially affect the ACL estimate and may include those that:

- a. are sensitive to variation or uncertainty in amount or nature (for example, assumptions about current asset-specific risk characteristics may be less susceptible to significant variation compared with current conditions).
- b. are susceptible to misapplication or bias.
- c. involve unobservable data or entity adjustments of observable data.
- d. are dependent on the entity's intent and ability to carry out specific courses of action.

Critical to the auditor's evaluation of assumptions, including those assumptions related to qualitative adjustments to historical loss information, is management's ability to demonstrate the basis for its assumptions. As discussed previously, management should document the basis for its assumptions and include it in the documentation evidence to support the amount (or lack) of adjustment and an explanation about why the adjustment is necessary.

The auditor may consider the sensitivity of the estimate to changes in significant assumptions, including qualitative factors affecting current asset-specific risk characteristics and current conditions. When applicable, management may use techniques such as a sensitivity analysis<sup>26</sup> to help identify particularly sensitive assumptions. If management has not identified particularly sensitive assumptions, the auditor may consider whether deficiencies exist and whether to employ techniques to identify those assumptions.

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<sup>26</sup> A sensitivity analysis is not required to be performed by management or by the auditor; however, a sensitivity analysis is a method that may be used to understand and address estimation uncertainty.

The auditor also may consider how management has considered alternative assumptions or outcomes and why it has rejected those considerations.

The evaluation of whether the assumptions provide a reasonable basis for the estimates relates to the entire set of assumptions as well as each assumption individually. Assumptions are frequently interdependent and, therefore, need to be internally consistent. A particular assumption that may appear reasonable when taken in isolation may not be reasonable when used in conjunction with other assumptions.

Below are questions the auditor may consider when assessing the nature of management's assumptions, including current asset-specific risk characteristics and current conditions, and when identifying the related risks of material misstatement.

**Questions related to how management assessed whether the methodology is appropriate and whether assumptions are relevant, complete, internally consistent, and consistent period over period within the ACL, include the following:**

1. What are the various assumptions, including qualitative adjustments to historical loss information, used in management's ACL estimate?
  - a. How did management develop the assumptions?
  - b. How did management apply the assumptions to the models and techniques used?
  - c. Does management reevaluate the assumptions each reporting period?
2. How are the assumptions relevant to the loan pools?
3. How did management determine relevant risk factors?

- a. What significant factors were considered in FASB ASC 326-20-55-4 and determined to be relevant, and why? Which factors were considered but determined not to be relevant, and why?
  - b. What significant factors were considered in addition to the factors identified in FASB ASC 326-20-55-4 and determined to be relevant, and why? Which additional factors were considered but determined not to be relevant, and why?
4. For assumptions that result in a qualitative adjustment to the expected credit losses, how did management determine the quantitative impact?
  5. Did assumptions or qualitative factors, change? If so, why? If not, why not?
  6. What alternative assumptions were considered but determined not to be the most appropriate?
  7. Is there other information management considered and determined was relevant but did not use?
  8. How did management determine the completeness of the qualitative factors affecting qualitative assumptions?
  9. How did management understand the sensitivity of assumptions and the impact on the analysis?
    - a. Did management assess the sensitivity of assumptions in the aggregate and at an individual level, at a model level, or both?

The following is a question related to data (for additional questions on data see the section titled "Relevance and Reliability of Data"):

1. What are the sources of the data management is using to develop its assumptions?

**Questions related to the nature and extent of management's documentation supporting the assumptions include the following:**

1. Has management properly documented its considerations of the significant factors affecting collectibility?
2. What documentation does management have supporting its assumptions and the related judgments? Has management considered the judgments identified in FASB ASC 326-20-55-6? For example, has management documented:
  - a. its definition of default for default-based statistics?
  - b. its approach to measuring the historical loss amount of loss-rate statistics, including whether the amount is simply based on the amortized cost amount written off and whether there should be adjustment to historical credit losses (if any) to reflect the entity's policies for recognizing accrued interest?
  - c. its approach to determining the appropriate historical period for estimating expected credit loss statistics?
  - d. its approach to adjusting historical credit loss information to reflect current conditions and reasonable and supportable forecasts that are different from conditions existing in the historical period?
  - e. its methods of utilizing historical experience?
  - f. its method of adjusting loss statistics for recoveries?
  - g. how expected prepayments affect the estimate of expected credit losses?
  - h. how the entity plans to revert to historical credit loss information for periods beyond which the entity is able to make or obtain reasonable and supportable forecasts of economic conditions?
  - i. its assessment of whether loans exhibit risk characteristics similar to other loans?
3. For adjustments to the expected credit losses,
  - a. has management anchored its assumptions to objective data or, otherwise, does management have objective documentation supporting the amount of the adjustment?
  - b. does management's documentation explain why the adjustments are necessary to reflect current asset-specific risk characteristics and current conditions?
4. What documentation does management have supporting that processes are in place to ensure that the factors are relevant and reliable?
5. What documentation does management have supporting that controls are in place to ensure that the factors are relevant and reliable?

As a result of the auditor's evaluation, the auditor may have identified risks of material misstatement. Potential risks of material misstatement related to current conditions and reasonable and supportable forecasts may include factors that are incomplete, inaccurate, or unable to capture current conditions that differ from conditions that existed for the period over which historical information was evaluated, resulting in the use of inappropriate adjustments within the ACL estimation process.

In accordance with paragraph .09 of AU-C 540, the auditor should review the outcome of accounting estimates included in the prior period financial statements or, when applicable, their subsequent re-estimation for the purpose of the current period. The nature and extent of the auditor's review takes account of the nature of the accounting estimates and whether the information obtained from the review would be relevant to identifying and assessing risks of material misstatement of accounting estimates made in the current period financial statements. However, the review is not intended to call into question the auditor's professional judgments made in the prior periods that were based on information available at the time.

Generally, performing an overall review of the outcome of estimates relevant to the ACL is not practical due to the long duration of the assets. However, under certain circumstances, a review may be appropriate, for example, reviewing the current year's charge-offs in comparison to the prior period ACL estimate. An auditor may perform retrospective review procedures on forecasted data. An outcome that was different than forecasted does not, in and of itself, indicate that the forecast was inappropriate.

## **Adjustments for Reasonable and Supportable Forecasts**

### ***Management's Considerations***

FASB ASC 326-20-30-9 requires an entity to adjust historical loss information to reflect the extent to which management expects reasonable and supportable forecasts to differ from the conditions that existed for the period over which historical information was evaluated. The adjustments for reasonable and supportable forecasts may be qualitative in nature and should reflect changes related to relevant data, such as changes in unemployment rates, property values, commodity values, delinquency, or other factors that are associated with credit losses on the financial asset or in the group of financial assets. FASB ASC 326-20-55-4 provides a list of significant factors for management's consideration when evaluating whether historical information is different from or representative of reasonable and supportable forecasts. FASB ASC 326 does not define the terms *reasonable* or *supportable forecast*.<sup>27</sup>

Adjustments to historical information for reasonable and supportable forecasts are inherently subjective and complex and may result in a high degree of estimation uncertainty. These adjustments require significant management judgment. The information used to support management's reasonable and supportable forecasts may be publicly available

information, such as a national, regional, or local economic forecast; economic forecasts specifically developed for the entity via management's specialist (internal or external); or other relevant and reliable information. The consideration of the relevance of the information generally should be at the pool level. For example, a sharp decline in oil prices may affect management's reasonable and supportable forecast related to certain loan pools, such as oil and gas commercial loans, but not all loan pools, such as residential loans.

Similar to the adjustments for current conditions and asset-specific risk characteristics, the analysis and documentation of adjustments for reasonable and supportable forecasts can take a variety of forms, including a memo, which is supported by qualitative and quantitative information, of significant relevant factors considered by management that may or may not affect loss rates, a matrix of factors, or other more complex methods. It is expected that management will document the relevant factors that it considered and include in the documentation objective evidence to support the amount (or lack) of adjustment and an explanation about why the adjustment is necessary.

### ***Auditor's Considerations***

As discussed previously, if the auditor is testing management's process of making the accounting estimate, the auditor is required to evaluate whether the assumptions used by management are reasonable in light of the measurement objectives of the applicable financial reporting framework.

Considerations by the auditor with respect to the nature and extent<sup>28</sup> of management's documentation supporting the adjustments related to the reasonable and supportable forecasts may include the following:

- The length of the forecast period
- Management's forecasting methodology

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<sup>27</sup> See FASB ASC 326-20-30-9.

<sup>28</sup> Paragraph .A30 of AU-C section 540.

- How management assessed whether the factors affecting the reasonable and supportable forecasts are relevant and complete (see FASB ASC 326-20-55-4 for a list of factors for management’s consideration and AICPA Issue Paper No. 6)
- Whether the reasonable and supportable forecasts are evaluated for internal consistency (other forecasts used by the entity)
- Whether the reasonable and supportable forecasts methodology is consistently and appropriately applied period over period
- The completeness and accuracy of the data upon which the forecasted losses are based
- “Information relating to forecasting assumptions used in establishing expected credit losses that are received before the registrant has completed an appropriate estimation process *would be* permitted to be included in the estimate, unless such information indicates a weakness or a deficiency in the registrant’s estimation process, in which case the information would be recognized.
- “Information relating to forecasting assumptions used in establishing expected credit losses that are received after the registrant has completed an appropriate estimation process *would not be* recognized, unless such information indicates a weakness or a deficiency in the registrant’s estimation process, in which case the information would be recognized.”

The auditor’s consideration of judgments about the future is based on information available at the time the judgment is made. Subsequent events may result in outcomes that are different from the judgments that were reasonable at the time they were made by management. In such circumstances, the auditor is required to obtain an understanding of the reasons and evaluate the differences. For example, did management use publicly available forecast data and the forecast was different from actual? In this situation, the forecast may have been reasonable at the time of the estimate based on the best data available. The SEC has stated the following with respect to subsequent events:<sup>29</sup>

- “Loan-specific information about factual conditions that existed at the balance sheet date ... *would be* recognized

Critical to the auditor’s evaluation of the reasonable and supportable forecasts is management’s ability to demonstrate the basis for its assumptions. As discussed previously, management should document the basis for its assumptions and include in the documentation objective evidence to support the amount (or lack) of adjustment and an explanation about why the adjustment is necessary.

Similar to other significant assumptions, the auditor may consider the sensitivity of the estimate to changes in the reasonable and supportable forecasts. When applicable, the auditor may encourage management to use techniques such as a sensitivity analysis.

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<sup>29</sup> SEC Remarks before the 2018 AICPA Conference on Current SEC and PCAOB Developments, December 10, 2018, Kevin L. Vaughn, Senior Associate Chief Accountant.

The following paragraph includes some questions that the auditor may consider when assessing the nature of management's adjustments for reasonable and supportable forecasts, and when identifying the related risks of material misstatement.



### Questions related to how management forecasted losses include the following:

1. When using economic data,
  - a. what is the source of the data that management is using in its reasonable and supportable forecast of economic conditions? Did management engage an expert?
  - b. how did management evaluate the relevance of economic data used for each loan pool?
  - c. how did management evaluate the reliability of economic data used?
  - d. how did management determine sources used? Were the sources consistent period over period? Were changes in sources reasonable?
2. How did management determine that the forecast period was reasonable?
  - a. Does management reevaluate the forecast period each reporting period?
3. How did management determine how losses might be impacted by forecasted economic assumptions?
  - a. Does management evaluate multiple scenarios? Is the model sensitive to these various scenarios?
4. Has management elected to probability weight different scenarios for forecasting losses? If so,
  - a. how many scenarios has management considered?
  - b. what assumptions have been made in weighing different scenarios for forecasting losses?
5. How does the data used reconcile with other areas where forecasted information is used?
  - a. For example, management expectations for the future (for example, reasonable and supportable forecasts) used for the expected credit loss model are different from similar forecasts used in evaluating deferred tax assets and goodwill impairment, and management is unable to explain the difference?

See additional questions applicable to reasonable and supportable forecasts in the "Adjustments to Historical Information" section of this chapter.

As a result of the auditor's evaluation, the auditor may have identified risks of material misstatement. For example, the auditor may include that the method used to develop forecasts is not appropriate, resulting in the use of an unreasonable and unsupported forecast and inappropriate reversion to historical losses within the ACL estimation process.

### Implementing Reversion

#### **Management's Considerations**

FASB ASC 326-20 requires an entity to adjust historical information when management expects current conditions and reasonable and supportable forecasts to differ from historical conditions. For periods beyond which the entity is able to make or obtain reasonable and supportable forecasts of economic conditions, an entity shall revert to

historical loss information in accordance with FASB ASC 326-20-30-8 that is reflective of the contractual term of the financial asset or group of financial assets, adjusted for prepayments. As stated in FASB ASC 326-20-30-9, an entity shall not adjust historical loss information for existing economic conditions or expectations of future economic or expectations of future economic conditions for periods that are beyond the reasonable and supportable period. An entity may revert at the input or estimate level and may revert either straight-line, immediate, or in another rational and systematic manner.

Because FASB ASC 326-20 does not require a specific reversion method, management's method of reversion represents a significant judgment based on the entity's facts and circumstances and should be representative of the entity's expected credit losses. Due to the level of judgment being applied by management, management should expect to have robust documentation at the loan pool level to support the method or pattern of reversion, the period for reversion, and the historical loss information to which management is reverting.

### **Auditor's Considerations**

As discussed previously, the auditor is required to evaluate whether the assumptions used by management are reasonable in light of the measurement objectives of the applicable financial reporting framework.<sup>30</sup> The significant judgments made by management in determining the reversion method generally are a source of risk of material misstatement. As part of the auditor's risk assessment, the auditor should understand the management's rationale when obtaining an understanding of how management makes the accounting estimate.<sup>31</sup> This includes obtaining an understanding of management's rationale and method for reversion, and whether the method is reasonable and supportable in the circumstances.

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<sup>30</sup> Paragraph .13b of AU-C section 540.

<sup>31</sup> Paragraph .08c of AU-C section 540.

The following paragraphs include some questions that the auditor may consider asking to understand management's reversion method and identify the related risks of material misstatement.

### **Questions related to the method of reversion include the following:**

1. Did management apply a reasonable reversion technique?
  - a. Did management document its rationale and analysis for selecting its reversion technique at transition?
  - b. Did management consider the appropriateness of its reversion techniques from one period to the next?

### **Questions related to the historical loss information included in the ACL include the following:**

1. How did management determine the historical loss period to revert to?
2. Did management sufficiently document its analysis and the basis for its conclusions, including the basis for using certain historical loss periods?

As a result of the auditor's evaluation, the auditor may have identified risks of material misstatement. Potential risks of material misstatement related to the reversion technique may include the following:

1. The method to revert to historical loss information is unsupported or unreasonable, resulting in inappropriate historical losses with the ACL estimation process.
2. The historical loss period reverted to is unsupported or unreasonable, resulting in inappropriate historical losses within the ACL estimation process.

## Evaluating Estimation Uncertainty

### **Management's Considerations**

Identification of risks related to estimation uncertainty should be a component of management's risk assessment process over financial reporting. FASB ASC 326-20 requires an estimate of expected losses over the contractual life of the loan portfolio, requiring an estimate of future economic conditions over a reasonable and supportable period. FASB ASC 326-20 includes an estimate that is forward looking and, thus, inherently has a higher degree of estimation uncertainty and imprecision than the incurred loss model.

Management is responsible for addressing the risk of estimation uncertainty. Considerations by management may include the following:

- Understanding the sources of estimation uncertainty
- Consideration of appropriate alternative methods, data or assumptions
- Sensitivity analysis for various appropriate alternative scenarios
- Responding to the results of retrospective reviews conducted by management
- Whether management determines that a range of loss is more appropriate, the appropriateness of the range, and the estimate recorded within that range
- Implementation of controls to address estimation uncertainty, for example, a management control to challenge whether a range is sufficiently narrowed to reduce the risk of material misstatement

### **Auditor's Considerations**

The auditor is required to evaluate the degree of estimation uncertainty associated with an accounting estimate.<sup>32</sup> In addition, the auditor is required to determine whether, in the auditor's professional judgment, any of those accounting estimates that have been identified as having high estimation uncertainty give rise to significant risks.<sup>33</sup> In such cases, the auditor focuses on the reasonableness of management's individual inputs and assumptions, management controls, management's determination of estimation uncertainty, and management's disclosures related to the estimate and its related uncertainty. As the level of estimation uncertainty increases, the level of the auditor's professional skepticism also needs to increase.

It is possible that management may develop a range of loss given the complexity and uncertainty implicit in an ACL model and the significant level of judgment involved in measuring the ACL. Large ranges may result from only minor differences in assumptions due to the size of the exposures and the sensitivity of the assumption. In some cases, this range may be in excess of performance materiality due to the level of judgment required, for example, as a result of:

- the number and sensitivity of assumptions (for example, alternative and contradictory external economic forecasts that are both reasonable and supportable),
- the length of the forecasted period, or
- because the amount of an adjustment to the historical loss information for a change in economic conditions may be highly judgmental in some cases.

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<sup>32</sup> Paragraph .10 of AU-C section 540.

<sup>33</sup> Paragraph .11 of AU-C section 540.

In this circumstance, the auditor likely will want to understand how management:

- a. selected the point estimate for the ACL.
- b. attempted to generate a point estimate or narrow the range by, for example, varying the assumptions in management's model, using other reasonable assumptions, and comparing the output with that obtained using management's assumptions or using a specialist.

It is not necessary to narrow the range below performance materiality. However, if the range exceeds performance materiality, the range may indicate a higher degree of estimation uncertainty for which the auditor may identify a significant risk.

### Questions related to estimation uncertainty include the following:

1. How does management determine the ACL when its analysis indicates a number of outcome scenarios? How does management select the point estimate for the ACL?
2. Is management's selection of its point estimate neutral, at the high end, or the low end of the range?
3. How has management assessed the implications of estimation uncertainty?
4. How does management consider alternative assumptions or outcomes? For example, does management perform a sensitivity analysis to determine the effect of changes in the assumptions on an accounting estimate?
5. How does management monitor the outcome of ACL made in the prior period and how does management respond to the outcome of that monitoring procedure?
6. How did management conclude on the reasonableness of range endpoints? (See chapter 4, "Presentation and Disclosure," of this practice aid on disclosures related to estimation uncertainty.)

## Consideration of Management Bias

### Management's Considerations

Identification of risks related to management bias should be a component of management's risk assessment process over financial reporting. High estimation uncertainty or factors for which relevant data may not be readily available or is difficult to quantify may contribute to increased subjectivity and be susceptible to management bias.

Management bias can be either intentional or unintentional. The entity should implement an appropriate system of internal control over its estimation process to evaluate for both unintentional and intentional bias. These controls should address whether the estimation process is transparent and whether the basis for ACL method determination and significant assumptions, particularly subjective assumptions, are appropriately documented and supported.

Bias may take the form of the following:

- **Availability bias.** Decision-makers rely on specific information or memory that is readily available to them and, as a result, believe the information used is more representative to the situation than is actually the case. This may result in the likelihood that decisions and information used are inherently flawed. In the auditing of estimates, the potential exists for relying on available information that may not be representative of management's estimates. This can be seen as a manifestation of findings that management may, at times, experience making inherently flawed decisions based on using information that may not be representative of the situation.
- **Anchoring bias.**<sup>34</sup> Decision-makers anchor or overly rely on specific information or a specific value and then adjust to that value to account for other elements of the circumstance so that there is a bias toward that value. In the

<sup>34</sup> For a discussion on anchoring biases and some evidence, see, for example, Robert Sugden, Jiwei Zheng, and Daniel John Zizzo, "Not All Anchors Are Created Equal," *Journal of Economic Psychology* 39, (2013): 21.

establishing of estimates, the potential exists for management to anchor on a desired outcome, or an outcome that is consistent with a prior period. This can be seen as a manifestation of findings that management may, at times, experience difficulties weighting evidence appropriately.

- **Confirmation bias.**<sup>35</sup> This is a phenomenon wherein decision-makers have been shown to actively seek out and assign more weight to evidence that confirms their hypothesis and to ignore or underweight evidence that could disconfirm their hypothesis. As such, it can be thought of as a form of selection bias in collecting evidence. It becomes even more problematic in the presence of anchoring bias because management may anchor on management's estimate and may only seek out information to corroborate that value (or focus primarily on confirming, rather than challenging, its own model).
- **Familiarity bias.**<sup>36</sup> Familiarity is associated with a general sense of comfort with the known and discomfort with — even distaste for and fear of — the alien and distant. In the context of preparing accounting estimates, management may be biased toward procedures, methods, models, and assumptions that seem more familiar to them.

The following illustrates the various forms of bias:

- When determining relevant data within management's portfolio or determining relevant factors when developing management's reasonable and supportable estimate, management only uses information readily available to it or that may come readily to mind, resulting in incomplete or inaccurate professional judgment determinations.

- Management strives to maintain the ACL at a percentage of the loan portfolio balance which leads to selecting qualitative factors that will result in, or when using a range, ultimately selecting, the point in the range that aligns with the anchored figure.
- When looking at reasonable and supportable forecasts or current asset-specific data points, using one versus the other to confirm a specific hypothesis, such as selecting a regional versus local economic figure to better support the qualitative factor despite disconfirming evidence in the other option.
- Not selecting or considering a certain methodology for calculating the ACL based on not being well versed in it or not considering different loan segmentation from what is currently used because of familiarity with the data points and how to segment in that way.

### **Auditor's Considerations**

The auditor is required to plan and perform an audit with professional skepticism, recognizing that circumstances may exist that cause the financial statements to be materially misstated.<sup>37</sup> Therefore, based on the nature of the ACL estimate, the auditor is required to maintain heightened professional skepticism. Professional skepticism is necessary for the critical assessment of audit evidence and assists the auditor in remaining alert for possible indications of management bias. This includes evaluating contradictory audit evidence and questioning the reliability of documents, responses to inquiries, and other information obtained from management and audit committees. It also includes being alert to conditions that may indicate possible misstatement due to error or fraud and considering the sufficiency and appropriateness of audit evidence obtained in light of the circumstances.

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<sup>35</sup> For a discussion of confirmation bias, see, for example, Raymond S. Nickerson, Confirmation Bias: A Ubiquitous Phenomenon in Many Guises, *Review of General Psychology* 2, (1998): 175. For a discussion of the manifestation of this bias in auditing, see, for example, Griffith et al., "Audits of Complex Estimates as Verification of Management Numbers: How Institutional Pressures Shape Practice," *Contemporary Accounting Research* 32, no. 3, (Fall 2015): 833-836.

<sup>36</sup> Gur Huberman, "Familiarity Breeds Investment," *Review of Financial Studies* 14, (2001): 659-678.

<sup>37</sup> Paragraph .17 of AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*.

Application of professional skepticism is required in all circumstances and the need for professional skepticism increases with the complexity of the accounting estimate, such as in the following scenarios:

- Evaluating whether sufficient appropriate audit evidence has been obtained, which can be particularly challenging when management uses third-party proprietary models, data or both
- Evaluating management's judgments and the potential for management bias in applying the entity's applicable financial reporting framework, in particular, management's choice of estimation techniques and use of assumptions in estimation techniques, and addressing circumstances in which the auditor's judgments and management's judgments differ
- Drawing conclusions based on the audit evidence obtained (for example, assessing the reasonableness of the estimate prepared by management and evaluating whether disclosures in the financial statements achieve fair presentation)

The auditor is required to review the judgments and decisions made by management in the making of accounting estimates to identify whether indicators of possible management bias exist.<sup>38</sup> When evaluating elements in the ACL estimation process that are more susceptible to bias, auditors may consider testing the entity's controls and performing substantive procedures to obtain sufficient appropriate audit evidence. The auditor may consider testing the entity's controls over management's significant judgments with respect to data, adjustments based on assumptions, and the model of the ACL estimation process, which are more uncertain, complex, or subjective in nature, and evaluate whether the judgments are appropriately

supported and are reasonably free from both intentional and unintentional bias.

For example, the auditor may identify and test controls regarding the nature, relevance, completeness, and accuracy of information used by the control operator in reviewing the ACL estimate management review function, including the potential for selection bias in the data sources used by management in making the estimate (that is, risk of exclusion of relevant data or information).

Even if the auditor does not identify risks of material misstatement due to fraud, a possibility exists that management override of controls could occur.<sup>39</sup> Therefore, the auditor may need to address the risk of management override of controls over data, assumptions, or processes and the reasons, if any, for such overrides. As part of testing the elements more susceptible to bias and management override, the auditor should evaluate the reasonableness of management's judgments by evaluating the support on which management based its judgments. When evaluating the reasonableness of the judgments, the auditor may consider the degree of consistency:

- a. of the judgments with the entity's own historical experience.
- b. of the judgments with other estimates within the entity, such as capital planning, stress testing, budgets, and goodwill impairment evaluation or deferred tax asset impairment tests.
- c. of the judgments with readily available external information, such as economist reports, regulatory outlooks, and the experience of peer entities, including how the entity considered potentially disconfirming evidence.
- d. in model methodologies, data, and assumptions, and the reasonableness of any changes.

<sup>38</sup> Paragraph .21 of AU-C section 540.

<sup>39</sup> Paragraph .32 of AU-C section 240, *Consideration of Fraud in a Financial Statement Audit*.

The auditor should evaluate potential bias in accounting estimates, both individually and in the aggregate. Although individual estimates may not demonstrate bias, the auditor has a requirement to evaluate the estimates in the overall context of the financial statements.<sup>40</sup> The auditor also has a requirement to document his or her consideration of indicators of management bias in estimates.<sup>41</sup> Accordingly, when evaluating the ACL estimate, the auditor may consider the following questions related to indicators of management bias:

1. When considered with other estimates, does the ACL estimate show a systematic pattern of being either at the low end or high end of ranges?
2. When considered with other estimates, does the impact of ACL on net income offset the impact of other estimates?
3. Does the ACL estimate change from "the high end of a range" to "the low end of a range" period over period, or vice versa?
4. When considered in the context of the auditor's understanding of the environment in which the entity operates, does the entity have a strong incentive to achieve a particular financial reporting outcome (for instance, to maintain a required capital level)?
5. Are assumptions being used consistently between other functions of the entity in determining other accounting estimates?
6. Has there been a change in estimation methodology or assumptions?
7. Is the change in methodology or assumptions appropriately supported? Is the change to a highly sensitive assumption? Is the change the result of new information or a change in circumstance? If not, is the change arbitrary?
8. Is there other information management considered but determined was not applicable?

9. How has management evaluated its consideration of potential risks and indicators of bias?
10. Are there significant deviations from historical patterns?
11. How does management monitor the outcome of ACL made in the prior period and how does management respond to the outcome of that monitoring procedure?

As a result of the auditor's evaluation, the auditor may have identified risks of material misstatement. Potential risks of material misstatement may include, but are not limited to, the following:

- Unsupported changes in the assumptions or factors of the ACL estimate to meet an earnings target (potential fraud risk)
- Management becomes aware of the contradictory information and fails to evaluate the potential impact on the ACL estimate
- Management selects less appropriate assumptions that are easier to support
- Management's selection of the point within the estimate within a range (always towards the high or low end of the range)

## Management's Specialists and Other Third Parties

### **Management's Considerations**

Management may employ or utilize internal or external specialists, including vendors, in developing assumptions because specialized skills or knowledge may be required to develop a best estimate. Failure by management to utilize a specialist when such expertise is necessary and not possessed by management increases the risks of material misstatement and may result in a significant deficiency or material weakness. Methods and assumptions developed by specialists, when used by

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<sup>40</sup> Paragraph .32b of AU-C section 240.

<sup>41</sup> Paragraph .22 of AU-C section 540.

management, become management's assumptions, which management needs to consider, in the same manner as management's other assumptions, when designing and implementing internal control over the reasonableness of the ACL estimate, including inputs, assumptions, and models.

Further, assumptions developed or supplied by third parties will require management to consider the information used by the third party in developing the assumptions, including the source of information used, relevance of information used as it relates to the entity, and the completeness and accuracy of the information used by the third party.

The following are examples of management's use of third parties:

- The use of third-party-developed loan pool data in developing expected historical loss information in the ACL
- The use of a specialist to develop an economic forecast that is relevant to the entity's loan portfolio
- The use of a third-party ACL model created or administered, or both, by a third party

Assumptions may be made or identified by management's specialist to assist management in developing the ACL estimate. Management must understand, document, and take ownership of such methods and assumptions.

As an example of management's need for considering the use of third parties, consider an instance in which management uses third-party-developed historical loan pool loss information. A vendor may provide management with historical loan pool loss information for all the entities that the vendor works with, aiding management in estimating expected losses when its own loss history alone is not adequate. The vendor aggregates information that it has received from its

customers and users of its software and then provides that information to management.

Prior to relying on this information, management will need to consider factors such as the following:

1. Availability of system and organization controls (SOC)<sup>42</sup> reports and user control considerations over data and, if applicable, over models and assumptions used.
  - a. Absent SOC report, management will need to have controls in place equivalent to those that would be in place were the processes conducted internally. It may be difficult for management to put these controls in place because management may not have sufficient access to the service organization to obtain an understanding of the service organization's relevant internal controls. Management also needs to consider whether the service organization will allow for testing of its internal controls by the user auditor.
2. The relevance of loss history of other entities as it relates to the entity:
  - a. Are the entities included similar in nature to the entity?
  - b. Are the entities of similar size?
  - c. Are the entities in similar geographic regions?
  - d. Are the entities' lending philosophies or underwriting approaches, such as the entities' loan-level risk characteristics and risk factors, similar?
3. Completeness and accuracy of the information obtained:
  - a. What controls are in place to ensure information is complete and accurate?
  - b. Have reported losses been recorded in the proper period?

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<sup>42</sup> In 2017, the AICPA introduced the term *system and organization controls* (SOC) to refer to the suite of services practitioners may provide relating to system-level controls of a service organization and system or entity-level controls of other organizations. Formerly, SOC referred to service organization controls. By redefining that acronym, the AICPA enables the introduction of new internal control examinations that may be performed (a) for other types of organizations, in addition to service organizations, and (b) on either system-level or entity-level controls of such organizations.

- c. Have losses been recorded by the relevant loan characteristic (for example, loan type, loan to value)?
  - d. Have all losses been captured?
4. Reliability of information obtained:
- a. What controls does the vendor have to prevent alteration?

Because certain information is not developed by management's third party, such third party may not be able to assert to the relevance, completeness, or accuracy of the information. The determination of the relevance of the information by management will be based on its knowledge of the source. In this example, the completeness and accuracy of the information are reliant on the vendor's customer or user inputting the information properly in prior years, and it is unlikely a vendor would be able to assert to its completeness and accuracy. Lastly, because the vendor is simply aggregating and reporting information it has been provided, management may need to consider controls at the vendor to ensure the information is aggregated and provided to management properly. Management may not be able to perform procedures to validate the completeness, accuracy, and integrity of this information. As such, consideration may need to be given to procedures performed by the vendor to validate the information, if any, and the ability to rely on it.

### **Auditor's Considerations**

The auditor is required to consider whether specialized skills or knowledge with regard to one or more aspects of the accounting estimates is required in order to obtain sufficient appropriate audit evidence.<sup>43</sup> In doing so, the auditor is required to evaluate the competency, capabilities, and objectivity

of the specialists to understand the work of that specialist and to evaluate its appropriateness as audit evidence.<sup>44</sup> The extent of the auditor's procedures in relation to management's specialist and that specialist's work depends on the significance of the specialist's work for the auditor's purposes. Evaluating the appropriateness of management's specialist's work assists the auditor in assessing whether the assumptions or modeling supplied by management's specialist provide sufficient appropriate audit evidence to support management's estimate. As explained in AU-C section 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, assumptions may be made or identified by a specialist to assist management in making the accounting estimates. Such assumptions, when used by management, become management's assumptions.<sup>45</sup> The auditor should evaluate the reasonableness of the specialist's assumptions.

As part of classifying a vendor, the auditor considers whether the vendor is a management specialist, a service organization, or is just considered part of management's accounting and estimation process.<sup>46</sup>

- **Management's specialist.** An individual or organization possessing expertise (skills, knowledge, and experience in a particular field) in a field other than accounting or auditing, whose work in that field is used by the entity to assist the entity in preparing the financial statements.<sup>47</sup>
- **Service organization.** An organization or segment of an organization that provides services to user entities that are relevant to those user entities' internal control over financial reporting.<sup>48</sup>

<sup>43</sup> Paragraph .14 of AU-C section 540.

<sup>44</sup> See paragraph .08 of AU-C section 500 with regard to a management's specialist or paragraph .09 of AU-C section 620, *Using the Work of an Auditor's Specialist*, with regard to an auditor's specialist.

<sup>45</sup> Paragraph .A30 of AU-C section 540.

<sup>46</sup> Paragraph .06 of AU-C section 500.

<sup>47</sup> Paragraph .05 of AU-C section 500.

<sup>48</sup> Paragraph .08 of AU-C section 402, *Audit Considerations Relating to an Entity Using a Service Organization*.

The auditor may consider the use of management's specialists in the following areas, depending on the circumstances, but there may be circumstances in which an auditor-engaged specialist would be appropriate to support or challenge the work of the management's specialist:

- **Forecasts.** Entities are required to incorporate reasonable and supportable forecasts when developing an estimate of ACL. Management may employ specialists to assist with the determination of these forecasts.
- **Collateral dependency.** An entity shall measure expected credit losses based on the fair value of collateral, including credit enhancements,<sup>49</sup> when foreclosure is probable.<sup>50</sup> In certain circumstances, collateral-dependent financial assets may also be measured for credit losses using the fair value of the underlying collateral at the reporting date, including credit enhancements, using the practical expedient provisions of FASB ASC 326-20-35-5. When this practical expedient is used, a specialist is often used to determine the fair value of the collateral, consistent with current practice.
- **Models.** FASB ASC 326 does not specify or mandate an estimation technique or model. In fact, FASB ASC 326-20-303 acknowledges that various methods may be employed. Auditors can expect to encounter a wide variety of models depending on the nature of the assets being measured for impairment and the size and sophistication of management. For many models, management may possess sufficient knowledge to operate the model and the auditor may possess sufficient knowledge to determine that the estimation techniques have been appropriately used. However,

for more complex models and techniques, management may require the assistance of a specialist to ensure that the model is being used appropriately.

### Questions related to understanding the use of third parties include the following:

1. Does management employ or use third parties in developing assumptions or models (are specialized skills or knowledge required)?
  - a. Does management have a process in place for selecting vendor models or hiring third parties to execute a portion of the process or a portion thereof?
  - b. Does the vendor provide transparency on how the model is built, including selection of inputs, assumptions, parameter values, and mathematical theory driving the model calculations?
  - c. In cases in which third-party models can be customized, does management appropriately document its customization decisions and appropriately document the reasoning for each decision?
  - d. Does management obtain sufficient information about the inputs and assumptions and how they link to the entity's current condition?
  - e. Does the entity have a contingency plan in place for when the vendor may no longer support the model?
  - f. Does management have the knowledge and expertise to appropriately evaluate third-party vendors?

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<sup>49</sup> See FASB ASC 326-20-30-12.

<sup>50</sup> See FASB ASC 326-20-35-4.



The following paragraphs include some indicators to help understand whether the third party is a service organization or a specialist.

Indicators of a service organization (that is, an outsourced provider that does not specify or determine inputs) include the following:

- Management outsources elements of or the entire calculation to the third-party service provider. Generally, the service provider applies data analysis and computations to client data.
- The service organization incorporates client-provided inputs into the ACL estimate.

Indicators of a specialist include the following (examples of information for which a specialist might be used may include forecasted economic data and other external information):

- May be published by a variety of sources or developed specifically for a client.
- May be the subject of debate and disagreement among providers.

- Providers perform meaningful analysis to derive the information.
- Different providers generally provide different information based on their differing views and interpretations of the subject matter.

Indicators that the third-party is neither a specialist nor a service organization include the following (examples of information<sup>51</sup> obtained by management may include historical economic data and other external information):

- Readily or publicly available information
- Often published by governmental or other authoritative sources
- Generally, most third parties report the same information
- Third parties perform limited analysis to derive the information
- The broad consensus around accuracy and reliability
- Objective information.

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<sup>51</sup> Paragraph .06 of AU-C section 500.

As a result of the auditor's evaluation, the auditor may have identified risks of material misstatement related to entity-engaged third parties:

- Management over relies on vendors and fails to understand the overall method and model for developing the ACL, resulting in a method that may not reflect management judgments about expected credit losses.
- Management relies on third-party data without evaluating the relevance and reliability of that data, resulting in a method that is based on potentially irrelevant and unreliable data.
- Management does not have the necessary level of knowledge, skills, and ability to develop the ACL and fails to seek the assistance of a specialist or vendor, resulting in an ACL that is not compliant with FASB ASC 326-20.

## Auditor's Specialists

### **Auditor's Considerations**

The auditor is required to determine whether to use the work of an auditor's specialist if expertise in a field other than accounting or auditing is necessary to obtain sufficient appropriate audit evidence.<sup>52</sup> In some cases, based on the auditor's professional judgment, the ACL model complexity and assumptions may require a specialist. The auditor may consider factors such as the following:

- The capabilities and competence of the engagement team, including the experience of the members of the engagement team
- The complexity of the model
- The sensitivity of the estimate
- Market conditions and the reasonable and supportable forecasts used by management

- The identification of unusual circumstances or risks in the engagement, as well as the need for professional judgment, particularly with respect to materiality and significant risks
- Fair value for collateral-dependent financial assets when management uses the practical expedient

The auditor may consider the use of specialists to do the following:

- a. Assist the engagement team in gathering evidence to evaluate management's estimate or to develop a point estimate or range, especially when:
  - i. the credit loss estimate is determined by a complex model, and data and assumptions are unobservable or difficult to obtain, or
  - ii. management has used a specialist or other third party.
- b. Assist the engagement team in understand the methodology used by the entity to develop the ACL estimate. Using specialized skills and knowledge may be needed to properly assess and understand the risk presented by management's estimate.
- c. Assist the engagement team in evaluating IT controls. IT may be highly complex (for example, when significant information is transmitted, processed, maintained, or accessed electronically). In addition, it may include relevant services provided by a service organization.

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<sup>52</sup> See AU-C section 620.

## Evaluating the Sufficiency and Appropriateness of Audit Evidence

In evaluating the ACL, consistent with other accounting estimates, the auditor is required to evaluate, based on the audit evidence, whether the accounting estimate for credit losses in the financial statements is either reasonable in the context of the applicable financial reporting framework or is misstated.<sup>53</sup>

The auditor may develop a point estimate and conclude that the evidence obtained points to an accounting estimate that differs from the management's point estimate. When the audit evidence supports a different point estimate, the difference between the auditor's point estimate and management's point estimate constitutes a misstatement. When the auditor has concluded that using the auditor's range provides sufficient appropriate audit evidence, a management point estimate that lies outside the auditor's range would not be supported by audit evidence. In such cases, the misstatement is no less than the difference between management's point estimate and the nearest point of the auditor's range.

Further, the auditor is required to conclude whether sufficient appropriate audit evidence has been obtained. In forming a conclusion, the auditor is

required to consider all relevant audit evidence, regardless of whether it appears to corroborate or contradict the assertions in the financial statements.<sup>54</sup>

The auditor's professional judgment about what constitutes sufficient appropriate audit evidence is influenced by factors such as the significance of the potential misstatement in the relevant assertion and the likelihood of it having a material effect, individually or aggregated with other potential misstatements, on the financial statements, as follows:<sup>55</sup>

- Effectiveness of management's responses and controls to address the risks
- Experience gained during previous audits with respect to similar potential misstatements
- Results of audit procedures performed, including whether such audit procedures identified specific instances of fraud or error
- Source and reliability of the available information
- Persuasiveness of the audit evidence
- Understanding of the entity and its environment, including its internal control

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<sup>53</sup> Paragraph .18 of AU-C section 540.

<sup>54</sup> Paragraph .28 of AU-C section 330.

<sup>55</sup> AU-C section 450, *Evaluation of Misstatements Identified During the Audit*.

# Chapter 4

## Presentation and Disclosure

### Presentation and Disclosure of Financial Assets

FASB *Accounting Standards Codification (ASC) 326, Financial Instruments – Credit Losses*, requires management to exercise significant judgment, even with the appropriate estimation process and methodology. The primary source of information for users of the financial statements regarding these judgments made by management will be determined through the financial reporting presentation and disclosures by users of the financial statements. As such, the financial reporting disclosures play a pivotal role in explaining key components in management's estimation process and in providing users with clear and useful information.

Entities are expected to ensure their disclosures are relevant, reliable, and transparent to the users of the financial statements. The disclosures allow users to:

- a. understand the key components of management's estimation process, methodology, and judgments.
- b. understand that the entity has based its information on reliable information.
- c. assess the quality of the entity's overall estimate.
- d. assess whether the estimate is free from professional judgment bias.

The disclosure objective of FASB ASC 326 is to provide users of the financial statements with useful information in analyzing an entity's exposure to credit risk and the measurement of credit losses. In making the disclosures, management must strike a balance between not obscuring important information as a result of too much aggregation and not overburdening financial statements with excessive detail that may not assist a financial statement user in understanding the entity's financial assets and allowance for credit losses (ACL).<sup>1</sup> The disclosure guidance in FASB ASC 326-20-50-2 should enable a user of the financial statements to understand:

- a. the credit risk inherent in a portfolio and how management monitors the credit quality of the portfolio.
- b. management's estimate of expected credit losses.
- c. changes in the estimate of expected credit losses that have taken place during the period.

To achieve the disclosure objectives related to credit quality and the ACL, FASB ASC 326-20 includes a number of disclosures that are consistent with the disclosure requirements of FASB ASC 310-10-50. FASB ASC 326 also requires a number of additional disclosures.

<sup>1</sup> FASB *Accounting Standards Codification (ASC) 326-20-50-3*.

With respect to credit quality disclosures, FASB ASC 326-20 continues to require, for all entities, a description of the credit quality indicators, the amortized cost basis by credit quality indicator, and the date (or date range) in which the credit quality indicator was last updated. In addition, for entities that are public business entities (PBEs), the new credit quality disclosure requires an entity to present the amortized cost basis within each credit quality indicator by year of origination (vintage year).

Management may currently be tracking, at some level, the necessary data required to make the vintage disclosures; however, management will need to ensure the completeness and accuracy of this information, including understanding when loan renewals and modifications are considered new originations and potentially gathering and assessing data from an acquired entity for the period prior to acquisition. Management should continue to follow the guidance in FASB ASC 310-20 in determining when a loan renewal or modification meets the requirements to be classified as a new loan.

With respect to the ACL disclosures, FASB ASC 326-20 continues to require the following:<sup>2</sup>

- a. A description of the entity's accounting policies and methodology and a description of factors that influenced management's estimate, including past events, current conditions, and reasonable and supportable forecasts about the future
- b. A discussion of risk characteristics relevant to each portfolio segment
- c. Identification of changes to the entity's accounting policies, changes to the methodology from the prior period, management's rationale for those changes, and the quantitative effect of those changes

It is expected that due to the highly subjective nature of the ACL, management will be required to disclose

more information, as compared to the probable incurred loss model, to appropriately disclose the methods, inputs, and assumptions used in the estimate.

FASB ASC 326-20 requires additional disclosures over the ACL, including the following:

- A description of how expected loss estimates are developed
- A discussion of the changes in the factors that influenced management's current estimate of expected credit losses and the reasons for those changes (for example, changes in portfolio composition, underwriting practices, and significant events or conditions that affect the current estimate but were not contemplated or relevant during a previous period)
- Reasons for significant changes in the amount of write-offs, if applicable
- A discussion of the reversion method applied for periods beyond the reasonable and supportable forecast period

The new disclosures require additional discussion and explanation related to the ACL. To satisfy the disclosures requirements, management will need to evaluate both quantitative and qualitative information. As discussed in chapter 3, "Audit Objectives," of this practice aid, the ACL includes a variety of new information and analyses that management should consider in determining the extent of required disclosures, for example, an entity's disclosures related to the following:

- How the ACL is developed should include the method used to develop the estimate, such as present value of discounted cash flow, loss rates, roll rates, probability of default, or other specific methods. The related disclosures may include descriptions and details behind those specific methods.

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<sup>2</sup> FASB ASC 310-10-50-11B and FASB ASC 326-20-50-11.

- How the ACL is developed should include a discussion of the historical loss information used in management's estimate of the ACL. Management's disclosure may consider in its discussion of historical losses, the relevance of the historical loss period selected, the length of the historical loss period, assumptions made to adjust the historical loss information, and other relevant information related to historical loss information.
- A discussion of the changes in the factors that influenced management's current estimate of ACL and the reasons for those changes may include changes in underwriting practices. Management's discussion may include the nature of the changes in the underwriting practices, the portfolio segments affected by the changes in underwriting, and a qualitative or quantitative (or both) discussion of the effect, such as disclosing whether the change increased or decreased the ACL and the amount of the change.
- A discussion of the reversion method applied for periods beyond the reasonable and supportable forecast, such as immediate, straight-line, or another rational and systematic method. This discussion may include the historical loss information that management is reverting to and why management is reverting to this period.

The importance of achieving the preceding disclosure objectives increases as the complexity, subjectivity, and estimation uncertainty of the estimate increases. In addition, the audit committee should obtain an understanding of controls and processes established by management to produce complete and accurate financial statement disclosures. Audit committees should continue to challenge the reliability, transparency, and usefulness of disclosures to users of the financial statements. The audit committee

should understand the auditor's approach to assessing the entity's disclosures, including critical matters he or she considered, and his or her findings.

## Considerations for the Auditor

Consideration of the appropriateness of presentation (for example, credit quality indicators) in substantive testing of the estimate for credit losses is relevant to the auditor's evaluation of the presentation and disclosure. The auditor should do the following:<sup>3</sup>

- Obtain sufficient appropriate audit evidence about whether the disclosures in the financial statements related to accounting estimates are in accordance with the requirements of the applicable financial reporting framework.
- For accounting estimates that give rise to significant risks, the auditor should also evaluate the adequacy of the disclosure of estimation uncertainty in the financial statements in the context of the applicable financial reporting framework.

Disclosures are expected to clearly present to the users of the financial statements that the process to estimate the ACL is reasonable. Auditors can make such an assessment by performing audit procedures to test the underlying data within the disclosures and evaluating the processes used by the entity to prepare the disclosures.

Information may come from systems outside traditional financial reporting systems. For example, FASB ASC 326-20-50-6 requires disclosure of credit quality indicators by class and vintage and may require data from nontraditional financial reporting systems, such as a loan origination and underwriting system. In responding to assessed risks relative to disclosures, auditors may choose to test the following:

- The process used to derive the disclosed information

<sup>3</sup> Paragraphs .19–.20 of AU-C section 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*. All AU-C sections can be found in *AICPA Professional Standards*.

- Controls over the data used in the preparation of disclosures
- Completeness and accuracy of the disclosed information

Some questions the auditor may ask related to the relevance and reliability of the information used in the financial statement disclosures include the following:

- Does the data reconcile to the ACL model and to the original source? Do the systems generating the data have appropriate information technology general controls?
- Is the data relevant (that is, if the system overwrites a prior risk rating with a change in rating, what data is being used for historical risk ratings)?

For accounting estimates that give rise to significant risks, the auditor is required to evaluate the adequacy of the disclosure of estimation uncertainty in the financial statements in the context of the applicable financial reporting framework.<sup>4</sup> In relation to the estimate of credit losses having significant risk, even when the disclosures are in accordance with the applicable financial reporting framework, the auditor may conclude that the disclosure of estimation uncertainty is inadequate in light of the facts and circumstances involved and, accordingly, the financial statements may not achieve fair presentation. AU-C section 705, *Modifications to the Opinion in the Independent Auditor's Report*, addresses the implications for the auditor's opinion when the auditor believes management's disclosures in the financial statements are inadequate or misleading.

As explained previously, the auditor is required to obtain sufficient appropriate audit evidence about whether the disclosures in the financial statements related to accounting estimates are in accordance with the requirements of the applicable financial reporting framework. This includes considering whether the disclosures

- a. are complete and understandable.

- b. are consistent with the auditor's understanding of the portfolio.
- c. describe the sources of credit risk.
- d. help a user understand the entity's estimation process and the judgments made by the entity.
- e. document the estimation uncertainty.
- f. are free from bias.

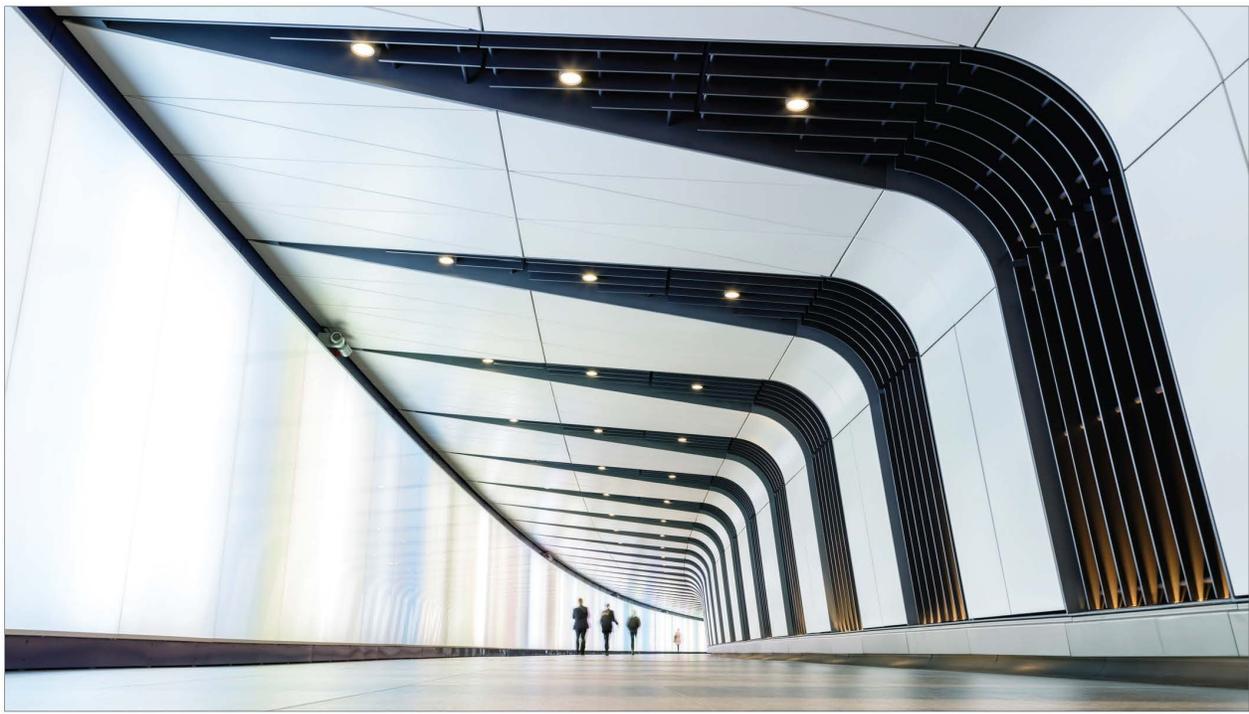
For example, all relevant information may be included in the financial statements, but it may be insufficiently drawn together to enable users of the financial statements to obtain an understanding of the position, or there may not be enough qualitative disclosure to give context to the amounts recorded in the financial statements. As another example, if an entity has included a disclosure related to the number of periods of historical loss information, without appropriate discussion of why the historical loss periods are relevant, the disclosure may not be sufficient for a user of the financial statements to understand management's historical loss assumption. The auditor's communications with audit committees include the auditor's views about qualitative aspects of the entity's significant accounting practices, including accounting policies, accounting estimates, and financial statement disclosures.<sup>5</sup>

Considering the inherently complex and subjective nature of the ACL estimation technique and models, auditors have a responsibility to assess whether the disclosures are sufficiently relevant, reliable, and transparent. The auditor's evaluation of the entity's disclosures should include a balance between qualitative and quantitative disclosures, and whether clear explanations have been provided for complex areas.

In evaluating the disclosures, the auditor may focus on the disclosure of inputs, including the incorporation of the new types of information in the ACL, the significance of forward-looking information, how management derives and uses this information, and the significant judgments and assumptions.

<sup>4</sup> Paragraph .20 of AU-C section 540.

<sup>5</sup> Paragraph .12 of AU-C section 260, *The Auditor's Communication With Those Charged With Governance*.



Questions the auditor may ask when evaluating the adequacy of the related disclosures include the following:

1. Is the level of disaggregation appropriate based on the ACL method used and does it provide meaningful information to the user (for example, portfolio segment and class of financing or lease receivable)?
2. Do the disclosures adequately enable the user to understand management's estimate of the ACL, including the methodology, assumptions, inputs, and the changes in the ACL that have taken place during the period?
3. How did the entity and those charged with governance consider whether the disclosures are free from management's bias?

### Considerations for SEC Issuers

Staff Accounting Bulletin (SAB) No. 74, Topic 11-M, *Disclosure of the Impact that Recently Issued Accounting Standards Will Have on the Financial Statements of the Registrant When Adopted in a Future Period*, applies to SEC issuers and requires disclosures to assist financial statement users in determining the significance of the effect that FASB

ASC 326 will have on the financial statements when adopted. Non-issuers may look to this guidance when preparing their disclosures. The SEC's staff announcements have expressed the staff's expectation that registrants disclose more robust qualitative and quantitative information as new accounting standards become effective.

Auditors should evaluate whether management have included within their disclosures the following

- a. A brief description of the new standard, the date that the adoption is required, and the date the entity plans to adopt, if earlier
- b. A discussion of the methods of adoption allowed by the standard and the method expected to be utilized by the entity, if determined
- c. The status of implementation, including significant matters not yet addressed
- d. A comparison of current accounting policies and expected accounting policies
- e. The quantitative impact of the new accounting standard (if reasonably estimated)
- f. The qualitative impact of the new accounting standard

- g. Disclosure of the potential impact of other significant matters that the entity believes might result from the adoption of the standard (such as violation of debt covenant agreements and planned or intended changes in business practices) is encouraged.

SAB Topic 11-M provides the SEC staff view that a registrant should evaluate ASUs that have not yet been adopted to determine the appropriate financial statement disclosures (including both management's discussion and analysis (MD&A) and the notes to the financial statements) about the potential material effects of those ASUs on the financial statements when adopted. Consistent with Topic 11-M, if a registrant does not know or cannot reasonably estimate the impact that adoption of the ASUs referenced in this announcement is expected to have on the financial statements, then in addition to making a statement to that effect, that registrant should consider additional qualitative financial statement disclosures to assist the reader in assessing the significance of the impact that the standard will have on the financial statements of the registrant when adopted. In this regard, the SEC staff expects the additional qualitative disclosures to include a description of the effect of the accounting policies that the registrant expects to apply, if determined, and a comparison to the registrant's current accounting policies. Also, a registrant should describe the status of its process to implement the new standards and the significant implementation matters yet to be addressed.<sup>6</sup>

PCAOB standards require auditors to perform procedures to identify and assess the risks of material misstatement of the financial statements, including consideration of the risk of omitted,

incomplete, or inaccurate disclosures.<sup>7</sup> Additionally, auditors are required to perform substantive procedures to test the relevant assertions of significant financial statement disclosures.<sup>8</sup> This includes transition disclosures<sup>9</sup> regarding FASB ASC 326 when presented in the notes to the financial statements (including when the transition disclosure asserts that the impact of FASB ASC 326 is not expected to be material to the financial statements).

Auditors are required to evaluate whether the financial statements contain the information essential for a fair presentation of the financial statements in conformity with the applicable financial reporting framework. This includes evaluating the entity's transition disclosures regarding FASB ASC 326 and, if such disclosures are omitted, incomplete, or inaccurate, evaluating the effect on the financial statements and auditor's report.

Additionally, in an integrated audit, the auditor should test controls that are important to the auditor's conclusion about whether the entity's controls sufficiently address the assessed risk of material misstatement related to the relevant assertions of over significant disclosures, including transition disclosures.

Auditors also have responsibilities under PCAOB standards for performing procedures with respect to transition disclosures presented in interim financial information. The objective of the auditor's review of interim financial information is to provide the auditor with a basis for communicating whether he or she is aware of any material modifications that should be made to the interim financial information for it to conform with U.S. generally accepted accounting principles.

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<sup>6</sup> FASB ASC 250-10-S99-6.

<sup>7</sup> For example, see paragraphs .49, .52, and .67 of PCAOB Auditing Standard (AS) 2110, *Identifying and Assessing Risks of Material Misstatement*. PCAOB auditing standards can be found in PCAOB Standards and Related Rules.

<sup>8</sup> Paragraph .36 of AS 2301, *The Auditor's Responses to the Risks of Material Misstatement*.

<sup>9</sup> See SEC Staff Accounting Bulletin No. 74, Topic 11-M, *Disclosure of the Impact That Recently Issued Accounting Standards Will Have on the Financial Statements of the Registrant When Adopted in a Future Period* (Dec 30, 1987).

The auditor's procedures in such a review are generally limited to analytical procedures, inquiries, and other procedures that address significant accounting and disclosure matters relating to the interim financial information to be reported.

Examples of review procedures directed toward an entity's transition disclosures include the following:

- Inquiring about the entity's implementation progress and the anticipated effects of FASB ASC 326 on the entity's financial statements. Auditors may find it necessary to make inquiries of the entity's personnel outside of the accounting function to obtain such information.
- Inquiring about whether interim transition disclosures relating to the adoption of FASB ASC 326 agree or reconcile with supporting data in the entity's records, such as management's reports to the audit committee about the anticipated effects of FASB ASC 326.

Information obtained by the auditor in performing procedures related to a entity's transition disclosures may identify a concern regarding management's anticipated application of FASB ASC 326. Auditors are reminded of their responsibility to communicate such concerns to the audit committee.

An example of a question related to appropriate disclosures follows:

- How does management determine the adequacy of the disclosure related to the progress in implementing FASB ASC 326 and the significant implementation matters that still need to be addressed?

## Critical Audit Matters

A critical audit matter (CAM) is defined as any matter arising from the audit of the financial statements that was communicated or required to be communicated to the audit committee that

- relates to accounts or disclosures that are material to the financial statements and
- involves especially challenging, subjective, or complex auditor judgment.

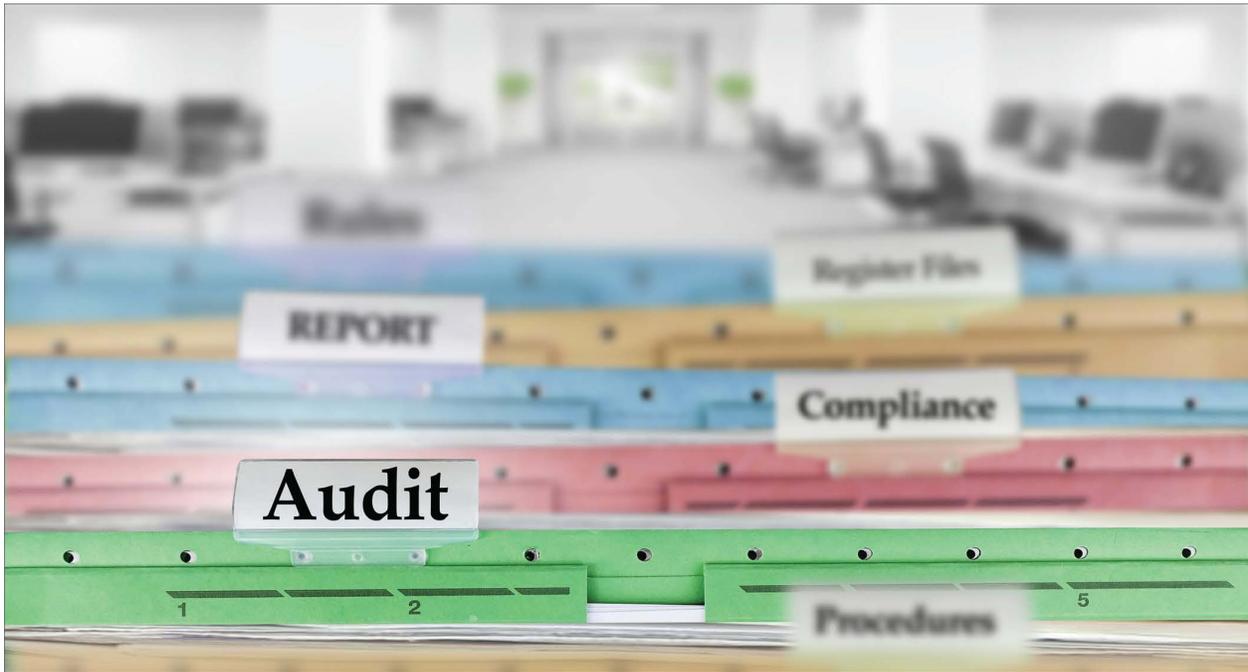
CAMs are drawn from matters required to be communicated to the audit committee. The PCAOB auditing standard 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*,<sup>10</sup> does not exclude any required audit committee communications from the source of CAMs.

The standard provides a list of factors<sup>11</sup> for the auditor to take into account when determining whether a matter involves especially challenging, subjective, or complex auditor judgment:

- The auditor's assessment of the risks of material misstatement, including significant risks
- The degree of auditor judgment related to areas in the financial statements that involved the application of significant judgment or estimation by management, including estimates with significant measurement uncertainty
- The nature and timing of significant unusual transactions and the extent of audit effort and judgment related to these transactions
- The degree of auditor subjectivity in applying audit procedures to address the matter or in evaluating the results of those procedures

<sup>10</sup> See PCAOB Release No. 2017-001, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards*.

<sup>11</sup> See PCAOB Staff Guidance: *Implementation of Critical Audit Matters: The Basics*.



- The nature and extent of audit effort required to address the matter, including the extent of specialized skill or knowledge needed or the nature of consultations outside the engagement team regarding the matter
- The nature of audit evidence obtained regarding the matter

The auditor should also take into account other factors specific to the audit.

The audit procedures related to assessing the ACL and related disclosures may give rise to disclosures in the auditor's report as CAMs. Any matter that will be communicated as a CAM should already have been discussed with the audit committee, and the auditor is required to provide a draft of the auditor's report to the audit committee and discuss the draft with them.<sup>12</sup>

As the auditor is drafting the audit opinion to comply with the communications requirements of the CAM standard, the auditor could discuss with management and the audit committee the treatment of any original information.

### **Control Environment**

An entity would likely adopt additional internal controls over financial reporting to comply with the ACL standard and may need to disclose this as a change in internal control in SEC periodic filings.

Auditors should discuss with both registrants and their audit committees the status of implementation of the new accounting standards, including changes in internal control over financial reporting.

Upon adoption, auditors should inquire of management about the application of FASB ASC 326, as well as evaluate the consistency of the financial statements from period to period along with management's associated internal control over financial reporting.

<sup>12</sup> See Paragraph .21 of AS 1301, *Communications with Audit Committees*.

# Chapter 5

## Communications



### Communication With Those Charged With Governance and Others

Because of the uncertainties associated with the estimate of expected credit losses, the potential effects on the financial statements are likely to be of interest to those charged with governance. The auditor may communicate the nature and consequences of significant assumptions used in the estimate, the degree of subjectivity involved in the development of the assumptions, and the relative materiality of the estimate to the financial statements as a whole. In addition, the need for appropriate controls over the initial and subsequent measurement processes are matters that may give rise to the need for communication with those charged with governance.

The appropriate timing for communications may vary with the circumstances of the engagement; however, it may be appropriate to communicate significant difficulties encountered during the audit as soon as practicable if those charged with governance are able to assist the auditor to overcome the difficulty or if it is likely to lead to a modified opinion.

Auditing standards address the auditor's responsibility to communicate with those charged with governance in an audit of financial statements.<sup>1</sup> With respect to estimates, matters to be communicated to those charged with governance may include the following:

- A lack of understanding of FASB *Accounting Standards Codification* (ASC) 326, Financial

Instruments – Credit Losses, and its requirements

- A lack of readiness to implement FASB ASC 326 and its requirements
- A lack of management understanding of the nature or extent of the lending activities or the risks associated with such activities
- Significant deficiencies or material weaknesses in the design or operation of the system of internal control relating to the entity's lending activities and related credit losses that the auditor has identified during the audit
- Significant difficulties encountered when obtaining sufficient appropriate audit evidence relating to the estimate of credit losses developed by management or management's specialist (for example, when management is unable to obtain an understanding of the methodology, assumptions, and data used by management's specialists, and such information is not made available to the auditor by management's specialist)
- Significant differences in judgments between the auditor and management or management's specialist regarding assumptions

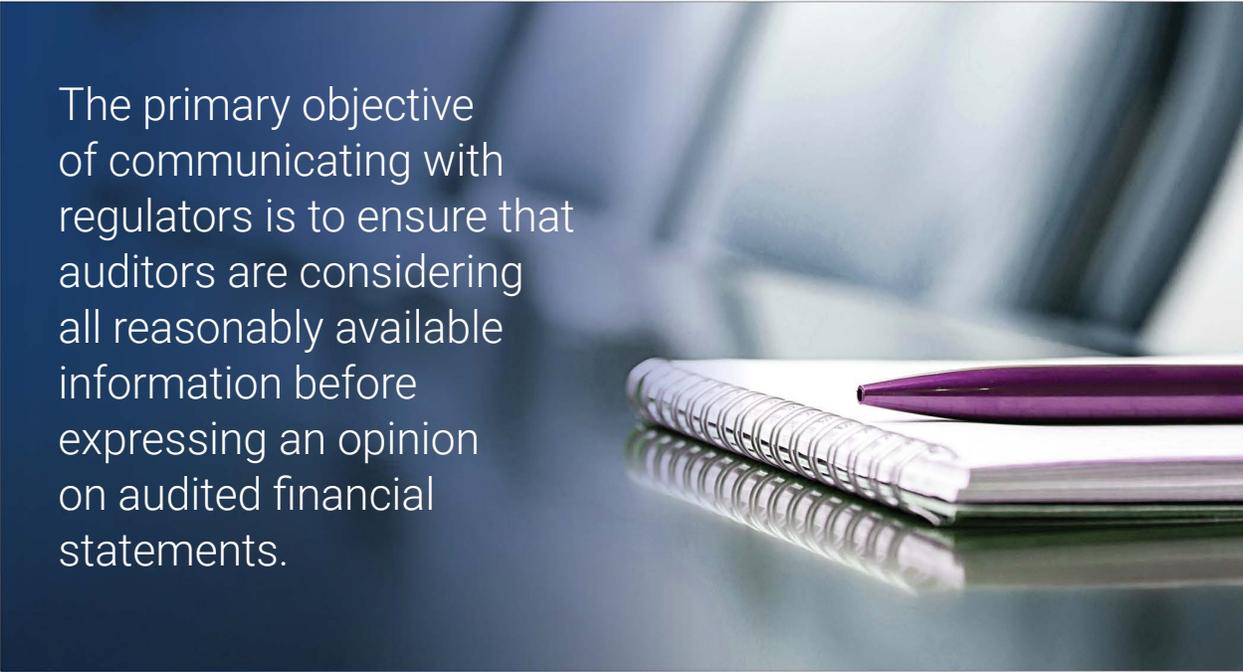
<sup>1</sup> See AU-C section 260, *The Auditor's Communication with Those Charged with Governance*. All AU-C sections can be found in AICPA Professional Standards.

- The potential effects on the entity's financial statements of material risks and exposures required to be disclosed in the financial statements, including the measurement uncertainty associated with the estimate of credit losses
- The auditor's views about the qualitative aspects of the entity's accounting practices and financial reporting for credit losses
- A lack of comprehensive and clearly stated policies for the estimation process related to credit losses, including operational controls and monitoring credit risk

## Communication With Regulators and Others

In addition, regulators may share information with the auditor about the operation and application of controls over credit risk management, credit losses, and compliance with regulations. This sharing of information in accordance with applicable regulations may be helpful to the auditor in identifying risks of material misstatement.

The primary objective of communicating with regulators is to ensure that auditors are considering all reasonably available information before expressing an opinion on audited financial statements. In areas such as the appropriateness of the allowance for credit losses and violations of laws or regulations, for example, information known to, or judgments made by, examiners generally should be made known to management and the auditor before financial statements are issued or an audit opinion is rendered.



The primary objective of communicating with regulators is to ensure that auditors are considering all reasonably available information before expressing an opinion on audited financial statements.

# Appendix A

## Clarified Auditing Standards and PCAOB Standards

This appendix identifies PCAOB standards that broadly correspond with the clarified auditing standards promulgated by the Auditing Standards Board of the AICPA and contained in Professional Standards. However, the underlying content within the clarified standards and PCAOB standards may not be analogous. Readers should review the full text of the corresponding PCAOB standards, review the related releases (available in the AICPA publication *PCAOB Standards and Related Rules* or at [pcaobus.org](http://pcaobus.org)), and use professional judgment to identify all guidance applicable to their engagements.

**Note:** The appendix has been prepared for informational and reference purposes only. It has not been reviewed, approved, disapproved, or otherwise acted on by the PCAOB or any senior committee of the AICPA and does not represent official positions or pronouncements of the PCAOB or the AICPA.

Clarified Standards		PCAOB Standards	
AU-C Section	Title	AS Section	Title
200	<i>Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards</i>	1001	<i>Responsibilities and Functions of the Independent Auditor</i>
		1005	<i>Independence</i>
		1010	<i>Training and Proficiency of the Independent Auditor</i>
		1015	<i>Due Professional Care in the Performance of Work</i>
		1101	<i>Audit Risk</i>
240	<i>Consideration of Fraud in a Financial Statement Audit</i>	2401	<i>Consideration of Fraud in a Financial Statement Audit</i>
		2810	<i>Evaluating Audit Results</i>
250	<i>Consideration of Laws and Regulations in an Audit of Financial Statements</i>	2405	<i>Illegal Acts by Clients</i>
260	<i>The Auditor's Communication With Those Charged With Governance</i>	1301	<i>Communications with Audit Committees</i>

Clarified Standards		PCAOB Standards	
AU-C Section	Title	AS Section	Title
315	<i>Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement</i>	2110	<i>Identifying and Assessing Risks of Material</i>
330	<i>Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained</i>	2301	<i>The Auditor's Response to the Risks of Material</i>
		2810	<i>Evaluating Audit Results</i>
402	<i>Audit Considerations Relating to an Entity Using a Service Organization</i>	2601	<i>Consideration of an Entity's Use of a Service Organizations</i>
450	<i>Evaluation of Misstatements Identified During the Audit</i>	2810	<i>Evaluating Audit Results</i>
500	<i>Audit Evidence</i>	1105	<i>Audit Evidence</i>
		1210	<i>Using the Work of a Specialist</i>
		2810	<i>Evaluating Audit Results</i>
540	<i>Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures</i>	2501	<i>Auditing Accounting Estimates</i>
		2502	<i>Auditing Fair Value Measurements and Disclosures</i>
620	<i>Using the Work of an Auditor's Specialist</i>	1210	<i>Using the Work of a Specialist</i>
705	<i>Modifications to the Opinion in the Independent Auditor's Report</i>	3105	<i>Modifications to the Opinion in the Independent Auditor's Report</i>



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