AUDIT READINESS 2 – LAYING THE INFORMATION OUT TO HELP THE AUDITOR

By **Vinayak Shetty**

CECL COUNTDOWN SERIES

marcus.cree@greenpointglobal.com | sanjay@greenpointglobal.com

International Corporate Center, 555 Theodore Fremd Avenue, Suite A102 Rye, NY 10580

CECL AND AUDIT READINESS

The Financial Accounting Standards Board (FASB) issued the credit loss accounting standard, the Current Expected Credit Losses (CECL), in June 2016. CECL focuses on expected credit losses over the life cycle of a loan and also on the reserves an institution is supposed to maintain to cover those losses. This is in contrast to the previous standard that relied on incurred losses. When implementing CECL, management will have to judge and estimate future losses. Institutions will have flexibility in developing techniques for estimating and measuring expected credit losses as long as they are consistent with the principles of the standard. Different estimation methodologies may be used by banks for different types of financial assets.

The credit loss allowance is a bank's most important estimate and is scrutinized by auditors and regulators. For audits of financial institutions that have implemented the CECL standard, the allowance for loan losses will be considered a significant risk due to its complexity, estimation uncertainty, materiality, and sensitivity, from a user's perspective. Auditors who audit accounting estimates need to do a high-level lookback analysis to understand the difference between actual results and previous estimates. This will help to assess the management's process reliability.

Auditing estimates and related procedures

Procedures involved in auditing estimates include tests of the management's methodology, evaluation of subsequent events, and tests of controls. In some instances, these procedures would also include the auditor's independent estimate. Since the FASB has not established a standard model, auditors must be prepared to adapt their methods to the facts and conditions present at each financial institution. Auditors are also responsible for auditing-related disclosures, information about the management's methods, and models and assumptions used in calculating the estimate.

The auditors will also look out for any management bias or irregularities in the management's process. Under CECL, the auditor will be required to examine how much evidence is required to substantiate the allowance for loan losses. Institution-specific data would be needed to support all components of the management's allowance for loan loss estimate, including qualitative factors. The FASB standard allows corresponding peer data to be used in certain cases where data is unavailable. The American Institute of Certified Public Accountants' Auditing Standards Board (ASB) seeks convergence of both domestic and international rules. It has therefore proposed certain changes to its procedures for auditing estimates to align with the International Auditing and Assurance Standards Board (IAASB) revised rules.

Management can discuss their loss estimation procedures with their auditors to set up best practices under CECL. Key discussion areas to review would include the best ways to document the decision-making process and the resulting review and approval procedures. It would be prudent to always maintain records and copies of the final documentation for auditor review.

Challenges faced when providing data to auditors

Auditing an estimate has always been a challenging task, especially when it comes to bad debts. The auditor needs to consider the assumptions and methods used to calculate a CECL estimate and also, how the management's bias can be a factor as far as estimates are concerned. The CECL standard needs more data while auditing the reserve calculations for future losses. From a preparer's point of view, the CECL estimate is more difficult to support and govern. To meet the expectations of auditors and regulatory bodies, preparers have to increase their documentation and implement incremental controls. The five areas where auditors are expected to focus are:

- Models and methods used
- Data
- Qualitative adjustments
- Assumptions
- Controls/Governance

Data and CECL audits

Of the above factors, data is going to be the key factor that preparers can use to align their CECL estimates with those of the auditors. Most preparers initially believed that they lacked sufficient data for loss observations to prepare a relevant CECL estimate. What needs to be understood is that, besides loss history, a CECL estimate will incorporate the following data:

- Production loan data
- Historical loss conditions data
- A reasonable forecast of loss conditions
- Historical and current underwriting behaviors
- Historical and current collateral details
- Prepayment data

Preparers focus on data during implementation and while preparing an estimate. Auditors, meanwhile, focus on this data while reviewing the estimate. The aim for most preparers will be to prove the completeness and accuracy of their data during audits. They should be ready to explain any adjustments and transformations of their data. Erroneous data will also need to be cleansed from the system and missing pieces will also need to be factored in and replaced with valid assumptions. For any manipulations in data, an effective system of internal control needs to be put in place by preparers.

Certain data can be verified against a public source such as the Securities and Exchange Commission (SEC) and can therefore be deemed as transparent data. There will also be times when the data has been sourced by a vendor whose data points can be questioned for validity. In such cases, preparers will have to conduct further tests to attest to the reliability of the data.

Economic data has become an integral part of the CECL estimate, and this includes economic forecasts and historical economic data. A considerable amount of external data will be utilized for economic forecasts that are prepared internally. This data will need to be subjected to a system of internal control for its accuracy and completeness. This will ensure that preparers are more responsible for their CECL forecasts during audits.

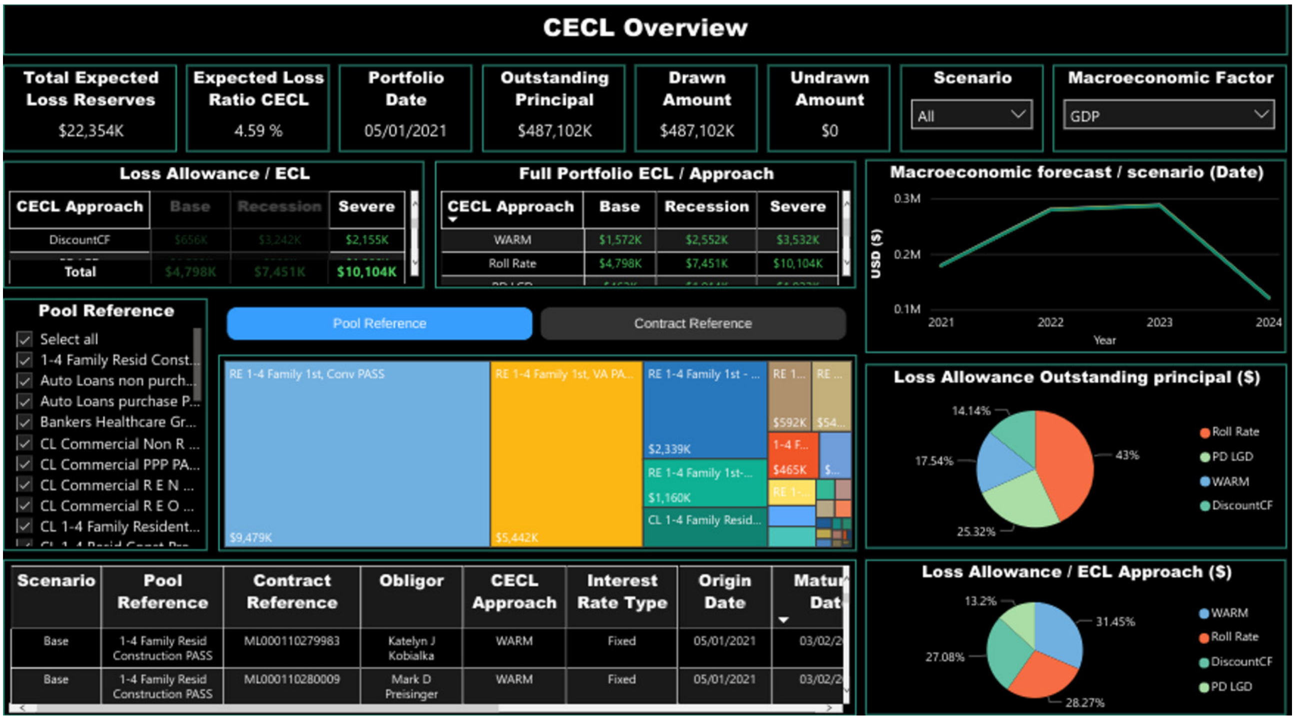
CECL Express can help...

CECL Express is a turnkey solution that fully satisfies all elements of the new CECL accounting standard. The system provides all non-loan data, including:

- Yield curves and Fed data
- Linked reports on losses from the FFIEC and NCUA
- PD and LGD curves
- Macroeconomic data

Banks and credit unions need to only provide the underlying loan details for the system to provide fully auditable ECL results for multiple calculation methods, including:

- Vintage
- Roll Rate
- Discounted Cashflow
- WARM
- PD/LGD



CECL Express provides more than valid ECL results. The system computes results for all methods and all loan pools, allowing the bank to optimize its CECL configuration and avoid the worst impacts of the new standard.

Visit ceclexpress.com for more information about the most efficient route to optimal CECL compliance.

ABOUT CECL EXPRESS

- CECL Express is a turnkey, cloud-based solution, designed to provide banks and credit unions with optimized results and reporting that fully meet the 'Current Expected Credit Loss' accounting standards.
- CECL represents a major change in what is expected from financial institutions in their reporting of, and provisioning against potential credit losses.
- Smaller financial institutions are expected to implement forward-looking credit models to estimate losses they may experience.
- Selecting inappropriate 'Expected Credit Loss' (ECL) models will create a need to hold far more capital than is required, directly causing a loss of Profit and Loss (P&L). Data used within these models must also be reported for audit purposes.
- January 2023 will see the first official reporting period for the beginning of CECL. Banks and credit unions must have a framework in place, which is fully tested and reports results based on that data. In practice, this means selecting, implementing, and testing the system in the first half of 2022.
- For Finastra core systems, the integration has already been built. For customers with these systems, their CECL results are ready to be calculated and reported.

ABOUT GREENPOINT FINANCIAL

- GreenPoint Financial is a division of GreenPoint Global, which provides software-enabled services, content, process and technology services, to financial institutions and related industry segments.
- GreenPoint is partnering with Finastra across multiple technology and services platforms.
- Founded in 2006, GreenPoint has grown to over 500 employees with a global footprint. Our production and management teams are in the US, India, and Israel with access to subject matter experts.
- GreenPoint has a stable client base that ranges from small and medium-sized organizations to Fortune 1000 companies worldwide. We serve our clients through our deep resource pool of subject matter experts and process specialists across several domains.
- As an ISO certified company by TÜV Nord, GreenPoint rigorously complies with ISO 9001:2015, ISO 27001:2013, and ISO 27701:2019 standards.

Marcus Cree

MANAGING DIRECTOR AND
HEAD OF FINANCIAL TECHNOLOGY AND SERVICES

Marcus has spent 25 years in financial risk management, working on both the buy and sell side of the industry. He has also worked on risk management projects in over 50 countries, gaining a unique perspective on the nuances and differences across regulatory regimes around the world.

As Managing Director, Marcus heads GreenPoint Financial Technology and Services and has been central in the initial design of GreenPoint products in the loan book risk area, including CECL and sustainability risk. This follows his extensive experience in the Finastra Risk Practice and as US Head of Risk Solutions for FIS. Marcus has also been a prolific conference speaker and writer on risk management, principally market, credit and liquidity risk. More recently, he has written and published papers on sustainability and green finance.

Marcus graduated from Leicester University in the UK, after studing Pure Mathematics, Phycology and Astronomy. Since graduation, Marcus has continually gained risk specific qualifications including the FRM (GARP's Financial Risk Manager) and the SCR(GARP's Sustainability and Climate Risk). Marcus's latest academic initiative is creating and teaching a course on Green Finance and Risk Management at NYU Tandon School of Engineering.

Sanjay Sharma, PhD

FOUNDER AND CHAIRMAN

Sanjay provides strategic and tactical guidance to GreenPoint senior management and serves as client ombudsman. His career in the financial services industry spans three decades during which he has held investment banking and C-level risk management positions at Royal Bank of Canada (RBC) Goldman Sachs, Merrill Lynch, Citigroup, Moody's, and Natixis. Sanjay is the author of "Risk Transparency" (Risk Books, 2013), Data Privacy and GDPR Handbook (Wiley, 2019), and co-author of "The Fundamental Review of Trading Book (or FRTB) - Impact and Implementation" (Risk Books, 2018).

Sanjay was the Founding Director of the RBC/Hass Fellowship Program at the University of California at Berkeley and has served as an advisor and a member of the Board of Directors of UPS Capital (a Division of UPS). He has also served on the Global Board of Directors for Professional Risk International Association (PRMIA).

Sanjay holds a PhD in Finance and International Business from New York University and an MBA from the Wharton School of Business and has undergraduate degrees in Physics and Marine Engineering. As well as being a regular speaker at conferences, Sanjay actively teaches postgraduate level courses in business and quantitative finance at EDHEC (NICE, France), Fordham, and Columbia Universities.