Implementation and audit readiness for lenders: ASC 326

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Overview

Significant. *Monumental*. *Noteworthy*. *Meaningful*. These are just a few words that have been used to describe Financial Accounting Standards Board's (FASB) Accounting Standards Update (ASU) 2016-13, *Financial Instruments–Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*. Arguably the most sweeping modification in accounting practices for financial institutions in a number of years, this ASU brings with it expectations for increased scrutiny, both from within and outside of the organization. Those charged with governance, investors, regulators and auditors are expected to take a particular interest in the adoption of this standard, which represents an important change to the measurement of credit losses on financial instruments.

This white paper provides an overview of implementation and audit-readiness considerations across a variety of topics related to the adoption of this standard. It is expected that comprehensive and well-documented efforts on behalf of management will lead to a more effective and efficient implementation process and audit thereof. The content in this white paper has been developed from an auditor's perspective and considers relevant accounting and auditing literature, regulatory guidance, observations from public company adoption, and other industry developments specific to the adoption of Accounting Standards Codification (ASC) Topic 326. While certain accounting matters are addressed, this white paper does not include an all-inclusive discussion of ASC 326. For further discussion of the accounting under ASC 326, please refer to RSM's white paper, A guide to accounting for investments, loans and other receivables.

Executive summary

This executive summary is intended to provide a broad overview of implementation and audit-readiness considerations. Members of management who will be responsible for implementation of ASC 326 and subsequent estimation and monitoring efforts should read the summary in conjunction with the entire white paper.

Introduction

ASU 2016-13 replaces much of the existing accounting guidance under ASC Topics 310 and 450, which are commonly referred to collectively as the “incurred loss” methodology. Under this existing guidance, losses on financial instruments are recognized when it is probable that a loss has been incurred. Topic 326 replaces the incurred loss methodology with an “expected loss” model, which results in entities reflecting expected credit losses for the life of the financial asset. While the fundamental changes to the recognition criteria alone are substantial, the broad scope of the standard adds to its impact. Subtopic 326-20 addresses the accounting for financial assets held at amortized cost basis, such as trade receivables, loans, net investments in leases, off-balance-sheet credit exposures, reinsurance receivables and held-to-maturity debt securities. For these financial assets, the new standard and approach is commonly referred to as *CECL (current expected credit losses).* Subtopic 326-30 impacts the accounting treatment for available-for-sale debt securities.

ASU 2016-13 originally was issued in June 2016 and has since been updated by several related ASUs to enhance clarity, add practical expedients and policy elections, and adjust effective dates. ASU 2016-13 was effective for public business entities that are SEC filers, but that do not qualify as smaller reporting companies (SRCs), for periods beginning on or after December 15, 2019. With the passage of the Coronavirus Aid, Relief, and Economic Security Act in 2020 and, subsequently, the Consolidated Appropriations Act in 2021, the effective date for many SEC filers that are not SRCs, including insured depository institutions such as regulated banks, was deferred until periods beginning on or after December 15, 2021 (2022 calendar year ends). For all others, the standard is effective for periods beginning on or after December 15, 2022 (2023 calendar year ends), including all interim periods within that fiscal year.

Policies and procedures

New accounting standards often result in the need for entities to revisit existing policies and procedures and to make appropriate adjustments in light of those changes. This has been evident in recent years with the adoption of the revenue recognition and leasing standards, and it expected to be the same for the new credit losses standard. If an entity did not previously have comprehensive, formal and current policies and procedures surrounding credit quality monitoring, establishment of the allowance, and ongoing review of its methodology, it should consider taking this period of implementation to develop them.

Policies often will address overarching matters such as accounting policy elections, practical expedients, the frequency at which assumptions are revisited, requirements for model risk management, and monitoring efforts. Procedures are often a byproduct of the policies and are used to guide preparers and reviewers through the mechanics of the estimation process.

It is important to assign competent individuals who have a strong understanding of the legacy and new guidance to prepare policies and procedures. A checklist or memorandum derived from the standard is an effective means of documenting compliance with the new standard, and likely may be requested by auditors and other third parties (e.g., regulators). Since the allowance is a significant estimate that likely involves assumptions subject to management bias and subjectivity, it is important that the documentation addresses not only the final assumptions or options selected, but also those not chosen and why.

After policies, procedures and implementation documentation have been developed, it is important to continually monitor the estimation approach and results. A well-defined and regularly executed monitoring process will be important to ensure continued compliance with the standard.

Third-party service providers and vendors

Many third-party service providers and vendors are available to assist financial institutions in their implementation and ongoing accounting efforts. While these third parties may supplement the internal implementation team, filling in certain knowledge, expertise and resource gaps, it is important to remember that the final assumptions, decisions and results remain the responsibility of management. Therefore, entities should perform appropriate due diligence prior to engaging and using a third-party service provider or vendor, and then should have an ongoing process in place to monitor the services provided.

Service Organization Control (SOC) I Type II reports may be available to provide insight into the internal controls present and operating at third-party service providers and vendors. These reports are often quite useful, but not without a thorough review of the SOC I Type II report by management. Given the volume of expected entity-specific assumptions, a SOC I Type II report in combination with other review processes and controls at the entity level likely is warranted.

A common area for which third-party service providers are used is in the development of adjustments for reasonable and supportable forecasts. Regardless of whether the forecasts are determined internally or through a third-party, management needs to maintain documentation supporting the forecasted data points selected. Third-party service providers may have resources such as validation reports that can be provided to user entities to support the validity of the data provided, but if this is not available, management will need to develop its own procedures to regularly challenge the source.

Supporting documentation

Considering the volume of assumptions and judgments involved in estimating the allowance, it remains ever important to maintain supporting documentation. Many meetings will take place during the implementation phase, and these discussions often will result in key decisions that impact the allowance. Without retaining meeting agendas, minutes, notes and (or) memorandums, it may be difficult for entities to support the matters discussed and conclusions reached.

With respect to the calculation itself, management not only needs to retain support for its selected assumptions and any judgments made, but it also needs to maintain evidence related to the review of data inputs and outputs. Sourcing data externally or using a third party for the calculation does not alleviate management's need to ensure the accuracy of its allowance.

Two areas that can be particularly challenging to support are adjustments to historical losses for current conditions and adjustments for reasonable and supportable forecasts, primarily due to their inherently subjective nature. Under the incurred loss methodology, many entities have made adjustments to historical losses in a purely subjective manner and have supported those adjustments primarily through narrative discussion. With the move to the expected credit losses methodology and the notion of lifetime losses, it may be beneficial to revisit existing processes and to incorporate more quantitative approaches and objective data points in the establishment of these adjustments.

Ultimately, if management does not maintain supporting documentation, there may be concern regarding the overall control environment, safety and soundness, and the conclusions reached with respect to the allowance, and there likely will be increased auditor scrutiny and professional skepticism. Management and other constituents (e.g., board of directors, audit committee) should be familiar with supervisory guidance such as the Joint Agencies' Interagency Policy Statement on Allowances for Credit Losses. While not all financial institutions are regulated by the Joint Agencies, the discussion with respect to required documentation applies conceptually to all types of financial institutions. Additionally, those charged with governance may find the Center for Audit Quality's Preparing for the New Credit Losses Standard: A Tool for Audit Committees beneficial in its oversight.

Model validation

Given that the allowance often has a material impact on lenders, it is expected that some form of model risk management takes place at implementation and on an ongoing basis. One common approach for model risk management for the allowance is model validation, the purpose of which is to challenge the entity's approach and to evaluate the sufficiency and appropriateness of the information input, processing, and reporting components of the model. Management should develop a process and controls to ensure that the model is appropriately tested and challenged as it relates to compliance with the standard, data integrity and output accuracy.

Model validations may be performed by internal personnel or outsourced to an external party, so long as the individuals performing the model validation are qualified, competent, and independent of the development and implementation of the model. Entities should plan to have the model validation performed well in advance of implementation to ensure that any findings can be addressed prior to the effective date.

Internal controls

The assessment of internal controls is important in all audit engagements, regardless of whether the auditor tests internal controls, as an understanding of internal controls is required as part of the risk assessment and planning phase of the audit. Management should consider all of the "what can go wrongs" throughout the allowance cycle and ensure that appropriate controls are in place to address them.

Additionally, just as it is important to maintain supporting documentation for the allowance calculation, it is also important that the entity maintains support to evidence the execution of the entity-level and allowance-related controls. Inquiry alone is not sufficient for audit purposes, and thus the auditor will need to be able to inspect the related supporting evidence (e.g., memorandums, meeting minutes, completed review checklists, notations, sign offs) or observe execution of the control in real time.

Transition

Auditors are required to test not only the allowance as of the balance sheet date, but also as of the adoption date, along with the associated transition-related journal entries and disclosures. Thus, supporting documentation needs to be maintained for both calculations. From a disclosure perspective, ASC 326 revises certain existing allowance disclosures and creates many new disclosure requirements at adoption and on an ongoing basis. Entities will also need to revisit and amend, as necessary, disclosures over significant accounting policies, estimates, risks and uncertainties, commitments and contingencies, and any impacted financial statement line items.

SEC Staff Accounting Bulletin (SAB) Topic 11M requires registrants to disclose the impact that recently issued accounting standards will have on the balance sheet and income statement when those standards are adopted in a future period. Non-SEC registrants do not have the same explicit requirement; however, it is likely advantageous to users of the financial statements to include a discussion of the expected impact in periods prior to adoption.

Specific considerations

Policies and procedures

Overall

ASC 326 makes meaningful changes to the measurement guidance for financial assets held at amortized cost basis and available-for sale debt securities. This includes both financial assets originated by the entity, as well as acquired financial assets that have been purchased with credit deterioration (PCD financial assets) and those without such credit deterioration present.

Specifically, Subtopic 326-20 applies to the following financial assets held at amortized cost basis (i.e., assets not otherwise held at fair value or for which the fair value election has not been made):

- Financing receivables, such as loans held for investment
- Held-to-maturity debt securities
- Receivables that result from revenue and other income transactions
- Receivables that relate to repurchase and securities lending agreements
- Reinsurance receivables that result from insurance contracts within the scope of ASC Topic 944, *Financial Services–Insurance*
- Net investments in leases recognized by a lessor
- Off-balance-sheet credit exposures, such as unrecognized loan commitments, standby letters of credit, financial guarantees and similar instruments that are not accounted for as insurance and that do not need to be accounted for as derivatives

Subtopic 326-30 applies to available-for-sale debt securities and, while the changes are not as extensive as those related to Subtopic 326-20, there are still notable changes that will require adjustments to policies and procedures within the organization.

To effectively adopt the standard and prepare for implementation, entities will need to revisit existing policies and procedures surrounding monitoring credit quality, establishing and calculating necessary allowances, reviewing the allowance, and monitoring processes on a continuous basis. If entities did not previously have formal allowance policies and procedures, they should strongly consider establishing them at the time of implementation. The documentation will serve as a guide for internal stakeholders, such as preparers and reviewers, as well as evidence for external parties, such as auditors and regulators, for compliance with the accounting standards and support for certain conclusions and assumptions made.

Examples of items that may be addressed in a policy include, but are not limited to, the following:

- Who is responsible for the tasks associated with establishing and maintaining the allowance
- The frequency at which certain key assumptions (e.g., segmentation, prepayment and curtailment rates, reversion periods for reasonable and supportable forecasts, key data points considered in establishing adjustments to historical losses) are revisited
- Policy elections and practical expedients selected
- Any departures from the accounting guidance, including rationale for the departure and how the impact (i.e., materiality of the departure) will be monitored on an ongoing basis
- The use of back testing and other mechanisms to monitor the effectiveness of management’s estimation process for specific inputs (e.g., reasonable and supportable forecasts)

- The sources of information allowed to be used in establishing the allowance (e.g., specific vendors, internal vs. external data sources) and related discussion of established policies for ensuring the relevance and reliability of such data (e.g., vendor due diligence, SOC report review, manual validation)
- The extent of model validation employed, including who can perform the validation, at what frequency it should be conducted, and how results are incorporated into the methodology
- How to treat differences between the computed and recorded allowance

Procedures are intended to serve as a guide for those preparing or reviewing the calculations, walking the user through the specific steps. While there are many options for presenting procedures, the use of flowcharts, manuals and other guides that incorporate screenshots and examples often is quite effective. Procedures often will include elements of the established policy, and thus the development and approval of a sound policy in conjunction with the preparation of procedural guidance will be critical to the success of implementation efforts. The increased use of software and service providers amplifies the need to incorporate step-by-step procedural guidance into the process to ensure all parties involved have a clear understanding of the flow of information.

Procedures also can help to ensure compliance with the standard by incorporating elements of the measurement guidance. For example, with the adoption of ASC 326-30 for available-for-sale debt securities and impairment considerations, certain factors such as the duration of loss and subsequent events no longer can be considered. Additionally, impaired loans and purchased credit impaired financial assets (along with the related measurement guidance) previously included in ASC 310 are superseded upon adoption of ASC 326, and new concepts such as individually evaluated loans and PCD financial assets are incorporated into the new standard. Establishing or updating procedures to reflect changes such as these will help to ensure that those preparing the analysis are considering the appropriate characteristics and that no carryover from legacy guidance exists.

To the extent available, entities may consider leveraging documentation provided by third-party service providers or outsourced vendors to supplement their policies and procedures, but it is ultimately the responsibility of management to have a full understanding of its assumptions and calculations and to be able to walk others through the process and conclusions.

Note that, with the scope of financial assets being so large, it may be necessary to have multiple policies and sets of procedures to properly address differences in the financial assets being evaluated and the measurement models used. As with all policies and procedures, regular reviews should be performed to ensure that necessary changes are appropriately reflected.

From an audit readiness perspective, the more clear, comprehensive and formalized the policies and procedures for the allowance, the more efficient and effective conversations with the auditor will be. See the Supporting documentation section for further discussion.

Compliance with ASC 326-20 and ASC 326-30

The changes to the measurement guidance for financial instruments are so significant that, instead of amending current literature, an entirely new Codification Topic (326) was written. Such an approach is similar to that used for other major Accounting Standards Updates such as those related to revenue recognition and leases, and highlights the significance of the revisions. Entities essentially will start from a "blank slate" with respect to adopting this standard, reading all applicable provisions of the standard and addressing compliance with each in its policies and procedures. Existing elements of an entity's policies, procedures and methodology may continue to be used upon adoption if in accordance with the revised standard.

An effective means of ensuring compliance with ASC 326 is to read the standard and any applicable interpretations in their entirety, isolate applicable components and develop a checklist or memorandum that outlines how the entity considered the elements of the standard and incorporated them into its implementation plan. This checklist or memorandum then can be used on an ongoing basis to ensure continued compliance with the provisions of ASC 326. Third-party service providers, vendors or others (e.g., industry groups, regulatory agencies) may have resources of this nature, but the responsibility remains with management to ensure that any checklist or memorandum used is comprehensive, tailored to the entity, and in compliance with the provisions of ASC 326.

When considering compliance with ASC 326-20 for financial assets held at amortized cost basis, examples of key elements to address in documentation include, but are not limited to:

- *Scope of financial assets impacted*, including consideration of any purchased financial assets with credit deterioration
- *Segmentation*, including how the entity defines pools where similar risk characteristics exist, how the entity defines and identifies financial assets that do not share similar risk characteristics (i.e., individually evaluated financial assets), and how the entity plans to address subsequent review of data and potential changes in segmentation
- *Method(s) selected*, including the appropriateness of the selected method(s) for the various segments, those methods considered but not selected and why those methods were rejected, plans to re-evaluate method(s) used on a go-forward basis, and conclusions surrounding the use of the collateral-dependent practice expedient for individually evaluated financial assets
- *PCD financial assets (as applicable)*, including transition-related decisions surrounding pooling, application of the revised definition on a prospective basis, and calculation methodologies for legacy purchased credit impaired and new PCD financial assets
- *Quantitative considerations and calculation*, including how the entity properly applies the revised definition of amortized cost basis and accounts for all elements accordingly, the determination of contractual term, the calculation of historical loss rates, the method by which expected recoveries are incorporated into the calculation, the identification of relevant loss drivers and how those are incorporated into the model(s), and how a zero risk of loss conclusion is supported (if applicable)
- *Qualitative considerations and adjustments for current conditions and reasonable and supportable forecasts*, including the identification of relevant loss drivers and how these are used to adjust for current conditions and reasonable and supportable forecasts, the data supporting the adjustments (e.g., source, considerations of relevance, reliability, completeness and accuracy), the period of reasonable and supportable forecasting, and the reversion method/period utilized
- *Disclosure*, including how the entity complies with implementation date and ongoing disclosure requirements
- *Practical expedients and policy elections*, including all available within the standard (e.g., accrued interest receivable, collateral-dependent financial assets) and the conclusions reached by the entity
- *Off-balance-sheet credit exposures*, including scope, segmentation, method and calculation considerations as outlined above

As part of documenting compliance with ASC 326-20, it is important to address not only the assumptions or options selected, but also those ultimately not selected and why. The allowance is a significant accounting estimate, often the most significant and subjective for a lender, and thus there is an increased risk of management bias and subjectivity. Maintaining documentation that establishes considerations of several options, as well as considerations of both confirming and disconfirming (or negative) evidence, will assist in the audit process as auditors likely may inquire of management regarding such matters. For example, when documenting compliance with respect to reasonable and supportable forecasts, the entity should document all relevant loss drivers and data points that were considered as opposed to only the data points that ultimately were selected. National unemployment ultimately may have been selected as a data point based on an analysis performed for residential real estate loans, and management should maintain support for the analysis supporting its conclusion, as well as for any other analyses performed in arriving at that selection. A common question that an auditor may ask in response is why a more granular unemployment rate, such as a regional or local rate, was not selected, as well as what other metrics may be relevant as a potential driver of losses in the subject segment (e.g., home price indices, consumer price indices).

When considering compliance with ASC 326-30 on available-for-sale debt securities, examples of key elements to address in documentation include, but are not limited to:

- *Scope*, including how the entity will ensure that all securities that are impaired (defined as having a fair value less than amortized cost) are individually evaluated for impairment and how securities with a more-than-insignificant deterioration in credit quality since origination will be defined and identified
- *Intent*, including how the entity will arrive at its decision to sell an impaired security or how it will evaluate whether it is more likely than not that it will be required to sell the impaired security prior to recovery of the amortized cost basis, both of which will require a write down to fair value
- *Measurement period*, including the frequency at which the evaluation will take place
- *Qualitative considerations,* including the factors outlined in ASC 326-30-55-1, such as the extent to which fair value is less than amortized cost, adverse conditions related to the security (e.g., the issuer or obligor's financial condition or collateral, industry, geography), general economic considerations, payment structure and likelihood of the issuer to be able to make payments, failure of the issuer to make scheduled payments, and credit ratings
- *Quantitative considerations and calculation*, including how the entity plans to comply with the requirement to use the discounted cash flows model for establishing write downs or an allowance for expected credit losses
- *Terminology adjustments*, including how the entity plans to remove all references to *other-than-temporary* impairment from its policies, procedures and reporting

Once again, preparing and maintaining documentation of positive and negative factors considered will prove beneficial in the oversight activities of internal reviewers, external auditors and regulators. For example, with respect to ASC 326-30 and available-for-sale debt securities, the standard includes a list of factors that can be considered in determining whether there is impairment and whether an allowance should be established for the security. Entities may consider developing a checklist or other documentation that prompts the preparer to evaluate each factor, and then provide a conclusion that evaluates all evidence as opposed to only evidence that may lead to a particular, desired conclusion (e.g., that no impairment exists at the balance sheet date). For example, a security may have a strong credit rating and have never missed a payment, but the issuer and its underlying operations may be in significant distress with no immediate, expected recovery. The documentation prepared by management should be comprehensive and include consideration of all positive and negative factors, which then will need to be weighed and evaluated in totality to arrive at the appropriate conclusion.

Ultimately, being proactive in both consideration and documentation of compliance when implementing the standard should result in efficiency during the audit process.

Monitoring and post-implementation efforts

Because no one method is prescribed by ASC 326-20 and since some assumptions or conclusions are expected to change over time based on their nature, it is critical that management has a well-defined process to continually revisit its methodology. Even if the re-evaluation does not result in changes to assumptions or models used, it is still imperative to challenge previous conclusions and consider the need for changes to comply with the standard. For example, on a regular basis, management should look at its portfolio composition and consider loss drivers and other relevant factors, which may lead to a change in risk characteristics that would impact segmentation. Other examples of assumptions that are subject to change over time given their nature include:

- Method(s) or model(s) used, as impacted by segmentation and data available
- Contractual term
- Prepayment and curtailment rates
- Loss drivers, which may impact segmentation and data points considered in adjusting historical losses for current conditions and reasonable and supportable forecasts
- Peer groups (as applicable) for external data used

Additionally, as this is a significant estimate, it is important for entities to have mechanisms in place to continually assess the effectiveness of the estimation process. Examples of mechanisms that may be used upon adoption and as data continues to build include back testing (commonly referred to as a *retrospective review*), stress testing, comparison to peers or other publicly available data, and review of documentation provided by third-party service providers or specialists with respect to the accuracy of the data used. Differences are likely expected as the allowance and many of its inputs are estimates; these differences may not necessarily be reflective of a fundamental flaw in the process, but they should be monitored on an ongoing, consistent basis to evaluate whether there are any indications of issues with the process. It should be noted that back testing may be an option as it relates to certain assumptions, such as forecasts, but is not generally expected to be a valuable approach for evaluating the allowance estimation process as a whole.

Finally, periodic model validation, even after adoption, will be helpful to ensuring that the allowance continues to be established properly. See the Model validation section for further discussion.

Third-party service providers and vendors

Models and methodologies

Many entities have engaged third-party service providers and vendors to assist in the adoption and ongoing evaluation of the allowance, particularly as it relates to ASC 326-20 and the calculation of allowances for loans held for investment. Some of these providers offer a full suite of services that includes helping entities derive key assumptions such as prepayment and curtailment rates using client-specific and external data, assisting in model selection, and helping implement the model and prepare required documentation. Such service providers and vendors serve as part of management’s implementation team. On the other hand, vendors may be used only for calculation purposes such as in providing software that is implemented to support a discounted cash flows approach.

In either case, management should ensure that appropriate policies and procedures are in place for vendor due diligence and that it ultimately takes responsibility for all assumptions and conclusions reached. It is important to remember that third-party service providers and vendors may validate how their allowance calculation works or provide other support with respect to the propriety of their output, but the underlying model assumptions, decisions and results are management’s responsibility.

Many software service providers have a SOC I Type II report available for their product. While a SOC I Type II report is excellent evidence and provides insight into the controls in place at the service organization for general information technology and application-specific controls, management should be cautious with respect to how much reliance is placed on the SOC I Type II report.

First and foremost, the entity should ensure that the SOC I Type II report covers the system or software and the specific functions used by the entity. For example, if the software vendor provides several available methodology options, management needs to review the SOC I Type II report and ensure that the particular model(s) selected by management are covered in enough detail. Management should have a clear understanding of how its models operate prior to reading the SOC I Type II report and consider whether the controls selected and evaluated address all risks associated with the calculation. If an entity uses a discounted cash flows model, the SOC I Type II report may address the accuracy of a discounted cash flows model from a computational perspective, but the entity should consider how the test selection for the SOC report compares to its test selection with respect to inputs, assumptions and complexity, as well as how many test calculations were performed. In other words, while a SOC I Type II report supports the service organization's controls and outputs, additional evidence will be necessary to support the completeness and accuracy of the allowance. There are generally so many entity-specific assumptions and variables that, depending on the degree of customization used, management likely will need to have additional processes and controls in place such as independent model validation to truly support the subject calculation. Refer to the Model validation section for further discussion of this approach.

Additionally, management should evaluate that the SOC I Type II report properly covers the period under audit (with appropriate documentation for any "gap" periods) and that the report addresses relevant data (e.g., proprietary data, other external data), calculations and risks associated with the use of the third-party. Controls over security, source data (i.e., inputs), and the calculations (i.e., the outputs) are definitely relevant and should be designed, implemented and operating effectively.

Management also will need to consider the complementary user entity controls identified within the report and ensure there is clear documentation to support that the user entity (i.e., the lender) has controls designed, implemented and operating that support relevant end user controls. Auditors who plan to rely on the SOC I Type II report will seek this documentation and will be required to test the user entity controls identified in the SOC I Type II report.

Forecasting

Similar to the discussion above, many entities have sought assistance from third parties in developing adjustments to historical losses for reasonable and supportable forecasts. This assistance may take the form of helping to identify the data that will be used (i.e., loss drivers) through regression analysis or other techniques that evaluate the correlation between metrics and expected losses. The third party also may be the source of the forecasts themselves once the data points have been selected. In either case, the entity needs to consider the completeness and accuracy of the information provided by the third party.

As with any data used in the allowance calculation, management needs to support its use, including documentation as to why it is relevant to the subject portfolio segment(s), the source or how it is otherwise derived (e.g., propriety data, calculation), and steps taken to ensure that it is accurate. The accuracy may be addressed in supporting documentation available from the specialist, such as its own documented due diligence and validation work, or the lender may need to develop its own policies and procedures to objectively test the data. Refer to the Monitoring and post-implementation efforts subsection above for further discussion. One important item to remember is that forecasts may not be "one size fits all" in nature. While there should be consistency in forecasts used across various estimates (e.g., forecasts or projections that may be used in evaluating goodwill impairment or income taxes), management should consider the objective of the forecasting and applicable accounting literature in each scenario to ensure the forecasts used are fit for their purpose.

Whatever approach is ultimately taken in establishing forecasts, management should ensure it has a systematic, unbiased, supported, consistent and regular process to ensure the appropriateness (i.e., relevance), completeness and accuracy of information used in establishing reasonable and supportable forecasts, and that this evidence is readily available to auditors.

Supporting documentation

Overall

Throughout this white paper thus far, a common theme has been formally documenting considerations and conclusions as a foundation for audit readiness; in other words, maintaining supporting documentation for all steps in the process. From an auditor's perspective, there are three methods for auditing estimates under existing auditing standards, which are summarized as follows:

- A retrospective analysis whereby the auditor considers events occurring after the balance sheet date and up to the date of the auditor's report that may provide additional audit evidence with respect to the accounting estimate;
- Testing how management made the accounting estimate and the data on which it is based, including consideration of the appropriateness of the method(s), the reasonableness of assumptions and data reliability; and (or)
- Developing a point estimate or range to evaluate management's point estimate, commonly referred to as an *independent estimate*.

Due to the degree of subjectivity inherent in the allowance and the volume of qualitative factors considered in both ASC 326-20 and ASC 326-30, the second approach of obtaining an understanding of and testing management's estimate may be the most effective for the auditor. As a result, supporting documentation that is formally retained by management, both at implementation and on an ongoing basis, is crucial to audit readiness. Absent clear supporting documentation, there may be concerns surrounding the entity-level control environment (e.g., oversight and monitoring), safety and soundness, and the appropriateness of the conclusions reached, which will trigger additional inquiry, scrutiny and professional skepticism by the auditor.

Further, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency and the National Credit Union Administration (collectively, the Joint Agencies) released an Interagency Policy Statement on Allowances for Credit Losses in 2020. While not all entities are regulated by the Joint Agencies, the discussion with respect to required documentation supporting the allowance applies conceptually to all types of financial institutions.

> "ACLs and PCLs should be well documented, with clear explanations of the supporting analyses and rationale…maintaining, analyzing, supporting, and documenting ACLs and PCLs in accordance with GAAP is consistent with safe and sound banking practices."
>
> Joint Agencies
> (*Interagency Policy Statement on Allowances for Credit Losses*, 2020)
>
> ACL – Allowance for credit losses
> PCL – Provision for credit losses

The Interagency Policy Statement from the Joint Agencies specifically goes on to stress that the process should be disciplined, consistently applied, comprehensive and well-documented in order to be as effective as possible.

Data relevance, reliability, completeness and accuracy

When establishing allowances under ASC 326, it is expected that there will be significant data needs. From an ASC 326-20 perspective, the movement from an incurred loss to an expected credit loss model likely will result in a need for new or additional data elements to support the identification of loss drivers, segmentation conclusions, the development of key assumptions such as prepayment speeds or loss given default, the application of the selected model(s), and disclosure requirements. With the inability to consider certain factors, such as duration of losses and subsequent events, for available-for-sale debt securities, entities may need to identify additional data that would be relevant to the qualitative analysis under ASC 326-30 and, as needed, information to calculate allowances for expected credit losses when impairment is identified.

Any data used by the entity should be relevant, reliable, complete and accurate, and thus having strong processes over data integrity is a necessity for audit readiness.

Relevance is another way of referring to the correlation of data to its intended output or its predictive nature (i.e., is it more representative of a dependent or independent variable). Sometimes the connection will be inherent or clear, such as when data supporting an adjustment to historical losses is directionally consistent with the conclusion reached (e.g., delinquency rates increased, resulting in an increased adjustment to historical losses for credit quality trends). These instances are generally easy to document by presenting the data point, how it relates to the output in general terms (i.e., how it impacts credit losses), the value of the data point as of the measurement date, and the resulting conclusion reached with respect to the adjustment to be made.

In other cases, the correlation may be less clear and may require more rigorous analysis and formal documentation to support the conclusion. For example, the entity may perform a loss driver analysis that seeks to identify which metrics and economic variables most impact credit losses. To assess the relationship to losses, this analysis may use a pool of options, such as gross domestic product, vacancy rates, real estate value indices, unemployment rates, consumer price indices, commodity prices, home price indices, and inflation rates. For the commercial real estate segment, management may start by performing a regression analysis to look at the correlation between commercial real estate value indices and credit losses, which would be considered a logical relationship. If the result of that is a low or moderate correlation, the entity may need to evaluate other loss drivers. Detailed documentation should be maintained to support the evaluation, including all loss drivers considered and the final conclusion reached.

For example, when establishing historical loss rates, Entity A determined that it did not have sufficient loss history in Portfolio Segment Z, given that it was a newer product for the lender and that losses have been low in recent years due to strong economic times. Entity A's third-party service provider assisted the entity by completing an analysis of peer and proprietary data to arrive at a historical loss rate for Portfolio Segment Z. While a benefit of ASC 326 is that it allows for data to be internal, external or a combination thereof, management does need to consider, and include specific discussion in its supporting documentation of, its assessment of the relevance of data used. In this example, management should maintain documentation as to how the peer and proprietary data used was similar in nature to the subject entity and that, if not, how it was adjusted to arrive at the most relevant output.

Reliability refers to the trustworthiness and dependability of the data, and it is impacted by several factors such as the following:

- Source (e.g., internal, external);
- Controls related to the preparation and maintenance of the data;
- Whether the data is able to be directly sourced or only indirectly obtained;
- The form of the evidence (e.g., paper, electronic, inquiry only); and
- The period the data covers.

It is important to note that obtaining information from an external source does not automatically mean that the information is reliable, and management should have mechanisms in place to regularly evaluate the data. Examples of factors to consider related to external data sources include the following:

- Authority and evidence of general market acceptance by users (as applicable);
- Objectivity;
- Competence and reputation;
- Past experience;
- Controls in place and evidence available of such controls operating;
- Alternative sources or information that may contradict the information;
- Any disclaimers or other restrictive language surrounding the data; and
- Availability of information related to the methodology used to gather the data and assess it for completeness and accuracy.

Considerations surrounding external data are particularly important in the context of reasonable and supportable forecasts that are derived from third-party data, as discussed in the *Forecasting* subsection above. It is also relevant to other aspects of the allowance and the use of external sources of data such as peer group information that may be used in establishing historical loss rates, for example. Once the entity has established that the peer group used is relevant, it then also should determine that the related data is reliable by considering factors such as whether it was pulled directly by the entity or through an intermediate source; whether it could be reproduced in exact form by another party or it frequently changes; and any other documentation from the source to support its assessment of completeness and accuracy. The latter may not always be easy to determine, particularly with respect to third parties and any sort of propriety data, but it is still critical to consider and document the results of the evaluation and any potential impact of issues identified. The supporting documentation package will be more comprehensive if preparers can produce screenshots or save the source data and provide it to internal and external reviewers, including auditors.

In addition to being relevant and reliable, the information used also should be complete and accurate. In other words, management needs to be confident that relevant and reliable information has been incorporated into the analysis and that it was correctly applied to produce an appropriate output. If internal or vendor data is used that cannot be supported with sufficient documentation of completeness and accuracy, management should consider whether it is appropriate to use that data.

Often management has many processes and controls that support the completeness and accuracy of the information used, such as manual recalculations, exercises that seek to reproduce the source data (e.g., pulling independently from the same source), reconciliation between reports/systems and the model, vouching or tracing of inputs between source documents and the model, and back testing or retrospective reviews as previously discussed. Supporting documentation should be maintained for all such efforts, and it is important that this support goes beyond verbal affirmations that such procedures were performed. Examples of supporting documentation may include the following:

- Memorandums or detailed meeting minutes supporting group discussions of assumptions and conclusions reached, including any questions or challenges and how they were addressed
- Emails or other correspondence between preparers, reviewers and (or) third parties to support discussions with respect to inputs, outputs and conclusions reached
- Tickmarks or other notations and independent calculations to prove tasks, such as vouching, data validation checks and recomputations

- Checklists that are completed during the preparation and review processes to ensure there are appropriate segregation of duties and that the calculation has gone through a thorough evaluation
- Worksheets or other documents used in performing estimate validation procedures (e.g., retrospective review)
- Memorandums documenting management's detailed assessment of any applicable SOC I Type II reports for third-party service providers and vendors, including the consideration and identification of complementary user-entity controls

Adjustments to historical losses and reasonable and supportable forecasts

ASC 326-20 requires the auditor to make necessary adjustments to historical losses for current conditions and asset-specific risk characteristics, commonly referred to as *qualitative adjustments* or *qualitative factors*. The purpose of these adjustments is to reflect the extent to which management expects current conditions and asset-specific risk characteristics to differ from the conditions that existed for the period over which historical information was evaluated (i.e., to adjust a "steady state" scenario). ASC 326-20 also requires adjustments for reasonable and supportable forecasts, a key change from the previous accounting guidance.

While the allowance is an estimate and there is an inherent element of subjectivity involved in deriving the balance, it is important when developing the model(s) to strive to identify and incorporate as objective of data points as possible in the evaluation. This includes the adjustments to historical losses and the adjustments for reasonable and supportable forecasts (collectively referred to as the *adjustments*), which are often among the most complex and subjective components of the allowance given that the accounting literature does not prescribe a single methodology, assumptions are subject to change, and they may be difficult to quantify. Ultimately, while not all of the subjectivity and estimation uncertainty can be removed from the methodology for determining adjustments, there are a number of ways to increase objectivity when determining this component of the allowance.

Foundationally, management should have a well-defined set of policies and procedures that define the adjustments and how to apply them in the calculation. Many entities have a process by which one or more individuals establish the initial adjustments, and then a committee or other group of cross-functional individuals (i.e., representatives from accounting, finance, credit, treasury) meet to discuss, challenge and ultimately approve or reject the recommended adjustments. Appropriate documentation should be maintained when establishing these policies and procedures to support the initial conclusions, and then a process should be in place to regularly re-evaluate the conclusions for any necessary changes to the approach (e.g., the factors themselves, the amounts of adjustments, how adjustments are to be determined, sources of data). Depending on the size and the complexity of the portfolio, an entity may use regression analysis or a grid, matrix, or scale that would seek to achieve the following:

a. Define the adjustments and their relationship to collectability and historical/expected losses;
b. Define the various thresholds used in application (e.g., low/moderate/high or improving/stable/declining);
c. Provide a clear outline of the entity's "base" or "steady state" scenario for each adjustment upon which basis points to adjust upward or downward are then assessed;
d. Identify data points that are relevant to the adjustments and for which supporting information is readily available to the entity (generally established through a regression or other similar analysis); and
e. Establish a mechanism for using the relevant data points for the period to assess and apply basis points adjustments to historical losses, generally defined by a threshold as outlined in b. above.

Often, management concludes on an adjustment, and the supporting documentation consists exclusively of qualitative considerations in narrative form with respect to trends that are focused on a period-to-period assessment (e.g., how charge-offs have trended since last quarter or whether the underwriting policy/criteria has undergone any changes since the prior period). It is important to consider whether there are objective data points correlated with the adjustment that can be used as part of the analysis. This may be easier for factors related to economic conditions and forecasts, for example, as objective and verifiable metrics are available and often have a connection to the historical and expected credit loss experience. Even for other factors, such as experience of lending personnel, though, there are objective data points that could serve as a foundation for the adjustments, such as the average tenure of loan officers (by segment or in total), average tenure of credit analysts (by segment or in total), percentage of staff with less than a specified number of years of experience, and volume of new lender positions.

Once management has established and documented its approach for determining adjustments, it then needs to apply the method in its calculation. The magnitude of qualitative adjustments under CECL should not be anchored to the magnitude of qualitative adjustments under an incurred loss model as they are inherently different in their objective for measuring credit losses (i.e., incurred vs. lifetime). Management must be able to support not only that the change in qualitative factors from period to period is directionally appropriate, but also the amount of the adjustment itself, both from period to period and in the absolute. For example, based on an increase in downgrades from internal or external loan review in the recent quarter, management may determine that an adjustment should be made in the current quarter to the historical loss starting point. Management decides that the previous adjustment of 50 basis points is no longer appropriate and increases it to 75 basis points based on the increase in downgrades. The auditor likely will question management as to how and why a 25-basis-point period-to-period increase is appropriate, and, ultimately, why a 75-basis-point adjustment in total is adequate. In other words, the auditor will probe as to the reasonableness of the adjustment and seek to understand how it was established, reviewed and challenged in arriving at the final amount. Management should be prepared to document these considerations and maintain support for the adjustments applied as part of audit readiness. This includes documenting both positive and negative (or disconfirming) data points that were considered in arriving at the conclusion. In no case should management pre-determine the magnitude of the adjustment and then produce documentation to support it; the amount should be determined by a thorough, repeatable, well-documented process with appropriate internal controls around that process.

Model validation

The Joint Agencies have issued many pieces of supervisory guidance related to ASU 2016-13 and model risk management (MRM). Once again, while not all entities are regulated by these parties, their messaging applies to all types of financial institutions, from commercial insured depository institutions to specialty finance companies, as it relates to governance over models relied upon in the course of operations.

It is expected that the degree of MRM will vary significantly from entity to entity, based largely on the following:

- The size of the organization;
- The model's intended use;
- The degree of customization;
- The volume of variables and assumptions employed;
- Whether it was developed internally, or externally sourced; and
- The overall complexity of the model.

Models that may have a material impact on the entity's financial condition, operations or compliance generally require more significant efforts, and the allowance for a lender generally would fall into this category. As such, entities should consider the need to refine their existing MRM over the incurred loss model or develop effective MRM practices over the CECL model upon implementation if the previous model did not undergo formal, regular model governance.

There currently is not any regulation or rule that defines specific requirements for MRM, nor a formal definition of a "model" for the purposes of MRM; however, there are industry norms and overall themes that are relevant to lenders and, specifically, the allowance modeling that is expected to be part of ASU 2016-13 implementation and steady state. For the purposes of this white paper, the definition of a model as defined by the Joint Agencies is used and defined as follows:

> "A quantitative method, system, or approach that applies statistical, economic, financial, or mathematical theories, techniques, and assumptions to process input data into quantitative estimates."
>
> Joint Agencies
> (*Interagency Statement on Model Risk Management for Bank Systems Supporting Bank Secrecy Act/Anti-Money Laundering Compliance,* 2021)

This definition is considered to cover quantitative approaches with inputs partially or wholly qualitative or based on expert judgment, provided that the output is quantitative in nature. An allowance calculated under ASC 326 has both quantitative and qualitative elements, as required by the accounting standard.

Models generally have three components, as outlined in Interagency Statements on MRM:

- 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.

Generally, the information input component is subject to manual and automated controls performed by the entity to ensure that data used in the allowance model is relevant, reliable, complete and accurate. This may take the form of initial manual controls over data at a transaction date (e.g., controls over the approval and processing of charge-offs in the loan system), automated controls such as interfaces between a system of record (e.g., a loan subledger) and the model, and manual controls that reconcile data back to source documentation.

For the processing and reporting components, the output may be more complex in nature and, as a result, the nature of the model validation may require more effort. In a spreadsheet-based model, validating the accuracy of processing may be achieved through manual controls such as recalculations as well as safeguarding controls that ensure that access to the model is appropriately restricted and monitored. However, to the extent that complex macros; proprietary data and models; interactions with other systems, files or data sources; and sophisticated calculations are embedded within the model, the MRM practices may need to be more complex.

In models that were derived by third-parties or that are part of a software vendor or other third-party service provider arrangement, it is expected that MRM will be required at adoption and on an ongoing basis. While the model may be from a reputable third-party that has been through extensive due diligence at selection and that may have a SOC I Type II report available, given the significance of the allowance to lenders and the entity-specific assumptions and other customizations expected, formal, regular MRM designed specifically to address the entity's unique allowance is likely still necessary. Ultimately, the allowance and the financial statements are the responsibility of management, and thus it is crucial that management understands how the model operates and how it was tailored to meet its needs, and that it has mechanisms in place to ensure that the model is operating as intended, regardless of whether it is internally developed or externally derived or sourced.

Commonly referred to as “model validations,” these exercises are designed to challenge the models, ensuring that input, processing and output are fully functioning. Many vendors that perform model validation over the allowance under ASC 326 take into consideration both the standard’s compliance elements, such as reviewing processes and conclusions for segmentation, selection of models and certain assumptions, as well as performing procedures to assess the logic and computational components of the model that are taking place “behind the scenes.” Approaches for model validation will differ based on the nature of the model and how it is applied by the entity, and may involve the validator evaluating and testing the model itself, developing a similar or independent model to “challenge” the subject model, or a combination of these methods.

Model validations may be performed internally or externally, but it is important to remember that any personnel performing this function need to be appropriately qualified and independent of the development and implementation of the model in order to effectively challenge it. Model validations generally are performed using a risk-based approach, with frequency varying based on risk and the nature and volume of changes. Prior to implementation, the model used for calculating the allowance should be validated. Entities should plan well in advance of the adoption date to have the validation completed.

The model validation process takes time, from identifying the appropriate party to perform it to setting the scope and ultimately completing the work. Then, upon receipt of the initial findings, follow up and remediation work commonly are needed. Management should work backward in its implementation timeline to make sure it has its methodology and an initial calculation refined and ready with enough time to complete the validation, address any concerns, and then test any adjustments prior to the adoption date. Management should maintain appropriate documentation regarding vendor selection (or the identification of internal personnel), how the results of the validation were received and reviewed, and how any follow-up items or recommendations were addressed. Effective methods of providing such documentation outside of the final report include saving calendar and meeting invitations between the various parties, taking detailed minutes of meetings, retaining tracked-changes versions of memorandums and draft validation reports, and maintaining copies of emails or other correspondence between the parties that support questions asked and responses provided.

Then, on an ongoing basis, it is expected that entities develop policies and procedures over MRM to perform additional model validations. These likely will be required when a material change is made to the model, but also should be considered for new products and new methods for deriving assumptions or inputs (e.g., a new prepayment rate approach), and simply on a regular cycle given the significance of the allowance to lenders.

Internal controls

Overall

Even if your entity is not subject to an audit of internal control over financial reporting for regulatory purposes, it is still important to have an established, well-designed and appropriately monitored control structure to support operations. Audit standards require the auditor to obtain an understanding of internal control as part of its risk assessment, regardless of whether an opinion on the effectiveness of internal control is issued or whether controls are otherwise tested by the auditor.

It is important to remember that there are both entity-level controls governing the organization as a whole (e.g., its tone-at-the-top and oversight), as well as account- or transaction-specific controls. Considering the significance of the allowance to lenders, auditors will seek to gain a thorough understanding of the entire process for establishing the allowance, including identifying key controls over authorization, processing, recording, reporting and safeguarding. This includes any applicable information technology general controls (ITGCs) such as those surrounding logical security (e.g., passwords, key configurations, administrative access), security administration (e.g., user access and privileges), change management, computer operations (e.g., backups, interface monitoring, job scheduling) and program development (e.g., project design, testing and implementation, data conversion, post-implementation monitoring).

Once these controls are identified, the auditor will evaluate the design of those controls and test, at a minimum, a sample of one instance of the control's operation to determine that it has been implemented by management. Further testing of the control through additional samples also may be required depending on the objectives of the audit (i.e., whether an opinion on internal control is required) and whether the auditor plans to rely on controls to reduce any of its detail testing.

When designing an effective control framework, it is important to take a step back and consider what can go wrong along the way in each process. Examples of these risks related to ASC 326-20 implementation for financial assets held at amortized cost basis include the following:

- Management has not established policies and procedures to provide reasonable assurance that adoption of ASC 326-20 is in accordance with generally accepted accounting principles (GAAP) and that implementation is subject to appropriate internal governance.
- Accounting policy elections and practical expedients are not appropriate under ASC 326-20.
- When measuring expected credit losses in accordance with ASC 326-20, financial assets are not appropriately segmented for collective evaluation or isolated to be evaluated on an individual basis.
- Appropriate periods are not used in the calculation of expected credit losses, including contractual term, historical loss, forecast and reversion periods.
- For collateral dependent financial assets measured under the practical expedient, there is not appropriate supporting documentation for the fair value of the collateral and any discounts/adjustments made.
- The key assumptions, methodology, adjustments and outputs are not evaluated for reasonableness.
- Data used in the calculation of expected credit losses is not reliable (i.e., complete and accurate) and relevant to the entity.
- The models and related data used to calculate expected credit losses are not appropriately safeguarded to prevent unauthorized changes (e.g., user access and change management considerations).
- ITGCs and application-specific controls are not designed and implemented to ensure that models are fit for the purpose (i.e., appropriate for the entity) and operating as intended.
- Disclosures do not comply with ASC 326-20 and allow financial statement users to understand the method(s) and information used in estimating expected credit losses.

Management should have controls in place to address what can go wrong and to ensure that the allowance, as a whole, is appropriately established, reviewed and reflected in the financial records. Some risks may be addressed by a single control, whereas several controls may be needed to properly address other risks. This consideration may be impacted by the complexity of the model, the level at which the review takes place (e.g., a high-level board review vs. a detailed management review), and the extent of use of third-party service providers or vendors.

As a reminder, it is likely that allowances calculated under ASC 326-20 will require the collection and tracking of information not previously used in the incurred loss methodology. This data may not have been previously subjected to internal controls. Management will need a detailed plan to address these challenges and establish controls over the data, including testing the propriety of any data incorporated at implementation date (i.e., in the initial calculation) and on an ongoing basis.

Additionally, if management is using software or otherwise placing more reliance on its systems as part of the calculation, it should consider the risks associated with the new or revised activities and ensure that necessary information technology-related controls have been designed and implemented. This may include controls surrounding user access, change management, review of SOC I Type II reports and model validation.

It is important that management, in connection with its process documentation as discussed in the Policies and procedures section above, maintain clear evidence that it has identified controls to address the risks and that it has a mechanism in place to evaluate that those controls are properly designed, implemented, and operating at the intended frequency.

Maintaining documentation

A control may in fact be designed effectively and implemented by management, but the only way to truly prove implementation and operation of the control is to maintain sufficient supporting documentation. The same messages from the Supporting documentation section above resonate here, and it is critical that management maintain sufficient evidence that the control has operated. Inquiry alone is not sufficient audit evidence, and thus auditors may seek to supplement inquiry by inspecting calculations and other documents for notations, tickmarks or signatures and observing live instances of the control taking place. The audit process likely will be more efficient to the extent that versions of the calculation and supporting memos can be maintained (e.g., through tracked changes), that results of meetings or reviews can be thoroughly documented through minutes or emails between parties, and that reviewers can formally notate source documents.

Transition

Overall

Pursuant to ASU 2016-13, transition adjustments are to be recorded through a cumulative-effect adjustment to opening retained earnings as of the beginning of the first reporting period in which the guidance is adopted, except as it relates to ASC 326-30 on available-for-sale debt securities and provisions related to PCD financial assets within ASC 326-20. (Refer to section 1.2 of RSM's white paper, A guide to accounting for investments, loans and other receivables, for discussion of the transition approach for available-for-sale debt securities and PCD financial assets.) As such, while the auditor typically performs its procedures on the allowance as of the balance sheet date, there will be a requirement in the year of implementation to evaluate not only the allowance as of period end, but also as of the transition date. For a calendar year entity, this will mean the auditor will be testing two allowance calculations in detail, the transition and implementation calculation as of January 1 and the final calculation as of December 31. Thus, the entity should maintain supporting documentation for both calculations.

It is important to remember that entities should continue to establish and record their allowances for financial assets held at amortized cost basis under the incurred loss methodology until ASC 326-20 is effective. A build-up of reserves in anticipation of adoption is not permitted under GAAP.

Journal entries

With respect to journal entries, entities should ensure they have maintained documentation that supports the cumulative-effect adjustment to retained earnings as of the transition date. This should include not only the detailed calculation as of adoption date, but also the calculation supporting the retained earnings impact itself (i.e., the difference between the allowance amount under the incurred loss model and the CECL model at the date of adoption). Additionally, entities should be prepared to provide all supporting implementation memos and computations, together with evidence that the entry was subject to proper segregation of duties related to its preparation, approval and posting.

Disclosures

ASC 326 includes several disclosure requirements related to credit losses on financial instruments, some of which retain existing disclosures and others that either revise current disclosure requirements or create new disclosures. Entities should perform a thorough evaluation of the standard and are encouraged to create a checklist or other mechanism to ensure that it has complied with all revised disclosure requirements.

Additionally, there are certain suggested and required disclosures prior to adoption, depending on the nature of the entity. SEC registrants with financial assets within the scope of the new credit losses accounting standard are required to disclose the impact that recently issued, but not yet effective, accounting standards will have on the entity's financial information when those standards are adopted in some future period. SAB Topic 11M requires SEC registrants to disclose the impact that recently issued accounting standards will have on the registrant's balance sheet and income statement when those standards are adopted in a future period.

For non-SEC registrants, while GAAP does not explicitly require an entity to make disclosures prior to the adoption of ASC 326, the objective of general-purpose financial reporting is to provide financial information about the reporting entity that is useful to the users of the financial statements. As such, to the extent material, information concerning the adoption of ASC 326 is considered essential for a fair presentation in conformity with GAAP, and related disclosures would be necessary. Considering the significance of ASC 326 and the allowance (particularly Subtopic ASC 326-20 for financial instruments held at an amortized cost basis) to lenders, many non-SEC registrants will provide disclosure in the pre-adoption period with respect to the transition and expected magnitude.

Conclusion

The adoption of ASC 326 is multidisciplinary in so many ways, from an internal perspective with the various stakeholders involved and externally as regulators and auditors thoroughly evaluate the implementation efforts. To best prepare for the first audit upon adoption of ASC 326 and to alleviate some stress from the audit, it is recommended to consider and incorporate audit readiness into each step of the implementation process.

For additional discussion of ASC 326 and financial instruments, please review our white paper, A guide to accounting for investments, loans and other receivables.

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