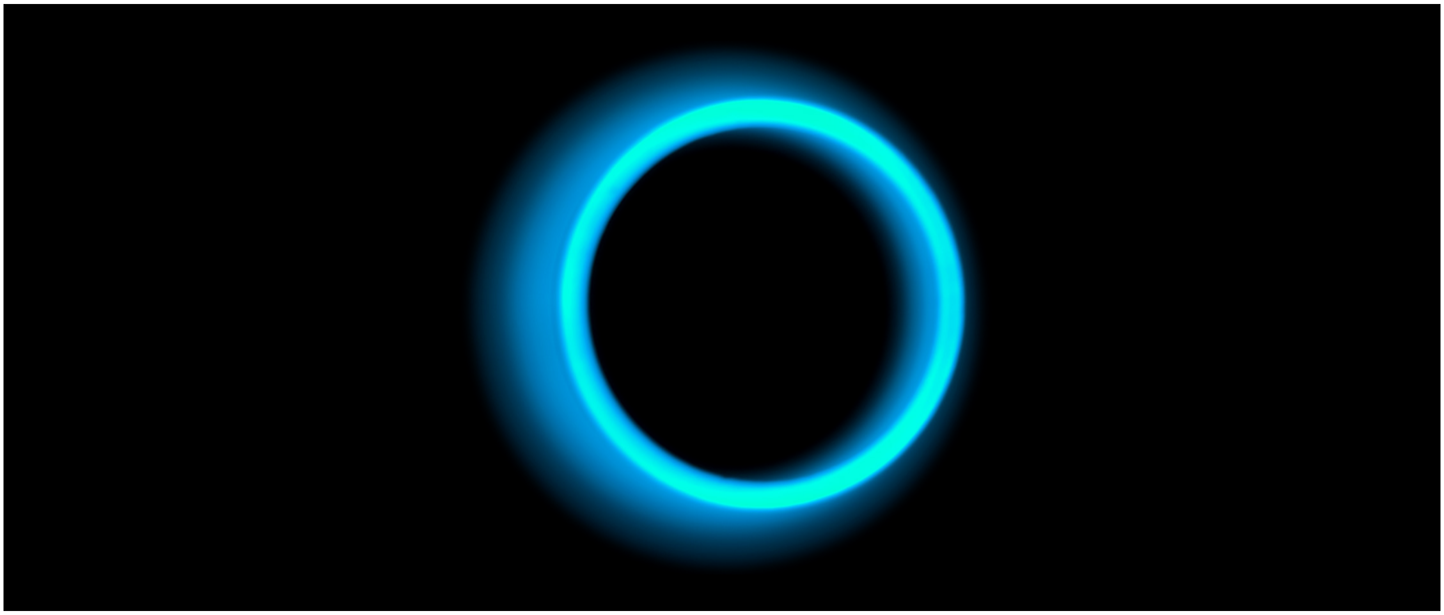

CECL 2019: Finish strong, with confidence

10 ways to gain clarity—and confidence—about CECL readiness

Is your company on a straight line to go live with the new current expected credit loss (CECL) standard when it takes effect January 1, 2020?[1] What measures are being taken to increase the certainty of that?

As companies evaluate their CECL readiness and complete the implementation, the calendar can be their most precious asset. As a result, the importance of conducting "parallel run" testing that is sufficient, effective, and informative cannot be overstated. Also imperative is an investor communication strategy that provides adequate transparency and enhances comparability between companies. Both require ample time to prepare – time that many companies are shrinking to save on costs.

To understand the scope of your CECL efforts in 2019, many companies can benefit from conducting a CECL readiness assessment now. It can serve to sharpen your organization's focus and help identify potential gaps that may lead to costly and disruptive last-minute issues. It can also increase confidence that your CECL implementation program can deliver a timely, end-to-end CECL-compliant process.

Based on Deloitte's end-to-end CECL implementation model and lessons learned in two years of client engagements, the following are actionable review steps companies can consider as they assess their CECL program and start the final sprint toward CECL adoption.

1. The Financial Accounting Standard Board's (FASB's) CECL standard takes effect for entities that are US Securities and Exchange Commission filers for fiscal years beginning after December 15, 2019.

1. Know where you are now, where you're going, and whether you're on track. The 2019 segment of your CECL journey will likely have many new twists and turns

- Evaluate the status of your program management capabilities.
- Conduct an in-depth readiness assessment as you might do for a merger announcement.
- Determine whether sufficient contingency time is built into the plan prior to your company's CECL adoption or "go live" date.
- Confirm that CECL program- and process-related roles are well defined.

Since the June 2016 issuance of the CECL standard, implementation efforts have raised many questions, including those about open accounting, that will likely challenge 2019 implementation efforts. An in-depth assessment can point toward implementation plan adjustments that can improve confidence that the adoption date can be met without unnecessary and costly last-minute changes. Since moving your go-live date is not an option, be sure to include adequate contingency time in the development program.

2. Assess your CECL allowance governance framework. CECL's allowance estimation model is complex and errors and control weaknesses could easily occur

- Review the framework governing your new CECL methodology.
- Conduct a governance committee review of key CECL decisions.
- Review the parallel run plan, including scope, timing, and resources.
- Engage with your external auditors on accounting, controls, and modeling.

Existing allowance oversight could be inadequate for many companies under the CECL standard. Your allowance governance committee is likely to need additional, more robust information for allowance decisions and preparation of external CECL communications. A clear understanding of provision drivers for each period and the sensitivity of the estimate to the various assumptions driving loss, such as forecasts, are essential for effective disclosure and investor communication. Additionally, a well-designed parallel run can boost management confidence in the implementation with the design effort itself highlighting potential program issues earlier. Remember the pivotal role of your company's external auditor in 2019; last-minute issues that arise because the auditor wasn't engaged earlier in the process may challenge your company's ability to respond in a timely and cost-effective manner.

3. Review models carefully. Simple or complex, they are the cornerstone of compliance

- Conduct a CFO-/CRO-level model review and brief your company's audit committee on the results.
- Conduct model review workshops with the modelers, accountants, and credit management group.
- Review model results in multiple reasonable and supportable (R&S) forecast scenarios.
- Define model production processes and assess operational efficiency and the ability to meet accounting close timelines.

Given the importance of the CECL estimate, a CFO-/CRO-level model review can provide a basic understanding of model performance attributes and facilitate investor dialogue. It can also reveal potential overlaps in factors being considered both within the models and through qualitative factors. Internal communications about model development can be challenging, so cross-functional workshops can provide transparency and clarity. Sensitivity analysis derived from multiple R&S forecasts can also provide a clearer understanding of model performance and volatility. Carefully planned production processing cycle times can provide sufficient time to run multiple scenarios and conduct scenario reviews. Additionally, it's important to assess how to address data lags that may result from using information other than quarter-end information in the CECL calculation.

4. Identify key data gaps. Remediation efforts could be complicated and costly

- Assess historic data set completeness, internal controls, and processes.
- Evaluate the data gap remediation plan for reasonableness and modeling impact.
- Review production data management decisions and processes.
- Confirm that data update procedures are well-controlled.

Whether you use simple or complex models, well-controlled data that reflects a full credit cycle is essential for CECL compliance. Data remediation decisions should not be left to modelers alone and should be reviewed by allowance governance leadership. Production data acquisition and management, including exposure at default (EAD) data, is often overlooked in CECL planning and can be a significant effort to integrate into the CECL model calculation.

5. Complete model validation and performance measurement soon. Late model changes are likely to be troublesome

- Conduct model validation reviews early and assess their model design impact.
- Include model validation in your parallel run.
- Define the scope of model validation as part of the overall allowance governance.
- Define ongoing quarterly and annual performance monitoring process scope and timing.

Model validation input and associated remediation can impact final model design, so receiving timely model validation feedback, including executive review, should be a top priority. Additionally, soliciting model validation feedback during parallel processing will be critical to obtaining timely final executive approval. Processes for performance monitoring of ongoing business as usual (BAU) models should be defined early and include quarterly internal control considerations. Companies should also decide whether model validation will have an expanded role in overall allowance governance, beyond its role in model review and governance.

6. Test and retest R&S forecast decisions. Many options are available

- Test R&S forecast inputs and period length for loss sensitivities.
- Verify that R&S forecasts are considered in the context of other internal economic forecasts.
- Evaluate design of the ongoing BAU R&S forecast update process and governance.
- Consider R&S forecast uncertainty in either a quantitative or qualitative adjustment.

Accounting and regulatory R&S forecast guidance continues to evolve. However, starting 2019 without near-final R&S forecast conclusions, such as R&S forecast duration, is likely to put pressure on parallel run timelines. A well-thought-out approach to whether, when, and how R&S forecast assumptions may evolve given changing circumstances should be an important part of your ongoing BAU CECL process. Additionally, an important governance consideration is the consistency of R&S forecasts relative to other internal economic forecasts. Measuring the allowance component of R&S forecast uncertainty as a qualitative adjustment may be appropriate for many companies.

7. Carefully evaluate qualitative allowance adjustments. Double-counting between quantitative and qualitative allowance components could result in restatements

- Conduct workshops to align quantitative and qualitative allowance components to reduce the risk of double-counting reserves.
- Assess whether qualitative components have sufficient quantitative support.
- Review production cut-off process and procedures for needed qualitative adjustments.
- Confirm that "relevant information" is considered in the qualitative adjustments.

Establishing separate allowance components for the same risk as part of both the quantitative and qualitative components of your allowance may lead to financial statement errors. The introduction of more complex models may increase the possibility that their theoretical application encompasses a risk that might have been simultaneously considered in a qualitative adjustment. Every effort, across all disciplines, will be necessary to ensure that risks are not considered multiple times. Many companies likely calculate the allowance estimate prior to quarter end, updating that estimate for certain critical factors. Factors such as changes in loan balances, loan risk grade migration, portfolio segment shifts, and changing R&S assumptions should be assessed as of quarter end in a robust and regimented manner subject to appropriate governance. Additional qualitative adjustments also may be required to provide assurance that relevant information which is reasonably available without undue cost is considered. This requirement may result in additional qualitative adjustments.

8. Thoroughly review the end-to-end production process. Challenges and complexities likely to emerge

- Conduct a broad review of the target operating model (TOM).
- Perform systems integration testing early.
- Confirm that the parallel run plan will thoroughly test the end-to-end process.
- Review the CECL production cycle and how it will integrate with the various closing cycles.

CECL is more complicated than today's incurred loss model. Define the TOM early and it can serve as the road map for a solid production design. Also, conducting tabletop reviews or walkthroughs of the end-to-end production process with representatives of all impacted functions may assist in identifying issues early and avoiding costly fixes late in the implementation. These walkthroughs should cover many management reviews and governance in addition to technology and control reviews. Using the results of a readiness assessment to help refine the scope of the parallel run testing effort will likely help confirm that potential risk areas are effectively tested. Further, detailed production processing design is essential for a smooth quarterly production process that is integrated with existing quarterly systems processing.

10. Carefully review internal controls. Control deficiencies can be a major CECL risk

- Perform a full walkthrough of control and governance procedures.
- Confirm that well-designed and precise internal controls are in place and clear evidence of effectiveness is available.
- Assess segregation of duties throughout the process.
- Determine that the second and third lines of defense conduct timely reviews.

The standard for measuring whether an internal control deficiency is a material weakness for financial reporting purposes is whether a deficiency or combination of deficiencies "could" result in a material misstatement of the company's financial statements. Developing appropriate internal controls, from modeling to external reporting, including data used in model development, should be one of the top objectives of companies' CECL implementation plans. Since modeling is often a team effort, a critical step is confirming that adequate segregation of duties and internal controls over access exist in model development and production. Late feedback from second and third lines of defense could lead to potential control deficiencies.

9. Develop an investor communications strategy early. CECL's flexibility and complexity increase the communications challenge

- Prepare the adoption communications plan now, not later.
- Develop the required preadoption disclosure approach early.
- Draft financial reporting disclosures including supporting "describe or discuss" information.
- Develop the investor relations strategy and consider a preadoption education session with investors.

Establishment of the communication and disclosure components of CECL compliance is often positioned toward the end of the program. However, early focus on it can help drive engagement decision making, and understanding of the CECL outcome. A key CECL disclosure consideration for public companies is the required "describe or discuss" narrative disclosures that are designed to help financial statement users understand the circumstances driving the period-over-period changes in the allowance balance. Companies should determine that adequate data is derived to inform the necessary narrative disclosures. Conducting a preadoption education session with investors may be valuable and help improve investor understanding of results that could yield benefits in April 2020 and beyond.

Final thoughts

Clarity, focus, and confidence are crucial as CFOs and other senior executives educate the board of directors, engage in leadership conversations, and communicate with investors about the final stage of CECL implementation. As you look toward 2019, these final considerations can help you enhance your company's CECL implementation efforts:

- Confirm that strong program management capabilities, transparency into the status of your company's implementation plans, and adequate contingencies exist to deal with inevitable CECL uncertainties.
- Define a detailed parallel run plan which can demonstrate that everything and everyone involved in implementation are working together efficiently, offer insights into the CECL calculations, and build the necessary skills to carry on with the CECL program after the go-live date.
- Develop a robust communication strategy that can provide useful preadoption information, help investors understand your company's CECL methodology and results, and prepare investors to better understand the company's allowance.

Let's talk

Deloitte's CECL implementation services can help you stay out front of fast-approaching deadlines and the many complexities of CECL implementation. Contact us to learn more.

Corey Goldblum
Principal | Deloitte Risk and Financial Advisory
Deloitte & Touche LLP
+1 404 220 1432
cgoldblum@deloitte.com

Gregory Norwood
Managing Director | Deloitte Risk and Financial Advisory
Deloitte & Touche LLP
+1 571 766 7804
grnorwood@deloitte.com

Jonathan Prejean
Managing Director | Deloitte Risk and Financial Advisory
Deloitte & Touche LLP
+1 703 885 6266
jprejean@deloitte.com

Troy Vollertsen
Partner | Audit & Assurance
Deloitte & Touche LLP
+1 703 885 6356
tvollertsen@deloitte.com

Peter Wilm
Managing Director | Deloitte Risk and Financial Advisory
Deloitte & Touche LLP
+1 215 246 2446
pwilm@deloitte.com

www2.deloitte.com/us/en/pages/financial-services/articles/us-current-expected-credit-losses-cecl.htm

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