Grant Thornton

Banking Audit Committee Outlook for 2020

January 2020

Introduction

This year's outlook offers audit committee members insights into key issues that will help them understand their role overseeing corporate financial reporting and disclosure.

Since the financial crisis more than a decade ago, banks have faced a number of regulatory and accounting changes. FASB's Current Expected Credit Loss Standard (CECL) takes effect on January 1, 2020 for calendar year-end for SEC issuers that are not smaller reporting companies as defined by the SEC, representing a major accounting change with significant audit and financial statement implications. The emergence of blockchain is another issue that audit committees will have to track to ensure that their controls are keeping pace with their technology. How banks will deal with reference rate reform resulting from the global transition away from referencing the London Interbank Offered Rate—or LIBOR—is another concern. Our 2020 Banking Audit Committee Outlook is designed to help audit committees understand and focus their oversight on these and other emerging issues.

Additional resources and information about Grant Thornton LLP programs for financial institutions can be found at https://www.grantthornton.com/industries/banking.aspx.

Outlook on CECL

After more than two years of preparation, CECL's effective date is nearly here. CECL is effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years, for public business entities that meet the definition of an SEC filer, excluding entities eligible to be SRCs as defined by the SEC. For all other entities, CECL will be effective for fiscal years beginning after December 15, 2022, including interim periods within those fiscal years.

Since the CECL standard was issued in June 2016, banks should have been assessing modeling methodologies and data requirements, updating policies, developing new processes and performing parallel runs in order to be ready for the effective date. With CECL being the latest, and one of the most significant, accounting change stemming from the Great Recession, many financial institutions may be experiencing accounting implementation fatigue. Meanwhile auditors have been finalizing their audit methodologies to address this highly subjective and complicated standard.

"Audit committees should be aware of several key audit risks surrounding CECL," says Rachel Binder, a senior manager within the national professional practice with Grant Thornton.

Questions to consider include:

- **How was your CECL model selected and implemented?**
  CECL requires entities to not only consider their own historical loss experience, but also incorporate reasonable and supportable forecasts into their estimate of expected credit losses. The standard provides flexibility in selecting the method utilized to perform this estimate, and is one of many areas where management can exercise their professional judgement. Therefore, the estimation technique, or techniques selected to estimate lifetime expected credit losses should be well documented by management. This documentation may also include credible challenges as to the method selection both by those in other management roles, as well as the board committee charged with oversight of CECL implementation. While there is no right answer, the method selection should be tailored to the size and complexity of the entity, while providing management's best estimate of lifetime expected credit losses.
- **Is the data used to execute the CECL allowance estimate complete and accurate?**
  Your auditors will want to know how your company determined the data utilized to develop your CECL estimate and how that historical data is both complete and accurate. For many entities, the data used to estimate credit losses comes from your core subsidiary systems, loan files and various other databases throughout the organization. If, prior to your adoption of CECL, some or all of this data did not fall within the scope of internal controls over financial reporting, you need to ensure that are both sufficient and appropriate controls were implemented as part of the implementation process to ensure these inputs are complete and accurate. If a bank supplements its own historical data or replaces its own historical experience with external data, audit committees should challenge their management teams as to how the financial institution verified completeness and accuracy of the underlying data. This would include understanding how the external data is an appropriate proxy or supplement to the entity's own internal data, and internal historical loss experience.
- **Does your bank's CECL methodology incorporate a reasonable and supportable forecast period?**
  One of the keys to answering this question is the documentation supporting management's position. Management will need to support the judgment applied to each pool of in-scope assets at each reporting period. Audit committees should be prepared to challenge management forecasts as not only reasonable assumptions that support management's position, but also the forecast period to ensure the period is consistent with other accounting estimates within the entity's financial statements.

- How did you gain comfort with your software?
  Entities may have implemented new software systems from third party service providers to assist in the computation of lifetime expected credit losses. However, management and the audit committee remain accountable for the accuracy of those calculations. There should be no black-box elements in your CECL implementation. Management needs to have a full understanding of how any third-party tools compute this estimate, and articulate that calculation to both the audit committee and their auditor. Audit committees may consider engaging an independent third party to validate their software-modeling tool, to enhance not only their understanding of the software calculation, but also provide additional assurance that the estimation is operating as intended.
- Do you have effective program governance and controls?
  Management should document their critical decisions during the CECL implementation process, from scoping the assets to performing the final parallel run. They should also be able to explain all necessary controls implemented to ensure the accuracy of the allowance for loan and lease losses as part of that process. The audit committee and others charged with governance should be sure they have reviewed and are comfortable with documentation and controls.
- Do you have a plan to transition to a business-as-usual environment?
  Many institutions have spent significant time and effort to develop an effective CECL approach. The activities have centered on the task of implementation, often centered on existing data, portfolios and products, and stretching over several months with multiple iterations, tests and validations. As institutions move past the effective date, careful consideration should be given to the processes needed to execute the CECL estimate within reporting timelines, while ensuring effective governance over the models, and develop sufficient and appropriate change management practices.

"Audit committees of calendar year-end SEC filers that are not SRC's should be mindful that they may, in accordance with SAB 74, be required to disclose the impact of CECL implementation in December 31, 2019 10-k financial statements," says Binder. "Such disclosures may be subject to audit procedures, and, in the case of large accelerated filers, auditors may determine this disclosure rises to the level of a critical audit matter. Audit committees and management should be in close contact with their auditors regarding both the relevant controls over financial reporting and the planned audit procedures over such disclosure."

If you serve on the audit committee of a private company, now is the time to ensure that management has a CECL implementation plan in place, including the necessary budgetary and personnel support, and identify any necessary third-party partners. To assist in a successful implementation, private companies could consider monitoring SEC comment letters on CECL implementation, and be able to establish best practices based on lessons learned by their public counterparts.

A final thought? "CECL is not a "set it and forget it" methodology or estimation method," says Binder. "Management and audit committees should ensure that their estimation technique is responsive to changes in economic conditions as they arise, and consistently engage in refining and improving their estimation as we continue through the next economic cycle."

Audit committee questions for management

- Can we document that our CECL model is reasonable and supportable?
- Do we have sufficient documentation for our CECL data?
- Can we adequately explain to our auditor and to regulators how and why our CECL model was selected?
- Have we established an effective internal control environment around our CECL effort?

Outlook on blockchain

Blockchain is a potentially transformative technology and has been the subject of wide discussion, not just in financial services, but in every industry. So far, though, blockchain applications have not been widely adopted in the banking sector. So how should audit committees be thinking about blockchain technology today?

“We’ve seen very few instances of blockchain-based tools being implemented at banks to date,” says Markus Veith, a partner in Grant Thornton’s audit practice who has broad experience working with clients involved with blockchain. “There has been some activity within larger consortiums and one group was recently approved by the SEC to pilot a blockchain based platform for the settlement of selected stocks.”

Veith points to certain key banking areas where he expects blockchain to be deployed soon. “Areas like payment processing, securities settlement, and trading platforms are some likely targets for near-term blockchain development,” says Veith.

Are there areas financial institution audit committees should focus on today when it comes to blockchain? “Their focus right now should be more on what relationships the institution might have with outside parties that are using blockchain and should also know if they are accepting cryptocurrency deposits,” says Veith. If an institution is working with a vendor or other third party that is using blockchain in a way that could impact the bank, the audit committee should ask management if that third party has a SOC report or some other proof that provides comfort that there are effective controls in place so that your institution can rely on the outputs from that system. Bank Secrecy Act and anti-money laundering compliance should also be a focus.

The bottom line on blockchain? “It is unlikely at most banks that blockchain is currently being used in a way that could have a material effect on the financial statements,” says Veith. “However, the institution may well be exploring or developing blockchain applications that will have such an effect in the near future. Too often, the evolution of new tools or systems gets ahead of the evolution of the controls around them. Check on any such developments now to ensure that the control environment is keeping up.”

Audit committee questions for management

- Do we currently utilize or are we developing any blockchain applications that will materially impact financial reporting?
- If so, are internal controls being developed in parallel with those tools?
- Do we have any exposure to blockchain through vendor, depositor or other third-party relationships and have we evaluated their controls?

Outlook on LIBOR

The London Interbank Offer Rate (LIBOR) will no longer be available after December 31, 2021. The scope of the challenge this presents to financial institutions is vast. Over more than three decades, LIBOR has evolved into an international standard rate supporting everything from consumer contracts, like auto loans and mortgages, to approximately $190 trillion in interest rate derivatives. It is used across the finance industry, internally and externally, for pricing, contracts, models, funding, risk management and other functions.

The Bank of England, in a statement on September 30, 2019, summed up the challenge succinctly. "Firms must be able to run their business without LIBOR from the end of 2021, so it is not in their interests to continue to increase exposures to LIBOR, or to have a large stock of legacy contracts that will become subject to significant legal uncertainty beyond that point."

"Audit committees should be working with the rest of the board and management to ensure that their institutions grasp, and are effectively planning to address, the LIBOR challenge," says Olly Dennison, a managing director in Grant Thornton's regulatory and compliance solutions practice.

Dennison recommends banks take the following steps:

- **Contain the problem.** As the Bank of England noted, the first step is to stop expanding your exposure. Remove LIBOR from all new contracts and ensure that all rollovers and renewals are tied to contracts with no LIBOR references. Change the fallback language to correctly identify alternative IBORs and the structures under which they would be used.
- **Know where you are using LIBOR.** LIBOR is likely used in functions throughout your institution, including systems and models that support pricing, risk assessment, forecasting, funding and other areas. Each area needs to be identified and updated, with consideration given to the fact that you will be moving to a new rate model that provides only a single overnight rate, not a borrowing duration view. Global and multi-currency institutions also need to implement solutions that operate across a multi-rate environment.
- **Identify your transition population.** Institutions need to complete an inventory of all loans and other contracts that reference LIBOR and that will extend past December 31, 2021. Any contracts that will renew before 2022 should be updated to change the reference rate and fallback language. Any contracts that extend beyond LIBOR's end date will need to be renegotiated.
- **Manage the LIBOR transition.** Be sure your institution has a strategy in place to deal with the LIBOR transition. Establish clear accountability for managing that process to ensure LIBOR efforts are coordinated and none of the important elements fall through the crack. Establishing a senior management leader for that effort is vital. Determine the metrics necessary around data, deals, customers, internal models and other areas to keep appropriate parties throughout the organization apprised of progress on your LIBOR effort. The audit committee will, in particular, want to ensure that LIBOR's impacts on the financial statements, which include areas like capital, net interest margin, provisions, risk models and key risk indicators, are addressed.

"It doesn't matter if yours is a $500 million community bank or a major national institution in the towers of midtown Manhattan," says Dennison, "the LIBOR transition affects every level of the financial community. Be sure you have a plan in place and that it's being followed diligently. The deadline is looming."

Audit committee questions for management

- Do we have a robust LIBOR transition strategy in place?
- Who is leading our LIBOR strategy and how is progress being measured?
- Have we identified LIBOR transition issues that could affect our financial statements?
- Have we determined our current LIBOR exposure and taken steps to keep it from expanding?

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