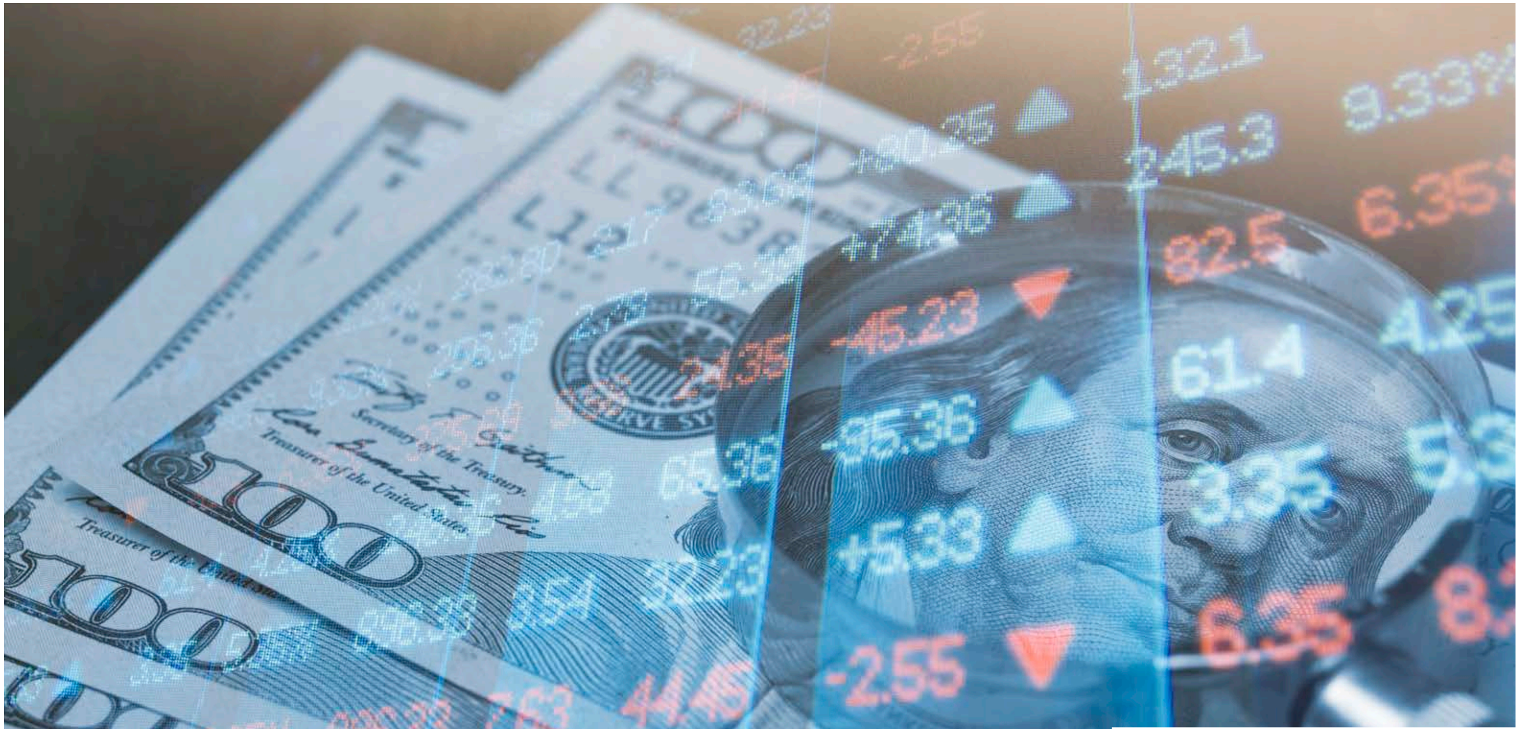


ARTICLE

Managing the Complexity of CECL, Variances in Forecasted Credit Losses

The Current Expected Credit Loss ("CECL") accounting standard requires entities to forecast credit losses expected over the life of a pool of loans. Estimating lifetime losses is complex and requires significant analysis. Regardless, at some point during the life of a loan pool, virtually every modeled forecast result will likely experience a significant variance between expected and actual losses.

Preparers should expect heavy scrutiny of these variances from auditors, regulators, shareholders, and other stakeholders who will have the benefit of hindsight in critiquing an entity's estimates and underlying process. The processes put in place during the implementation of the CECL standard should include analyzing variances to address why those variances occurred and their potential implications to the forecasts used to estimate credit losses.

It is critical to understand the underlying drivers of actual activity relative to expectations to support an assertion that the model is designed properly and operating effectively. Not being able to address the reasons for the variances could lead an auditor to conclude that internal controls are not functioning properly, which could trigger a restatement and increased shareholder litigation. Performing sufficient analysis to understand the underlying drivers of differences creates confidence in management's ability to identify the business risks, along with how those risks will change in response to economic forecasts, that should be captured in measuring expected future losses.

Preparing for Variances

Entities that have not already adopted CECL are required to do so for years beginning after December 15, 2022 (January 1, 2023 for entities with a calendar year-end), with early adoption allowed. During times of economic uncertainty, management may believe it is preferable to err on the side of conservatism when estimating reserves for expected losses. Regardless of whether management is conservative or not in determining its model inputs in response to the economic uncertainty, if the entity reports significant adjustments (positive or negative) to reserves in subsequent periods, management may find itself needing to justify its previous reserve levels in light of those subsequent changes.

The risk of missing badly on an estimate and being forced to make significant changes to underlying assumptions should be anticipated within the loan loss methodology and the internal processes developed (or modified) when adopting the CECL standard. Building processes around incorporating changes in estimates into its methodology will help management in responding to the inevitable scrutiny or challenges that will likely accompany significant changes to reserves.

Significant and systematic analysis of actual loan losses and their impact on future losses will better prepare management to manage this estimation risk. Further, that same analysis will help management avoid missing key indicators when market conditions change.

Entities will have to consistently monitor actual loan losses and compare them to forecasted loan losses. Preparers that can explain why variances have occurred and understand the implications of those variances on developing the forecasts needed to measure expected credit losses will be better prepared to respond to changes in market conditions. When reserves need to change, the methodology and analysis applied should make it clear as to not only what changes in assumptions are necessary, but when they are necessary. That analysis should consider whether the original assumptions were appropriate in light of the reasons for the variances.

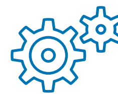
Documenting variances and the drivers of differences is essential to demonstrate that the loan loss reserving process is effective and well-controlled. It often requires significant analysis, including modeling multiple scenarios and consistently re-evaluating existing methodologies, to ensure that the underlying process results in a relevant and reliable estimate.

HOW FTI CONSULTING CAN HELP

FTI Consulting helps clients develop and enhance their accounting methodologies. We can assist with the strategy of analyzing variances and responding to stakeholder and regulator challenges to the integrity of and changes to the estimation process. Also, we can assist an entity in achieving an effective and regulatory-compliant reporting of CECL or, as an alternative, the fair value option. Because we do not provide auditing or other attestation services, we can offer the following services without creating independence conflicts:

Credit/Loan Loss Reserve Methodology (Allowance for Loan and Lease Losses)

Regulatory Compliance



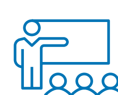
Model Development & Validation

Status Assessment/ Gap Analysis

Loan Portfolio Diagnostics

Project Management

Policy & Internal Controls Development



Training

Our Experts

FTI Consulting has a diverse team of experts with the necessary skills and experience to help entities evaluate the impact of CECL and implement it in an effective and regulatory-compliant manner. Our relevant practices include:

SEC & Accounting Advisory – Experienced professionals with extensive GAAP and SEC reporting experience, including former Big 4 audit partners and former SEC staff with a strong understanding of PCAOB audit requirements

National Office – Technical accounting CPAs who share knowledge on detailed issues across all industries and jurisdictions

Financial Services – Former high-level banking executives and in-house legal professionals who help financial institutions manage credit risk and implement policies/procedures that are consistent with leading industry practices and regulatory expectations

If you would like to discuss your CECL or fair value reporting strategy, please reach out to one of our experts listed below.

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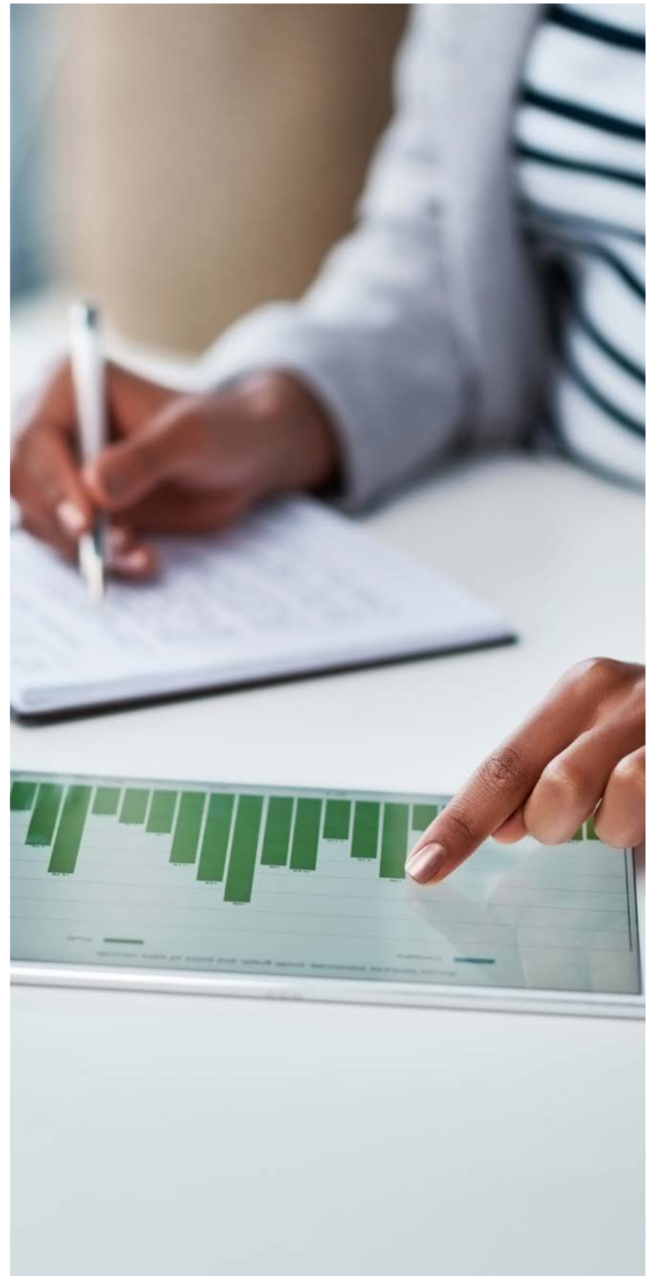

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