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Meeting highlights

Since the financial crisis a decade ago, the banking industry has faced significant regulatory scrutiny. Speakers at the AICPA National Conference on Banks and Savings Institutions, which took place September 17-19 in Washington D.C., covered a wide range of changes occurring in the accounting and auditing profession.

Implementation of the FASB’s new current expected credit loss (CECL) standard was the main topic, much like last year. However, because many banks expect to run parallel models starting in 2019, time is running out to make significant changes to methodologies and models. As our survey indicated, banks are reporting differing levels of readiness. Wes Bricker, Chief Accountant, SEC’s Office of the Chief Accountant (OCA), said we are past the questions about ‘why’ and ‘whether’ CECL will be implemented and are now asking the question of ‘how’ CECL will be implemented.

Unlike last year’s conference, the urgency to be prepared for the new CECL and leasing standards increased substantially. Speakers also discussed the PCAOB’s new auditor’s reporting model for Critical Audit Matters (CAM), which was described as the first substantive change to the model. Large accelerated filers will adopt it in 2019.

Marci Rossell, former Chief Economist for CNBC and former economist with the Federal Reserve Bank of Dallas, commented that while the stock market is experiencing all-time highs and global economic growth appears stable, cracks are emerging. Rising trade tensions between the United States and China, and instability in emerging market such as South Africa, Argentina and Turkey, put recent economic growth at risk.

Views from other speakers were similar, and questioned whether a recession was on the horizon after nearly a decade of economic growth. Hal Schroeder, FASB Board member, emphasized that financial institutions should continue to be diligent: “Banks don’t make bad loans in bad times, they make bad loans in good times.”

Speakers also discussed emerging issues such as blockchain and digital assets.

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1 ASU 2016-13, Measurement of Credit Losses on Financial Instruments
2 KPMG’s Issues & Trends, 2017 AICPA National Conference on Banks & Savings Institutions
3 CECL implementations gather steam amid uncertainty: KPMG CECL survey 2017
4 ASC 842, Leases
5 PCAOB Auditing Standard 3101, The Auditor’s Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion
Current expected credit loss standard

Countdown to adoption

While smaller banks have additional time to implement the CECL standard and appear to lag implementation at the large banks, both say they are making progress. Large banks indicate that they will begin to run parallel models starting in the first quarter of 2019. There was a general consensus that banks are well on their way by forming multi-disciplinary task forces across their organizations and are meeting regularly to ensure that implementation is moving ahead.

Much of the discussion focused on the challenges of implementing CECL, including critical decisions and documentation of internal controls. As banks make progress, they have raised several issues with the FASB that are being deliberated, such as the treatment of recoveries.

Joanne Wakim, Chief Accountant of the Federal Reserve, said that it is important that banks make a “good faith effort” to implement CECL. Regulators frequently echoed each other’s comments that there will be no bright line related to reserve amounts or methods. Regulators expect banks to comply with the CECL standard instead of achieving a certain level of reserves.

Implementation

“CECL is a team sport” speakers repeatedly said when discussing implementation efforts. They stressed that implementation efforts required input from employees in credit risk, accounting, operations, IT, internal audit and business unit leadership to address CECL’s complex implementation. Speakers reminded participants that management owns the processes, data, models, assumptions and controls regardless of whether they are developed internally or by a vendor. Further, management is responsible for its CECL estimate, which involves evaluating the individual components as well as the total estimate to determine whether it is reasonable overall.

Several speakers focused on practical application issues of the CECL standard. They pointed out that a discounted cash flow estimation model, which was initially considered the preferred model, is expected to be used only in certain circumstances, for example for interest rate concession TDRs. Wakim said that banks do not need to prepare a reconciliation between existing qualitative factors and those expected to be used under CECL. She also highlighted that while regulatory agencies are not requiring multiple economic scenarios, it is unacceptable to not make an estimate based on relevant and available information. She added that the length of the reasonable and supportable period is not considered to be an accounting policy election.
SAB 102 and FRR 28\(^6\) are important tools that banks are required to follow to establish their CECL accounting process and determine their CECL estimate, a point that was made frequently. The SEC’s Bricker said:

“… the underlying principles in the SEC staff guidance included within [SAB 102] will continue to be relevant, even after being updated to align the concepts to an expected loss measurement that incorporates reasonable and supportable forecasts. These principles include maintaining documentation and supporting evidence to facilitate the review, validation, and audit of that estimate.”

The SEC is evaluating conforming changes to SAB 102.

The necessity of audit committees’ involvement in implementation was addressed by several speakers. Audit committees should be made aware of, ask questions about and challenge management’s implementation plans, status of progress and planned changes to internal control over financial reporting.

Finally, during implementation banks should consider the reporting and analysis that will be needed to explain the estimate to management, investors or other external parties, and build the necessary processes and controls to address those requirements.

**Disclosures**

Many speakers discussed disclosures, and they reported that numerous banks have made significant progress on the modeling of credit losses under the new CECL standard. Now attention is turning to appropriate disclosures under SAB 74\(^7\) for the anticipated financial effects of adopting the new standard as well as drafting the required disclosures under the CECL standard.

Many speakers echoed that the SAB 74 disclosures are expected to be increasingly extensive as adoption deadlines near. Speakers from the SEC said that the SEC will treat SAB 74 disclosures for CECL in the same manner as those disclosures for the revenue and leases standards. “Nobody likes surprises. Transition disclosures enable investors to understand the anticipated effects of the new standard,” said Bricker.

He explained four concepts that will help investors understand the disclosures:

— explanations of new terms and key concepts;
— specific descriptions of the methodology and significant judgments made by management;
— tabular presentation of the economic assumptions; and
— quantified effects of moving from incurred to expected credit losses, disaggregated by lending portfolio.

Speakers from the SEC also stated that the intention of SAB 74 is to disclose how much progress a company has made to adopt a new standard and requires critical thinking about how it can provide insight to investors. Only a few banks

\(^6\) SAB 102, *Selected Loan Loss Allowance Methodology and Documentation Issues*; FRR 28, *Procedural Discipline in Determining the Allowance and Provision for Loan Losses to be Reported, of Section 401.09, Accounting for Loan Losses by Registrants Engaged in Lending Activities, to the Codification of Financial Reporting Policies*

\(^7\) SAB 74 (codified in SAB Topic 11-M), *Disclosure Of The Impact That Recently Issued Accounting Standards Will Have On The Financial Statements Of The Registrant When Adopted In A Future Period*
have begun to provide the expected quantitative effect that CECL will have on their allowance for loan losses and capital ratios.

Speakers discussed the disclosures required by the CECL standard, and said that disclosure work still needs to be completed, and will remain a primary focus over the next year. Banks will need to consider whether new processes and internal controls should be developed for the data being collected for the new disclosures. Specific disclosures discussed included explaining how the origination vintage disclosure is applied to revolving loans, modified loans and extensions.

Internal control over financial reporting

Incorporation of ICFR into the implementation plan was stressed by Michael Berrigan of the SEC’s OCA. Berrigan stated that changes can take time to complete because CECL processes may require changes to multiple business processes and controls.

Speakers discussed focusing on the following elements when considering ICFR.

— **Risk assessment.** Financial reporting, operational and regulatory reporting risks will likely change as a result of CECL. Identifying and evaluating those changes will be critical to designing and implementing appropriate controls.

— **Evaluation of current controls.** Current controls that are sufficient for the incurred loss methodologies may no longer be appropriate to address new methodologies and related models used to estimate CECL.

— **Day 1 vs. Day 2.** Risks identified likely will vary between Day 1 implementation and Day 2 ongoing reporting. Different controls may be needed around Day 1 cumulative effect adjustments compared with controls needed to address Day 2 accounting.

— **COSO components.** Banks should consider all COSO components when implementing new controls and evaluating appropriateness of ICFR.

Interpretive accounting issues

Many accounting issues were discussed throughout the conference, notably the FASB staff shared their views on CECL accounting topics. The members of the FASB Transition Resource Group (TRG) for Credit Losses recommended that attendees read the FASB’s papers on these topics that are published periodically on its website.\(^8\)

In addition to the TRG, the FASB staff said that banks can send inquiries to them, and pointed out that meeting minutes and webcasts will help clarify the standards and their interpretations. The SEC staff said that they will take inquiries once a bank has conducted an appropriate internal process to evaluate and support its position based on its facts and circumstances.

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\(^8\) FASB TRG for Credit Losses
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| Accrued interest⁹     | ASU 2016-13 requires entities to present financial assets measured on an amortized cost basis at the net amount expected to be collected, which includes applicable accrued interest. Stakeholders raised concerns about the operational burden and cost of tracking accrued interest at the individual loan level, changing current practice of reversal of accrued interest, and other issues. At its August 29 meeting, the FASB decided to continue to include accrued interest in the definition of the amortized cost basis, but to provide relief for the measurement, presentation and disclosure requirements for accrued interest receivable balances.¹⁰  
  The FASB decided to amend the guidance to allow entities to measure the allowance for credit losses on accrued interest receivable balances separately from other components of the amortized cost basis of associated financial assets.  
  The Board also decided to amend the guidance to allow entities to (1) make a policy election to reverse accrued interest either by an adjustment to interest income or as a deduction from the allowance for credit losses, and (2) make a separate policy election to exclude accrued interest receivable balances from the calculation of the allowance for credit losses. These elections would be contingent on the entity having an accounting policy in place that results in the timely reversal or writeoff of any unpaid accrued interest. Both policy elections would be made by class of financing receivable or major security type.  
  The FASB plans to issue an exposure draft on this topic in the fourth quarter of 2018 with a 30-day comment period. |
| Recoveries            | At its August 29 meeting, the FASB decided to amend the guidance to (1) require entities to consider expected recoveries when measuring the allowance for credit losses, and (2) limit the scope of expected recoveries to only include amounts collected from the borrower. During the conference, the FASB staff addressed this issue of recoveries from collateral versus recoveries from the borrower, stating that the Board did not intend to change existing loss models or have banks bifurcate recoveries between those from the borrower and those from collateral or sales of charged-off assets. They announced that the topic |

⁹ FASB TRG for Credit Losses meeting June 11, 2018, memo No. 9 Accrued Interest  
¹⁰ Wednesday, August 29, 2018 FASB Board meeting
### Topic | Highlights
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**Current expected credit loss standard** |  

#### of recoveries will be on the TRG agenda for November 1, 2018.

#### Fair value option at transition

Speakers from the FASB spoke about requests to provide a fair value option election at the CECL implementation date to ease transition. This potential election will be discussed by the FASB in October 2018.

#### Subsequent events

ASU 2016-13 made consequential amendments to the subsequent events accounting guidance. Stakeholders have raised questions about the treatment of common types of subsequent events that are expected to affect the allowance for credit losses under CECL. Further discussion is expected on this topic.

#### Alternative proposal for CECL

The FASB’s Schroeder commented on a proposal made by a group of banks to ease the capital effect of CECL. The proposal included a request to bifurcate the CECL estimate between a 12-month loss estimate recorded in net income, and a component comprising the remaining lifetime loss estimate recorded in other comprehensive income.

Schroeder said that the FASB will consider the proposal, which had not yet been formally submitted, during a public board meeting. He also pointed out that it may introduce additional complexity to require bifurcation of the allowance for credit losses estimate into these two components.
Critical Audit Matters

The introduction of CAMs into auditor’s reports on financial statements through the PCAOB’s AS 31015 is the most meaningful change in the auditor’s report since the 1940s. “The goal of the new standard is to make the auditor’s report more informative and relevant to investors and other users of the financial statements. As I’ve said previously, to achieve this, ongoing dialogue among auditors, audit committees, management, and others, will be critical,” said the SEC’s Bricker.

PCAOB Board member, James Kaiser, commented on the new Auditor’s Reporting Model and introduction of CAMs into PCAOB auditor’s reports. He echoed other speakers’ comments that auditor’s reports will include discussion of critical areas of the audit that were communicated or required to be communicated to audit committees, related to material accounts or disclosures in the financial statements, and that involved especially challenging, subjective or complex auditor judgment. Speakers commented that they expect many auditor’s reports of banks to disclose the allowance for loan losses as a CAM.

Kaiser commented that large firms have already conducted pilot programs to understand the effect of the standard; they are now working with large accelerated filers on dry-runs to identify and draft CAM disclosures for current audits, and are sharing those CAMs with management and audit committees to increase understanding of their effect on auditor’s reports. Kaiser said that because of the new standard “auditors need to change their processes and dialogue with management to identify CAMs … and its impact on the auditor’s report.” This is in anticipation of large accelerated filers’ adoption of the standard for fiscal years ending after June 30, 2019.

A key takeaway from the speakers’ comments was that all stakeholders of banks, especially of large accelerated filers, should be working with their auditors to understand the similarities and differences between disclosures on critical accounting estimates and critical accounting policies in Form 10-Ks compared to what is expected to be disclosed in CAMs. They should also understand what CAM disclosures their auditors will make in the financial statement audit report.

During the SEC staff’s remarks it was noted that the exercise of performing a dry-run (identifying and drafting the CAMs) and then reviewing the disclosures for related financial statement accounts should not be an exercise in negotiation or an effort to make the disclosures match. Although it is not expected that the auditors will disclose new information about the bank through the CAM disclosure, there will be new information related to the audit, which is the intention of the PCAOB standard.
PCAOB strategic plan

The PCAOB’s board member comments included discussion of the recently released draft Strategic Plan\textsuperscript{11}, whose comment period has just ended. With unprecedented turnover having occurred earlier this year, the PCAOB’s board is taking a fresh look at the way in which the PCAOB operates.

The Strategic Plan is still publicly available in its current draft form, together with the comments that were sent to the PCAOB. It will now go through a revision process and ultimately be approved by the SEC. It sets forth the major goals of the board, which focus on improving audit quality taking into account emerging technology and the need to enhance transparency and pursue operational excellence.

Kaiser said, “the [PCAOB] Board Members are champions to facilitate transformation” and “we want to connect with you and we want to hear from you.”

\footnotesize{\textsuperscript{11} PCAOB Draft Strategic Plan 2018-2022}
Other accounting highlights

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<tr>
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<tr>
<td><strong>Hedging – Layering in last-of-layer method</strong></td>
<td>The FASB staff received feedback that the ability to hedge a single layer within a closed portfolio may not be particularly useful in a last-of-layer method. Some asked whether it is possible to hedge multiple layers during the overall portfolio life. The FASB staff does not believe ASU 2017-12 allows multiple layers, and said that the Board did not contemplate these strategies in its deliberations. Outreach by the FASB has begun with development of the multiple layer, last-of-layer method and additional guidance forthcoming.12</td>
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<td><strong>Hedging – Benchmark interest rate</strong></td>
<td>In response to the ‘end of LIBOR’, the FASB tentatively decided to add the Overnight Index Swap (OIS) rate based on the Secured Overnight Financing Rate (SOFR) as a benchmark interest rate for hedge accounting purposes.10 Shayne Kuhaneck, FASB assistant director, said the FASB continues to evaluate whether additional benchmark rates, including a SOFR term rate, are needed. At its August 29, 2018 meeting, the FASB confirmed the decisions it reached in its proposed ASU.13 The FASB also added a separate project to consider changes in US GAAP necessitated by the market-wide transition from LIBOR to SOFR, with the objective of facilitating the transition.</td>
</tr>
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<td><strong>Leasing – Narrow-scope improvements</strong></td>
<td>The FASB issued ASU 2018-1114 which provides optional transition relief on adoption of ASC 842.15 Companies that elect the new transition option will not adjust their comparative period financial information for the effects of ASC 842; not make the new required lease disclosures for periods before the effective date; and carry forward their ASC 840 disclosures for comparative periods.</td>
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12 For additional guidance on the last-of-layer method, see KPMG’s Handbook, Hedging  
13 FASB Proposed ASU, Inclusion of the Overnight Index Swap (OIS) Rate Based on the Secured Overnight Financing Rate (SOFR) as a Benchmark Interest Rate for Hedge Accounting Purposes  
14 ASU 2018-11, Targeted Improvements  
15 KPMG’s Defining Issues, FASB approves new transition method and lessor practical expedient for leases standard  
16 ASC 840, Leases  

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### Other accounting highlights

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<td></td>
<td>Further, lessors may elect a practical expedient that allows them to make an accounting policy election by class of underlying asset to not separate lease and non-lease components if specified criteria are met. The FASB provided an example of common area maintenance costs on a building lease of where this practical expedient might apply. The FASB has proposed further targeted improvements for lessors. The proposed amendments address operational issues for lessors related to sales taxes, lessee payments of lessor costs, and variable payments in contracts with lease and non-lease components.</td>
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17 KPMG’s Defining Issues, FASB issues proposed ASU on narrow-scope improvements for lessors
Other highlights

Digital assets
The SEC’s Bricker highlighted several recent innovations that are expected to have a significant effect on the financial services industry, focusing on blockchain and digital assets, and the related challenges and importance of compliance with federal securities laws. He provided several illustrations to highlight management’s responsibilities about these new technologies.¹⁸

One illustration (#2) related to fair value measurement and related party disclosures. The illustration reminds banks and auditors that the anonymity of distributed ledgers requires specific considerations to determine whether those transactions are between related parties and whether the terms “reflect competitive, arm’s-length transactions between market participants.” The accounting for digital assets is an emerging area, and so far the FASB has not provided specific accounting guidance. As the technology continues to evolve, it may not be clear how to apply accounting requirements to these transactions.¹⁹

Internal control over financial reporting
ICFR was a common theme throughout the conference. Multiple SEC speakers addressed this topic. Marc Panucci, Deputy Chief Accountant of the SEC’s OCA, discussed many important questions that management should consider when designing review controls. During a Q&A session, Panucci stated the importance of dialogue with all stakeholders to ensure that the design of the review controls, along with other controls in the process, is sufficient to address the appropriate risks.

Regulatory changes
Speakers also noted that the turnover of primary regulatory institution heads will lead to some changes in the regulatory regime. However, they pointed out that it will take time for a difference in stated regulatory approach to result in a change in the actual regulatory approach.

Speakers also highlighted that five federal financial regulatory agencies have clarified that supervisory guidance is not law and does not guide enforcement actions; however, it can outline supervisory expectations, priorities and general views. The SEC reiterated its “longstanding position” that all staff statements and documents are nonbinding and create no enforceable legal rights or obligations of the SEC or other parties.²⁰ In response to these clarifications, speakers and attendees had numerous questions about how the announcements would affect regulation of individual financial institutions.

¹⁸ Remarks before the AICPA National Conference on Banks & Savings Institutions, Wesley Bricker, Chief Accountant, September 17, 2018
¹⁹ KPMG’s Defining Issues, Blockchain and digital currencies challenge traditional accounting and reporting models
²⁰ Washington Report 360 | September 14, 2018
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