ALLL Overview, Audit, and Validation

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ABOUT MOSS ADAMS LLP

- Full-service public accounting firm with assurance, tax, and consulting services for middle-market public and private companies
- One of the 15 largest accounting firms in the U.S. and largest firm headquartered on the West Coast
- 22 offices in Arizona, California, Kansas, New Mexico, Oregon, and Washington
- Founded in 1913 and headquartered in Seattle, Washington
- We are the 3rd largest firm servicing credit unions in the nation (based on assets)
- Founding member of Praxity, a global alliance of accounting firms
PRESENTERS

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PRESENTATION OBJECTIVES

• At the end of the presentation, participants should be able to:
  o Understand an overview of the allowance for loan losses
  o Understand the external auditors approach to the ALLL as part of a financial statement audit
  o Autopsy a sample allowance for loan loss calculation and identify some potential issues
  o Understand the focus and objectives of an ALLL validation and regulatory feedback on the ALLL
ALLL – WHAT IS IT?

• Nature and Purpose of the ALLL –
  o Typically, the most significant estimate in a credit union’s financial statements and regulatory reports
  o Because of the significance, each institution has a responsibility for:
    ▪ Developing,
    ▪ Maintaining, and
    ▪ Documenting a comprehensive, systematic and consistently applied process for determining the amounts of the ALLL and the provision for loan and lease losses (PLLL).
ALLL – INTERAGENCY POLICY

Interagency Policy Statement on the Allowance for Loan and Lease Losses, originally issued in 1999, with subsequent updates, gives us a road map for what the ALLL is, what components should be included or considered in the ALLL methodology, and board and management responsibility over the ALLL.
ALLL – GENERAL

• Important aspects of loan loss allowance practices are as follows:
  o Arriving at an appropriate allowance involves a high degree of management judgment and results in a range of estimated losses;
  o Prudent, conservative, but not excessive, loan loss allowances that fall within an acceptable range of estimated losses are appropriate. In accordance with GAAP, an institution should record its best estimate within the range of credit losses, including when management’s best estimate is at the high end of the range;
ALLL – GENERAL

• Important aspects of loan loss allowance practices are as follows:
  o Determining the allowance for loan losses is inevitably imprecise, and an appropriate allowance falls within a range of estimated losses;
  o An “unallocated” loan loss allowance is appropriate when it reflects an estimate of probable losses, determined in accordance with GAAP, and is properly supported;
  o Allowance estimates should be based on a comprehensive, well-documented, and consistently applied analysis of the loan portfolio; and
  o The loan loss allowance should take into consideration all available information existing as of the financial statement date, including environment factors such as industry, geographical, economic, and political factors.
ALLL – GENERAL

• Each institution’s responsibility includes ensuring controls are in place to consistently determine the ALLL in accordance with:
  o Generally Accepted Accounting Principles (GAAP),
  o The institution’s stated policies and procedures,
  o Management’s best judgment, and
  o Relevant supervisory guidance.
ALLL – GENERAL

• How is all this accomplished?

  o At least quarterly, the Credit Union must:
    ▪ Analyze the collectibility of its loans and leases (loans) held for investment; and
    ▪ Maintain an ALLL at a level that is appropriate and determined in accordance with GAAP.
EXTERNAL AUDIT OF ALLL

• How we approach
  o Policies and procedures
  o Internal controls over the loan systems
  o Mechanics of calculation
    ▪ General reserve for homogeneous loan pools
    ▪ Specific reserve for individually impaired loans
    ▪ Unallocated reserve for qualitative factors
  o Independent review of the results
POLICIES AND PROCEDURES

• Policies and procedures should cover the following:
  o General overview of ALLL
  o Homogeneous loan pools
  o TDRs and impaired loans
  o Role of those involved with the ALLL calculation
INTERNAL CONTROLS

• Elements of strong internal controls over ALLL
  o Controls over the loan systems
  o Reconciliation controls
  o Spreadsheet controls over the calculation
    ▪ Formulas/review
    ▪ Access
  o Controls over input of information into spreadsheet
  o Output and review controls
INTERNAL CONTROLS

• Areas where we find issues
  o Too much access to spreadsheet/multiple versions
  o Lack of controls over formulas/errors in formulas
  o Poor controls over input of data
    ▪ Loss histories (net charge-off entry)
    ▪ Average asset balances
    ▪ Incorrect loss rates
    ▪ Information not entered
  o Unsupported qualitative/environmental factors
INTERNAL CONTROLS

• Areas where we find issues
  o Incorrect approach to impaired loans
  o Lack of proper identification of TDR
  o Poor transfer of impaired loan information into ALLL calculation
  o Unsupported other elements of calculation
  o Calculated allowance doesn’t agree to general ledger
  o Subsequent events not properly evaluated
  o Unusual delinquencies not properly evaluated
ALLL – GENERAL

• Every credit union has a different methodology, but all methodologies should have similarities that comply with GAAP and Interagency Guidance. Including:
  o Allowance for loans collectively evaluated for impairment (ASC 450, aka FAS 5 or general reserve),
  o Qualitative factors, and
  o Allowance for loans individually evaluated for impairment (ASC 310, aka FAS 114 or specific reserve).
For loans that are collectively evaluated for impairment, the credit union must estimate the inherent loss embedded within those loans at the reporting period. That is determined by, but not limited to the following:

- Based on loss history of the credit union or using peer data, and
- Adjusted for changes in trends, conditions, and other relevant factors, known as qualitative factors (there are nine that are required to be addressed, more on this).
ALLL – LOANS COLLECTIVELY EVALUATED

• Historical loss rates

• Tracking

• Period

• Changes
ALLL – LOANS COLLECTIVELY EVALUATED

- There should be some level of disaggregation in the analysis, most typical is by loan categories based on similar loan terms and risks.
- As a loan’s risk rating increases, the corresponding amount of ALLL associated should also increase.

- The loss history and qualitative factors should be directionally consistent individually, as well as a whole.
ALLL – QUALITATIVE FACTORS

• Qualitative factors required to be considered included, but are not limited, to the following:
  o Changes in lending policies and procedures, including changes in underwriting standards and collections, charge-off, and recovery practices not considered elsewhere in estimating credit losses;
  o Changes in international, national, regional, and local economic and business conditions and developments that affect the collectibility of the portfolio, including the condition of various market segments;
ALLL – QUALITATIVE FACTORS

• Qualitative factors required to be considered included, but are not limited, to the following:
  o Changes in the nature and volume of the portfolio and in the terms of loans;
  o Changes in the experience, ability, and depth of lending management and other relevant staff;
  o Changes in the volume and severity of past due loans, the volume of nonaccrual loans, and the volume and severity of adversely classified or graded loans;
  o Changes in the quality of the institution’s loan review system;
ALLL – QUALITATIVE FACTORS

• Qualitative factors required to be considered included, but are not limited, to the following:
  o Changes in the value of underlying collateral for collateral-dependent loans;
  o The existence and effect of any concentrations of credit, and changes in the level of such concentrations; and
  o The effect of other external factors such as competition and legal and regulatory requirements on the level of estimated credit losses in the institution’s existing portfolio.
ALLL – IMPAIRED LOANS

- For all loans individually evaluated for impairment, a separate impairment analysis for each loan is required.

The ALLL is simply the total of allowance provided from the analysis of loans collectively evaluated for impairment, including the qualitative factors and those individually impaired.
ALLL - IMPAIRED LOANS

• Impaired loans
  o Definition
  o Impaired loans evaluated in pools
  o Impaired loans evaluated individually
  o Discounted cash flows
  o Fair value of loan
  o Fair value of collateral
ALLL - IMPAIRED LOANS

• Definition
  o Loans that are no longer expected to be collected in accordance with their original terms

• Certain impaired loans may be pulled out of the homogeneous reserve pools and evaluated as separate impaired loan pools
ALLL - IMPAIRED LOANS

• Individually impaired loans
  o Generally member business loans due to their size
• Measured using fair value of the loan (uncommon), discounted expected future cash flows (most common with TDRs), fair value of collateral (most common with nonperforming impaired loans where foreclosure is the most likely source of repayment
ALLL - IMPAIRED LOANS

• Fair value of collateral
  o Often determined by obtaining an appraisal, AVM, Zillow, etc.
  o Less estimated selling costs
  o Should be based on existing condition of collateral (for example, as is value

• Specific reserves

• Partial charge offs
INDEPENDENT REVIEW

• Independent review of ALLL
  o Should be performed by someone not involved in the preparation of the allowance calculation
  o Focus on
    ▪ Tick and tie all critical figures back to supporting documents
    ▪ Check all Excel formulas
    ▪ Ensure everything links properly within the document
ALLL VALIDATION ENGAGEMENT

ALLOWANCE FOR LOAN AND LEASE LOSSES (ALLL) – METHODOLOGY REVIEW

We will review the Credit Union’s compliance with Interagency Policy Statement on the Allowance for Loan and Lease Losses (the “Interagency Policy”) issued in December 2006, and subsequent updates in calculation of its estimate of the Allowance for Loan and Lease Losses and compliance with Credit Union policies and procedures for preparation and calculation of periodic estimates of allowance for loan losses. Our testing will include consideration of the following:
ALLL VALIDATION ENGAGEMENT

**ALLL Methodology** – Our testing will focus on key components of the Credit Union’s methodology, including:

- Consideration of historical Credit Union losses and recoveries.
- Provisions and methods for applying impairment analysis under FASB 114 provisions.
- Support for calculation of general reserve for various loan pools under FASB 5 provisions.
- Use of peer analysis in calculations.
- Risk classification and grading of significant credit balances.
- Frequency of re-classification and responsiveness to revisions in grading recommended by independent reviewers of credit risk classifications.
- Consideration and responsiveness to trends affecting the Credit Union’s loan portfolio, including external market conditions, concentrations in higher risk business sectors, and characteristics of the Credit Union’s portfolio including workouts, troubled debt restructurings, and delinquency volumes.
- Consideration of unfunded loan commitments and percentages assigned to these obligations in calculating the ALLL estimate.
ALLL VALIDATION ENGAGEMENT

**Accuracy of Calculations** – We will analyze and recalculate components of the Credit Union’s ALLL through review of formulas in calculation worksheets and independent summation of loan totals utilizing analysis software such as ACL and Excel.

**Responsiveness to Loan Risk Reclassification** – We will evaluate the Credit Union’s responsiveness and timeliness in reclassification of risk grading for credits that have been adversely classified in categories that significantly affect the calculation of the Credit Union’s ALLL estimates. We will rely on information pertaining to loans identified through review of periodic reporting provided by independent credit reviewers, results of examinations, and loan officer reclassification recommendations.

**Reporting of Results to the Board of Directors** – We will evaluate the frequency and content of reporting provided to the Board of Directors or appointed committees for frequency, adequacy, and accuracy.

**Use of Software in Development of Estimate** – We will evaluate the Credit Union’s use of software in developing estimates for calculation of the ALLL and procedures for validating calculations and data output.
The ALLL methodology is not in compliance with Generally Accepted Accounting Principles. In particular, Accounting Standards Codification (ASC) 310 impairment analysis and ASC 450 environmental factors have not been appropriately applied. Refer to the Risk Management Assessment page for specific ALLL findings and recommendations for improvement. Despite these deficiencies, the dollar amount of the ALLL is still more than adequate for the current risk exhibited in the loan portfolio. The ALLL totals $___ million or ___ percent of total loans, which is significantly above the peer group average of ___ percent.

Recommendation: Upon remediation of the deficiencies noted in the ASC 310 and ASC 450 analysis, management must reassess the appropriate level of the ALLL.
COMMON REGULATORY COMMENTS RELATED TO ALLL VALIDATION

Loan Pools - In accordance with Accounting Standards Codification (ASC) 450, management separated the loan portfolio into homogeneous loan pools; however, management included impaired loans in the loan pool balances. TDR loans should be removed from the loan pools and individually reserved for to prevent layering. Per NCUA IRPS 02-3, "Credit unions should ensure that they do not layer their loan loss allowances. Layering is the inappropriate practice of recording in the ALLL more than one amount for the same probable loan loss."
COMMON REGULATORY COMMENTS RELATED TO ALLL VALIDATION

TDR Impairments - The methodology for TDR impairments did not comply with the GAAP requirements addressed in ASC 310. In the ___ ALLL analysis, impairments for TDRs were based on a percentage of the deficiency balance between the loan balance and the collateral value. ASC 310 requires that all TDRs be evaluated for impairment based on net present value of future cash flows calculation, unless the loan is collateral dependent (i.e., sale of collateral is the source of loan repayment); for collateral dependent loans, the impairment may be based on fair market value.
SAMPLE ALLOWANCE CALCULATION

• Review the calculation
  • What items do you notice that may not be accurate
  • What control issues do you notice
  • Anything else
THANK YOU

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