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Welcome

Industry Overview for Financial Services Companies' Audit Committee Members

July 14, 2021

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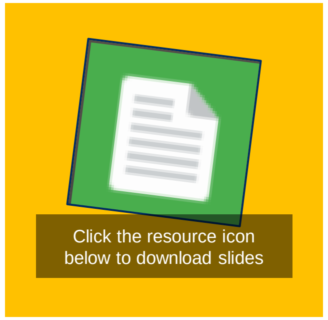

Housekeeping

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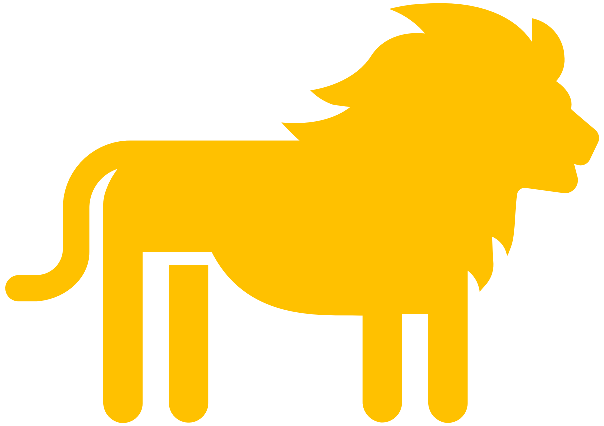
Agenda

- Financial reporting observations *(Sydney Garmong and Mark Shannon)*
  - CECL developments
  - FASB segments project
  - ESG developments
  - SEC and PCAOB developments
- Digital assets *(Matthew Schell)*
- Allowance for loan losses *(Mandi Simpson)*
- Q&A *(Kara Baldwin)*

Financial reporting observations

CECL developments



FASB Roundtable: CECL Implementation

May 20, 2021, to discuss implementation issues and proposed alternatives related to PCD/Non-PCD and TDR accounting.

Participants included preparers, analysts, auditors and regulators.

FASB staff will come back to the Board “in the near future” to discuss whether a project(s) should be added.

PCD and non-PCD accounting

- Illustrative example, loan purchased at discount:

Facts:

Purchase Price
$900,000

Par Amount
$1,000,000

Discount
($100,000)

Stated Coupon
5.00%

Purchase Yield
7.47%

Remaining Term
5 years

Initial ACL estimate
$60,000

Current Non-PCD Accounting		Proposed Gross-Up Approach	
1/1/2021 To record acquisition			
Dr. Loans 1,000,000		Dr. Loans 1,000,000	
Cr. Discount	100,000	Cr. Noncredit Discount	40,000
Cr. Cash	900,000	Cr. Allowance for credit losses	60,000
		Cr. Cash	900,000
3/31/2021 To record estimate of expected credit losses at reporting date			
Dr. Credit loss expense 60,000		There has been no change in the ACL estimate, so no entry is recorded.	
Cr. Allowance for credit losses 60,000			
3/31/2021 Income statement impact			
Interest income	$ 16,807	Interest income	$ 14,276
Credit loss expense	(60,000)		

PCD and non-PCD accounting

- Illustrative example, loan purchased at par:

Facts:
Purchase Price
$1,000,000
Par Amount
$1,000,000
Stated Coupon
5.00%
Remaining Term
5 years
Initial ACL estimate
$60,000

	Current Non-PCD Accounting	Proposed Gross-Up Approach
1/1/2021 To record acquisition		
	Dr. Loans 1,000,000 Cr. Cash 1,000,000	Dr. Loans 1,000,000 Dr. Premium* 60,000 Cr. Allowance for credit losses 60,000 Cr. Cash 1,000,000
3/31/2021 To record estimate of expected credit losses at reporting date		
	Dr. Credit loss expense 60,000 Cr. Allowance for credit losses 60,000	There has been no change in the ACL estimate, so no entry is recorded.
3/31/2021 Income statement impact		
	Interest income $ 12,500 Credit loss expense (60,000)	Interest income $ 9,712

*Under the gross-up approach, a premium is recorded (instead of a discount) for assets acquired at par or where the ACL estimate is greater than the discount.

Troubled Debt Restructurings (TDR) accounting

- Some believe TDR accounting does not provide decision-useful information after CECL adoption.
- Stakeholders proposed eliminating TDR accounting
  - Instead of evaluating modifications for TDRs, entities would determine if a modification is a new loan or a continuation of the existing loan.
    - This may require applying the “10% test” (change in present value of cash flows) to determine if the modification is more-than-minor.
  - If effect of a concession is not recognized in the ACL, entities must consider ASC 310-10 guidance that prohibits recognizing interest income if the net investment in a loan becomes greater than the payoff amount.
  - Certain disclosures related to loan modifications would be retained.

FASB agenda decisions

- FASB board meeting, July 14 at 9:00 a.m. EDT

And the decision is……

  - Agenda decisions on whether to add a project on:
    - Troubled debt restructurings (TDRs) for those who have adopted the CECL model
    - Acquired financial assets, including PCD and non-PCD financial assets

  - Discussion on whether gross write-offs and recoveries, as part of the vintage table, should:
    - Continue as a separate project
    - Removed from the technical agenda and considered in conjunction with the credit losses post-implementation review process

And the decision is……

FASB segments project

FASB segments project

Current requirements	
Current requirements ASC 280 FAS 131 (June 1997) FAS 14 (Dec. 1976)	• Management view principle • Disclose certain information about operating segments, including revenue, segment profit and loss, other items
Intervening period Previous FASB projects SEC speeches and comment letters	• 2005—Meaning of Similar Economic Characteristics • 2010—Financial Statement Presentation Project • 2012/2013—Post Implementation Review • FASAC discussions
Current project	• Users seeking better and more segment information critical to analysis (trends, forecasts) • Revising aggregation criteria considered, but current focus is enhancing disclosure of segment's "significant expenses"

Segments – FASB developments

October 2020

- Board decided to pursue a disclosure principle based on the significant segment expense categories.

March 2021

- Board decided each significant expense category would be required to be reconciled to its corresponding consolidated amount.

May 2021

- Board decided that a public entity would be required to apply the significant expense principle on an interim basis in addition to an annual basis.
- Prior period disclosures required to be recast when certain segment changes are made.

Next Steps

The staff will present an analysis of further issues related to the significant expense principle for discussion in a future meeting.

ESG developments

SEC recent ESG developments

DEVELOPMENT	DATE
Acting Chair Allison Herren Lee issues directive on staff review of climate-related disclosure	Feb. 24
SEC announces creation of a Climate and ESG Task Force in the Division of Enforcement	Mar. 4
Commissioners weigh in on enhanced focus on climate and ESG	Mar. 4
Acting Chair Allison Herren Lee issues request for comment on climate change disclosure	Mar. 15
Additional perspectives from Commissioners	Mar. 19
"SEC Responds to Investor Demand by Bringing Together Agency Information About Climate and ESG Issues"	Mar. 22

RESOURCES
SEC Speeches: https://www.sec.gov/news/speeches
SEC Public Statements: https://www.sec.gov/news/statements
SEC Press Releases: https://www.sec.gov/news/pressreleases

SEC recent ESG developments

DEVELOPMENT	DATE
SEC issues risk alert, "The Division of Examinations' Review of ESG Investing"	Apr. 9
Commissioner Peirce on ESG risk alert (statement) and ESG speech	Apr. 12 and 28
Chair testifies before House Committee on Financial Services and Subcommittee on Financial Services and General Government	May 6 and 26
Commissioner Lee, "Living in a Material World"	May 24
Commissioner Roisman, "Putting the Electric Cart Before the Horse"	June 3
Commissioner Roisman, "Can the SEC Make ESG Rules That Are Sustainable?"	June 22
Chair, "Prepared remarks at London City Week"	June 23
Commissioner Lee, "Climate, ESG, and the Board of Directors: "You Cannot Direct the Wind, But You Can Adjust Your Sails"	June 28
Commissioner Peirce, "Statement on the IFRS Foundation's Proposed Constitutional Amendments Relating to Sustainability Standards"	July 1

Comment letters on climate change request

SEC received over 5,700 comment letters

- 400+ were unique
- 5,400 represented variations of 4 different form letters.

SEC staff also documented approximately 30 meetings with stakeholder groups over the past 3 months

Comment letters climate change - themes

Users
These disclosures are important for decision-making, but the extent varies by industry.

Preparers
Transparency is important, but so is materiality, and convergence around a single standard for disclosures.

Regulators
Climate change poses a risk to the financial system and comparable, consistent and proportionate disclosure could help users appropriately estimate the impact.

Auditors
Disclosures are important, and consistency is necessary, confidence is vital, and we should leverage work of voluntary frameworks.

Crowe
A single global framework helps with comparability and transparency, auditor involvement can help with reliability, if users see a benefit, and disclosure location should be carefully considered.

Polling question

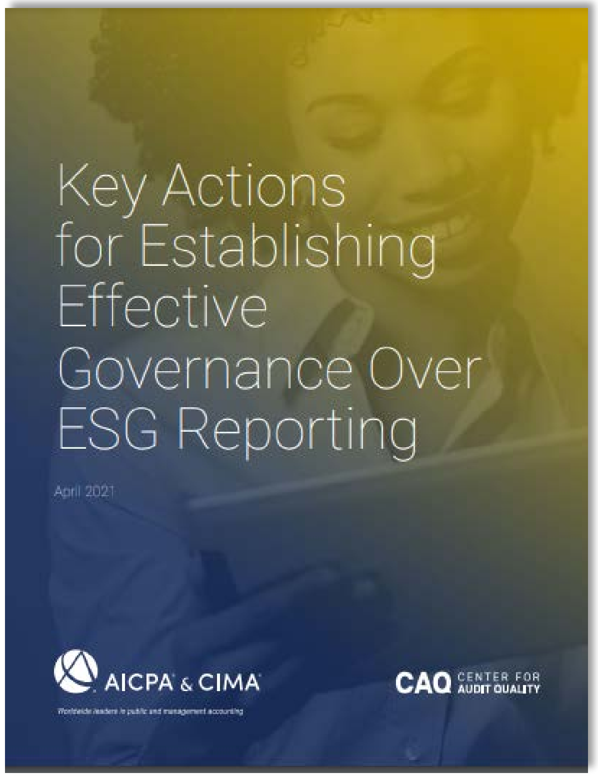
My entity responded to the SEC's request for comment on climate change disclosures:

A. Yes
B. No
C. Unsure

AICPA and CAQ ESG resources

- “Key Actions for Establishing Effective Governance Over ESG Reporting”
  - April 22, 2021
  - Conducting materiality or risk assessments
  - Board oversight and integration into ERM and overall strategy

  https://www.thecaq.org/wp-content/uploads/2021/04/caq_key-actions-for-establishing-effective-governance-over-esg-reporting_2021-04.pdf



- CAQ summary, “S&P 100 and ESG Reporting”
  - April 29, 2021
  - All provided some ESG information, most in a separate stand-alone report

  https://www.thecaq.org/sp-100-and-esg-reporting/

SEC and PCAOB developments

SEC and PCAOB landscape developments

- April 14 – Senate confirmed Gary Gensler to serve through June 2026
- Chair announced commencement of search for five new Board members of the PCAOB
- SEC recently updated its regulatory agenda to reflect Chair Gensler's priorities

SEC regulatory agenda update

Forecasted action: October 2021

- Climate change disclosure
- Human capital management
- Cybersecurity risk governance
- Corporate board diversity
- Rule 10b-5 (insider and company trading plans)

Forecasted action: April 2022

- Incentive-based compensation arrangements and claw-back listing standards
- Share repurchase disclosure modernization
- Shareholder proposals (Rule 14a-8)

https://www.reginfo.gov/public/do/eAgendaMain

Alternative perspectives:
https://www.sec.gov/news/public-statement/moving-forward-or-falling-back-statement-chair-genslers-regulatory-agenda

SEC Final Rule: Selected Financial Data, Supplementary Financial Information, and MD&A

Objective: Eliminate duplicative disclosure and modernize MD&A for the benefit of investors, while simplifying compliance efforts for preparers. Revises Items 301, 302, and 303 of Regulation S-K.

Effective date: Mandatory compliance for the first fiscal year ending on or after Aug. 9, 2021; can elect compliance with individual items prior to mandatory compliance if disclosure provided complies with the entirety of the amended item. Required for a registration statement and prospectus that on its initial filing date is required to contain <u>annual</u> financial statements for a period on or after the mandatory compliance date.

Selected Financial Data (Item 301)	Supplementary Financial Info. (Item 302)	MD&A (Item 303)
• Removes requirement to present five years of selected financial data	• Removes disclosure requirement unless a registrant reports a material retrospective change to comprehensive income for any of the quarters within the two most recent fiscal years (or subsequent interim period)	• Provides objective of MD&A • Codifies staff guidance on critical accounting estimates • Clarifies and provides certain flexibility for results of operations discussion
• Encourages preparers to consider whether presenting additional MD&A trend information preceding historical financial statement periods is needed for investors	• Auditors required to review fourth quarter information when Item 302 disclosure is required; some registrants might voluntarily disclose quarterly information; voluntary disclosure of fourth quarter information is not required to be reviewed	• Requires disclosure of prospective information that is "reasonably likely" to have a material impact • Revises liquidity and capital resources disclosure

Polling question

My entity either early adopted, or plans to early adopt, at least part of the SEC's final rule on Selected Financial Data, Supplementary Financial Information, and MD&A:

A. Yes, but only Items 301 and 302

B. Yes, including Item 303

C. No

D. N/A (not SEC registrant)

SEC Final Rule: Selected Financial Data, Supplementary Financial Information, and MD&A

MD&A (Item 303)	Disclosure Impact
Critical accounting estimates	<u>Requires</u> disclosure of each critical accounting estimate and, when material: • Why the estimate is subject to uncertainty; • How much each estimate and/or assumption has changed during the relevant period; and • The sensitivity of the reported amounts to the material methods, assumptions and estimates underlying the estimate's calculation.
Clarifies requirements to discuss material changes and provides option to compare current quarter to preceding quarter	• Requires discussion of the underlying reasons for material changes in quantitative and qualitative terms, including offsetting changes, and it changes threshold for trend discussion to "reasonably possible." • Change to discuss current quarter to preceding quarter (versus current quarter to prior year quarter); requires discussion under both methods in period of change
Revises liquidity and capital resources disclosures (including removing contractual obligations table)	Requires discussion of included material cash requirements, which might include commitments for capital expenditures, known contractual, and other obligations.

PCAOB resources

- “Spotlight: Staff Outlook for 2021 Inspections” (April 6, 2021)
  - Changes the PCAOB plans for 2021 inspections and other areas of planned inspection focus
- “Audit Committee Resource: 2021 Inspections Outlook” (April 6, 2021)
  - Companion for audit committees

Publications available: https://pcaobus.org/resources/staff-publications

Digital assets

First...some definitions

- **Blockchain technology** – A technology that records a list of records, referred to as blocks, that are linked using cryptography. Each block contains a cryptographic hash of the previous block, a timestamp and transaction data.
- **Digital assets** – Digital records, made using cryptography for verification and security purposes, on a distributed ledger (referred to as a *blockchain*).

Source: AICPA Blockchain Universal Glossary

One more definition...

Crypto asset – A type of digital asset that:

1. Functions as a medium of exchange and
2. Has all the following characteristics:
   - They are not issued by a jurisdictional authority (for example, a sovereign government).
   - They do not give rise to a contract between the holder and another party.
   - They are not considered a security under the Securities Act of 1933 or the Securities Exchange Act of 1934.

These characteristics are not all-inclusive, and other facts and circumstances may need to be considered. Examples of crypto assets meeting these characteristics include bitcoin, bitcoin cash and ether.

Source: AICPA Blockchain Universal Glossary

...and the last definition

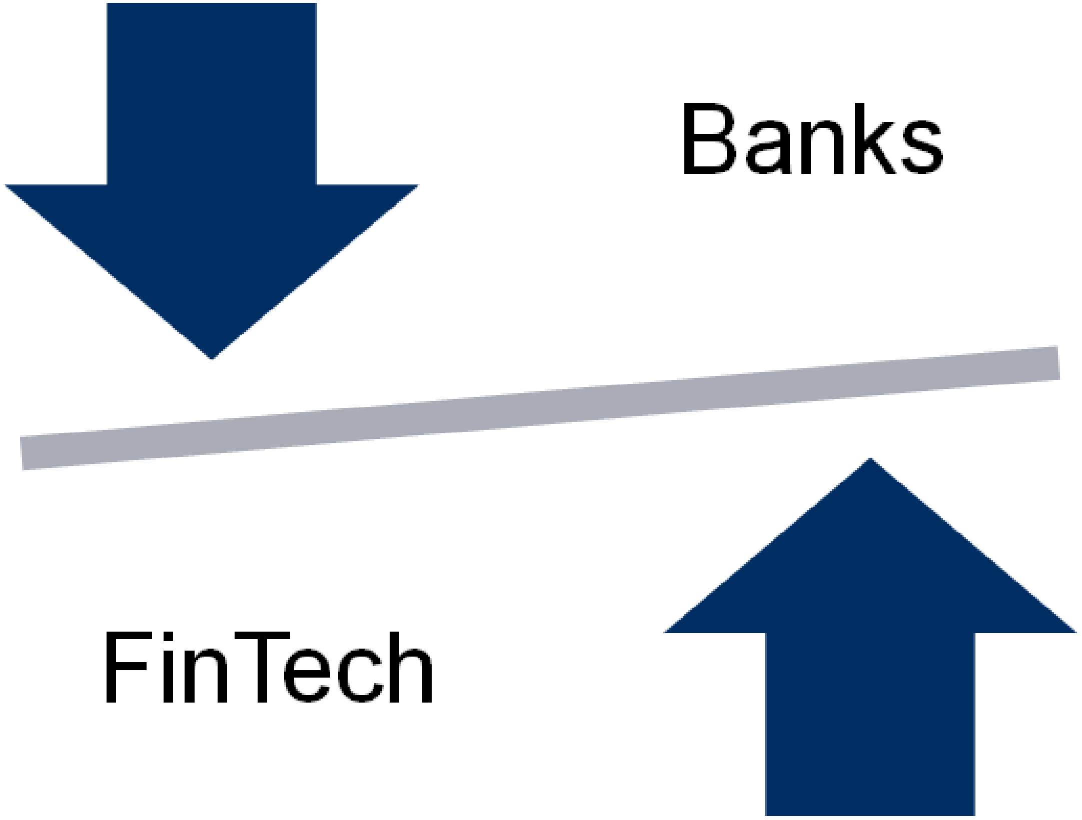
- **Stablecoins** – Digital assets that include mechanisms designed to minimize price volatility by linking their values (e.g., a “peg”) to the value of another asset such as a fiat currency, a commodity, a digital asset or basket of assets.

- Examples can be asset backed (e.g., 1:1 USD fiat currency) or could be backed by other assets (e.g., commodities, crypto assets)

Source: AICPA Blockchain Universal Glossary

Worlds colliding

- Typical applications
  - Payments/settlements
  - Custody/wealth management
  - Lending/collateral perfection
  - Merchant processing
  - Crypto ATMs
  - Stablecoins
  - Crypto rewards
  - DeFi applications (including lending, staking, etc.)
  - Investment vehicles sponsor



Where, oh where, did the accounting standards go?

- **US GAAP** – There is no specific accounting standard that explicitly addresses the accounting for digital assets.
  - Are they financial assets?
  - Are they a form of currency (e.g., cash)?
  - Are they something else?
  - What is the right accounting model?

Did you know?

- IFRS also does not have specific guidance on how to account for investments in digital assets.

The key to understanding digital asset accounting

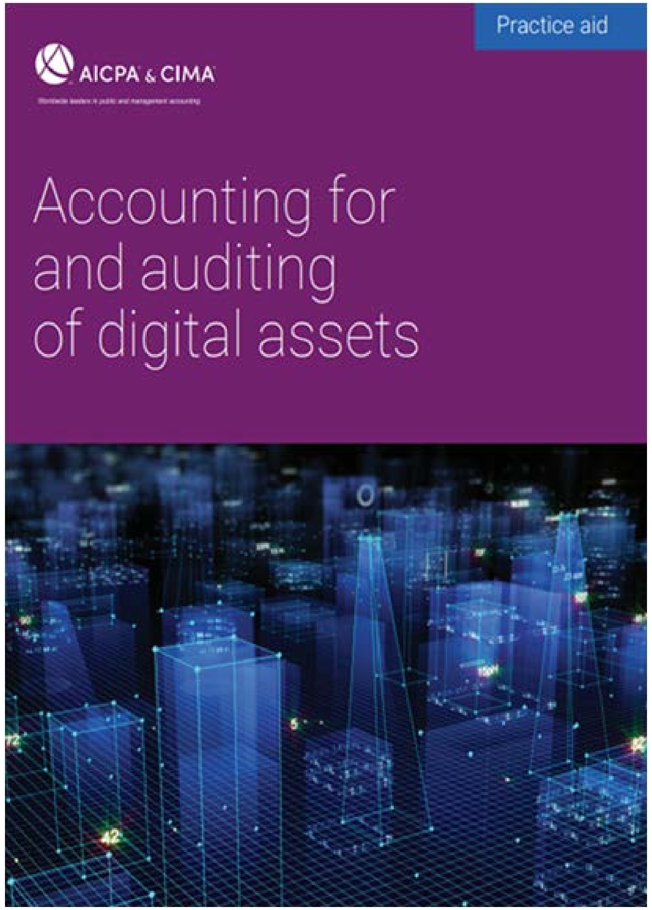
The appropriate accounting treatment for transactions involving digital assets is highly dependent on the nature of, and the rights and obligations conveyed by, the digital asset type.

- The rights and obligations associated with digital assets vary significantly.
- The accounting treatment for a digital asset will ultimately be driven by the specific terms, form, underlying rights, and obligations of the digital asset.

Efforts of the AICPA to help the industry

AICPA Digital Assets Working Group

- Develop accounting and auditing guidance for practitioners
- Provide multiple viewpoints for various ecosystem members
- Accounting
  - Focus on U.S.GAAP for non-governmental entities
  - Question and answer format
- Auditing
  - Focus on audit assurance
  - Topics address challenges unique for digital assets



https://www.aicpa.org/interestareas/informationtechnology/resources/blockchain/digital-assets.html

Applicable AICPA Q&As

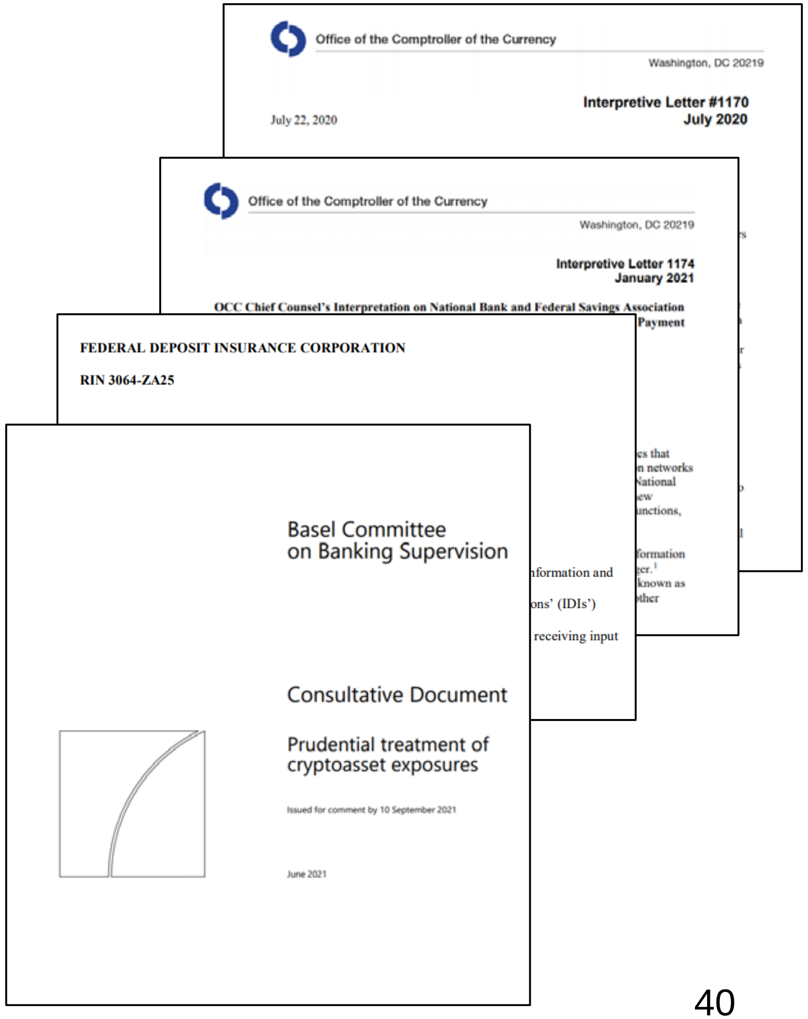
- Question 1 – How should an entity that does not apply specialized industry guidance (for example, it is not applying FASB Accounting Standards Codification [ASC] 946, Financial Services – Investment Companies) account for purchases of crypto assets for cash?
- Answer –
  - The FASB ASC Master Glossary defines intangible assets as assets (not including financial assets) that lack physical substance. Accordingly, crypto assets with the previously defined characteristics meet the definition of intangible assets and would generally be accounted for under FASB ASC 350, Intangibles – Goodwill and Other.
  - These crypto assets generally would not meet the definitions of other asset classes within generally accepted accounting principles (GAAP), and therefore, accounting for them as other than intangible assets may not be appropriate.

Applicable AICPA Q&As

- Questions 22/23 – How to account for stablecoin holdings redeemable for and backed 1:1 by U.S. dollars
- Answer –
  - Entity A's stablecoin holding would not be a derivative but does meet the definition of a financial asset under U.S. GAAP because it can be redeemed for cash. If the stablecoin also meets the definition of a security (as defined in the definition 2 in the FASB ASC Master Glossary), it would generally be accounted for under FASB ASC 320, Investments – Debt Securities. If the stablecoin does not meet the definition of a security, it would generally be accounted for under FASB ASC 310, Receivables, because it is contractually redeemable for cash. A stablecoin that meets the definition of a financial asset would also typically be eligible for the fair value option under FASB ASC 825, Financial Instruments. Depending on the relevant facts and circumstances of the stablecoins, entities may also need to consider the definitions of *cash* or *cash equivalent*.

Regulatory implications

- OCC Interpretive Letters 1170 and 1174
  - https://www.occ.gov/topics/charters-and-licensing/interpretations-and-actions/2020/int1170.pdf
  - https://www.occ.gov/news-issuances/news-releases/2021/nr-occ-2021-2a.pdf
- FDIC Request for Information and Comment on Digital Assets (comments close July 16, 2021)
  - https://www.fdic.gov/news/press-releases/2021/pr21046a.pdf
- Basel Committee on Banking Supervision
  - Consultative Document – treatment of crypto asset exposure (comments due Sept. 10, 2021)
  - https://www.bis.org/bcbs/publ/d519.pdf



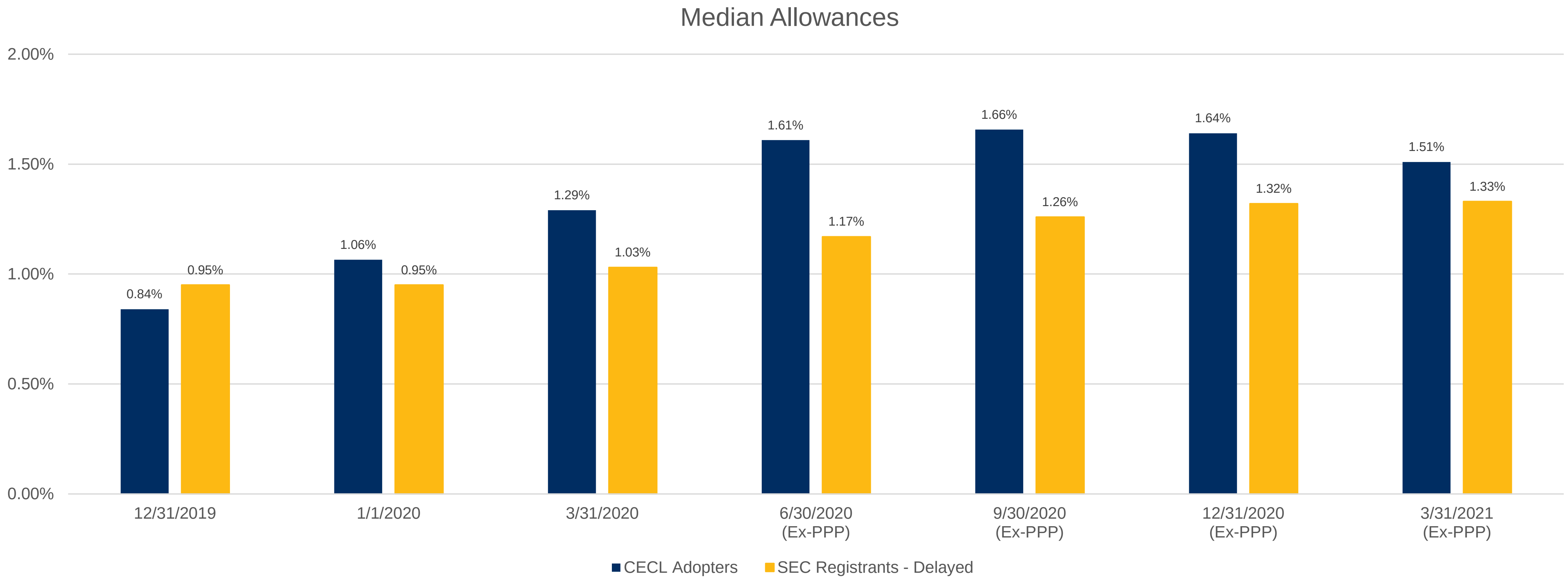
Polling question

What best describes your financial institution's CECL adoption status?

A. We have adopted CECL
B. We have not adopted CECL because we availed ourselves of the CARES Act relief and delayed adoption until no later than Jan. 1, 2022
C. We have not adopted because our original adoption date was not until FY 2023
D. I am not part of a financial institution
E. I'm not sure

Allowance for loan losses

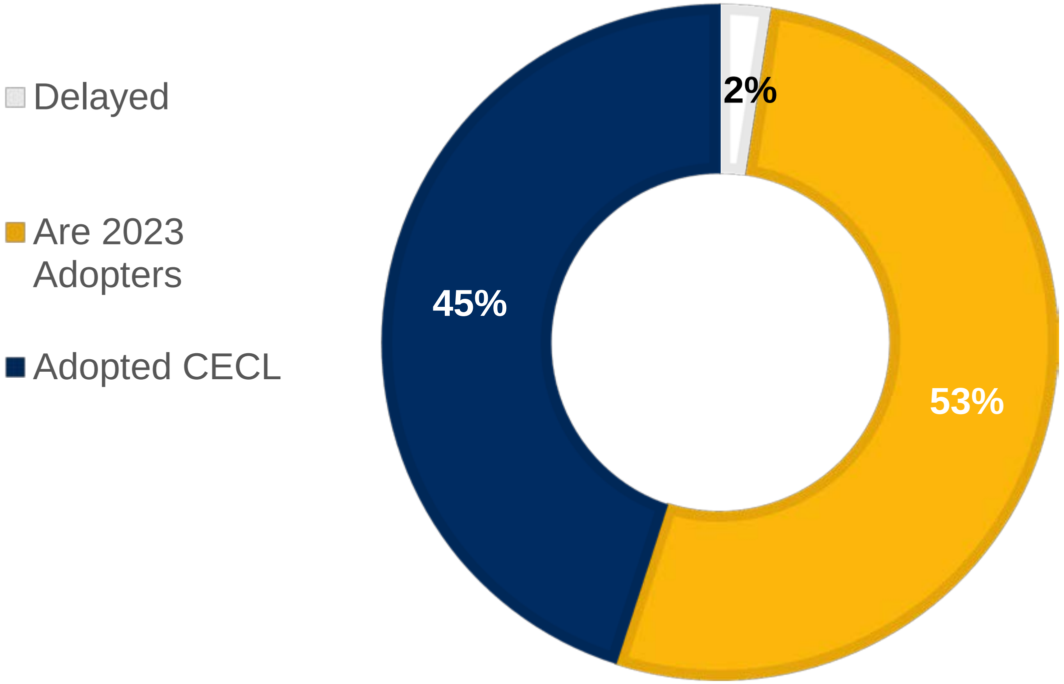
CECL vs. Incurred: Allowance Trends for SEC Filers



Source: Earnings releases filed with the SEC

CECL Adoption: The Stats

AS OF MARCH 31, 2021, PERCENTAGE OF ISSUERS WHO:



*As of Mar. 31, 2021
Source: Earnings releases filed with the SEC

# of CECL Banks @ 1/1/2020: 152
# of CECL Banks @ 3/31/2021: 167

Average increase in ACL on Day 1: 27%

Range of Day 1 ACL Impact:
-39% to +222%

CECL Adoption Dates: Reminders

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Issuers Electing the CARES Act Deferral	Must adopt as of Jan. 1, 2022 (absent an early termination of the national emergency)
All Other Institutions	Must adopt at the beginning of fiscal years beginning after Dec. 15, 2022 (i.e., Jan. 1, 2023 for calendar year-end institutions)

CECL Adoption Challenges Observed

Effectiveness of models	Extreme economic circumstances challenged the effectiveness of many models built for CECL that were primarily driven by declines in home price index or changes in unemployment.
Developing a reasonable and supportable forecast	In benign times, developing a forecast and understanding its interaction with the model may be the most difficult part of applying the standard. The pandemic increased this challenge, especially in estimating the impacts of announced and potential fiscal stimulus and loan modification efforts.
Rapidly changing economic conditions	Economic forecasts changed significantly during the first quarter and into April 2020. Significant pressure was placed on banks to communicate which economic conditions were captured in their estimate and to provide expectations of how the changing economic environment may affect future results.

Federal Reserve’s SCALE

- On Jul. 1, 2021, the Federal Reserve announced it would soon release a new tool, the Scaled CECL Allowance for Losses Estimator (SCALE), to assist community banks with < $1B in assets in calculating their allowance under CECL.
  - An “Ask the Fed” webinar will be held on Jul. 15, 2021, to launch the SCALE tool and answer questions. Registration for this session is open at www.askthefed.org/.
  - The FASB and Conference of State Bank Supervisors are expected to participate.
  - The tool will be available at https://www.supervisionoutreach.org/cecl.

CAQ CECL Tool

- Preparing for the New Credit Losses Standard: A Tool for Audit Committees (May 2019)
  - Designed to help A/Cs exercise their oversight responsibilities
  - Includes a CECL overview
  - Offers key questions and resources for A/Cs to consider

https://www.thecaq.org/wp-content/uploads/2019/05/caq_preparing_for_new_credit_losses_standard_2019-05.pdf

Questions?

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