

figures, the cost impact of this AD on U.S. operators is estimated to be \$720, or \$240 per airplane.

The cost impact figure discussed above is based on assumptions that no operator has yet accomplished any of the requirements of this AD action, and that no operator would accomplish those actions in the future if this AD were not adopted. The cost impact figures discussed in AD rulemaking actions represent only the time necessary to perform the specific actions actually required by the AD. These figures typically do not include incidental costs, such as the time required to gain access and close up, planning time, or time necessitated by other administrative actions.

### Regulatory Impact

The regulations adopted herein will not have a substantial direct effect on the States, on the relationship between the national Government and the States, or on the distribution of power and responsibilities among the various levels of government. Therefore, it is determined that this final rule does not have federalism implications under Executive Order 13132.

For the reasons discussed above, I certify that this action (1) is not a "significant regulatory action" under Executive Order 12866; (2) is not a "significant rule" under DOT Regulatory Policies and Procedures (44 FR 11034, February 26, 1979); and (3) will not have a significant economic impact, positive or negative, on a substantial number of small entities under the criteria of the Regulatory Flexibility Act. A final evaluation has been prepared for this action and it is contained in the Rules Docket. A copy of it may be obtained from the Rules Docket at the location provided under the caption **ADDRESSES**.

### List of Subjects in 14 CFR Part 39

Air transportation, Aircraft, Aviation safety, Incorporation by reference, Safety.

### Adoption of the Amendment

Accordingly, pursuant to the authority delegated to me by the Administrator, the Federal Aviation Administration amends part 39 of the Federal Aviation Regulations (14 CFR part 39) as follows:

### PART 39—AIRWORTHINESS DIRECTIVES

1. The authority citation for part 39 continues to read as follows:

**Authority:** 49 U.S.C. 106(g), 40113, 44701.

### § 39.13 [Amended]

2. Section 39.13 is amended by adding the following new airworthiness directive:

#### 2001-14-02 McDonnell Douglas:

Amendment 39-12312. Docket 2000-NM-229-AD.

**Applicability:** Model DC-9-51 and DC-9-83 series airplanes modified by Supplemental Type Certificate (STC) SA8026NM, certificated in any category.

**Note 1:** This AD applies to each airplane identified in the preceding applicability provision, regardless of whether it has been otherwise modified, altered, or repaired in the area subject to the requirements of this AD. For airplanes that have been modified, altered, or repaired so that the performance of the requirements of this AD is affected, the owner/operator must request approval for an alternative method of compliance in accordance with paragraph (c) of this AD. The request should include an assessment of the effect of the modification, alteration, or repair on the unsafe condition addressed by this AD; and, if the unsafe condition has not been eliminated, the request should include specific proposed actions to address it.

**Compliance:** Required as indicated, unless accomplished previously.

To prevent the inability of the flight crew to remove power from the in-flight entertainment (IFE) system when necessary; which, during a non-normal or emergency situation, could result in inability to control smoke or fumes in the airplane flight deck or cabin; accomplish the following:

#### Deactivation and Removal

(a) Within 18 months after the effective date of this AD, deactivate the IFE system and remove the system from the airplane, in accordance with Hollingsead International Service Bulletin 2526-2332-001, dated July 19, 2000.

#### Spares

(b) As of the effective date of this AD, no person shall install an IFE system in accordance with STC SA8026NM on any airplane.

#### Alternative Methods of Compliance

(c) An alternative method of compliance or adjustment of the compliance time that provides an acceptable level of safety may be used if approved by the Manager, Los Angeles Aircraft Certification Office (ACO), FAA. Operators shall submit their requests through an appropriate FAA Principal Maintenance Inspector, who may add comments and then send it to the Manager, Los Angeles ACO.

**Note 2:** Information concerning the existence of approved alternative methods of compliance with this AD, if any, may be obtained from the Los Angeles ACO.

#### Special Flight Permits

(d) Special flight permits may be issued in accordance with sections 21.197 and 21.199 of the Federal Aviation Regulations (14 CFR 21.197 and 21.199) to operate the airplane to a location where the requirements of this AD can be accomplished.

### Incorporation by Reference

(e) The actions shall be done in accordance with Hollingsead International Service Bulletin 2526-2332-001, dated July 19, 2000. This incorporation by reference was approved by the Director of the Federal Register in accordance with 5 U.S.C. 552(a) and 1 CFR part 51. Copies may be obtained from Hollingsead International, Inc., 7416 Hollister Avenue, Goleta, California 93117. Copies may be inspected at the FAA, Transport Airplane Directorate, 1601 Lind Avenue, SW., Renton, Washington; at the FAA, Los Angeles Aircraft Certification Office, 3960 Paramount Boulevard, Lakewood, California; or at the Office of the Federal Register, 800 North Capitol Street, NW., suite 700, Washington, DC.

### Effective Date

(f) This amendment becomes effective on August 16, 2001.

Issued in Renton, Washington, on June 29, 2001.

**Vi L. Lipski,**

*Manager, Transport Airplane Directorate, Aircraft Certification Service.*

[FR Doc. 01-17156 Filed 7-11-01; 8:45 am]

**BILLING CODE 4910-13-U**

## SECURITIES AND EXCHANGE COMMISSION

### 17 CFR Part 211

[Release No. SAB 102]

### Staff Accounting Bulletin No. 102

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Publication of staff accounting bulletin.

**SUMMARY:** This staff accounting bulletin expresses certain of the staff's views on the development, documentation, and application of a systematic methodology as required by Financial Reporting Release No. 28 for determining allowances for loan and lease losses in accordance with generally accepted accounting principles. In particular, the guidance focuses on the documentation the staff normally would expect registrants to prepare and maintain in support of their allowances for loan losses. The guidance in this staff accounting bulletin is being issued in light of the March 10, 1999 Joint Interagency Letter to Financial Institutions in which the staff agreed to provide, in parallel with guidance provided by the federal banking agencies, guidance on loan loss allowance methodologies and supporting documentation. On July 6, 2001, the federal banking agencies issued their guidance through the Federal Financial Institutions

Examination Council (FFIEC) as interagency guidance, "Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions."

**DATES:** Effective July 6, 2001.

**FOR FURTHER INFORMATION CONTACT:**

Jenifer Minke-Girard, Office of the Chief Accountant (202-942-4400), or Donald A. Walker, Jr., Division of Corporation Finance (202-942-1799), Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549; electronic addresses: Minke-GirardJ@sec.gov; WalkerDo@sec.gov.

**SUPPLEMENTARY INFORMATION:**

**Background**

In December 1986, the Commission issued Financial Reporting Release No. 28, which added subsection (b), *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 (hereafter referred to as FRR No. 28). In FRR No. 28, the Commission noted that certain registrants had appeared to lack adequate documentation of procedures for performing detailed reviews of loan portfolios and for determining amounts of allowances and provisions for loan losses. The Commission indicated that the staff normally would expect to find "that the books and records of registrants engaged in lending activities include documentation of: (a) Systematic methodology to be employed each period in determining the amount of loan losses to be reported, and (b) rationale supporting each period's determination that the amounts reported were adequate."

Since the issuance of FRR No. 28, the Commission's staff has continued to observe, in some cases, insufficient documentation of allowances for loan losses. In the ordinary course of its reviews of filings, the staff asked a number of registrants why significant favorable or unfavorable trends in the quality of the loan portfolio, as evidenced by statistical data presented in Management's Discussion and Analysis and/or in the notes to the financial statements, did not correspond with decreases or increases in the allowance for loan losses reported in the financial statements. Explanations offered by some registrants have indicated a lack of reasoned analysis or discipline in the establishment of the loss allowance. Some registrants assured the staff that they had assessed significant loans individually for

impairment, but could not produce documentation demonstrating how the loans were evaluated or how any loan impairment was measured. In other cases, registrants' internal documentation indicating that a particular loan was impaired could not be reconciled with management's ultimate decision not to provide for any loss on that loan. Several registrants that recorded loan loss allowances for pools of loans did not maintain documentation indicating how the amounts of the loan loss allowances were determined or how the amounts related to the composition of the loan pool at any particular balance sheet date.

The staff's observations were similar to those of the General Accounting Office (GAO). In its October 1994 Report to Congressional Committees, *Depository Institutions: Divergent Loan Loss Methods Undermine Usefulness of Financial Reports* (GAO Report), the GAO reported its findings resulting from its review of the loan loss reserving practices of 12 depository institutions. One of the GAO's principal findings was that most of the reviewed institutions' loan loss allowances included large supplemental reserves that generally were not linked to an analysis of loss exposure or supported by evidence.<sup>1</sup> The GAO noted: "Such use of unjustified supplemental reserves can conceal critical changes in the quality of an institution's loan portfolio and undermine the credibility of financial reports."<sup>2</sup>

In recognition of these concerns, the Federal Deposit Insurance Corporation, the Federal Reserve Board, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the Commission (together, the Agencies) issued a joint letter to financial institutions on the allowance for loan and lease losses (ALLL) on March 10, 1999 (the Joint Letter). In the Joint Letter, the Agencies announced the establishment of a Joint Working Group to study ALLL issues and to assist financial institutions by providing them with improved guidance on this topic.<sup>3</sup>

On September 7, 2000, the federal banking agencies, working through the FFIEC, sought public comment on a proposed policy statement on ALLL methodologies and documentation practices for banks and savings

institutions. After considering the 31 comment letters received on the proposed guidance, the FFIEC issued its final interagency guidance, "Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions," on July 6, 2001. This Staff Accounting Bulletin represents the SEC staff's views relating to methodologies and supporting documentation for the ALLL that should be observed by all public companies in complying with the federal securities laws and the Commission's interpretations. It is also generally consistent with the guidance published by the FFIEC on July 6, 2001.

Loan loss estimates developed without a disciplined methodology or adequate documentation (of both a disciplined methodology and the resulting amounts of loan loss provisions and allowances) can undermine the credibility of an institution's financial statements. A critical function of the independent accountant's examination of the financial statements is to evaluate the reasonableness of accounting estimates made by management, including its estimates of loan impairments and the associated allowance for loan losses.<sup>4</sup> To perform that duty, an auditor must obtain an understanding of how management developed the estimate, and must apply that understanding to the review and testing of the estimation process or its results.<sup>5</sup> The auditor must obtain sufficient competent evidential matter supporting the financial statements, and must give adequate attention to the propriety and accuracy of the data underlying material assumptions and estimates. Chapter 7 of the AICPA Audit and Accounting Guide, *Banks and Savings Institutions* (Audit Guide), states that "[a]n institution's method of estimating credit losses \* \* \* should \* \* \* be well documented, with clear explanations of the supporting analyses and rationale."<sup>6</sup> Additionally, the Audit Guide states that "the institution's conclusions about the appropriate amount [of the loan loss allowance] should be well documented."<sup>7</sup> Chapter 7<sup>8</sup> provides details of audit procedures to be performed, including procedures that relate to documentary evidence supporting the loan loss allowance. The staff believes that the documentation

<sup>1</sup> Page 5 of GAO Report.

<sup>2</sup> *Ibid.*

<sup>3</sup> The Accounting Standards Executive Committee (AcSEC) of the American Institute of Certified Public Accountants (AICPA) is in the process of developing guidance on the accounting for loan losses and the techniques for measuring probable incurred losses in a loan portfolio.

<sup>4</sup> See Auditing Accounting Estimates, AU Section 342.04.

<sup>5</sup> See AU Section 342.10.

<sup>6</sup> See paragraph 7.05, item j, in the Audit Guide.

<sup>7</sup> See paragraph 7.14 in the Audit Guide.

<sup>8</sup> See, in particular, the section on Auditing in paragraphs 7.34 to 7.74.

described in this Staff Accounting Bulletin regarding a registrant's loan loss allowance methodologies, policies, procedures, and decisions is likely to be necessary for most registrants with material loan portfolios in order to provide sufficient competent evidential matter that auditors must consider in accordance with GAAS.<sup>9</sup>

The statements in staff accounting bulletins are not rules or interpretations of the Commission, nor are they published as bearing the Commission's official approval. They represent interpretations and practices followed by the Division of Corporation Finance and the Office of the Chief Accountant in administering the disclosure requirements of the Federal securities laws.

Dated: July 6, 2001.

**Margaret H. McFarland,**  
Deputy Secretary.

## PART 211—[AMENDED]

Accordingly, Part 211 of Title 17 of the Code of Federal Regulations is amended by adding Staff Accounting Bulletin No. 102 to the table found in Subpart B.

### Staff Accounting Bulletin No. 102

**Note:** The text of Staff Accounting Bulletin No. 102 will not appear in the Code of Federal Regulations.

The staff hereby revises the title of Topic 6 of the Staff Accounting Bulletin Series to be "Interpretations of Accounting Series Releases and Financial Reporting Releases" and adds Section L entitled "Financial Reporting Release No. 28—Accounting for Loan Losses by Registrants Engaged in Lending Activities" to Topic 6.

### Topic 6: Interpretations of Accounting Series Releases and Financial Reporting Releases

\* \* \* \* \*

<sup>9</sup>In responding to requests for comment on the interagency guidance published by the FFIEC, AcSEC stated:

"Although AcSEC agrees that documentation is needed to support loss recognition, AcSEC believes the Policy Statement should make clear that financial institutions may not avoid recognizing losses by deliberately failing to comply with the Policy Statement's documentation requirements." The Commission's staff agrees with the statement made by AcSEC and reiterates that the statements made herein represent interpretations and examples of documentation that are likely to be necessary for sufficient competent evidential matter in the course of an audit in accordance with GAAS. Failure to adequately document the loan loss allowance is not in accordance with GAAP (see paragraphs 7.05 and 7.14 in the Audit Guide) and can also demonstrate a lack of adequate internal accounting controls.

### L. Financial Reporting Release No. 28—Accounting for Loan Losses by Registrants Engaged in Lending Activities

#### 1. Accounting for Loan Losses—General

Generally accepted accounting principles (GAAP) for recognition of loan losses is provided by Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies* (SFAS No. 5) and No. 114, *Accounting by Creditors for Impairment of a Loan* (SFAS No. 114).<sup>10</sup> An estimated loss from a loss contingency, such as the collectibility of receivables, should be accrued when, based on information available prior to the issuance of the financial statements, it is probable that an asset has been impaired or a liability has been incurred at the date of the financial statements and the amount of the loss can be reasonably estimated.<sup>11</sup> SFAS No. 114 provides more specific guidance on measurement of loan impairment and related disclosures but does not change the fundamental recognition criteria for loan losses provided by SFAS No. 5. Additional guidance on the recognition, measurement, and disclosure of loan losses is provided by Emerging Issues Task Force (EITF) Topic No. D-80, *Application of FASB Statements No. 5 and No. 114 to a Loan Portfolio* (EITF Topic D-80), FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss* (FIN 14), and the American Institute of Certified Public Accountants (AICPA) Audit and Accounting Guide, *Banks and Savings Institutions*.

Further guidance for SEC registrants is provided by Financial Reporting Release No. 28, which added subsection (b), *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 (hereafter referred to as FRR No. 28). Additionally, public companies are required to comply with the books and records provisions of the Securities Exchange Act of 1934 (Exchange Act). Under Sections 13(b)(2)–(7) of the Exchange Act, registrants must make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of assets of the registrant. Registrants also must maintain internal accounting controls that are sufficient to provide reasonable assurances that, among other things, transactions are recorded as necessary to permit the preparation of financial statements in conformity with GAAP.

This staff interpretation applies to all registrants that are creditors in loan transactions that, individually or in the aggregate, have a material effect on the registrant's financial statements.<sup>12</sup>

<sup>10</sup>As amended by Statement of Financial Accounting Standards No. 118, *Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures*.

<sup>11</sup>Paragraph 8 of SFAS No. 5.

<sup>12</sup>For purposes of this interpretation, a loan is defined (consistent with paragraph 4 of SFAS No. 114) as a contractual right to receive money on demand or on fixed or determinable dates that is recognized as an asset in the creditor's statement of

#### 2. Developing and Documenting a Systematic Methodology

2.A. Developing a Systematic Methodology. *Facts:* Registrant A, or one of its consolidated subsidiaries, engages in lending activities and is developing or performing a review of its loan loss allowance methodology.

*Question 1:* What are some of the factors or elements that the staff normally would expect Registrant A to consider when developing (or subsequently performing an assessment of) its methodology for determining its loan loss allowance under GAAP?

*Interpretive Response:* The staff normally would expect a registrant that engages in lending activities to develop and document a systematic methodology<sup>13</sup> to determine its provision for loan losses and allowance for loan losses as of each financial reporting date. It is critical that loan loss allowance methodologies incorporate management's current judgments about the credit quality of the loan portfolio through a disciplined and consistently applied process. A registrant's loan loss allowance methodology is influenced by entity-specific factors, such as an entity's size, organizational structure, business environment and strategy, management style, loan portfolio characteristics, loan administration procedures, and management information systems. However, as indicated in the AICPA Audit and Accounting Guide, *Banks and Savings Institutions* (Audit Guide), "[w]hile different institutions may use different methods, there are certain common elements that should be included in any [loan loss allowance] methodology for it to be effective."<sup>14</sup> A registrant's loan loss allowance methodology generally should:<sup>15</sup>

- Include a detailed analysis of the loan portfolio, performed on a regular basis;
- Consider all loans (whether on an individual or group basis);
- Identify loans to be evaluated for impairment on an individual basis under SFAS No. 114 and segment the remainder of the portfolio into groups of loans with similar risk characteristics for evaluation and analysis under SFAS No. 5;
- Consider all known relevant internal and external factors that may affect loan collectibility;
- Be applied consistently but, when appropriate, be modified for new factors affecting collectibility;

financial position. For purposes of this interpretation, loans do not include trade accounts receivable or notes receivable with terms less than one year or debt securities subject to the provisions of FASB Statement of Financial Accounting Standards No. 115, *Accounting for Certain Investments in Debt and Equity Securities*.

<sup>13</sup>FRR No. 28 states that "\* \* \* the Commission's staff normally would expect to find that the books and records of registrants engaged in lending activities include documentation of [the]: (a) systematic methodology to be employed each period in determining the amount of the loan losses to be reported, and (b) rationale supporting each period's determination that the amounts reported were adequate."

<sup>14</sup>See paragraph 7.05 of the Audit Guide.

<sup>15</sup>*Ibid.*

- Consider the particular risks inherent in different kinds of lending;
- Consider current collateral values (less costs to sell), where applicable;
- Require that analyses, estimates, reviews and other loan loss allowance methodology functions be performed by competent and well-trained personnel;
- Be based on current and reliable data;
- Be well documented, in writing, with clear explanations of the supporting analyses and rationale (see *Question 2* below for staff views on documenting a loan loss allowance methodology); and
- Include a systematic and logical method to consolidate the loss estimates and ensure the loan loss allowance balance is recorded in accordance with GAAP.

For many entities engaged in lending activities, the allowance and provision for loan losses are significant elements of the financial statements. Therefore, the staff believes it is appropriate for an entity's management to review, on a periodic basis, its methodology for determining its allowance for loan losses.<sup>16</sup> Additionally, for registrants that have audit committees, the staff believes that oversight of the financial reporting and auditing of the loan loss allowance by the audit committee can strengthen the registrant's control system and process for determining its allowance for loan losses.<sup>17</sup>

A systematic methodology that is properly designed and implemented should result in a registrant's best estimate of its allowance

<sup>16</sup> For federally insured depository institutions, the December 21, 1993 "Interagency Policy Statement on the Allowance for Loan and Lease Losses (ALLL)" (the 1993 Interagency Policy Statement) indicates that boards of directors and management have certain responsibilities for the ALLL process and amounts reported. For example, as indicated on page 4 of that statement, "the board of directors and management are expected to: Ensure that the institution has an effective loan review system and control \* \* \* [;] Ensure the prompt charge-off of loans, or portions of loans, that available information confirms to be uncollectible; and [;] Ensure that the institution's process for determining an adequate level for the ALLL is based on a comprehensive, adequately documented, and consistently applied analysis of the institution's loan and lease portfolio.\* \* \*"

<sup>17</sup> Statement on Auditing Standards No. 61, *Communication With Audit Committees* (as amended by Statement on Auditing Standards No. 90, *Audit Committee Communications*) (SAS No.61) states, in part:

"In connection with each SEC engagement \* \* \* the auditor should discuss with the audit committee the auditor's judgments about the quality, not just the acceptability, of the entity's accounting principles as applied in its financial reporting \* \* \* The discussion should \* \* \* include items that have a significant impact on the representational faithfulness, verifiability, and neutrality of the accounting information included in the financial statements. [Footnote omitted.] Examples of items that may have such an impact are the following:

- Selection of new or changes to accounting policies
- Estimates, judgments, and uncertainties
- Unusual transactions
- Accounting policies relating to significant financial statement items, including the timing or transactions and the period in which they are recorded. \* \* \*

for loan losses.<sup>18</sup> Accordingly, the staff normally would expect registrants to adjust their loan loss allowance balance, either upward or downward, in each period for differences between the results of the systematic determination process and the unadjusted loan loss allowance balance in the general ledger.<sup>19</sup>

## 2.B. Documenting a Systematic Methodology

*Question 2:* Assume the same facts as in Question 1. What would the staff normally expect Registrant A to include in its documentation of its loan loss allowance methodology?

*Interpretive Response:* In FRR No. 28, the Commission provided guidance for documentation of loan loss provisions and allowances for registrants engaged in lending activities. The staff believes that appropriate written supporting documentation for the loan loss provision and allowance facilitates review of the loan loss allowance process and reported amounts, builds discipline and consistency into the loan loss allowance determination process, and improves the process for estimating loan losses by helping to ensure that all relevant factors are appropriately considered in the allowance analysis. The staff, therefore, normally would expect a registrant to document the relationship between the findings of its detailed review of the loan portfolio and the amount of the loan loss allowance and the provision for loan losses reported in each period.<sup>20</sup>

The staff normally would expect to find that registrants maintain written supporting documentation for the following decisions, strategies, and processes:<sup>21</sup>

<sup>18</sup> Registrants should also refer to FIN 14, which provides accounting and disclosure guidance for situations in which a range of loss can be reasonably estimated but no single amount within the range appears to be a better estimate than any other amount within the range.

<sup>19</sup> Registrants should refer to the guidance on materiality in SEC Staff Accounting Bulletin No. 99, *Materiality* (SAB No. 99).

<sup>20</sup> FRR No. 28 states: "The specific rationale upon which the [loan loss allowance and provision] amount actually reported is based—i.e., the bridge between the findings of the detailed review [of the loan portfolio] and the amount actually reported in each period—would be documented to help ensure the adequacy of the reported amount, to improve auditability, and to serve as a benchmark for exercise of prudent judgment in future periods."

<sup>21</sup> Paragraph 7.39 in the Audit Guide outlines specific aspects of effective internal control related to the allowance for loan losses. These specific aspects include the control environment ("management communication of the need for proper reporting of the allowance"); management reports that summarize loan activity and the institution's procedures and controls ("accumulation of relevant, sufficient, and reliable data on which to base management's estimate of the allowance"); "independent loan review;" review of information and assumptions ("adequate review and approval of the allowance estimates by the individuals specified in management's written policy"); assessment of the process ("comparison of prior estimates related to the allowance with subsequent results to assess the reliability of the process used to develop the allowance"); and "consideration by management of whether the allowance is consistent with the operational plans of the institution."

- Policies and procedures:
- Over the systems and controls that maintain an appropriate loan loss allowance, and
- Over the loan loss allowance methodology;
- Loan grading system or process;
- Summary or consolidation of the loan loss allowance balance;
- Validation of the loan loss allowance methodology; and
- Periodic adjustments to the loan loss allowance process.

*Question 3:* The *Interpretive Response* to Question 2 indicates that the staff normally would expect to find that registrants maintain written supporting documentation for their loan loss allowance policies and procedures. In the staff's view, what aspects of a registrant's loan loss allowance internal accounting control systems and processes would appropriately be addressed in its written policies and procedures?

*Interpretive Response:* The staff is aware that registrants utilize a wide range of policies, procedures, and control systems in their loan loss allowance processes, and these policies, procedures, and systems are tailored to the size and complexity of the registrant and its loan portfolio. However, the staff believes that, in order for a registrant's loan loss allowance methodology to be effective, the registrant's written policies and procedures for the systems and controls that maintain an appropriate loan loss allowance would likely address the following:

- The roles and responsibilities of the registrant's departments and personnel (including the lending function, credit review, financial reporting, internal audit, senior management, audit committee, board of directors, and others, as applicable) who determine or review, as applicable, the loan loss allowance to be reported in the financial statements;<sup>22</sup>
- The registrant's accounting policies for loans and loan losses, including the policies for charge-offs and recoveries and for estimating the fair value of collateral, where applicable;<sup>23</sup>
- The description of the registrant's systematic methodology, which should be consistent with the registrant's accounting policies for determining its loan loss allowance (see *Question 4* below for further discussion);<sup>24</sup> and

<sup>22</sup> Paragraph 7.39 of the Audit Guide discusses "management communication of the need for proper reporting of the allowance." As indicated in that paragraph, the "control environment strongly influences the effectiveness of the system of controls and \* \* \* reflects the overall attitude, awareness, and action of the board of directors and management concerning the importance of control."

<sup>23</sup> Paragraph 7.33 of the Audit Guide refers to the documentation, for disclosure purposes, that an entity should include in the notes to the financial statements describing the accounting policies the entity used to estimate its allowance and related provision for loan losses.

<sup>24</sup> *Ibid.* As indicated in Paragraph 7.33, "[s]uch a description should identify the factors that influenced management's judgment (for example, historical losses and existing economic conditions) and may also include discussion of risk elements relevant to particular categories of financial instruments."

• The system of internal controls used to ensure that the loan loss allowance process is maintained in accordance with GAAP.<sup>25</sup>

The staff normally would expect an internal control system<sup>26</sup> for the loan loss allowance estimation process to:

• Include measures to provide assurance regarding the reliability<sup>27</sup> and integrity of information and compliance with laws, regulations, and internal policies and procedures;<sup>28</sup>

• Reasonably assure that the registrant's financial statements are prepared in accordance with GAAP; and

• Include a well-defined loan review process.<sup>29</sup>

A well-defined loan review process<sup>30</sup> typically contains:

• An effective loan grading system that is consistently applied, identifies differing risk characteristics and loan quality problems accurately and in a timely manner, and prompts appropriate administrative actions;<sup>31</sup>

• Sufficient internal controls to ensure that all relevant loan review information is appropriately considered in estimating losses. This includes maintaining appropriate reports, details of reviews performed, and identification of personnel involved;<sup>32</sup> and

• Clear formal communication and coordination between a registrant's credit administration function, financial reporting group, management, board of directors, and

<sup>25</sup> See also paragraph 7.39 in the Audit Guide which provides information about specific aspects of effective internal control related to the allowance for loan losses.

<sup>26</sup> *Ibid.* Public companies are required to comply with the books and records provisions of the Exchange Act. Under Sections 13(b)(2)–(7) of the Exchange Act, registrants must make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of assets of the registrant. Registrants also must maintain internal accounting controls that are sufficient to provide reasonable assurances that, among other things, transactions are recorded as necessary to permit the preparation of financial statements in conformity with GAAP.

<sup>27</sup> FASB Statement of Concepts No. 2, *Qualitative Characteristics of Accounting Information*, provides guidance on “reliability” as a primary quality of accounting information.

<sup>28</sup> Section 13(b)(2)–(7) of the Exchange Act.

<sup>29</sup> As indicated in paragraph 7.05, item a, in the Audit Guide, a loan loss allowance methodology should “include a detailed and regular analysis of the loan portfolio \* \* \*.” Paragraphs 7.06 to 7.13 provide additional information on how creditors traditionally identify and review loans on an individual basis and review or analyze loans on a group or pool basis.

<sup>30</sup> *Ibid.* Additionally, paragraph 7.39 in the Audit Guide provides guidance on the loan review process. As stated in that paragraph, “[m]anagement reports summarizing loan activity, renewals, and delinquencies are vital to the timely identification of problem loans.” The paragraph further states: “Loan reviews should be conducted by institution personnel who are independent of the underwriting, supervision, and collections functions. The specific lines of reporting depend on the complexity of the institution's organizational structure, but the loan reviewers should report to a high level of management that is independent from the lending process in the institution.”

<sup>31</sup> *Ibid.*

<sup>32</sup> *Ibid.*

others who are involved in the loan loss allowance determination or review process, as applicable (e.g., written policies and procedures, management reports, audit programs, and committee minutes).<sup>33</sup>

*Question 4:* The *Interpretive Response* to Question 3 indicates that the staff normally would expect a registrant's written loan loss allowance policies and procedures to include a description of the registrant's systematic allowance methodology, which should be consistent with its accounting policies for determining its loan loss allowance. What elements of a registrant's loan loss allowance methodology would the staff normally expect to be described in the registrant's written policies and procedures?

*Interpretive Response:* The staff normally would expect a registrant's written policies and procedures to describe the primary elements of its loan loss allowance methodology, including portfolio segmentation and impairment measurement. The staff normally would expect that, in order for a registrant's loan loss allowance methodology to be effective, the registrant's written policies and procedures would describe the methodology:

• For segmenting the portfolio:  
■ How the segmentation process is performed (i.e., by loan type, industry, risk rates, etc.);<sup>34</sup>

■ When a loan grading system is used to segment the portfolio:

• The definitions of each loan grade;  
• A reconciliation of the internal loan grades to supervisory loan grades, if applicable; and

• The delineation of responsibilities for the loan grading system.

• For determining and measuring impairment under SFAS No. 114:<sup>35</sup>

■ The methods used to identify loans to be analyzed individually;

■ For individually reviewed loans that are impaired, how the amount of any impairment is determined and measured, including:

• Procedures describing the impairment measurement techniques available; and  
• Steps performed to determine which technique is most appropriate in a given situation.

■ The methods used to determine whether and how loans individually evaluated under SFAS No. 114, but not considered to be individually impaired, should be grouped with other loans that share common characteristics for impairment evaluation under SFAS No. 5.<sup>36</sup>

<sup>33</sup> *Ibid.*

<sup>34</sup> Paragraph 7.07 in the Audit Guide states that “creditors have traditionally identified loans that are to be evaluated for collectibility by dividing the loan portfolio into different segments. Each segment should contain loans with similar characteristics, such as risk classification, past-due status, and type of loan.” Paragraph 7.08 provides additional guidance on classifying individual loans and paragraph 7.13 indicates considerations for groups or pools of loans.

<sup>35</sup> See SFAS No. 114, paragraphs 8 through 10 on recognition of impairment and paragraphs 11 through 16 on measurement of impairment. See also the guidance in EITF Topic D–80.

<sup>36</sup> See EITF Topic D–80, Exhibit D–80A, Question #10.

• For determining and measuring impairment under SFAS No. 5:<sup>37</sup>

■ How loans with similar characteristics are grouped to be evaluated for loan collectibility (such as loan type, past-due status, and risk);

■ How loss rates are determined (e.g., historical loss rates adjusted for environmental factors or migration analysis) and what factors are considered when establishing appropriate time frames over which to evaluate loss experience; and

■ Descriptions of qualitative factors (e.g., industry, geographical, economic, and political factors) that may affect loss rates or other loss measurements.

3. Applying a Systematic Methodology—Measuring and Documenting Loan Losses Under SFAS No. 114

### 3.A. Measuring and Documenting Loan Losses under SFAS No. 114—General

*Facts:* Approximately one-third of Registrant B's commercial loan portfolio consists of large balance, non-homogeneous loans. Due to their large individual balances, these loans meet the criteria under Registrant B's policies and procedures for individual review for impairment under SFAS No. 114. Upon review of the large balance loans, Registrant B determines that certain of the loans are impaired as defined by SFAS No. 114.<sup>38</sup>

*Question 5:* For the commercial loans reviewed under SFAS No. 114 that are individually impaired, how would the staff normally expect Registrant B to measure and document the impairment on those loans? Can it use an impairment measurement method other than the methods allowed by SFAS No. 114?

*Interpretive Response:* For those loans that are reviewed individually under SFAS No. 114 and considered individually impaired, Registrant B must use one of the methods for measuring impairment that is specified by SFAS No. 114 (that is, the present value of expected future cash flows, the loan's observable market price, or the fair value of collateral).<sup>39</sup> Accordingly, in the circumstances described above, for the loans considered individually impaired under SFAS No. 114, it would not be appropriate for Registrant B to choose a measurement method not prescribed by SFAS No. 114. For example, it would not be appropriate to measure loan impairment by applying a loss rate to each loan based on the average historical loss percentage for all of its commercial loans for the past five years.

The staff normally would expect Registrant B to maintain as sufficient, objective evidence<sup>40</sup> written documentation to support

<sup>37</sup> See SFAS No. 5, paragraphs 8(a) and 8(b) on accrual of loss contingencies and paragraphs 22 and 23 on collectibility of receivables. See also the guidance in EITF Topic D–80.

<sup>38</sup> Paragraph 8 of SFAS No. 114 provides that a loan is impaired when, based on current information and events, it is probable that all amounts due will not be collected pursuant to the terms of the loan agreement.

<sup>39</sup> See paragraph 13 of SFAS No. 114.

<sup>40</sup> Under GAAS, auditors should obtain “sufficient competent evidential matter” to support

its measurement of loan impairment under SFAS No. 114.<sup>41</sup> If Registrant B uses the present value of expected future cash flows to measure impairment of a loan, it should document the amount and timing of cash flows, the effective interest rate used to discount the cash flows, and the basis for the determination of cash flows, including consideration of current environmental factors<sup>42</sup> and other information reflecting past events and current conditions. If Registrant B uses the fair value of collateral to measure impairment, the staff normally would expect to find that Registrant B had documented how it determined the fair value, including the use of appraisals, valuation assumptions and calculations, the supporting rationale for adjustments to appraised values, if any, and the determination of costs to sell, if applicable, appraisal quality, and the expertise and independence of the appraiser.<sup>43</sup> Similarly, the staff normally would expect to find that Registrant B had documented the amount, source, and date of the observable market price of a loan, if that method of measuring loan impairment is used.

### 3.B. Measuring and Documenting Loan Losses under SFAS No. 114 for a Collateral Dependent Loan

**Facts:** Registrant C has a \$10 million loan outstanding to Company X that is secured by real estate, which Registrant C individually evaluates under SFAS No. 114 due to the loan's size. Company X is delinquent in its loan payments under the terms of the loan agreement. Accordingly, Registrant C determines that its loan to Company X is impaired, as defined by SFAS No. 114. Because the loan is collateral dependent, Registrant C measures impairment of the loan based on the fair value of the collateral. Registrant C determines that the most recent valuation of the collateral was performed by an appraiser eighteen months ago and, at that time, the estimated value of the collateral (fair value less costs to sell) was \$12 million.

Registrant C believes that certain of the assumptions that were used to value the

collateral eighteen months ago do not reflect current market conditions and, therefore, the appraiser's valuation does not approximate current fair value of the collateral. Several buildings, which are comparable to the real estate collateral, were recently completed in the area, increasing vacancy rates, decreasing lease rates, and attracting several tenants away from the borrower. Accordingly, credit review personnel at Registrant C adjust certain of the valuation assumptions to better reflect the current market conditions as they relate to the loan's collateral.<sup>44</sup> After adjusting the collateral valuation assumptions, the credit review department determines that the current estimated fair value of the collateral, less costs to sell, is \$8 million.<sup>45</sup> Given that the recorded investment in the loan is \$10 million, Registrant C concludes that the loan is impaired by \$2 million and records an allowance for loan losses of \$2 million.

**Question 6:** What documentation would the staff normally expect Registrant C to maintain to support its determination of the allowance for loan losses of \$2 million for the loan to Company X?

**Interpretive Response:** The staff normally would expect Registrant C to document that it measured impairment of the loan to Company X by using the fair value of the loan's collateral, less costs to sell, which it estimated to be \$8 million.<sup>46</sup> This documentation<sup>47</sup> should include the registrant's rationale and basis for the \$8 million valuation, including the revised valuation assumptions it used, the valuation calculation, and the determination of costs to sell, if applicable. Because Registrant C arrived at the valuation of \$8 million by modifying an earlier appraisal, it should document its rationale and basis for the changes it made to the valuation assumptions that resulted in the collateral value declining from \$12 million eighteen months ago to \$8 million in the current period.

### 3.C. Measuring and Documenting Loan Losses under SFAS No. 114—Fully Collateralized Loans

**Question 7:** In the staff's view, what is an example of an acceptable documentation practice for a registrant to adequately support its determination that no allowance for loan losses should be recorded for a group of loans because the loans are fully collateralized?

**Interpretive Response:** Consider the following fact pattern: Registrant D has \$10

million in loans that are fully collateralized by highly rated debt securities with readily determinable market values. The loan agreement for each of these loans requires the borrower to provide qualifying collateral sufficient to maintain a loan-to-value ratio with sufficient margin to absorb volatility in the securities' market prices. Registrant D's collateral department has physical control of the debt securities through safekeeping arrangements. In addition, Registrant D perfected its security interest in the collateral when the funds were originally distributed. On a quarterly basis, Registrant D's credit administration function determines the market value of the collateral for each loan using two independent market quotes and compares the collateral value to the loan carrying value. If there are any collateral deficiencies, Registrant D notifies the borrower and requests that the borrower immediately remedy the deficiency. Due in part to its efficient operation, Registrant D has historically not incurred any material losses on these loans. Registrant D believes these loans are fully-collateralized and therefore does not maintain any loan loss allowance balance for these loans.

Registrant D's management summary of the loan loss allowance includes documentation indicating that, in accordance with its loan loss allowance policy, the collateral protection on these loans has been verified by the registrant, no probable loss has been incurred, and no loan loss allowance is necessary. Documentation in Registrant D's loan files includes the two independent market quotes obtained each quarter for each loan's collateral amount, the documents evidencing the perfection of the security interest in the collateral, and other relevant supporting documents. Additionally, Registrant D's loan loss allowance policy includes a discussion of how to determine when a loan is considered "fully collateralized" and does not require a loan loss allowance. Registrant D's policy requires the following factors to be considered and its findings concerning these factors to be fully documented:

- Volatility of the market value of the collateral;
- Recency and reliability of the appraisal or other valuation;
- Recency of the registrant's or third party's inspection of the collateral;
- Historical losses on similar loans;
- Confidence in the registrant's lien or security position including appropriate:
  - Type of security perfection (e.g., physical possession of collateral or secured filing);
  - Filing of security perfection (i.e., correct documents and with the appropriate officials); and
  - Relationship to other liens; and
  - Other factors as appropriate for the loan type.

In the staff's view, Registrant D's documentation supporting its determination that certain of its loans are fully collateralized, and no loan loss allowance should be recorded for those loans, is acceptable under FRR No. 28.

its audit opinion. See AU Section 326, *Evidential Matter*. The staff normally would expect registrants to maintain such evidential matter for its allowances for loan losses for use by the auditors in conducting their annual audit.

<sup>41</sup> Paragraph 7.45 in the Audit Guide outlines sources of information, available from management, that the independent accountant should consider in identifying loans that contain high credit risk or other significant exposures and concentrations. These sources of information would also likely include documentation of loan impairment under SFAS No. 114 or SFAS No. 5. Additionally, as indicated in paragraphs 7.56 to 7.68 of the Audit Guide, the independent accountant, in conducting an audit, may perform a detailed loan file review for selected loans. A registrant's loan files may contain documentation about borrowers' financial resources and cash flows (see paragraph 7.63) or about the collateral securing the loans, if applicable (see paragraphs 7.65 and 7.66).

<sup>42</sup> Question #16 in Exhibit D-80A of EITF Topic D-80 indicates that environmental factors include existing industry, geographical, economic, and political factors.

<sup>43</sup> See paragraphs 7.65 and 7.66 in the Audit Guide for additional information about documentation of loan collateral.

<sup>44</sup> When reviewing collateral dependent loans, Registrant C may often find it more appropriate to obtain an updated appraisal to estimate the effect of current market conditions on the appraised value instead of internally estimating an adjustment.

<sup>45</sup> An auditor who uses the work of a specialist, such as an appraiser, in performing an audit in accordance with generally accepted auditing standards (GAAS) should refer to the guidance in AU Section 336, *Using the Work of a Specialist*.

<sup>46</sup> See paragraphs 7.65 to 7.66 in the Audit Guide for further information about documentation of loan collateral and associated audit procedures that may be performed by the independent accountant.

<sup>47</sup> As stated in paragraph 7.14 of the Audit Guide, "[t]he institution's conclusions about the appropriate amount [of loan impairment and the allowance for loan losses] should be well documented."

#### 4. Applying a Systematic Methodology—Measuring and Documenting Loan Losses under SFAS No. 5

##### 4.A. Measuring and Documenting Loan Losses under SFAS No. 5—General

*Question 8:* In the staff's view, what are some general considerations for a registrant in applying its systematic methodology to measure and document loan losses under SFAS No. 5?

*Interpretive Response:* For loans evaluated on a group basis under SFAS No. 5, the staff believes that a registrant should segment the loan portfolio by identifying risk characteristics that are common to groups of loans.<sup>48</sup> Registrants typically decide how to segment their loan portfolios based on many factors, which vary with their business strategies as well as their information system capabilities. Regardless of the segmentation method used, the staff normally would expect a registrant to maintain documentation to support its conclusion that the loans in each segment have similar attributes or characteristics. As economic and other business conditions change, registrants often modify their business strategies, which may result in adjustments to the way in which they segment their loan portfolio for purposes of estimating loan losses. The staff normally would expect registrants to maintain documentation to support these segmentation adjustments.<sup>49</sup>

Based on the segmentation of the loan portfolio, a registrant should estimate the SFAS No. 5 portion of its loan loss allowance. For those segments that require an allowance for loan losses,<sup>50</sup> the registrant should estimate the loan losses, on at least a quarterly basis, based upon its ongoing loan review process and analysis of loan performance.<sup>51</sup> The registrant should follow a systematic and consistently applied approach to select the most appropriate loss measurement methods and support its conclusions and rationale with written documentation.<sup>52</sup>

<sup>48</sup> Paragraph 7.07 of the Audit Guide indicates that "[e]ach segment [of the loan portfolio] should contain loans with similar characteristics, such as risk classification, past-due status, and type of loan."

<sup>49</sup> Segmentation of the loan portfolio is a standard element in a loan loss allowance methodology. As indicated in paragraph 7.05 of the Audit Guide, the loan loss allowance methodology "should be well documented, with clear explanations of the supporting analyses and rationale."

<sup>50</sup> An example of a loan segment that does not generally require an allowance for loan losses is a group of loans that are fully secured by deposits maintained at the lending institution.

<sup>51</sup> FRR No. 28 refers to a "systematic methodology to be employed each period" in determining provisions and allowances for loan losses. As indicated in FRR No. 28, the staff normally would expect that the systematic methodology would be documented "to help ensure that all matters affecting loan collectibility will consistently be identified in the detailed [loan] review process."  
\* \* \*

<sup>52</sup> *Ibid.* Also, as indicated in paragraph 7.05 of the Audit Guide, the loan loss allowance methodology "should be well documented, with clear explanations of the supporting analyses and rationale." Further, as indicated in paragraph 7.14 of the Audit Guide, "[t]he institution's conclusions

*Facts:* After identifying certain loans for evaluation under SFAS No. 114, Registrant E segments its remaining loan portfolio into five pools of loans. For three of the pools, it measures loan impairment under SFAS No. 5 by applying historical loss rates, adjusted for relevant environmental factors, to the pools' aggregate loan balances. For the remaining two pools of loans, Registrant E uses a loss estimation model that is consistent with GAAP to measure loan impairment under SFAS No. 5.

*Question 9:* What documentation would the staff normally expect Registrant E to prepare to support its loan loss allowance for its pools of loans under SFAS No. 5?

*Interpretive Response:* Regardless of the method used to determine loan loss measurements under SFAS No. 5, Registrant E should demonstrate and document that the loss measurement methods used to estimate the loan loss allowance for each segment of its loan portfolio are determined in accordance with GAAP as of the financial statement date.<sup>53</sup>

As indicated for Registrant E, one method of estimating loan losses for groups of loans is through the application of loss rates to the groups' aggregate loan balances. Such loss rates typically reflect the registrant's historical loan loss experience for each group of loans, adjusted for relevant environmental factors (e.g., industry, geographical, economic, and political factors) over a defined period of time. If a registrant does not have loss experience of its own, it may be appropriate to reference the loss experience of other companies in the same business, provided that the registrant demonstrates that the attributes of the loans in its portfolio segment are similar to those of the loans included in the portfolio of the registrant providing the loss experience.<sup>54</sup> Registrants should maintain supporting documentation for the technique used to develop their loss rates, including the period of time over which the losses were incurred. If a range of loss is determined, registrants should maintain documentation to support the identified range and the rationale used for determining which estimate is the best estimate within the range of loan losses.<sup>55</sup>

The staff normally would expect that, before employing a loss estimation model, a

about the appropriate amount [of the allowance] should be well documented."

<sup>53</sup> Refer to paragraph 8(b) of SFAS No. 5. Also, as indicated in Exhibit D-80A of EITF Topic D-80, "[t]he approach for determination of the allowance should be well documented and applied consistently from period to period." (See the overview section of Exhibit D-80A and Question #18.)

<sup>54</sup> Refer to paragraph 23 of SFAS No. 5.

<sup>55</sup> Registrants should also refer to FIN 14, which provides guidance for situations in which a range of loss can be reasonably estimated but no single amount within the range appears to be a better estimate than any other amount within the range. Also, paragraph 7.14 of the Audit Guide notes the use of "a method that results in a range of estimates for the allowance," except for impairment measurement under SFAS No. 114, which is based on "a single best estimate and not a range of estimates." Paragraph 7.14 also states that "[t]he institution's conclusions about the appropriate amount should be well documented."

registrant would evaluate and modify, as needed, the model's assumptions to ensure that the resulting loss estimate is consistent with GAAP. In order to demonstrate consistency with GAAP, registrants that use loss estimation models should typically document the evaluation, the conclusions regarding the appropriateness of estimating loan losses with a model or other loss estimation tool, and the objective support for adjustments to the model or its results.<sup>56</sup>

In developing loss measurements, registrants should consider the impact of current environmental factors and then document which factors were used in the analysis and how those factors affected the loss measurements. Factors that should be considered in developing loss measurements include the following:<sup>57</sup>

- Levels of and trends in delinquencies and impaired loans;
- Levels of and trends in charge-offs and recoveries;
- Trends in volume and terms of loans;
- Effects of any changes in risk selection and underwriting standards, and other changes in lending policies, procedures, and practices;
- Experience, ability, and depth of lending management and other relevant staff;
- National and local economic trends and conditions;
- Industry conditions; and
- Effects of changes in credit concentrations.

For any adjustment of loss measurements for environmental factors, a registrant should maintain sufficient, objective evidence<sup>58</sup> (a) to support the amount of the adjustment and (b) to explain why the adjustment is necessary to reflect current information, events, circumstances, and conditions in the loss measurements.

##### 4.B. Measuring and Documenting Loan Losses under SFAS No. 5—Adjusting Loss Rates

*Facts:* Registrant F's lending area includes a metropolitan area that is financially dependent upon the profitability of a number of manufacturing businesses. These businesses use highly specialized equipment and significant quantities of rare metals in the manufacturing process. Due to increased low-cost foreign competition, several of the parts suppliers servicing these manufacturing firms declared bankruptcy. The foreign suppliers have subsequently increased prices and the manufacturing firms have suffered from increased equipment maintenance costs and smaller profit margins. Additionally, the cost of the rare metals used in the manufacturing process increased and has now stabilized at double last year's price. Due to these events, the manufacturing businesses are experiencing financial

<sup>56</sup> The systematic methodology (including, if applicable, loss estimation models) used to determine loan loss provisions and allowances should be documented in accordance with FRR No. 28, paragraph 7.05 of the Audit Guide, and EITF Topic D-80.

<sup>57</sup> Refer to paragraph 7.13 in the Audit Guide.

<sup>58</sup> AU Section 326 describes the "sufficient competent evidential matter" that auditors must consider in accordance with GAAS.



difficulties and have recently announced downsizing plans.

Although Registrant F has yet to confirm an increase in its loss experience as a result of these events, management knows that it leads to a significant number of businesses and individuals whose repayment ability depends upon the long-term viability of the manufacturing businesses. Registrant F's management has identified particular segments of its commercial and consumer customer bases that include borrowers highly dependent upon sales or salary from the manufacturing businesses. Registrant F's management performs an analysis of the affected portfolio segments to adjust its historical loss rates used to determine the loan loss allowance. In this particular case, Registrant F has experienced similar business and lending conditions in the past that it can compare to current conditions.

*Question 10:* How would the staff normally expect Registrant F to document its support for the loss rate adjustments that result from considering these manufacturing firms' financial downturns?<sup>59</sup>

*Interpretive Response:* The staff normally would expect Registrant F to document its identification of the particular segments of its commercial and consumer loan portfolio for which it is probable that the manufacturing business' financial downturn has resulted in loan losses. In addition, the staff normally would expect Registrant F to document its analysis that resulted in the adjustments to the loss rates for the affected portfolio segments.<sup>60</sup> The staff normally would expect that, as part of its documentation, Registrant F would maintain copies of the documents supporting the analysis, which may include relevant economic reports, economic data, and information from individual borrowers.

Because in this case Registrant F has experienced similar business and lending conditions in the past, it should consider including in its supporting documentation an analysis of how the current conditions compare to its previous loss experiences in similar circumstances. The staff normally would expect that, as part of Registrant F's effective loan loss allowance methodology, it would create a summary of the amount and rationale for the adjustment factor for review by management prior to the issuance of the financial statements.<sup>61</sup>

<sup>59</sup>This question and response would also apply to other registrant fact patterns in which the registrant adjusts loss rates for environmental factors.

<sup>60</sup>Paragraph 7.33 of the Audit Guide refers to the documentation, for disclosure purposes, that an entity should include in the notes to the financial statements describing the accounting policies and methodology the entity used to estimate its allowance and related provision for loan losses. As indicated in paragraph 7.33, "[s]uch a description should identify the factors that influenced management's judgment (for example, historical losses and existing economic conditions) and may also include discussion of risk elements relevant to particular categories of financial instruments."

<sup>61</sup>Paragraph 7.39 in the Audit Guide indicates that effective internal control related to the allowance for loan losses should include "accumulation of relevant, sufficient, and reliable data on which to base management's estimate of the allowance."

#### *4.C. Measuring and Documenting Loan Losses under SFAS No. 5—Estimating Losses on Loans Individually Reviewed for Impairment but Not Considered Individually Impaired*

*Facts:* Registrant G has outstanding loans of \$2 million to Company Y and \$1 million to Company Z, both of which are paying as agreed upon in the loan documents. The registrant's loan loss allowance policy specifies that all loans greater than \$750,000 must be individually reviewed for impairment under SFAS No. 114. Company Y's financial statements reflect a strong net worth, good profits, and ongoing ability to meet debt service requirements. In contrast, recent information indicates Company Z's profitability is declining and its cash flow is tight. Accordingly, this loan is rated standard under the registrant's loan grading system. Despite its concern, management believes Company Z will resolve its problems and determines that neither loan is individually impaired as defined by SFAS No. 114.

Registrant G segments its loan portfolio to estimate loan losses under SFAS No. 5. Two of its loan portfolio segments are Segment 1 and Segment 2. The loan to Company Y has risk characteristics similar to the loans included in Segment 1 and the loan to Company Z has risk characteristics similar to the loans included in Segment 2.<sup>62</sup>

In its determination of its loan loss allowance under SFAS No. 5, Registrant G includes its loans to Company Y and Company Z in the groups of loans with similar characteristics (*i.e.*, Segment 1 for Company Y's loan and Segment 2 for Company Z's loan).<sup>63</sup> Management's analyses of Segment 1 and Segment 2 indicate that it is probable that each segment includes some losses, even though the losses cannot be identified to one or more specific loans. Management estimates that the use of its historical loss rates for these two segments, with adjustments for changes in environmental factors, provides a reasonable estimate of the registrant's probable loan losses in these segments.

*Question 11:* How would the staff normally expect Registrant G to adequately document a loan loss allowance under SFAS No. 5 for these loans that were individually reviewed for impairment but are not considered individually impaired?

*Interpretive Response:* The staff normally would expect that, as part of Registrant G's effective loan loss allowance methodology, it would document its decision to include its loans to Company Y and Company Z in its determination of its loan loss allowance

<sup>62</sup>These groups of loans do not include any loans that have been individually reviewed for impairment under SFAS No. 114 and determined to be impaired as defined by SFAS No. 114.

<sup>63</sup>Question #10 in Exhibit D-80A of EITF Topic D-80 states that if a creditor concludes that an individual loan specifically identified for evaluation is not impaired under SFAS No. 114, that loan may be included in the assessment of the allowance for loan losses under SFAS No. 5, but only if specific characteristics of the loan indicate that it is probable that there would be an incurred loss in a group of loans with those characteristics.

under SFAS No. 5.<sup>64</sup> The staff also normally would expect that Registrant G would document the specific characteristics of the loans that were the basis for grouping these loans with other loans in Segment 1 and Segment 2, respectively.<sup>65</sup> Additionally, the staff normally would expect Registrant G to maintain documentation to support its method of estimating loan losses for Segment 1 and Segment 2, which typically would include the average loss rate used, the analysis of historical losses by loan type and by internal risk rating, and support for any adjustments to its historical loss rates.<sup>66</sup> The registrant would typically maintain copies of the economic and other reports that provided source data.

When measuring and documenting loan losses, Registrant G should take steps to prevent layering loan loss allowances. Layering is the inappropriate practice of recording in the allowance more than one amount for the same probable loan loss. Layering can happen when a registrant includes a loan in one segment, determines its best estimate of loss for that loan either individually or on a group basis (after taking into account all appropriate environmental factors, conditions, and events), and then includes the loan in another group, which receives an additional loan loss allowance amount.

#### 5. Documenting the Results of a Systematic Methodology

##### *5.A. Documenting the Results of a Systematic Methodology—General*

*Facts:* Registrant H has completed its estimation of its loan loss allowance for the current reporting period, in accordance with GAAP, using its established systematic methodology.

*Question 12:* What summary documentation would the staff normally expect Registrant H to prepare to support the amount of its loan loss allowance to be reported in its financial statements?

*Interpretive Response:* The staff normally would expect that, to verify that loan loss allowance balances are presented fairly in accordance with GAAP and are auditable, management would prepare a document that summarizes the amount to be reported in the financial statements for the loan loss allowance.<sup>67</sup> Common elements that the staff

<sup>64</sup>Paragraph 7.05 in the Audit Guide indicates that an entity's method of estimating credit losses should "include a detailed and regular analysis of the loan portfolio," "consider all loans (whether on an individual or poll-of-loans basis)," "be based on current and reliable data," and "be well documented, with clear explanations of the supporting analysis and rationale." Question #10 in Exhibit D-80A of EITF Topic D-80 provides guidance as to the analysis to be performed when determining whether a loan that is not individually impaired under SFAS No. 114 should be included in the assessment of the loan loss allowance under SFAS No. 5.

<sup>65</sup>*Ibid.*

<sup>66</sup>*Ibid.*

<sup>67</sup>FFR No. 28 states: "The specific rationale upon which the [loan loss allowance and provision] amount actually reported is based—*i.e.*, the bridge between the findings of the detailed review [of the loan portfolio] and the amount actually reported in each period—would be documented to help ensure



normally would expect to find documented in loan loss allowance summaries include:<sup>68</sup>

- The estimate of the probable loss or range of loss incurred for each category evaluated (e.g., individually evaluated impaired loans, homogeneous pools, and other groups of loans that are collectively evaluated for impairment);
- The aggregate probable loss estimated using the registrant's methodology;
- A summary of the current loan loss allowance balance;
- The amount, if any, by which the loan loss allowance balance is to be adjusted;<sup>69</sup> and
- Depending on the level of detail that supports the loan loss allowance analysis, detailed subschedules of loss estimates that reconcile to the summary schedule.

Generally, a registrant's review and approval process for the loan loss allowance relies upon the data provided in these consolidated summaries. There may be instances in which individuals or committees that review the loan loss allowance methodology and resulting allowance balance identify adjustments that need to be made to the loss estimates to provide a better estimate of loan losses. These changes may be due to information not known at the time of the initial loss estimate (e.g., information that surfaces after determining and adjusting, as necessary, historical loss rates, or a recent decline in the marketability of property after conducting a SFAS No. 114 valuation based upon the fair value of collateral). It is important that these adjustments are consistent with GAAP and are reviewed and approved by appropriate personnel.<sup>70</sup> Additionally, it would typically be appropriate for the summary to provide each subsequent reviewer with an understanding of the support behind these adjustments. Therefore, the staff normally would expect management to document the nature of any adjustments and the underlying rationale for making the changes.<sup>71</sup> The staff also normally would expect this documentation to be provided to those among management making the final determination of the loan loss allowance amount.<sup>72</sup>

the adequacy of the reported amount, to improve auditability, and to serve as a benchmark for exercise of prudent judgment in future periods."

<sup>68</sup> See also paragraph 7.14 of the Audit Guide.

<sup>69</sup> Subsequent to adjustments, the staff normally would expect that there would be no material differences between the consolidated loss estimate, as determined by the methodology, and the final loan loss allowance balance reported in the financial statements. Registrants should refer to SAB No. 99 and Statement on Auditing Standards No. 89, *Audit Adjustments*, and its amendments to AU Section 310.

<sup>70</sup> Paragraph 7.39 in the Audit Guide indicates that effective internal control related to the allowance for loan losses should include "adequate review and approval of the allowance estimates by the individuals specified in management's written policy."

<sup>71</sup> See the guidance in paragraph 7.14 of the Audit Guide ("The institution's conclusions about the appropriate amount should be well documented.") and in FRR No. 28 ("The specific rationale upon which the amount actually reported in each individual period is based \* \* \* would be documented \* \* \*").

<sup>72</sup> *Ibid.*

### 5.B. Documenting the Results of a Systematic Methodology—Allowance Adjustments

**Facts:** Registrant I determines its loan loss allowance using an established systematic process. At the end of each reporting period, the accounting department prepares a summary schedule that includes the amount of each of the components of the loan loss allowance, as well as the total loan loss allowance amount, for review by senior management, including the Credit Committee. Members of senior management meet to discuss the loan loss allowance. During these discussions, they identify changes that are required by GAAP to be made to certain of the loan loss allowance estimates. As a result of the adjustments made by senior management, the total amount of the loan loss allowance changes. However, senior management (or its designee) does not update the loan loss allowance summary schedule to reflect the adjustments or reasons for the adjustments. When performing their audit of the financial statements, the independent accountants are provided with the original loan loss allowance summary schedule reviewed by senior management, as well as a verbal explanation of the changes made by senior management when they met to discuss the loan loss allowance.

**Question 13:** In the staff's view, are Registrant I's documentation practices related to the balance of its loan loss allowance in compliance with existing documentation guidance in this area?

**Interpretive Response:** No. A registrant should maintain supporting documentation for the loan loss allowance amount reported in its financial statements.<sup>73</sup> As illustrated above, there may be instances in which loan loss allowance reviewers identify adjustments that need to be made to the loan loss estimates. The staff normally would expect the nature of the adjustments, how they were measured or determined, and the underlying rationale for making the changes to the loan loss allowance balance to be documented.<sup>74</sup> The staff also normally would expect appropriate documentation of the adjustments to be provided to management for review of the final loan loss allowance amount to be reported in the financial statements. This documentation should also be made available to the independent accountants. If changes frequently occur during management or credit committee reviews of the loan loss allowance, management may find it appropriate to analyze the reasons for the frequent changes and to reassess the methodology the registrant uses.<sup>75</sup>

<sup>73</sup> *Ibid.*

<sup>74</sup> *Ibid.*

<sup>75</sup> As outlined in paragraph 7.39 of the Audit Guide, effective internal controls related to the allowance for loan losses should include adequate review and approval of allowance estimates, including review of sources of relevant information, review of development of assumptions, review of reasonableness of assumptions and resulting estimates, and consideration of changes in previously established methods to arrive at the allowance.

### 6. Validating a Systematic Methodology

**Question 14:** What is the staff's guidance to a registrant on validating, and documenting the validation of, its systematic methodology used to estimate loan loss allowances?

**Interpretive Response:** The staff believes that a registrant's loan loss allowance methodology is considered valid when it accurately estimates the amount of loss contained in the portfolio. Thus, the staff normally would expect the registrant's methodology to include procedures that adjust loan loss estimation methods to reduce differences between estimated losses and actual subsequent charge-offs, as necessary. To verify that the loan loss allowance methodology is valid and conforms to GAAP, the staff believes it is appropriate for management to establish internal control policies,<sup>76</sup> appropriate for the size of the registrant and the type and complexity of its loan products. These policies may include procedures for a review, by a party who is independent of the allowance for loan losses estimation process, of the allowance for loan losses methodology and its application in order to confirm its effectiveness.

In practice, registrants employ numerous procedures when validating the reasonableness of their loan loss allowance methodology and determining whether there may be deficiencies in their overall methodology or loan grading process. Examples are:

- A review of trends in loan volume, delinquencies, restructurings, and concentrations.
- A review of previous charge-off and recovery history, including an evaluation of the timeliness of the entries to record both the charge-offs and the recoveries.
- A review by a party that is independent of the loan loss allowance estimation process. This often involves the independent party reviewing, on a test basis, source documents and underlying assumptions to determine that the established methodology develops reasonable loss estimates.
- An evaluation of the appraisal process of the underlying collateral. This may be accomplished by periodically comparing the appraised value to the actual sales price on selected properties sold.

It is the staff's understanding that, in practice, management usually supports the validation process with the workpapers from the loan loss allowance review function. Additional documentation often includes the summary findings of the independent reviewer. The staff normally would expect that, if the methodology is changed based upon the findings of the validation process, documentation that describes and supports the changes would be maintained.<sup>77</sup>

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<sup>76</sup> *Ibid.*

<sup>77</sup> See paragraph 7.39 of the Audit Guide.