

allowance to be reported in the financial statements;¹⁰

- 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;¹¹

- 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);¹² and

- The system of internal controls used to ensure that the loan loss allowance process is maintained in accordance with GAAP.¹³

The staff normally would expect an internal control system¹⁴ for the loan loss allowance estimation process to:

- Include measures to provide assurance regarding the reliability¹⁵ and integrity of information and compliance with laws, regulations, and internal policies and procedures;¹⁶

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

- Include a well-defined loan review process.¹⁷

¹⁰ 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."

¹¹ 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.

¹² *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."

¹³ 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.

¹⁴ *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.

¹⁵ Concepts Statement 2 provides guidance on "reliability" as a primary quality of accounting information.

¹⁶ Section 13(b)(2)–(7) of the Exchange Act.

¹⁷ 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

A well-defined loan review process¹⁸ 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;¹⁹

- 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;²⁰ and

- Clear formal communication and coordination between a registrant's credit administration function, financial reporting group, management, board of directors, and 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).²¹

Question 3: 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

traditionally identify and review loans on an individual basis and review or analyze loans on a group or pool basis.

¹⁸ *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."

¹⁹ *Ibid.*

²⁰ *Ibid.*

²¹ *Ibid.*

procedures would describe the methodology:

- For segmenting the portfolio:
- How the segmentation process is performed (i.e., by loan type, industry, risk rates, etc.);²²

- 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 Statement 114;²³

- 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 Statement 114, but not considered to be individually impaired, should be grouped with other loans that share common characteristics for impairment evaluation under Statement 5.²⁴

- For determining and measuring impairment under Statement 5;²⁵

- 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,

²² 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.

²³ See Statement 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.

²⁴ See EITF Topic D-80, Exhibit D-80A, Question #10.

²⁵ See Statement 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.