

and political factors) that may affect loss rates or other loss measurements.

3. Applying a Systematic Methodology—Measuring and Documenting Loan Losses Under Statement 114

a. Measuring and Documenting Loan Losses Under Statement 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 Statement 114.

Upon review of the large balance loans, Registrant B determines that certain of the loans are impaired as defined by Statement 114.¹

Question: of the commercial loans reviewed under Statement 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 Statement 114?

Interpretive Response: For those loans that are reviewed individually under Statement 114 and considered individually impaired, Registrant B must use one of the methods for measuring impairment that is specified by Statement 114 (that is, the present value of expected future cash flows, the loan's observable market price, or the fair value of collateral).² Accordingly, in the circumstances described above, for the loans considered individually impaired under Statement 114, it would not be appropriate for Registrant B to choose a measurement method not prescribed by Statement 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 evidence³ written documentation to support its measurement of loan impairment under

Statement 114.⁴ 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 factors⁵ 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.⁶ 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.

b. Measuring and Documenting Loan Losses Under Statement 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 Statement 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 Statement 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.⁷ 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.⁸ 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: 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.⁹ This documentation¹⁰ 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

¹ Paragraph 8 of Statement 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.

² See paragraph 13 of Statement 114.

³ Under GAAS, auditors should obtain "sufficient competent evidential matter" to support its audit opinion. See AU Section 326. 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.

⁴ 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 Statement 114 or Statement 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 paragraph 7.65 and 7.66).

⁵ Question #16 in Exhibit D-80A of EITF Topic D-80 indicates that environmental factors include existing industry, geographical, economic, and political factors.

⁶ See paragraphs 7.65 and 7.66 in the Audit Guide for additional information about documentation of loan collateral.

⁷ 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.

⁸ An auditor who uses the work of a specialist, such as an appraiser, in performing an audit in accordance with GAAS should refer to the guidance in SAS 73 (AU Section 336).

⁹ 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.

¹⁰ 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."