

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>6</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>7</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>8</sup>

The staff normally would expect that, before employing a loss estimation model, a 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>9</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>10</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>11</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.

#### **b. Measuring and Documenting Loan Losses Under Statement 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.

<sup>9</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 28, paragraph 7.05 of the Audit Guide, and EITF Topic D-80.

<sup>10</sup> Refer to paragraph 7.13 in the Audit Guide.

<sup>11</sup> AU 326 describes the "sufficient competent evidential matter" that auditors must consider in accordance with GAAS.

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 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:* 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>12</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>13</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,

<sup>12</sup> This question and response would also apply to other registrant fact patterns in which the registrant adjusts loss rates for environmental factors.

<sup>13</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>6</sup> Refer to paragraph 8(b) of Statement 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>7</sup> Refer to paragraph 23 of Statement 5.

<sup>8</sup> Registrants should also refer to Interpretation 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 that the use of "a method that results in a range of estimates for the allowance," except for impairment measurement under Statement 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."