

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.¹⁴

c. Measuring and Documenting Loan Losses Under Statement 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 Statement 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 substandard 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 Statement 114.

Registrant G segments its loan portfolio to estimate loan losses under Statement 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 2.¹⁵

In its determination of its loan loss allowance under Statement 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).¹⁶ 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: How would the staff normally expect Registrant G to adequately document a loan loss allowance under Statement 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 under Statement 5.¹⁷ 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.¹⁸ 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.¹⁹ 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

¹⁶ 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 Statement 114, that loan may be included in the assessment of the allowance for loan losses under Statement 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.

¹⁷ 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 pool-of-loans basis)," "be based on current and reliable data," and "be well documented, with clear explanations of the supporting analyses 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 Statement 114 should be included in the assessment of the loan loss allowance under Statement 5.

¹⁸ *Ibid.*

¹⁹ *Ibid.*

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

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: 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.¹ Common elements that the staff normally would expect to find documented in loan loss allowance summaries include:²

- 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;³ and

¹ FRR 28 states: "[t]he specific rationale upon which the [loan loss allowance and provision] amount actually reported is based—*i.e.*, the bridge between 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."

² See also paragraph 7.14 of the Audit guide.

³ Subsequent to adjustments, the staff normally would expect that there would be no material differences between the consolidated loss estimate,

¹⁴ 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."

¹⁵ These groups of loans do not include any loans that have been individually reviewed for impairment under Statement 114 and determined to be impaired as defined by Statement 114.