

# MBA's Accounting, Tax and Financial Analysis Conference



## Allowance for Loan & Lease Losses: The Latest Nov. 2007



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# Overview of Current Accounting Literature: The Good News and The Bad News

*Primary GAAP  
Sources*  
FAS 5  
FAS 114  
FIN 14  
EITF D-80  
AICPA A&A Guide,  
Including SOP 01-6

## Relevant U.S. GAAP

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- FAS 5, Accounting for Contingencies
- FIN 14, Reasonable Estimation of the Amount of a Loss – an interpretation of FAS 5
- FAS 114, Accounting by Creditors for Impairment of a Loan
- AICPA A&A Guide, Banks, Mortgage Companies, Finance Companies (includes AICPA Statement of Position 01-6)
- FASB Viewpoints article, EITF Topic D-80

## FAS 5

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- Two criteria must be met to accrue for a loss under FAS 5:
  - “Probable that an asset has been impaired” and “one or more future events will occur to confirm the loss”
  - The amount of the loss can be reasonably estimated
- If information available prior to the issuance of the financial statements indicates loss is likely, it should be accrued for as of that balance sheet date
- Specific loans where the loss is yet be identified

## FIN 14

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- Recognize the amount that is the best estimate within the estimated range of credit losses
- OR
- If no amount within that range is a better estimate than any other amount, the creditor should recognize the minimum amount within the range
    - Additional disclosures may be required if the minimum amount is accrued. Such disclosures should note the nature of the contingency, the amount accrued and additional potential exposure

## FAS 114

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- Recognition under FAS 114 is same as FAS 5
- Excludes smaller balance homogeneous loans
- Defines “impaired” loan as loan in which the creditor does not expect to collect all amounts due under the contractual terms of the loan agreement
- Measurement guidance:
  - Present value of expected cash flow streams discounted at the note’s effective rate
  - Fair value of collateral securing the loan
  - Observable market price
- Requires disclosures

## AICPA A&A Guide

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- Methods that rely solely on mathematical calculations such as:
  - a percentage of total loans based on historical experience or
  - similar allowance percentages of peer institutions... generally fail to contain the essential elements needed to properly support the allowance
- Allowances for off balance sheet instruments should be reported separately as a liability

## EITF Topic D-80

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- AKA The FASB Staff Viewpoints article
- Issued April 1999
- Accrue for probable losses incurred at the balance sheet date
- Do not accrue for probable future losses
- No “double dipping” is allowed (shouldn’t have both a FAS 5 and FAS 114 allocation)
- Need to justify general or unallocated allowance
- Provides a nice flowchart

## Most Recent GAAP

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- FASB Staff Position (FSP) SOP 94-6-1 *Terms of Loan Products That May Give Rise to a Concentration of Credit Risk*
  - Issued Dec. 2005
  - Clarifies required disclosures under FAS 107 and SOP 94-6 guidance for entities that originate, hold, guarantee, or service loan products with certain features (principal deferrals, high LTV, negative am loans, loans subject to significant paymer<sup>+</sup> increases, etc.)
  - Don't forget about the servicing asset



## Observations: The Seven Deadly Sins

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1. Impaired loans not segregated from rest of portfolio
2. Impaired loans are “double counted”
3. Recorded allowance is significantly different than management’s calculation
4. Loss percentages for special mention, substandard and doubtful are not supported
5. ALLL and provision expense are based on budgeted amounts
6. Inclusion of unfunded commitments
7. ALLL is based on target levels or peer data



## Observations: Common Mistakes

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- Historical loss ratios do not include current period
- New loan products are assigned historical loss rates that aren't necessarily appropriate for the product
- Gross charge-offs are used for historical loss ratios rather than net
- No distinction between secured and unsecured loans
- ALLL calculation is prepared by collections or loan review department with little to no input from lending function or oversight by financial reporting

# Standard-setter's project



## Milestones

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- Oct. 1994 - GAO Study, Depository Institutions: Divergent Loan Loss Methods Undermine Usefulness in Financial Reports
- June 19, 2003 - AcSEC issued a proposal, *Allowance for Credit Losses*, for comment through Sept. 19, 2003
- Oct. 6, 2004 – Comment letter from the principals of the five agencies
- Jan. 31, 2004 – AcSEC discussed how to proceed and decided, based on input from the FASB, to pursue a 'disclosure-only' document
- Nov. 2005 – AcSEC votes to issue proposal on disclosures, *Disclosures Concerning Credit Quality Related to Loans*
- Sept. 2006 – AcSEC removes project
- Jan. 2007 – FASB considers project



## FASB Board Minutes

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- “Statements 5 and 114 require that impairment be based on incurred losses.”
- “The staff believes that, in practice, there is **pervasive inconsistency** in recognizing and measuring the allowance for losses.”
- “The staff believes that **many financial institutions are using some form of an expected losses model** in which historical loss rates are used to calculate impairment. Thus, losses are recognized before the losses have been incurred.”
- “The staff received feedback from preparers and regulators and noted that **many constituents would prefer an expected losses model** in which expected losses are recognized when a loan is written or at the soonest reporting date thereafter.”

## FASB Meeting – Jan '07

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- FASB staff recommended the Board add a project and provided three options:
  1. Keep current accounting, reconsider disclosures
  2. Reconsider current accounting - incurred vs. expected loss model & disclosures
  3. Require fair value for financing receivables (i.e. loans and finance leases) reconsider disclosures
    - a) Require fair value for financial instruments



**Recommended**



**Wanted**

## FASB Meeting – Jan '07

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- Several Board commented that Option 3 is the 'right' answer but just not achievable at this time.
- Board voted 4-3 for Option 1 to continue to require current accounting for allowance for loan losses, reconsider all existing disclosure requirements and develop a package of new disclosures
- No public meeting to date – timing of expected proposal TBD

# Regulatory Developments



*Key Message:  
Follow GAAP  
and  
Document,  
Document,  
Document*

## Dec '06 Interagency Policy Statement

- Issued Dec. 13, 2006, along FAQ
- PCAOB Release
- Replaces Dec. 21, 1993 Interagency Policy
- Includes FDIC, Fed, NCUA, OCC, OTS
- Key points:
  - The ALLL must be maintained at a level that is appropriate and determined in accordance with GAAP
  - Responsibilities of directors, management and examiners
  - Objectives and elements of an effective loan review system
  - Documentation



**Included  
in your  
materials**

# Dec '06 Interagency Policy Statement

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## Key Points:

- Requires quarterly analysis of the ALLL, at a minimum
- Removes use of the regulatory percentages (15% substandard, 50% doubtful, 100% loss)
- Adjusting the historical loss rates
- Peer group data
- Use of ratios
- Directionally consistent



- Next Up? More documentation guidance?

# Questions?



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## Reference List: Regulatory Guidance

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- Nov. 1998 - Interagency Statement
- March 1999 – Joint Interagency Letter
- July 1999 – Joint Interagency Letter
- July 2001 – *Interagency Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions*
- March 2004 – Interagency Release: Update on Accounting for Loan and Lease Losses
- Dec. 2006 – *Interagency Policy Statement on the Allowance for Loan Losses* and Q&A issued