EM-21.2

Category: **Assets**
Topic: **Allowance for Losses**
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Overview

The *Allowance for Losses* topic provides guidance on evaluating the adequacy of the allowance for loan losses (ALL or allowance) and related processes. The ALL is a valuation account to reflect the estimated incurred losses in the loan and lease portfolio. It is a contra account recorded as an offset (reduction) to loans on the balance sheet. Farm Credit Administration (FCA) examiners determine ALL adequacy by evaluating institution processes for identifying risk and establishing the ALL, and by analyzing whether the ALL is reasonable in relation to portfolio risk, general economic conditions, and other applicable factors. More specifically, an ALL examination will consider:

- The board's oversight of the ALL process, either directly or through the Audit Committee, to ensure compliance with generally accepted accounting principles (GAAP) and regulatory guidance.
- Management's processes for assessing incurred losses and estimating ALL needs. This includes an assessment of supporting assumptions and documentation.
- The process for establishing a specific allowance on individual impaired loans in accordance with Accounting Standards Codification (ASC) 310 (formerly Financial Accounting Standard (FAS) 114).
- The process for establishing a general or contingent loss allowance on non-impaired loans in accordance with ASC 450 (formerly FAS 5) as well as applicable concepts in ASC 310.

Institutions need a well-documented ALL process that considers all credit risks, assesses incurred loss exposure, and estimates the ALL needed to cover probable losses based on past events and conditions existing at the date of the financial statements. Sound ALL methodologies include consideration of both quantitative and qualitative factors that accurately reflect risk embedded in the loan portfolio. With this information, management must apply judgment to ensure the ALL is within an acceptable range of reasonably estimable losses, and support this determination with a well-documented analysis.

Note: This section will be updated when the current expected credit losses (CECL) methodology for estimating allowances for credit losses goes into effect. Refer to FCA's Informational Memorandum on New Accounting Standard on Financial Instruments – Credit Losses dated September 1, 2016, and industry guidance for additional information.

Examination Procedures and Guidance

General

1. Allowance Level:

Evaluate management's assessment of allowance needs, and determine if the allowance is adequate.

Guidance:

FCA Regulation 621.5(a) requires Farm Credit System (System) institutions to maintain an ALL in accordance with GAAP. More broadly, FCA Regulation 621.3 requires institutions to prepare and maintain accurate and complete records of business transactions and to prepare financial statements and reports in accordance with GAAP. Under GAAP, the purpose of the ALL is not to absorb all risk in the loan and lease portfolio, but to cover probable credit losses that have already been incurred. FCA Bookletter BL-049 contains regulatory guidance and expectations for maintaining an adequate ALL level. Failure to analyze loan portfolio collectability and maintain and support an appropriate ALL in accordance with GAAP and regulatory guidance is an unsafe and unsound practice.

The ALL should be based on a comprehensive, well-documented, and consistently applied loan portfolio analysis. Estimates of loan losses should consider all significant quantitative and qualitative factors that affect portfolio collectability as of the evaluation date. The basis for these estimates should not be limited to historical loss experience, but also include judgment and the probable impact of key economic indicators that have already occurred. Arriving at an appropriate ALL involves a high degree of management judgment and typically results in a range of estimated losses. In accordance with GAAP, an institution must record its best estimate of probable losses within this range. ASC 450-20 states, in part, "If some amount within a range of loss appears at the time to be a better estimate than any other amount within the range, that amount shall be accrued. When no amount within the range is a better estimate than any other amount, however, the minimum amount in the range shall be accrued." Examiners should closely evaluate the institution's risk profile and justification, especially when the amount is at the low end of the range.

When evaluating the ALL level, examiners should be aware of and address several general considerations in addition to reviewing the specific and general allowance components. These general considerations, along with guidance for examining the specific and general allowance components, are outlined in the subsections below.

General Considerations: General considerations that examiners should address when evaluating the ALL level include:

- ***Key ratios:*** **Do key ratio levels and trends indicate any potential concerns with the ALL level?** This analysis should determine whether key ratio levels and trends are reasonable based on the examiner's knowledge of the institution's loan portfolio risk and current operating environment. Common ratios to consider include the ALL to nonaccrual loans, adverse loans, and total loans. Another measure to consider is the ALL amount relative to the past 3 to 5 years of chargeoffs. The analysis may also consider a comparison to peers as an additional indicator, but should take into consideration differences such as portfolio performance, industry, loan types, and collateral. If the analysis indicates potential concerns with the ALL's reasonableness (an allowance that does not appear to be consistent with portfolio risk, general economic conditions, or historical losses), examiners should closely review the support for the ALL to determine if methodologies and assumptions are appropriate. Also, if the institution has acquired assets through a business combination (merger), examiners should be aware of the accounting treatment impact when analyzing ALL-related ratios (as discussed later in this section).

- ***ALL Summary Analysis and Approval:* Has the board and management appropriately analyzed, summarized, and approved the ALL?** The ALL analysis should be completed, documented, and approved consistent with GAAP, regulatory guidance, and the institution's policies and procedures. Refer to the *Policy, Procedures, & Controls* procedure in this section for guidance on evaluating an institution's ALL process. Management should incorporate reasonable and supported assumptions, valuations, and judgments into the ALL analysis, as discussed in the *Specific Allowance* and *General Allowance* subsections below. In addition:

    - If the ALL analysis was not based on quarter-end information (e.g., the initial analysis may have been prepared on information as of 1 month prior to quarter-end), it should be adjusted for any significant subsequent changes or events. Management should document the nature and underlying rationale of any adjustments. It is important that these adjustments are consistent with GAAP.

    - To verify that ALL balances are presented fairly in accordance with GAAP, management should prepare a document that summarizes the ALL analysis and the amount to be reported in the financial statements. The board should review and approve this summary and the final ALL level to be reported.

- ***Financial Statements:* Were quarterly adjustments to the financial statements appropriate based on the ALL analysis?** ASC 450-20 *(link requires login to FASB website)* requires a loss contingency accrual when information available prior to financial statement issuance indicates it is probable an asset has been impaired at the date of the financial statements and the loss amount can be reasonably estimated. If the ALL needed based on the current analysis is different than the amount recorded in the financial statements, the financial statements should be adjusted accordingly in the current quarter.

    - Decisions to adjust the ALL are not dependent on earnings or capital levels, but on the need to ensure the ALL provides for estimated losses that exist in the loan portfolio at the financial statement date. Not adjusting the ALL to comply with GAAP is a violation of FCA Regulations 621.3 and 621.5(a).

    - If there are any significant changes needed in the ALL amount, management should clearly determine that events causing the change occurred in the current period and not in prior periods. If changes should have been made in prior periods, consider whether the institution needs to re-state its financial statements for shareholders and re-file its Call Reports. While changes in estimates are treated prospectively, material errors should cause re-statement of the financial statements and Call Reports.

- ***ALL on Assets Acquired via Merger:* Was the allowance appropriately addressed on loans acquired in a business combination (merger)?** Loans acquired on or after January 1, 2009, are initially recorded on the acquirer's books at fair value at the date of acquisition per ASC 805-20 *(link requires login to FASB website)*. Fair value is determined based on the present value of cash flows expected to be collected, which is inherently discounted for probable losses. As a result, any related allowance is not carried over or established at acquisition. For this reason, the ALL level after a merger may appear low in relation to total loan volume. Although loans acquired in a merger have no initial ALL, the institution may establish an ALL subsequent to merger if credit conditions associated with these loans deteriorate. On the merger date, the institution will need to identify loans as impaired or non-impaired. The following describes how these loans are then treated at the time of, and subsequent to, the merger:

  - *Impaired Assets* – These assets are usually brought on the books at the net recorded investment, which is the book value of the loan less any specific allowance. Any subsequent changes in valuation would follow normal ALL processes.

  - *Non-Impaired Assets* – Generally, all non-impaired loans are accounted for as one pool at the time of the merger, with no general allowance associated with it. As the size of the pool decreases over time (due to refinancing, renewals, pay-offs, etc.), the ALL process should include procedures to monitor the credit quality of the remaining assets. If the credit quality of the pool deteriorates, an ALL provision may be necessary as the initial fair value assessment may no longer be sufficient.

  - Note: Prior to January 1, 2009, loans acquired in a business combination were generally recorded at book value, along with the related allowances for uncollectibility and collection costs, if necessary. For this reason, institutions may continue to account for an allowance associated with loans acquired via merger prior to the effective date of this change in applicable accounting guidance.

- ***Off-Balance Sheet Items:*** **Does the institution appropriately account for reserves on off-balance sheet items?** A reserve for credit losses may be needed for off-balance sheet exposures, including unfunded commitments such as letters of credit or unfunded lines of credit the institution is legally obligated to fund. This reserve is separate from the ALL and is a liability account on the balance sheet per ASC 450. If significant off-balance sheet exposures such as unfunded commitments exist, management should conduct quarterly analyses to support the reserve amount.

Specific Allowances: Specific allowances are determined on impaired assets in accordance with ASC 310 *(link requires login to FASB website)*. Evaluative questions and items to consider when examining specific allowance determinations include:

- ***Impaired Loan Identification:*** **Are impaired loans appropriately identified?** An individual loan is impaired and should be evaluated for a specific allowance when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due (principal and interest) according to the contractual terms of the loan agreement. ASC 310-10 does not specify how an institution should identify loans to evaluate for collectability, nor does it specify how an institution should determine if a loan is impaired. An institution should select loans and determine impairment based on its own policy and criteria. Generally, institutions classify nonaccrual loans, troubled debt restructures (per ASC 310-40), and loans 90 days or more past due as impaired loans. While there is no direct correlation of GAAP impairment to the System risk rating guidance or the Uniform Classification System (UCS), the line between unimpaired and impaired assets would likely be between a Probability of Default rating of 11 (substandard viable loans) and 12 (substandard nonviable loans). Under UCS, loans that are substandard or doubtful and in nonaccrual status are usually considered impaired because there is doubt regarding full collection of all principal and interest from operating sources.

- *Impaired Loan Evaluations:* **Are specific allowances accurately determined based on impaired loan evaluations?** If a loan is impaired, the specific allowance as of the evaluation date must be based on one of the three impairment measurement methods in ASC 310-10. Generally, a measurement method is selected on a loan-by-loan basis. However, when the creditor determines collection through collateral liquidation is probable, measurement must be based on fair value of the collateral. The specific allowance amount is the difference between the loan exposure and the amount expected to be recovered.
    - The three impairment measurement methods are as follows:
        - The present value of expected future cash flows discounted at the loan's effective interest rate.
        - The loan's observable market price.
        - The fair value of the collateral less cost to sell if the loan is collateral dependent. While fair value is often the appraised value, the institution should consider current market conditions and distressed sales conditions to establish the fair value. Selling costs are those costs that are known at the financial statement date, such as attorney fees and real estate commissions to sell the collateral, and should not include items such as future taxes and insurance or anticipated value declines. Ongoing expenses (e.g., taxes, insurance, or legal expenses separate from selling costs) should be expensed as incurred.
    - The specific allowance is determined in conjunction with determining whether immediate loss recognition is needed for known losses on the loan. Also, the specific allowance amount does not directly correlate to any particular UCS classification or risk rating category. For example, the portion of a loan equal to the specific allowance amount would not necessarily need to be classified Doubtful. Refer to the *Risk Identification* Examination Manual topic for additional guidance on loan classifications and chargeoffs.
    - Other property owned (OPO) should not be part of the ALL analysis. OPO should be recorded at fair value less costs to sell.
- *Shared Assets:* **Are effective processes in place to coordinate with other System institutions on shared assets to ensure consistency in loan classifications, specific allowances, and chargeoffs?** FCA's Informational Memorandum on Allowance for Loan Losses dated June 30, 2009, identifies the need for consistency in reporting Systemwide financial results to investors and the public. As such, FCA expects loan classifications, specific allowances, and chargeoffs on loans to the same borrower to be reported consistently among System institutions sharing in those loans. The institution should have documented processes for ensuring coordination with other System institutions that are involved in the same shared asset. However, institutions should still perform their own independent analysis since they are ultimately responsible for assigning their own classifications and specific allowances. There may be instances where differences are warranted (e.g., the System lead's classification or specific allowance is deemed to be inaccurate). These differences should be justified and documented.

General Allowance: General allowances are determined by reviewing the risk in the loan portfolio to identify probable and reasonably estimable losses in accordance with ASC 450-20 *(link requires login to FASB website)*, as well as the applicable concepts in ASC 310-10. It should involve both quantitative and qualitative measurements that accurately reflect risk embedded in the portfolio. An institution should document the relationship between its detailed loan portfolio review results and the ALL and provision for loan loss amounts reported in each period. Evaluative questions and items to consider when examining general allowance analyses include:

- ***Quantitative Models:*** **Are models and related assumptions used in the general allowance analysis appropriate? Are the models managed in accordance with the institution's model risk management (MRM) framework and the guidance outlined in FCA's *Model Risk Management* procedure in the *Corporate Governance* Examination Manual topic?** Institutions will typically use a quantitative model in determining the general allowance. Before employing a loss estimation model, an institution should evaluate and modify, as needed, the model's assumptions to ensure the resulting loss estimate is consistent with GAAP and current credit risk. The model should differentiate among various risk pools or loan portfolio segments and evaluate risks separately. Different assumptions may be needed for each risk pool. These assumptions should be periodically back-tested against historical loss experience. The institution should also conduct sensitivity tests to identify the impact of changes in model assumptions on risk ratings, especially if the risk environment is increasing and ratings may be lagging indicators. Results from these tests should be considered in ALL decisions. The remaining bullets in this section provide more specific information related to ALL model use. These models should be included in the institution's model inventory, which should accurately represent each model's risk, materiality, and validation status. Model validation, change controls, staffing, separation of duties, and new model development should be consistent with the guidance in the institution's MRM framework and FCA's *Model Risk Management* procedure, recognizing that application of this guidance varies based on model risk and materiality. *Note: Examiners completing this procedure should focus on the specific model(s) being used; the overall MRM framework is examined using the Model Risk Management procedure referenced above.*

- ***Credit Review System:*** **Does the institution have a reliable credit review system for determining ALL needs?** An effective credit review system serves as a valuable control to ensure risk identification is accurate and that information used to determine the ALL is reliable. It is essential that management accurately classify the risk in individual assets to ensure the ALL model reflects an adequate amount of general allowance in relation to portfolio risk. Institutions commonly use the System risk rating guidance to classify risk and as the foundation of the model for determining the general allowance. It uses a dual approach that includes the probability that the borrower will default (Probability of Default) and a loss estimate on the loan assuming that the borrower does default (Loss Given Default). Other methods of classifying risk, such as UCS, may also be used, but institutions generally use the System risk rating guidance for a higher degree of granularity in deriving their ALL and managing portfolio risk. Refer to the *Risk Identification* Examination Manual topic for examining risk rating and UCS classification processes.

- ***Historical Losses:*** **Is historical chargeoff experience appropriately factored into the general allowance analysis?** The general allowance for a pool of loans should be based on loss factors that reflect historical chargeoff experience, with adjustment for current economic or other conditions. These loss factors are applied to loan pools in the current portfolio with similar characteristics or classifications. Methods for calculating loss rates include average historical chargeoff rates, migration analysis, and loss estimation models. If quantitative ALL estimates are considerably below historical losses, examiners should further investigate model reliability and accuracy. While there is no fixed period of losses the ALL must absorb per GAAP, FCA considers ALL coverage rates of 3 to 5 years average chargeoffs as a reasonable rule of thumb when evaluating ALL adequacy.

  - Loss history, in and of itself, should not be the basis for determining the appropriate ALL level. Management should always consider the need for qualitative adjustments.

  - The analysis of loss history needs to consider how the current operating environment compares to the environment experienced during the historical loss period being evaluated. It is possible that significant adjustments may be needed to reflect the effect of economic cycles. These adjustments should be well-documented and supported.

  - There may be times when an institution does not have its own historical loss experience on which to base its estimate of the credit losses in a loan pool. If an institution has no experience of its own for a loan pool, it may be appropriate to use the experience of other enterprises in the same lending business. The institution needs to demonstrate that attributes of the loan pool in its portfolio are similar to those of the other enterprise's loan pool*. This, however, should only be used until it has developed its own loss experience for a particular loan pool.* Regardless of the loss factor source and any changes made, the institution should have documentation supporting the loss factor used.

- ***Removal of Impaired Loans:* Are impaired loans evaluated for a specific allowance removed from the general allowance analysis?** The specific allowance amount for an impaired loan should not be supplemented by any general allowance determined in accordance with ASC 450-20 or ASC 310-10. Also, even if the impaired loan evaluation determined that a specific allowance was not required, the loan should not be included in the process for determining the general allowance. However, loans evaluated for impairment that were determined to not be impaired should remain in the general allowance pool when the specific characteristics of the loan indicate it is probable that there would be an incurred loss in a group of loans with those characteristics. For example, this may include a loan reviewed for impairment based on a substandard classification, but where projections indicate the borrower is able to service the debt from ongoing operations (thus not meeting the impairment definition under ASC 310-10). In a group of loans with these characteristics, it is likely the projections for one or more of the loans are inaccurate and incurred loss exists.

- ***Qualitative Adjustments:* Does the institution adequately evaluate the impact of current economic and other conditions or events on ALL adequacy?** Management should consider those qualitative or environmental factors that are likely to cause estimated credit losses associated with the institution's existing portfolio to differ from historical loss experience. Because historical loss experience will not include the impact of the current operating environment, management must be diligent in evaluating the impact current conditions will have on the loss factors used to evaluate the ALL. The analysis of current economic and other conditions or events may result in adjustments to the formula-driven ALL that relies primarily on historical loss experience. It can be incorporated into the ALL analysis by adjusting the loss factors for a loan pool, or through an industry-specific or event-specific

ALL adjustment. The adjustment factors should reflect management's best estimate of chargeoffs that will be recognized based on facts and circumstances that have occurred as of the date of the financial statements. Since the impact of these adjustments on current losses is uncertain, the institution should consider a range of possibilities if adjusting historical loss rate factors for individual loan pools. Failure to fully consider and document the impact of current conditions could result in an unsupported ALL and be considered an unsafe and unsound practice. When evaluating current conditions to determine if qualitative adjustments are needed, management should consider factors such as:

- *Economic or environmental conditions* – Examples of conditions to consider include:
    - Changes in international, national, regional, and local economic and business conditions, including the condition of various market segments that affect the institution's borrowers and portfolio collectability.
    - Changes in environmental or other conditions affecting the institution's borrowers.
    - Changes in the nature and volume of the portfolio (e.g., total loans, delinquencies, nonperforming or nonaccrual assets, and impaired loans).
    - The existence and effect of credit concentrations and changes in those concentrations.
    - The effect of other external factors, such as competition and legal and regulatory requirements, on estimated credit losses.
- *Staffing and lending practices* – Examples of factors to consider include changes in the experience or ability of lending management and staff, and changes in lending policies and procedures such as underwriting processes and practices.
- *Risk identification* – Qualitative adjustments may be needed if internal or external reviews identify concerns regarding risk identification or credit administration. Inaccurate and untimely risk identification and weak credit administration practices are often precursors to deterioration in portfolio quality.
- *Stress testing* – Stress testing is an appropriate way to support qualitative adjustments needed for changes in conditions, such as commodity prices, weather, or collateral values, that exist but may not be reflected in current risk ratings. For example, stress testing results can be used to show the expected impact on risk ratings for loans in a distressed commodity if the current risk ratings do not fully reflect the impact from the stress factors.
- *Unallocated amounts* – An ALL component labeled as *unallocated* is appropriate when it reflects estimated credit losses within the portfolio determined in accordance with GAAP and is properly supported and documented. As noted above, this could include an industry-specific or event-specific ALL adjustment.

Refer to the following supplemental guidance documents prepared by FCA for additional guidance and examples:

- Applying GAAP in the Allowance Analysis
- High-Risk Asset Accounting and Reporting

In addition, refer to the following documents developed by other federal regulatory agencies for further information on evaluating ALL adequacy:

- Interagency Policy Statement on the Allowance for Loan and Lease Losses
- ASC 310-10-S99-4 (SEC Staff Accounting Bulletin) *(link requires login to FASB website)*
- FedLinks Article - Allowance for Loan and Lease Losses

2. Policy, Procedures, & Controls:

Evaluate the adequacy of policy, procedures, and controls to guide the allowance process and to ensure compliance with GAAP and FCA guidance.

Guidance:

The board and management must establish policy and procedure guidance to ensure the ALL is consistent with GAAP and regulatory requirements. The guidance should require an ALL assessment on a regular basis, but not less than quarterly. If this assessment determines the ALL is inadequate or excessive, the guidance should require a timely ALL provision or reversal to ensure financial statement accuracy. In addition, internal controls should be sufficient to ensure compliance with policies and procedures. FCA Bookletter BL-049 contains guidance on ALL policies, procedures, and controls, with an emphasis on board and management roles in the ALL process. Refer to the Bookletter for specific expectations and minimum criteria that an institution should consider in its ALL process. In addition, examiners should address the following evaluative questions and items to consider when examining ALL policies and procedures:

- ***Board Policy*: Does the institution have an effective policy to establish and maintain the ALL consistent with GAAP and regulatory requirements? Has the board provided sufficient direction over the ALL process?** FCA Regulation 621.5(b) requires institutions to develop, adopt, and consistently apply ALL policies and procedures. The board policy should direct management to develop, document, and maintain an appropriate, systematic, and consistently applied process to ensure the ALL and related provision for loan losses are adequate and fully supported. Policies should specifically address the institution's unique goals, systems, risk profile, and personnel as they relate to the ALL process.

- ***Board Processes and Controls:* Does the board have sufficient processes and controls to review management's ALL analysis and recommendations and ensure compliance with the ALL policy?** The board or Audit Committee, if so delegated, should review and approve the amounts to be reported each period for the ALL and provision for loan losses. This may be completed as part of approving the quarterly financial statements. On a periodic basis, the board should ensure management evaluates the reliability of processes to estimate losses and adjusts calculation factors and models accordingly. Further, the board should oversee and monitor internal controls over the ALL process through management reporting and internal audit coverage. Controls over the ALL methodology should be tested to ensure validity and conformance to GAAP and regulatory guidance. Furthermore, the external auditor must evaluate the reasonableness of the ALL in issuing its opinion on the financial statements. Refer to the *FCS Board of Directors' Responsibilities* and the *Internal Controls* sections in FCA Bookletter BL-049 for specific criteria on the board's role related to ALL processes and controls.

- ***Management Operating Procedures and Practices:* Are operating procedures and practices consistent with GAAP, regulatory guidance, and the board policy?** Management must develop and implement suitable procedures that translate the board policy into appropriate standards and practices that comply with GAAP and regulatory guidance. FCA Regulation 621.5(b) requires policies and procedures to conform, at a minimum, to all applicable rules, definitions, and standards. The remaining bullets below highlight several specific aspects of the ALL process that procedures should address.

- ***Methodology:* Has the institution developed systematic methodologies to determine it's ALL and related provisions for loan losses?** Procedures should describe the methodology for assessing incurred loss exposure and estimating ALL needs to help ensure an effective ALL process. It is critical that ALL methodologies incorporate management's current judgment about loan portfolio quality through a disciplined and consistently applied process. This process is influenced by several institution-specific factors, such as institution size, organizational structure, business environment and strategy, management style, loan portfolio characteristics, loan administration procedures, and management information systems. The following are key ALL methodology components that institutions should address in procedures. Refer to the *Methodologies* section in FCA Bookletter BL-049 for additional considerations.

  - *Determining specific allowances* – How impairment under ASC 310-10 will be determined and measured, such as:

    - Methods to identify loans to be analyzed individually.

    - For impaired loans, methods or techniques to determine and measure the impairment amount, including steps to determine which technique is appropriate in a given situation.

    - Methods to determine how loans individually evaluated, but not considered to be impaired, should be grouped with other loans that share common characteristics, as part of the general allowance process. This should occur when the specific characteristics of the loan indicate it is probable there would be an incurred loss in a group of loans with those characteristics.

  - *Determining general allowances* – How impairment under ASC 310-10 and 450-20 will be determined and measured, such as:

    - Methods to group or segment loans with similar characteristics (e.g., by loan type, industry, past due status, and risk) and identify how loan classification or risk rating systems will be used.

    - Methods to determine loss rates (e.g., historical loss rates adjusted for environmental factors or migration analysis) and identify what factors are considered when establishing appropriate time frames over which to evaluate loss experience.

    - Descriptions of qualitative factors (e.g., industry, geographical, economic, and political factors) that may affect loss rates or other loss measurements.

- *Adjusting loss estimation methods* – How loss estimation methods will be periodically evaluated and tested to determine if estimated losses calculated by the model are consistent with actual subsequent chargeoffs.

- ***Documentation Requirements:* Do procedures appropriately address documentation expectations related to the ALL analysis process?** Procedures should identify the types of information that need to be documented as part of the ALL process. This includes items such as key judgments, assumptions, and analyses, as well as summaries of results and recommendations. Procedures should clearly identify documentation standards, giving consideration to the elements specifically outlined in ASC 310-10 and in the *Documentation Standards* section of FCA Bookletter BL-049. Appropriate supporting documentation contributes to the control environment, builds discipline and consistency into the ALL determination process, and improves the process for estimating loan losses by helping to ensure that all relevant factors are considered.

Refer to the following documents developed by other federal regulatory agencies for additional guidance and information on evaluating ALL policies, procedures, and controls:

- Interagency Policy Statement on the Allowance for Loan and Lease Losses
- ASC 310-10-S99-4 (SEC Staff Accounting Bulletin) *(link requires login to FASB website)*
- FedLinks Article - Allowance for Loan and Lease Losses

3. Audit:

Determine if the institution conducts an effective audit (scope, reporting, and followup) of the allowance for losses.

Guidance:

The internal audit and review program is a key mechanism for ensuring that ALL processes are functioning effectively and in compliance with regulations and policies. FCA Bookletter BL-049 notes that a sound internal control system provides for an audit of the allowance process and the adequacy of the level maintained. The internal auditor or other qualified, independent party should review ALL processes and adequacy to ensure compliance with applicable criteria. The audit risk assessment and scope should address ALL processes, and audit or review frequency should be commensurate with the complexity of the institution's operations and risk profile. A reliable audit program provides the board reasonable assurance that ALL processes are sound and related reporting is complete and accurate.

Note: This procedure focuses on evaluating the reliability and effectiveness of internal audits and reviews in this topical area. Refer to the *Audit & Review Programs* topic in the Examination Manual for guidance on examining the overall internal audit and review program.

Evaluative questions and items to consider when examining the audit or review of the ALL include:

- ***Audit Coverage:* Is there periodic audit or review coverage of the ALL?** Audit or review coverage and frequency should be appropriate relative to risks, changes in the operating environment, regulatory requirements, and periodic testing needs. Coverage should also be consistent with the institution's risk assessment results and annual audit plan.

- ***Scope and Depth:* Are audit or review scope and depth sufficient to conclude on the accuracy, completeness, and timeliness of the ALL process and results?** The scope and depth of work, including transaction testing, should cover the primary processes and controls within the area being audited or reviewed and be sufficient to determine if internal controls are functioning as intended and regulatory requirements are met. The scope and depth of coverage should be documented and consistent with the approved audit or review plan and engagement contract (if applicable). Audit or review workpapers should be examined to verify the actual scope and depth of work performed. The workpapers may indicate the scope and depth deviated from what was identified (or implied) in the audit plan. For example, workpapers may indicate the work performed was limited to evaluating the existence of policies and procedures and didn't include reviewing other controls, such as training or reporting, or testing compliance with regulations or institution guidance. If the work deviated materially from the original planned scope, internal audit should notify the board (or Audit Committee, if so delegated) of the reasons for the change. Specific items that should be considered in the audit or review scope include:

  - ALL policies and procedures.
  - Compliance with ALL policies, procedures, accounting requirements, FCA Regulations, and other FCA guidance.
  - Monitoring and control processes (e.g., reporting, management oversight, delegated authorities, separation of duties, management information systems and data).
  - Analysis supporting the ALL.
  - Impaired loan identification and specific allowance evaluations, including sufficient transaction testing to ensure established criteria are followed.
  - Management of all significant ALL management models, including consistency with the institution's overall model risk management framework.
  - Fraud-related threats and vulnerabilities, as well as anti-fraud controls.

- ***Reliability of Results:*** **Did FCA identify any concerns with audit or review reliability?** It is important to understand the scope and depth of the audit or review being examined, as discussed above, when evaluating audit or review reliability. With this understanding, the following are key considerations when evaluating the reliability of audit or review results:

  - *FCA Testing* – Evaluate the reliability of internal audit or review work by comparing the results to FCA's examination results in this area. This comparison often includes FCA testing transactions that were covered in the internal audit or review (transactions are often loans or loan applications, but may include other types of transactional activity, as well). In addition to the audit or review report, examiners should request and review the workpapers and hold discussions with the auditor to obtain a more thorough understanding of work completed. This can be especially important if the audit or review report is not sufficiently detailed or FCA's examination work and testing identifies potential concerns. Auditors and reviewers complete line sheets, flowcharts, control matrices, standard work programs, workpaper forms, or other relevant audit evidence when conducting and supporting their work. (IIA Standards 2240, 2300, 2310, and 2320) Workpapers should adequately document the work performed and support the final report. If FCA identifies weaknesses that were not identified in the audit or review, the cause for any discrepancy should be determined.

- *Audit/Review Staffing* – Whether internal or outsourced, auditors and reviewers conducting the work need to be qualified, independent, and objective to ensure reliable results. They should have the right mix of knowledge, skills, and other competencies needed to perform the work. (IIA Standard 2230) Additionally, auditors and reviewers need to be independent of the activities they audit so they can carry out their work freely and objectively. (IIA Standards 1100, 1112, 1120, and 1130) For example, audit and review staff should not be involved in developing and installing procedures, preparing records, operating a system of internal controls, or engaging in any other activity that they would normally review. Examiners should evaluate the staffing on the individual audit or review being examined as part of determining the reliability of results.

- *Institution Review of Work Performed* – The institution should complete an independent review of the workpapers to ensure audit or review objectives and scope were met and the results and conclusions were reliable and supported. (IIA Standard 2340) Examples could include a supervisory review of in-house audit work by the CAE or other audit staff, or a review of outsourced work by the CAE or audit coordinator. Examiners should consider whether the institution completed these reviews, and if any concerns were identified, when concluding on audit or review reliability.

- ***Reports:* Does the internal audit or review report sufficiently communicate ALL review results and recommendations, if applicable?** Examiners should consider the following when evaluating the audit or review report:

  - Is the report prepared and communicated in accordance with the institution's guidelines?
  - Is an executive summary or overview included to provide the board with a general conclusion on audit or review results?
  - Is the report accurate, concise, supported, and timely in communicating the audit or review objectives, scope, results, conclusions, and recommendations? (IIA Standards 2330, 2400, 2410, 2420, 2440, and 2450)
  - Are conclusions and recommendations realistic and reasonable, with material and higher risk issues clearly identified and prioritized?
  - Are conclusions and recommendations supported by convincing evidence and persuasive arguments (condition, criteria, cause, and effect)?
  - Do results in the workpapers align with report conclusions?
  - Does the report conclude whether the institution adheres to policies, procedures, and applicable laws or regulations, and whether operating processes and internal controls are effective?
  - Does the report address potential vulnerabilities to fraud, if applicable?

- ***Corrective Action:* Are management responses to audit or review findings in this area reasonable, complete, and timely? Have corrective actions been effective?** Audits and reviews are only effective if corrective action is taken to remedy the weaknesses identified. As such, there should be a reasonable, complete, and timely management response to the audit or review report. Management commitments and agreements or any areas of disagreement should be documented in the report or in a separate memo or tracking system. (IIA Standards 2500 and 2600) If corrective actions are not resolving the issues or concerns in a timely manner, examiners should further investigate the reasons. For example, this could indicate the audit or review did not sufficiently identify the underlying causes or materiality of weaknesses, sufficient resources are not being directed toward corrective actions, or weaknesses exist in the institution's corrective action process, including board oversight of the process.

4. Transaction Testing:

Examine individual assets to assess accuracy of the recorded allowance, compliance with regulatory requirements and the institution's guidance or standards, and reliability of allowance-related internal controls.

Guidance:

The ALL examination should be supplemented as necessary with transaction testing conducted as part of FCA's loan review. This testing should determine if policies, procedures, and internal controls are working as intended when establishing specific allowances on individual loans. When selecting a loan sample, examiners should consider including both impaired loans and other adversely classified loans that have not been identified as impaired.

Some specific objectives of ALL-related transaction testing are to determine the following:

- Reasonableness of the impairment decision.
- Adequacy of the collateral evaluation, including whether it reasonably reflects the current fair value. This should be supported by a recent inspection to verify existence and condition, and be adjusted for current conditions and distressed sale values if applicable. Liquidation values should be used if that is the anticipated collection method.
- Reasonableness and support for the cost to sell estimate. This should factor in the costs to acquire and market the assets and be reasonable based on the asset type. The fair value of the collateral less the costs to sell is the amount the institution anticipates collecting upon disposition, and is commonly referred to as the net realizable value.
- Accuracy of the specific allowance calculation.
- Accuracy of internal audit or review testing and related conclusions.
- Consistency in reporting specific allowances on shared assets. FCA's Informational Memorandum on Allowance for Loan Losses dated June 30, 2009, identifies the need for consistently reporting these assets. Any differences should be justified and documented.

When evaluating the specific allowance calculation, examiners should consider whether the institution appropriately addressed the need for immediate loss recognition. In addition, it is important that risk ratings are accurate to support the general allowance determination. Transaction testing for chargeoffs and risk ratings is addressed in the *Risk Identification* Examination Manual topic.