EXPOSURE DRAFT

PROPOSED STATEMENT OF POSITION

ALLOWANCE FOR CREDIT LOSSES

JUNE 19, 2003

Prepared by the Accounting Standards Executive Committee
American Institute of Certified Public Accountants

Comments should be received by September 19, 2003, and sent by electronic mail to fgill@aicpa.org, or addressed to
Frederick Gill, Senior Technical Manager
Accounting Standards, File 3480, AICPA, 1211 Avenue of the Americas, New York, NY 10036-8775

June 19, 2003

Accompanying this letter is an exposure draft of a proposed AICPA Statement of Position (SOP) *Allowance for Credit Losses*. A summary of the proposed SOP follows this letter.

The purpose of the exposure draft is to solicit comments from preparers, auditors, and users of financial statements and other interested parties.

The proposed SOP would provide guidance on the recognition and measurement by creditors of the allowance for credit losses related to loans in conformity with generally accepted accounting principles. It would also require creditors to make certain financial statement disclosures related to the allowance for credit losses.

AREAS REQUIRING PARTICULAR ATTENTION BY RESPONDENTS

Comments are specifically requested on the following issues addressed by this exposure draft.

Scope

Issue 1: Is the scope of the proposed SOP set forth in paragraph 6 readily understandable with respect to the kinds of loans and the kinds of entities to which the proposed SOP would apply? Do you agree or disagree with the scope? If you disagree, what changes would you recommend?

Issue 2: The scope of the proposed SOP would exclude loans that are unconditional promises to give that are assets of not-for-profit organizations and that are due in one year or less. That implies (*a*) that unconditional promises to give that are assets of not-for-profit organizations are *loans*, as that term is defined in paragraph 4 of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 114, *Accounting by Creditors for Impairment of a Loan*, and (*b*) that unconditional promises to give that are assets of not-for-profit organizations and that are due in more than one year are in the scope of the proposed SOP. Do unconditional promises to give that are assets of not-for-profit organizations meet the definition of loans? If not, why not? Do you believe unconditional promises to give that are assets of not-for-profit organizations and that are due in more than one year should be included in the scope of the proposed SOP regardless of whether they meet the definition of loans? If not, why not?

Recognition and Measurement

Issue 3a: SOP 03-X, *Accounting for Loans or Certain Debt Securities Acquired in a Transfer*,[1] paragraph 13, permits investors to aggregate smaller balance homogeneous loans that were acquired in the same fiscal quarter and that have *common risk characteristics*, as defined, and thereby use a composite interest rate and cash flow expectation for the pool for purposes of the recognition, measurement, and disclosure provisions of that SOP. SOP 03-X requires investors to maintain the integrity of such a pool once it is assembled. In contrast, the proposed SOP states in paragraph 17 that certain loans should be grouped for purposes of collective loan impairment evaluation into pools based on *similar credit risk characteristics*, as defined in the proposed SOP. The Accounting Standards Executive Committee (AcSEC) chose to use a different basis for the grouping of loans into pools in the proposed SOP because AcSEC believes the concept of common risk characteristics, as defined in SOP 03-X, is too restrictive for purposes of collective loan impairment evaluation. In addition, AcSEC viewed SOP 03-X as a revenue recognition model rather than a loss recognition model. Is the difference between the guidance in the proposed SOP and the guidance in SOP 03-X on pools of loans appropriate? What practical difficulties would the application of the guidance in the proposed SOP by an entity that is also complying with SOP 03-X present? Would the proposed SOP's aggregation guidance impose an unjustifiable cost on an entity that is also complying with SOP 03-X?

[1] SOP 03-X, *Accounting for Loans or Certain Debt Securities Acquired in a Transfer*, has not yet been issued.

Issue 3b: The proposed SOP would apply to loans that are within the scope of SOP 03-X. Concerning recognition and measurement of any impairment subsequent to acquisition, however, the proposed SOP states that, although paragraphs 19 and 20 are applicable to loans that are within the scope of SOP 03-X, as defined in paragraph 3 of that SOP, for purposes of determining whether impairment of multiple loans accounted for as a single asset may have occurred, the methodology for recognition and measurement of any loss is set forth in SOP 03-X. Other guidance in the proposed SOP, such as the guidance on loan impairment concepts and components of the allowance for credit losses and the proposed disclosure requirements, would apply to loans within the scope of SOP 03-X, as defined in paragraph 3 of that SOP, in its entirety. Is the applicability of the proposed SOP to loans within the scope of SOP 03-X sufficiently clear?

Issue 4: The proposed SOP requires creditors to consider relevant observable data in the recognition and measurement of components of collective loan impairment and to support each component of collective loan impairment with one or more sets of observable data. Is the concept of observable data described in paragraph 19 of the proposed SOP understandable? Do you agree with the proposed SOP's requirements concerning relevant observable data? If not, why not?

Issue 5: The proposed SOP requires in paragraph 25 that creditors consider the directional consistency of the measurement of a component of collective loan impairment with changes in the relevant observable data from period to period, taking into account the interaction of components of collective loan impairment over time. Is that concept understandable? Do you agree with that guidance? If not, why not?

Issue 6: The proposed SOP, which is premised on an incurred loss model, provides only limited guidance on the measurement of impairment in a pool of loans. AcSEC considered several measurement methods and techniques but could identify no single measurement method or technique that should be required in all situations to capture losses that have been incurred while excluding from the measurement those future losses that are expected to occur but that have not yet occurred. AcSEC decided not to prescribe any specific methodology. Should the proposed SOP require a specific impairment measurement method or technique for pools of loans? If so, please describe the method or technique you would propose and your views on why it would produce results that are in conformity with existing authoritative literature.

Disclosures

Issue 7: Paragraph 28 of the proposed SOP sets forth additional disclosure requirements related to the allowance for credit losses. Do you believe the volume of the disclosures set forth in the proposed SOP is too much, just right, or not enough? Will the proposed disclosures be useful to users of financial statements? Will preparers be able to develop the proposed disclosures from existing information? If not, would it be unjustifiably costly to obtain the necessary information and why?

AcSEC welcomes comments or suggestions on any aspect of this exposure draft. When making comments or suggestions, please refer to specific paragraph numbers, include reasons for any comments or suggestions, and provide alternative wording where appropriate.

Comments on the exposure draft should be sent by electronic mail to fgill@aicpa.org, or addressed to Frederick Gill, Senior Technical Manager, Accounting Standards, File 3480, American Institute of Certified Public Accountants, 1211 Avenue of the Americas, New York, NY 10036-8775, in time to be received by September 19, 2003. Responses should not be faxed.

Written comments on the exposure draft will become part of the public record of the AICPA and will be available for public inspection at the AICPA offices after XXXXX, for one year.

Sincerely,

Mark V. Sever, CPA
Chair
Accounting Standards
Executive Committee

Martin F. Baumann, CPA
Chair
Loan Losses Task Force

Daniel J. Noll, CPA
Director
Accounting Standards

Accounting Standards Executive Committee

(2001-2002)

Mark V. Sever, *Chair*
Mark M. Bielstein
Val R. Bitton
Lawrence N. Dodyk
Karin A. French
David W. Hinshaw
James A. Koepke
Robert J. Laux
Francis T. McGettigan
Andrew M. Mintzer
Richard H. Moseley
Benjamin S. Neuhausen
Paula C. Panik
Ashwinpaul C. Sondhi
Mary S. Stone

Loan Losses Task Force

Martin F. Baumann, *Chair*
Randy Black
James L. Brown
Donald Chapin
Karin A. French
Carol H. Larson
Dayton G. Lierley
David M. Morris
Greg Norwood
Michael L. Richards

AICPA Staff

Daniel J. Noll
Director
Accounting Standards

Frederick Gill
Senior Technical Manager
Accounting Standards

The task force and staff also gratefully acknowledge the contributions of former task force member Dorsey L. Baskin, Jr., and of Stephen Connelly, Sydney Garmong, Jay W. Harris, and Eric J. Schuppenhauer.

Summary

This Statement of Position (SOP) addresses the recognition and measurement by creditors of the allowance for credit losses related to all *loans*, as that term is defined in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 114, *Accounting by Creditors for Impairment of a Loan*, with certain exceptions. This SOP applies to all creditors other than state and local governmental entities and federal governmental entities.

This SOP amends existing guidance in the AICPA Audit and Accounting Guide *Certain Financial Institutions and Entities That Lend to or Finance the Activities of Others.*[1]

This SOP provides that:

- The allowance for credit losses reported on a creditor's balance sheet should consist only of (1) a component for individual loan impairment recognized and measured pursuant to FASB Statement No. 114 and (2) one or more components of collective loan impairment recognized pursuant to FASB Statement No. 5, *Accounting for Contingencies*, and measured in accordance with the guidance in this SOP.
- If a creditor evaluates or grades an individual loan as part of a credit risk evaluation or grading process, that loan has been "identified for evaluation" within the meaning of paragraph 6 of FASB Statement No. 114.
- A creditor should group into pools, based on similar credit risk characteristics**,** loans other than those that were individually determined to be impaired. Those pools should be evaluated for collective loan impairment and include loans that were individually evaluated and determined to not be impaired and loans that were not individually evaluated. Loans that have been individually evaluated and have been determined to be impaired, regardless of whether an impairment allowance has been recorded,[2] should not be included in those pools.
- Creditors should specifically consider relevant observable data in the recognition and measurement of components of collective loan impairment and each component of collective loan impairment should be supported with one or more sets of relevant observable data.
- The measurement of a component of collective loan impairment should be directionally consistent with changes in the related observable data from period to period, taking into account the interaction of components of collective loan impairment over time.
- Creditors should change the observable data considered only if changes in the environment indicate that other observable data has become more relevant or if new observable data that is more relevant becomes available.
- Components of the allowance for credit losses recognized pursuant to FASB Statement No. 5, that is, components of collective loan impairment, should be measured based on the present value of expected future cash flows. Each component of collective impairment should be estimated based on relevant observable data relating to existing conditions; creditors should not project changes in the observable data that may occur in the future. The estimate of loss in pools of loans should reflect losses that have already been incurred, even if not yet identifiable, and not losses that might be incurred over the remaining life of the loans, even if predictable based on historical experience.

The provisions of this SOP are effective for financial statements for fiscal years beginning after December 15, 2003. Earlier application of this SOP is permitted. The effect of initially applying the provisions of this SOP should be reported as a change in accounting estimate. Previously issued financial statements should not be restated.

[1] The AICPA Audit and Accounting Guide *Certain Financial Institutions and Entities That Lend to or Finance the Activities of Others* has not been issued as of the date of this exposure draft.

[2] A loan may be evaluated for impairment because of its past-due status or deterioration in the credit worthiness of the borrower. Although the creditor may conclude that the loan is impaired because it is probable that the creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement, in certain situations, no impairment allowance is recognized due to mitigating factors (such as collateral value substantially in excess of the recorded amount of the loan and any accrued interest). Even though the loan evaluation resulted in no allowance, that loan is nonetheless considered impaired under Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 114, *Accounting by Creditors for Impairment of a Loan,* and not eligible for any further impairment evaluation under FASB Statement No. 5, *Accounting for Contingencies*.

TABLE OF CONTENTS

Page
Number

SUMMARY **6**
FOREWORD **8**
INTRODUCTION **9**
SCOPE **10**
CONCLUSIONS **10**
Loan Impairment Concepts 10
Components of the Allowance for Credit Losses 11
Individual Loan Impairment 12
Collective Loan Impairment 12
Disclosures 15
EFFECTIVE DATE AND TRANSITION **16**
APPENDIX A - Background Information and Basis for Conclusions **17**
APPENDIX B – Examples Illustrating the Application of this Statement of Position **24**
APPENDIX C - Amendments to Existing AICPA Pronouncements **40**
GLOSSARY **41**

FOREWORD

The accounting guidance contained in this document has been cleared by the Financial Accounting Standards Board (FASB). The procedure for clearing accounting guidance in documents issued by the Accounting Standards Executive Committee (AcSEC) involves the FASB reviewing and discussing in public board meetings (1) a prospectus for a project to develop a document, (2) a proposed exposure draft that has been approved by at least 10 of AcSEC's 15 members, and (3) a final document that has been approved by at least 10 of AcSEC's 15 members. The document is cleared if at least four of the seven FASB members do not object to AcSEC undertaking the project,[*] issuing the proposed exposure draft or, after considering the input received by AcSEC as a result of the issuance of the exposure draft, issuing the final document.

The criteria applied by the FASB in its review of proposed projects and proposed documents include the following.

1. The proposal does not conflict with current or proposed accounting requirements, unless it is a limited circumstance, usually in specialized industry accounting, and the proposal adequately justifies the departure.

2. The proposal will result in an improvement in practice.

3. The AICPA demonstrates the need for the proposal.

4. The benefits of the proposal are expected to exceed the costs of applying it.

In many situations, prior to clearance, the FASB will propose suggestions, many of which are included in the documents.

[*] At the time the Accounting Standards Executive Committee (AcSEC) undertook this project, at least five of the seven Financial Accounting Standards Board members were required to not object to AcSEC undertaking this project.

PROPOSED STATEMENT OF POSITION

ALLOWANCE FOR CREDIT LOSSES

INTRODUCTION

1. This Statement of Position (SOP) addresses the accounting by creditors for the allowance for credit losses related to loans. It provides guidance on how those entities should determine the allowance for credit losses in accordance with Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*; FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan* (as amended by FASB Statement No. 118, *Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures*); and FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss.*

2. The allowance for credit losses is a valuation account used by creditors to recognize impairment of a creditor's recorded investment in loans[1] on its balance sheet before losses have been confirmed resulting in a subsequent charge-off or write-down.[2] The balance in this account on any reporting date is an accounting estimate of probable but unconfirmed asset impairment that had occurred in the creditor's loan portfolio as of the date of the financial statements. The determination of that balance involves significant judgment about when a loss has been incurred and the amount of that loss.

3. Some believe existing authoritative literature related to the allowance for credit losses permits excessive flexibility in its application. Others believe allowances for credit losses currently tend to reflect the past credit quality of a loan portfolio rather than the current credit quality of a loan portfolio. Some suggest that an allowance for credit losses is often inappropriately increased in periods of improving credit quality and earnings, and reduced in periods of declining credit quality and earnings. Still others have expressed concerns regarding compliance with existing generally accepted accounting principles (GAAP) with respect to accounting for the allowance for credit losses, the adequacy of documentation supporting a reported allowance for credit losses,[3] and the sufficiency of financial statement disclosures

---

[1] Footnote 17 of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings,* states, "The recorded investment in the receivable is the face amount increased or decreased by applicable accrued interest and unamortized premium, discount, finance charges, or acquisition costs and may also reflect a previous direct write-down of the investment."
FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities,* paragraph 27, addresses impairment requirements for an asset designated as being hedged and accounted for pursuant to paragraphs 22 through 24. If an entity adjusts the carrying amount of a loan pursuant to paragraph 22 of FASB Statement No. 133 for gain or loss attributable to a hedged risk of (*a*) changes in the overall fair value of the loan since the date the loan was originated or acquired (that is, the fair value was equal to the carrying amount) or (*b*) changes in its fair value attributable to changes in the obligor's creditworthiness since the date the loan was originated or acquired (that is, the fair value was equal to the carrying amount), no allowance for credit losses should be provided for that loan. FASB Derivatives Implementation Group Issue No. F4, "Fair Value Hedges: Interaction of Statement 133 and Statement 114," provides additional implementation guidance on the measurement of impairment of the recorded investment in a hedged loan.

[2] The term *charge-off* is commonly used in the financial services industry, whereas *write-down* is commonly used in other industries. From this point forward, *charge-off* and *write-down* are used in this Statement of Position (SOP) interchangeably.

[3] In July 2001, the federal banking agencies, under the auspices of the Federal Financial Institutions Examination Council (FFIEC), issued a policy statement, *Interagency Policy Statement on Allowance for Loan and Lease Losses (ALLL) Methodologies and Documentation for Banks and Savings Associations*. The policy statement provides guidance on the design and implementation of ALLL methodologies and supporting documentation practices. Specifically, it emphasizes the banking agencies' longstanding position that institutions should maintain and support the ALLL with documentation that is consistent with their stated policies and procedures, generally accepted accounting principles, and applicable supervisory guidance; and provides guidance on maintaining and documenting policies and procedures that are appropriately tailored to the size and complexity of the institution and its loan portfolio. In July 2001, the Securities and Exchange (SEC) staff issued Staff Accounting Bulletin No. 102, *Selected Loan Loss Allowance Methodology and Documentation Issues*. The staff accounting bulletin expresses certain of the staff's views on the development, documentation, and application of a systematic methodology as required by Financial Reporting Release No. 28, "Accounting for Loan Losses by Registrants Engaged in Lending Activities," for determining allowances for loan and lease losses in accordance with generally accepted accounting principles. In particular, the guidance focuses on the documentation the staff normally would expect registrants to prepare and maintain in support of their allowances for loan losses. The bulletin and policy were issued in light of the March 10, 1999, Joint Interagency Letter to Financial Institutions, in which the SEC staff and federal banking agencies agreed to provide parallel guidance on loan loss allowance methodologies and supporting documentation.

related to the allowance for credit losses. Many critics of current accounting practice agree, however, that shortcomings in financial reporting of the allowance for credit losses appear to stem, in part, from a lack of sufficient guidance in the authoritative literature. Accordingly, the AICPA's Accounting Standards Executive Committee (AcSEC) undertook this project to provide further authoritative guidance on accounting for the allowance for credit losses and to enhance financial statement disclosures related to the allowance for credit losses in order to improve the transparency of financial reporting.

4. Although some believe that the allowance for credit losses should include losses expected to be incurred in the future in addition to losses incurred at the date of the financial statements, AcSEC did not consider an "expected loss" model because such a model is inconsistent with the requirements of FASB Statement No. 5.

5. AcSEC believes that this SOP will improve practice regarding the accounting for the impairment of a creditor's recorded investment in loans and will result in a more narrow and consistent application of GAAP. Further, all other things being equal, AcSEC believes this SOP will result in creditors increasing their allowance for credit losses in periods of weakening portfolio credit quality and decreasing their allowance for credit losses in periods of improving portfolio credit quality, thus addressing what AcSEC believes is a significant criticism of the application of current guidance. AcSEC acknowledges that the allowance is not a pure mathematical computation but involves the use of significant judgment and expertise.

SCOPE

6. This SOP applies to all creditors other than state and local governmental entities and federal governmental entities. This SOP addresses the recognition, measurement, and disclosure by creditors of the allowance for credit losses related to all *loans,* as that term is defined in FASB Statement No. 114,[4] except for the following:

a. Loans that are measured at fair value or at the lower of cost or fair value
b. Leases accounted for in accordance with FASB Statement No. 13, *Accounting for Leases*
c. Debt securities, as defined in FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*
d. Loans, other than purchased or originated credit card receivables, that are:
   - Accounts receivable with contractual maturities of one year or less and that arose from the sale by the reporting entity of goods or services, or
   - Unconditional promises to give that are assets of not-for-profit organizations and that are due in one year or less
e. Amounts intended to provide security for a counterparty to an agreement with the reporting entity (for example, security deposits, retainages on construction contracts)
f. Loans that are retained interests[5]

CONCLUSIONS

Loan Impairment Concepts

7. FASB Statement No. 5 requires the accrual of a loss when it is probable[6] that an asset has been impaired and the amount of the loss can be reasonably estimated.[7] FASB Statement No. 114, paragraph

[4] FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*, paragraph 4, defines a loan as "a contractual right to receive money on demand or on fixed or determinable dates that is recognized as an asset in the creditor's statement of financial position. Examples include but are not limited to accounts receivable (with terms exceeding one year) and notes receivable."
[5] The Emerging Issues Task Force (EITF) discussed accounting for loans that are retained interests in EITF Issue No. 99-20, "Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets."
[6] *Probable* is used in this SOP with the same meaning as in FASB Statement No. 5, *Accounting for Contingencies,* paragraphs 8 and 84.
[7] FASB Statement No. 5, paragraph 8, states:

8, defines a loan as being "impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement." An allowance for credit losses should be established only if an assessment of current information indicates that it is probable that an asset had been impaired as of the balance-sheet date and the amount of the loss can be reasonably estimated.

8. The fundamental objective of existing GAAP for the allowance for credit losses is for a creditor to recognize loan impairment in the financial statements for the period in which the impairment occurred and in the amount of the impairment that occurred. Impairment should not be recognized before it is probable that impairment *has* occurred, even though it may be expected that impairment *will* occur in the future. Conversely, recognition of asset impairment should not be deferred to periods after the period in which the impairment has occurred if the amount of impairment can be reasonably estimated.

9. FASB Statement No. 5 notes in paragraph 59 that "[a]ttribution of a loss to events or activities of the current or prior periods is an element of asset impairment." Occasionally, a creditor may be able to identify a single, distinct event that caused an individual loan or a pool (portfolio or specific category) of loans to be impaired. In most cases, however, a creditor will be unable to identify a single, distinct event that caused the impairment; rather, there will be an accumulation or series of events that have occurred over time resulting in the impairment of an individual loan or a pool of loans.

10. Determining an appropriate allowance for credit losses involves a significant degree of estimation and judgment. Credit loss estimation processes require many discrete judgments, which result in recognition of an overall allowance for credit losses. The process of estimating the allowance for credit losses (or its collective impairment components, as discussed further in this SOP) may result in either a specific amount representing the impairment estimate or a range of possible amounts. In accordance with FASB Interpretation No. 14, a creditor should 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.[8] In determining the best estimate, the creditor should take into account all relevant information available prior to the issuance of the financial statements about conditions existing at the balance-sheet date, including credit quality, current trends (that are indicative of current conditions and not projections), and existing environmental factors (for example, industry, geographical, and economic factors). A creditor should not default to the minimum amount within the range to avoid recognizing its best estimate within the range.

11. For loans that were acquired by the reporting entity subsequent to their origination, the allowance for credit losses should reflect only those losses incurred by the investor-creditor after acquisition; it should not reflect losses incurred by previous owners of the loans.[9]

Components of the Allowance for Credit Losses

12. FASB Statement No. 114 provides guidance on accounting for credit losses associated with individually impaired loans. FASB Statement No. 5 provides guidance on accounting for credit losses associated with pools of loans that are either outside the scope of FASB Statement No. 114 or that are not considered individually impaired pursuant to FASB Statement No. 114. The allowance for credit losses reported on a creditor's balance sheet should consist only of (*a*) a component for individual loan

---

> An estimated loss from a loss contingency (as defined in paragraph 1) shall be accrued by a charge to income if *both* of the following conditions are met:
>
> a. Information available prior to the issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements. It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss.
>
> b. The amount of the loss can be reasonably estimated. [Footnotes omitted]

[8] Paragraph 10 of FASB Statement No. 5 requires disclosure of the additional exposure to loss if there is at least a reasonable possibility of loss in excess of the amount accrued.

[9] Statement of Position 03-X, *Accounting for Loans or Certain Debt Securities Acquired in a Transfer*, addresses accounting for differences between contractual and expected cash flows from an investor's initial investment in certain loans or debt securities acquired in a transfer if those differences are attributable, at least in part, to credit quality. That SOP has not yet been issued.

impairment recognized and measured pursuant to FASB Statement No. 114 and (*b*) one or more components of collective loan impairment recognized pursuant to FASB Statement No. 5 and measured in accordance with the guidance in this SOP. No other components should be recognized.

Individual Loan Impairment

13. If a creditor evaluates or grades an individual loan as part of a **credit risk evaluation or grading process**,[10] that loan has been "identified for evaluation" within the meaning of paragraph 6 of FASB Statement No. 114. Loans identified for evaluation for impairment are, with certain exceptions,[11] within the scope of FASB Statement No. 114.

14. When a loan has been identified for evaluation pursuant to paragraph 13 of this SOP, a creditor should make an explicit decision as to whether or not the loan is individually impaired in accordance with paragraph 8 of FASB Statement No. 114. If the loan is deemed to be impaired, the creditor should measure impairment in accordance with paragraphs 12 through 16 of FASB Statement No. 114.[12]

15. If a creditor determines that an individual loan that was identified for evaluation is impaired, the amount of the allowance for credit losses determined pursuant to FASB Statement No. 114 should not be supplemented by an allowance for credit losses determined pursuant to FASB Statement No. 5, even if the measurement of impairment under FASB Statement No. 114 results in no allowance for credit losses.[13]

16. If a creditor determines that an individual loan that was identified for evaluation is not impaired, the creditor should determine whether there are other loans with **similar credit risk characteristics** and, if there are, the loan should be included in a pool of loans that is collectively evaluated for impairment ("collective loan impairment") in accordance with FASB Statement No. 5, paragraph 22.[14]

Collective Loan Impairment[15]

17. *Aggregation of loans*. A creditor should group into pools, based on similar credit risk characteristics, all loans other than those that were individually determined to be impaired.[16] Those pools should be evaluated for collective loan impairment and include loans that were individually evaluated and determined to not be impaired and loans that were not individually evaluated. Loans that have been individually evaluated and have been determined to be impaired, regardless of whether an impairment allowance has been recorded,[17] should not be included in those pools.

---

[10] Terms defined in the glossary are set in boldface type the first time they appear in this SOP.

[11] FASB Statement No. 114, paragraph 6, excludes the following from the scope of that Statement:

- Large groups of smaller-balance homogeneous loans that are collectively evaluated for impairment
- Loans that are measured at fair value or at the lower of cost or fair value
- Leases, as defined in FASB Statement No. 13, *Accounting for Leases*
- Debt securities as defined in FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*

[12] The measure of impairment under FASB Statement No. 114 is based on a single best estimate and not a range of estimates.

[13] A loan can be deemed impaired in accordance with FASB Statement No. 114 and yet the measurement of impairment under FASB Statement No. 114 may result in no allowance for credit losses, for example, if it is probable the creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement but the loan is collateral dependent and is fully collateralized.

[14] FASB Statement No. 114 states in paragraph 7, "In addition to the allowance calculated in accordance with this Statement, a creditor should continue to recognize an allowance for credit losses necessary to comply with Statement 5."

[15] This SOP's pooling criteria do not apply to loans that are within the scope of SOP 03-X, *Accounting for Loans or Certain Debt Securities Acquired in a Transfer*, as defined in paragraph 3 of that SOP. Furthermore, although the guidance in paragraphs 19 and 20 of this SOP is applicable to loans that are within the scope of SOP 03-X, as defined in paragraph 3 of that SOP, for purposes of determining whether impairment of multiple loans accounted for as a single asset may have occurred, the methodology for recognition and measurement of any loss is set forth in SOP 03-X.

[16] FASB Statement No. 5, paragraph 22, states that the conditions for accrual of an estimated loss from a loss contingency "may be considered in relation to individual receivables or in relation to groups of similar types of receivables."

[17] See footnote 13.

18. *Allowance components related to collective loan impairment.* A component of the allowance for credit losses based on historical charge-off experience should be the primary basis for the recognition and measurement of collective loan impairment for a pool of loans. However, historical charge-off experience, without adjustment, may not be representative of current impairment of the pool of loans because of changed circumstances. Thus, creditors should consider whether historical charge-off experience needs to be adjusted to reflect the effects of current conditions that did not affect the period that the historical charge-off experience covers.[18] Further, the historical charge-off experience component may need to be adjusted to remove the effects of conditions in the historical period that do not exist currently. For example, changes in the age of loans in a portfolio,[19] changes in the creditor's underwriting standards, changes in the business climate in a particular industry to which the creditor has loans outstanding, or changes in economic conditions affecting consumer borrowers in a particular geographic region may require an adjustment. Each adjustment to a historical charge-off experience component of the allowance for credit losses should be considered a separate component of the allowance. Thus there may be multiple components of the allowance for credit losses that relate to the same pool of loans.[20] Both components based on historical charge-off experience and components that adjust historical charge-off experience are hereinafter referred to as components of collective loan impairment.

19. *Observable data.* Each component of collective loan impairment should be supported with relevant **observable data**. Observable data is relevant for a particular creditor if it is representative of the component of collective loan impairment (in other words, if the data provides information about the existence of a factor that has a logical relationship to the probability of incurred credit losses in a pool of loans for that creditor or about how that factor affects the amount of incurred credit losses in the pool for that creditor). Observable data is not relevant if its relationship to impairment of a pool of loans is purely or primarily coincidental. A creditor need not demonstrate a direct mathematical correlation between the observable data and the amount of the element of asset impairment that the component of collective loan impairment is intended to capture—it is sufficient that the observable data be indicative of an increase or a decrease in the element of asset impairment. Creditors should make a reasonable effort to obtain relevant observable data to support their components of collective loan impairment.

20. Creditors may be unable to identify relevant observable data to support recognition and measurement of a component of collective loan impairment. In those cases, recognition of the component would be inappropriate and the creditor should consider the need for disclosure pursuant to paragraph 10 of FASB Statement No. 5 and paragraphs 13 and 14 of SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties.*

21. Following are illustrative examples of components of collective loan impairment and of relevant observable data that may support them depending on their relevance to the specific lending environment and risk characteristics for the specific creditor. Each of the components described below may be one of multiple components relating to a creditor's collective loan impairment estimate.

- *Component*: historical charge-off experience for credit risk graded loans or loans grouped by industry that are not individually impaired in accordance with FASB Statement No. 114. *Observable data*: charge-off data[21] for the particular credit risk grade or industry group.[22]
- *Component*: historical charge-off experience for consumer loans grouped by payment status (that is, current, 30 days past due, 60 days past due, greater than 90 days past due). *Observable data*: charge-off data for the respective payment categories.

[18] Whether the historical charge-off experience requires adjustment and the extent of any adjustment is necessarily a matter of judgment.
[19] Pools of loans generally include loans that are in various stages of their contractual life, including loans that were originated recently. Originating a loan does not, in and of itself, satisfy the loss recognition criteria of FASB Statement No. 5, unless there is a faulty credit underwriting decision, fraud, or a change in circumstances between the credit decision and loan origination.
[20] Multiple components of collective loan impairment should not result in double-counting loss amounts associated with pools of loans.
[21] Charge-offs of the recorded investment in a loan are often used by creditors as a substitute for confirmed losses.
[22] Creditors should also consider recoveries of amounts charged-off to the extent that recoveries would be a significant factor in estimating historical charge-off rates.

- *Component*: adjustment to historical charge-off experience for consumer loans affected by a change in bankruptcy rates. *Observable data*: publicly available bankruptcy data.
- *Component*: historical charge-off experience for long-term product financing; *Observable data*: charge-off data for the respective accounts receivable by aging categories.

22. The relevance of the observable data to the assessment of a component of collective loan impairment should be assessed at each balance-sheet date. Observable data may become more or less relevant as circumstances change. Additionally, more relevant observable data may become available. Creditors should change the observable data they consider only if changes in the environment indicate that other observable data has become more relevant or if new observable data that is more relevant becomes available.

23. A creditor with sufficient experience of its own should use that experience as the observable data supporting the recognition and measurement of the historical charge-off experience component of collective loan impairment. A creditor that has no experience or insufficient experience in certain lending products or markets should make a reasonable effort to obtain peer group experience for a peer group portfolio that is representative of the creditor's own portfolio and should use that peer group experience to develop collective loan impairment estimates.[23] Representativeness should be supported by an analysis of the portfolios, including borrower and loan types. Collective loan impairment based on peer group experience should not be recognized if a representative peer group cannot be identified and there is no other relevant observable data that would support a component of the allowance. In those circumstances, disclosure would be required pursuant to paragraph 10 of FASB Statement No. 5 and paragraphs 13 and 14 of SOP 94-6.

24. *Measurement*. Components of the allowance for credit losses recognized pursuant to FASB Statement No. 5, that is, components of collective loan impairment, should be measured based on the present value of expected future cash flows.[24] The objective of the measurement is to provide for losses that have been incurred and not to provide for future losses. Expected future cash flows should be the creditor's best estimate based on reasonable and supportable assumptions and projections.[25] In

---

[23] Peer group experience is acceptable for new lending operations and for new lending products of established lending operations. However, peer group experience should be used only in limited circumstances. Two to three years of lending experience normally would provide data that is more relevant than peer group experience.

[24] The estimate of loss in pools of loans should be based on an assessment of losses that have already been incurred, even if not yet identifiable, and not on an assessment of losses that might be incurred over the remaining life of the loans, even if predictable based on historical experience. Although not required by this SOP, creditors may calculate the present value of expected future cash flows indirectly. Under the indirect approach, incurred but not yet confirmed credit losses in a pool of loans are analogous to incurred but not reported losses in the insurance industry. The average lag between the incurrence of a credit loss (deterioration in the borrower's financial condition) and the confirmation of that loss (identification of the individual loan as impaired) is referred to as the loss confirmation period. Typically, charge-offs occur at or near the time that individual loans are impaired, so charge-offs are viewed as a measure of confirmed losses. A creditor estimates the incurred but not yet confirmed credit losses in a pool by estimating the loss confirmation period, computing a historical charge-off rate, and then multiplying the historical charge-off rate times the loss confirmation period times the pool's loan balance. (A charge-off rate is determined by dividing charge-offs for a period, such as a year or a quarter, by the average loan balance in the pool during that period.) Because the pool's loan balance is already a discounted amount (the present value of the contractual future cash flows), further discounting is unnecessary. Thus, if a creditor had $1 million of loans outstanding at the end of the period, a charge-off rate of 2 percent (that is, annual charge-offs divided by the average loan balance each year for the applicable historical period), and a loss confirmation period of 2.5 (that is, examining past charge-offs, the creditor determined that on average the losses occurred two to three years before the charge-offs), the historical charge-off experience component of the creditor's allowance for credit losses would be $50,000 ($1,000,000 x 2% x 2.5). The calculation assumes that the creditor's charge-off policy is applied consistently from period to period; if a creditor's charge-off policy is not applied consistently, the creditor would need to consider any implications of the change in its policy. To apply this calculation, a creditor needs to evaluate each pool of loans to estimate the average lag between the deterioration in a borrower's financial condition and the charge-off or write-down of the individual loan. For example, a creditor may determine that the deterioration in the financial condition of individual borrowers (for instance, 36-month auto loans, revolving credit card loans, and 30-year residential mortgages) occurs on average one year before the individual loans are identified as impaired and that deterioration in the financial condition of commercial or industrial borrowers occurs on average two to three years before the individual loans are identified as impaired, depending on the nature and kind of loan (for instance, unsecured versus asset based). That creditor's allowance for credit losses for a portfolio of consumer loans would approximate one year's worth of charge-offs, and that creditor's allowance for credit losses for a portfolio of commercial or industrial loans would approximate two to three year's worth of charge-offs, representing in each case an estimate of losses incurred on loans in the pool to borrowers whose financial condition has deteriorated sufficiently to impair their loans, even though the creditor has not yet identified the deterioration.

[25] Paragraphs 42 through 54 of FASB Statement of Financial Accounting Concept No. 7, *Using Cash Flow Information and Present*

discounting the expected future cash flows (for example, when those cash flows are based on principal and interest), creditors should use the composite effective interest rate of the loans to which the component of the collective loan impairment applies.

25. The measurement of a component of collective loan impairment should be based on the relevant observable data relating to existing conditions and should not project changes in the observable data that may occur in the future. The measurement will rarely be a mathematical function of the observable data; rather, significant judgment will usually be needed to develop an estimate. However, a creditor should consider the directional consistency of the measurement with changes in the related observable data from period to period. For example, if the change in the observable data indicates a deterioration in the credit quality of a pool of loans, an increase in the component of collective loan impairment related to that pool of loans (as a percentage of the pool of loans under assessment) would be directionally consistent with the change in the observable data. Conversely, if the change in the observable data indicates an improvement in the credit quality of a pool of loans, a decrease in the component of collective loan impairment related to that pool of loans (as a percentage of the pool of loans under assessment) would be directionally consistent with the change in the observable data. In applying this principle, creditors should take into account the interaction of components of collective loan impairment over time. For example, in applying this principle to a component established in a previous period to adjust the creditor's historical charge-off experience component for conditions not reflected in the historical experience, the creditor should take into account the extent to which those conditions are currently reflected in the creditor's historical charge-off experience component. Further, the extent to which such directional changes should affect the amount of the allowance for credit losses is a matter of significant judgment and expertise.

26. The measurement of a component of collective loan impairment may use multiple sets of relevant observable data. The weight of each set of observable data on the expected cash flows used to estimate the component of collective loan impairment should be commensurate with the extent to which the relevance of the observable data to the measurement of the component of collective loan impairment can be verified.

27. As discussed in paragraph 10 of this SOP, a creditor should assess the likelihood of possible outcomes in determining its best estimate of the component of collective loan impairment. A creditor's selection of its best estimate within a range should be based on judgment parameters that are applied in a consistent manner. Changes in the creditor's assessment of the likelihood of possible outcomes should be directionally consistent with changes in the observable data from period to period.

Disclosures

28. A creditor should disclose the following information:[26]

a. The methodology for determining each significant[27] component of the allowance for credit losses. The disclosure should include sufficient narrative information to enable users of the financial statements to understand critical aspects of the methodology and the breadth and depth of the process.

b. The accounting recognition and measurement policies and methods used by the creditor for each significant component of its allowance for credit losses. The disclosure should include the following:
   (1) A general description of each significant component of the allowance for credit losses.
   (2) For pools of loans, a description of the credit risk evaluation processes used (for example, credit risk grading schemes, credit scoring models, industry, collateral, and

---

Value in Accounting Measurements, discuss the use of an expected cash flow approach in developing a present value measurement. FASB Concept Statement No. 7 discusses a "traditional" approach and an "expected cash flow" approach to present value. The term *expected future cash flows* has the same meaning in this SOP as in FASB Statement No. 114.

[26] The disclosures set forth in this SOP are intended to be incremental to existing disclosure requirements and are not intended to replace or eliminate any existing requirements.

[27] *Significant* is defined for this purpose as 10 percent of the allowance for credit losses. Insignificant components should not, however, exceed 25 percent in the aggregate.

geography), if applicable, and the similar credit risk characteristics associated with each pool or category of credit risk-graded loans.

(3) A description of the observable data that are used in the measurement of the component, and significant changes in the types of observable data for all periods presented.

c. For those loans that are subject to a credit risk grading methodology, the recorded investment by credit risk grade. Credit risk grades may be combined for this purpose based on the Federal Financial Institutions Examination Council (FFIEC) loan classes (pass, special mention, substandard, doubtful, and loss).

d. For loans that are not subject to a credit risk grading methodology, the recorded investment by payment status.

e. The total allowance for credit losses by loan type.

EFFECTIVE DATE AND TRANSITION

29. The provisions of this SOP are effective for financial statements for fiscal years beginning after December 15, 2003. Earlier application of this SOP is permitted, as of the end of any fiscal quarter for which financial statements have not yet been issued.

30. Although the effect of initially applying the provisions of this SOP will, in individual cases, have elements of a change in accounting principle and of a change in accounting estimate, those elements often will be inseparable. Consequently, the entire effect of initially applying the provisions of this SOP should be reported as a change in accounting estimate (see Accounting Principles Board (APB) Opinion No. 20, *Accounting Changes,* paragraphs 31 through 33). Previously issued financial statements should not be restated. The effect of initial application on income before extraordinary items, net income, and related per share amounts should be disclosed.

APPENDIX A — Background Information and Basis for Conclusions

A.1 Existing authoritative accounting literature that relates to accounting for the allowance for credit losses includes Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*; FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan* (as amended by FASB Statement No. 118, *Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures*); and FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*. In addition, the AICPA Audit and Accounting Guide *Banks and Savings Institutions* (Audit Guide) and the April 12, 1999, FASB Viewpoints article, "Application of FASB Statements 5 and 114 to a Loan Portfolio,"[1] provide additional guidance on how creditors should apply those pronouncements in determining their allowances for credit losses. However, the existing authoritative literature is unclear in some respects. Some believe that lack of clarity has allowed creditors excessive flexibility in the determination of asset impairment and the amount to record as an allowance for credit losses.

A.2 FASB Statements No. 5 and No. 114 (as amended) and the Audit Guide require that certain disclosures be made for the allowance for credit losses. For Securities and Exchange (SEC) registrants, the SEC's Industry Guide 3, *Statistical Disclosure by Bank Holding Companies*, provides additional disclosure guidance. However, some have raised concerns regarding whether adequate information is being disclosed about creditors' loan portfolios and the related allowances for credit losses.

A.3 The Accounting Standards Executive Committee (AcSEC) developed this Statement of Position (SOP) to narrow the spectrum of practices and interpretations of existing literature and to improve the transparency of financial reporting by improving required disclosures regarding the allowance for credit losses.

BASIS FOR CONCLUSIONS

Scope

A.4 This SOP addresses the recognition and measurement by creditors, other than state and local and federal governmental entities, of the allowance for credit losses in accordance with FASB Statements No. 5 and No. 114, as amended. It applies to all *loans,* as that term is defined in FASB Statement No. 114, with certain exceptions.

A.5 This SOP does not apply to loans that are measured at fair value or at the lower of cost or fair value. As noted in FASB Statement No. 114, guidance for impairment associated with loans that are measured in accordance with specialized industry practice at fair value or at the lower of cost or fair value is unnecessary. Like FASB Statement No. 114, this SOP also does not apply to leases or debt securities. Although issues of collectibility also relate to direct finance lease receivables and receivables from sales type leases, AcSEC did not want to consider all the issues related to lease financing, including valuation of residuals, and instead excluded leases from the scope of this SOP. AcSEC observes, however, that the principles set forth in this SOP could be useful to a creditor in determining the allowance for credit losses of a lease portfolio.

A.6 This SOP does not apply to loans that are accounts receivable that arose from the sale by the reporting entity of goods or services and that have contractual maturities of one year or less, or to loans that are unconditional promises to give of not-for-profit organizations and that are due in one year or less. AcSEC made those scope exclusions because this SOP was never intended to address impairment of short-term trade receivables or short-term unconditional promises to give. Furthermore, AcSEC was

[1] The Financial Accounting Standards Board (FASB) Viewpoints article is reproduced as an appendix to Emerging Issues Task Force (EITF) Topic D-80, "Application of FASB Statements No. 5 and No. 114 to a Loan Portfolio."

concerned that the costs of applying this SOP's disclosure requirements by commercial enterprises extending short-term trade credit and by not-for-profit organizations accepting short-term unconditional promises to give would exceed the benefits. Moreover, AcSEC notes that receivables arising from transactions with customers in the normal course of business that are due in customary trade terms not exceeding one year are excluded from the scope of Accounting Principles Board (APB) Opinion No. 21, *Interest on Receivables and Payables*. AcSEC believes that the application of the measurement principles set forth in this SOP to those amounts would be an expansion of the application of present value measurement techniques that is beyond the intent of this SOP. However, AcSEC agreed that that scope exclusion should not apply to any purchased or originated credit card receivable (that is, that this SOP should apply to all purchased or originated credit card receivables). AcSEC believes it would often be impracticable to distinguish credit card receivables that arose from the sale by the reporting entity of goods or services from credit card receivables that arose from solely financing transactions. As a result, all credit card receivables, regardless of whether the card is a bank credit card or private label (for example, retailer) credit card and regardless of amount and maturity, are in the scope of this SOP.

A.7 This SOP also does not apply to amounts intended to provide security for a counterparty to an agreement with the reporting entity (for example, security deposits, retainages on contracts). AcSEC notes that, like short-term trade receivables, those amounts are excluded from APB Opinion No. 21, and AcSEC believes that, as with short-term trade receivables, the application of the measurement principles set forth in this SOP to those amounts would be an expansion of the application of present value measurement techniques that is beyond the intent of this SOP.

A.8 This SOP also does not apply to loans that are retained interests. Under FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities,* a transferor allocates the previous carrying amount of transferred assets to interests sold and interests retained based on their relative fair values. The EITF addressed the accounting for loans that are retained interests in EITF Issue No. 99-20, “Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets.”

Loan Impairment Concepts

A.9 FASB Statement No. 5 sets forth the principles underlying accrual of loss contingencies. Paragraph 8 of that Statement states as a condition precedent to the recognition of the impairment of an asset that it must be probable that the asset has been impaired as of the date of the financial statements (not that it is probable that a loss will ultimately be incurred and realized sometime over the life of the asset). FASB Statement No. 114 defines a loan as being impaired when “based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement.”

A.10 AcSEC deliberated the conclusions in this SOP within the parameters set by established authoritative literature (specifically FASB Statements No. 5 and No. 114), which provides for an incurred-loss model. Some AcSEC members viewed an expected-loss model, which would recognize losses expected to be incurred over the life of the loan, to be an alternative method that should be considered. However, a model that recognizes losses expected to be incurred over the life of the loan is inconsistent with the incurred-loss concepts of FASB Statement No. 5.

A.11 FASB Statement No. 5 states in paragraph 59 that “[a]ttribution of a loss to events or activities of the current or prior periods is an element of asset impairment or liability incurrence.” Some may interpret that statement to prohibit the recognition of asset impairment or loss incurrence unless a single, distinct past event can be identified as having given rise to asset impairment or a liability. As noted in the FASB Viewpoints article, however, it is usually difficult, even with hindsight, to identify any single event that made a particular loan uncollectible. AcSEC considered whether an objective triggering event such as a loan downgrade or movement to past due status would be an objective point at which to measure impairment. AcSEC was concerned that such events could be considered confirmation of uncollectibility. Thus, waiting for these events to occur before recognizing losses would inappropriately delay recognition

of an incurred loss. AcSEC concluded that it could not require creditors to identify a specific loss-causing event in order to justify the recognition of impairment.

A.12 AcSEC notes that paragraph 84 of FASB Statement No. 5 states that the conditions for recognition of asset impairment are not intended to be so rigid that they require virtual certainty before a loss is accrued. AcSEC also notes that FASB Statement No. 5, as amended, states in paragraph 23 that "if, based on current information and events, it is probable that the enterprise will be unable to collect all amounts due according to the contractual terms of the receivable, the condition in paragraph 8(a) [it is probable that an asset had been impaired at the date of the financial statements] is met." AcSEC believes those statements support AcSEC's view that it is not necessary to identify a single, distinct past event that is considered to have caused a credit loss in order to recognize the impairment of a loan or group of loans. Rather, it is sufficient to have reasonable evidence that the loan or pool of loans is impaired.

Components of the Allowance for Credit Losses

A.13 This SOP requires that the reported allowance for credit losses include only those components that are determined pursuant to either FASB Statement No. 5 or FASB Statement No. 114. The FASB Statement No. 114 component results in a specific loss allocation for loans that have been evaluated individually for impairment and that have been determined to be impaired. No "add on" or other incremental amounts may be recognized for those loans. FASB Statement No. 5 governs the recognition of allowances for credit losses related to pools of loans that are evaluated collectively for impairment.

A.14 In developing this SOP, AcSEC debated whether to prohibit the recognition of what are commonly referred to as *unallocated* components[2] of the overall reported allowance for credit losses. It became apparent, however, that the term *unallocated* is used in practice with various meanings. For example, some refer to adjustments to historical charge-off experience factors as unallocated while others believe that those adjustments are an element of the allocated allowance for credit losses. Still others believe *unallocated* refers to allowances for credit losses that are not attributable to individual loans. AcSEC became convinced that it was not feasible to develop a satisfactory definition of an unallocated component and was concerned that prohibiting unallocated components of the allowance for credit losses would result in definitional debates over subjective terminology. Similarly, AcSEC debated whether to prohibit the recognition of what is commonly referred to as a "margin for imprecision."

A.15 Observers have noted that, in a March 10, 1999, Joint Interagency Letter to Financial Institutions issued by the SEC, Federal Deposit Insurance Corporation, Federal Reserve Board, Office of the Comptroller of the Currency, and Office of Thrift Supervision (the Agencies), the Agencies stated that "when determining the level of the allowance, management should always ensure that the overall allowance appropriately reflects a margin for imprecision inherent in most estimates of expected credit losses." The Agencies also stated in the Joint Interagency Letter that:

> Simply because a portion of the allowance is designated as "unallocated," it is not thereby inconsistent with GAAP. The important consideration is whether the allowance reflects an estimate of probable losses, determined in accordance with GAAP, and is appropriately supported.

This SOP does not preclude any specific component of collective loan impairment by name or shorthand description. However, AcSEC reiterates its view that all components of collective loan impairment should be supported by observable data that are relevant to the specific credit risk characteristics of the pool of loans. AcSEC accepts that judgment is necessary in interpreting the observable data in order to estimate losses, but believes that all components should be supported by observable data and that collective loan impairment components should not result in the double counting of loan impairment.

---

[2] Those components are also referred to in practice as *supplemental, general, unassigned,* or *general contingency* reserves.

A.16 Accordingly, AcSEC concluded that the allowance for credit losses reported on a creditor's balance sheet should consist only of (*a*) a component for individual loan impairment recognized and measured pursuant to FASB Statement No. 114 and (*b*) one or more components of collective loan impairment recognized pursuant to FASB Statement No. 5 and measured in accordance with the guidance in this SOP. This SOP prohibits the recognition of collective impairment components of an allowance for credit losses that do not meet the criteria of this SOP and paragraph 8 of FASB Statement No. 5.

Individual Loan Impairment

A.17 FASB Statement No. 114 applies to all loans that are "identified for evaluation," with certain exceptions. Paragraph 7 of FASB Statement No. 114 does not specify how a creditor should identify loans that are to be evaluated for collectibility. It states that a creditor should "apply its normal loan review procedures in making that judgment."

A.18 Financial services industry practice for commercial loans generally includes reviewing loans individually as part of a creditor's normal credit-risk evaluation process for purposes of evaluating the collectibility of those loans. As a result of performing that evaluation of collectibility, the creditor often places individual loans into risk grading categories, a watch list, or some other categorization based on the identified likelihood of collectibility (or risk of loss). AcSEC believes that, when a creditor reviews or grades an individual loan as part of a credit-risk evaluation or grading process, the creditor has identified that loan for evaluation and is, therefore, subject to the provisions of FASB Statement No. 114 with respect to that loan. AcSEC notes that different segments of the financial services industry use different techniques for estimating asset or loan impairment. Any process that specifically addresses the degree of repayment ability of a specific borrower is a process that meets the FASB Statement No. 114 definition of *identified for evaluation*.

A.19 A creditor should, therefore, explicitly conclude whether the identified loan is impaired. If the creditor determines that an individual loan is impaired, the creditor should measure the amount of impairment pursuant to the measurement guidance in FASB Statement No. 114. If the creditor determines that a loan is not individually impaired, the next step is to consider whether there are other loans with similar credit risk characteristics and, if so, to include the loan in a pool of loans that is evaluated for impairment in accordance with FASB Statement No. 5.

A.20 This SOP further clarifies that the allowance for credit losses provided for a specific individual loan under FASB Statement No. 114 may not be supplemented by an additional allowance for credit losses under FASB Statement No. 5. If the loan is determined to be impaired, the FASB Statement No. 114 allowance should be the sole measure of impairment for that loan even if the measurement of impairment under FASB Statement No. 114 results in no allowance for credit losses. In the April 1999 Viewpoints article, the FASB staff clarified that “double counting” is not permitted. AcSEC believes that point is intuitive, but has nevertheless incorporated that guidance in this SOP.

Collective Impairment

A.21 FASB Statement No. 114 states in paragraph 7, “In addition to the allowance calculated in accordance with this Statement, a creditor should continue to recognize an allowance for credit losses necessary to comply with [FASB] Statement [No.] 5." Although FASB Statement No. 5 provides a recognition threshold, it does not provide significant measurement guidance.

A.22 This SOP reaffirms the position expressed in the FASB Viewpoints article (April 1999) that (*a*) loans that are considered to be impaired after a specific FASB Statement No. 114 review should not be considered within an FASB Statement No. 5 assessment and (*b*) loans that are not considered to be impaired after a specific FASB Statement No. 114 review should be considered for inclusion within an FASB Statement No. 5 assessment.

A.23 AcSEC considered establishing specific loss recognition "triggers" for portfolios (or specific categories) of loans. Those loss recognition triggers would provide evidence that a loan within a pool of loans had been impaired at the date of the financial statements. Loss recognition triggers considered by AcSEC were (*a*) the downgrading by a creditor of a loan that is credit-risk graded to a below investment grade classification and (*b*) the movement of a consumer loan that is not credit risk graded into a past due payment status.

A.24 AcSEC was concerned, however, that the downgrading of a commercial loan's credit risk grade constitutes a management decision, whereas the actual causes of impairment (credit loss) are events and circumstances that occur independent of management's actions. AcSEC was even more concerned that the movement of a consumer loan that is not credit risk graded into a past due status is an event that may occur well after a borrower's inability to repay has impaired the asset. Thus, using past due status as the sole recognition trigger for pools of loans would result in delaying recognition of asset impairment that has occurred. AcSEC could identify no specific loss recognition triggering events earlier than past due status for consumer loans that are not credit risk graded. Accordingly, AcSEC rejected the triggering-event recognition approach.

A.25 AcSEC also considered mandating a measurement approach for pools of loans that incorporates an estimate of the period from the occurrence of an event causing a loss to the confirmation of the loss. That “loss confirmation period,” which represents the time it takes an otherwise unidentified incurred loss to progress to loss confirmation (or charge-off), is then used to calculate the amount of incurred losses in a pool of loans. One approach to determining the loss confirmation period is back-testing confirmed losses (or charge-offs) to determine when the events that gave rise to the losses occurred. However, back-testing requires the ability to identify an event or group of events that gave rise to a loss, and many believe that event is not identifiable for every loan, even with hindsight. Thus, while noting the conceptual merits of the loss-confirmation-period measurement approach for pools of loans, AcSEC agreed not to mandate that approach.

A.26 AcSEC concluded that an allowance for credit losses recognized pursuant to FASB Statement No. 5 should consist of components that (*a*) are predicated on observable data that are relevant to the measurement of the asset impairment associated with a pool of loans having similar credit risk characteristics and (*b*) change in a manner that is directionally consistent with changes in the related observable data from period to period, taking into account the interaction of components of collective loan impairment over time.

A.27 FASB Statement No. 5 requires creditors to consider available information in recognizing and measuring asset impairment. This SOP requires creditors to specifically consider relevant observable data in the recognition and measurement of components of collective loan impairment and to support each component of collective loan impairment with one or more sets of relevant observable data. Although AcSEC acknowledges that the allowance for credit losses will continue to be an accounting estimate requiring significant judgment, AcSEC believes that basing recognition and measurement of the allowance for credit losses on observable data will introduce more objectivity into the collective loan impairment estimation process, resulting in a significant improvement in that process. For that reason, this SOP requires that observable data be used in the development of loss recognition and measurement. At the same time, AcSEC understands that the interpretation of that observable data and its translation to a measure of the allowance for credit losses is an area that is subjective and will require judgment.

A.28 AcSEC believes that only observable data related to existing conditions should be used in the measurement of impairment. AcSEC concluded that observable data related to future conditions (for example, futures prices and existing long-range weather forecasts at the balance-sheet date) should not be used in the measurement of impairment, because AcSEC believes that data related to conditions that are expected to exist in the future is not representative of credit losses that have been incurred at the date of the financial statements.

A.29 Observable data also is necessary to enable a creditor to make a more consistent assessment of collective loan impairment from period to period. A consistent assessment would require that the same

kind of observable data be obtained from period to period. Accordingly, this SOP requires that creditors support components of collective loan impairment with relevant observable data that is available currently and that is expected also to be available in the future. AcSEC, however, acknowledges that the estimation of the allowance for credit losses is a dynamic process and that, accordingly, particular observable data may over time become more or less relevant to the recognition and measurement of impairment. Thus AcSEC concluded that creditors should use different observable data if changes in the environment indicate that other observable data became more relevant or if new observable data that is more relevant became available.

A.30 AcSEC believes that most creditors will rely principally on their own historical charge-off experience for pools of loans as the predominant component of collective loan impairment. However, creditors should consider whether historical charge-off experience needs to be adjusted to reflect the effects of current conditions that did not affect the period on which the historical charge-off experience is based or to remove the effects of conditions in the historical period that do not exist currently. Creditors should identify the observable data to analyze and support additional components of collective loan impairment (which may increase or decrease the allowance) needed to arrive at a more precise estimate of impairment.

A.31 This SOP provides that creditors should measure collective impairment components based on the present value of expected future cash flows. That guidance is consistent with FASB Statement No. 114, which represents the most recent thinking of the FASB on the subject of measurement of loan impairment. AcSEC acknowledges that paragraph 13 of FASB Statement No. 114 provides alternative bases for the measurement of impairment of individual loans and pools of individually impaired loans (such as observable market prices of loans and the fair value of underlying collateral). AcSEC believes, however, that those alternative measurement bases are not suitable for pools of loans that are not individually impaired.

A.32 The mechanics of estimating the present value of expected future cash flows for pools of loans may vary. For example, cash flows of the loans in a pool may be estimated and then discounted using the composite effective interest rate of the loans in that pool. The present value of the expected future cash flows from the pool then would be compared with the current recorded investment in the pool of loans to arrive at a collective-impairment component of the allowance for credit losses. Alternatively, a creditor may estimate the collective-impairment component by focusing on the principal amount that will not be collected.

A.33 This SOP does not mandate or recommend specific methods of estimating expected future cash flows. However, AcSEC notes that the estimation of incurred losses in a pool of loans based on historical charge-off experience requires creditors to make reasonable assumptions, either explicit or implicit, about the period over which incurred losses in the pool of loans are confirmed. As discussed in paragraph A.25, this SOP does not require creditors to determine a loss confirmation period by back-testing confirmed losses or charge-offs. Nor does this SOP provide guidance on any other methods creditors should use to estimate the period over which incurred losses in a pool of loans are confirmed. However, the objective of designing and applying loss-measurement procedures is the estimation of incurred losses, not future losses.

A.34 AcSEC chose to illustrate a methodology in footnote 24 that uses a loss confirmation period to estimate incurred losses. Although AcSEC believes that applying that methodology properly is one acceptable way to estimate incurred losses, there may be other methodologies that result in an acceptable estimate of incurred losses in a pool of loans. A creditor should be able to establish that the methodology used results in an estimate of expected future cash flows that excludes the effects of losses that would result from an event or events expected to occur in the future.

Disclosures

A.35 Although AcSEC believes this SOP will result in the necessary relationship between available information and the level of a creditor's allowance for credit losses and that it will narrow the range of

judgment in the determination of a creditor's allowance for credit losses, estimates and judgment will remain significant factors in the determination of the allowance for credit losses. FASB Statement of Financial Accounting Concepts No. 1, *Objectives of Financial Reporting by Business Enterprises*, states in paragraph 54 that—

> [F]inancial reporting often provides information that depends on, or is affected by, management's estimates and judgment. Investors, creditors, and others are aided in evaluating estimates and judgmental information by explanations of underlying assumptions or methods used, including disclosure of significant uncertainties about principal underlying assumptions or estimates.

AcSEC believes that the ability to understand a creditor's credit risk position and the related allowance for credit losses has a significant effect on the overall usefulness of the financial statements. Thus, AcSEC believes that users of financial statements need robust disclosures regarding the allowance for credit losses.

A.36 AcSEC believes that existing generally accepted accounting principles disclosures regarding a creditor's accounting policies related to the bad debt expense[3] and the allowance for credit losses are both limited and too broad to facilitate a sufficient understanding of the effect of those policies on the overall financial statements or any meaningful comparison among entities or of a creditor from period to period. AcSEC believes that more transparency is needed regarding the factors that cause the estimation judgments and the results of those judgments. Moreover, AcSEC believes more transparency is needed regarding the data that influences the estimation judgments and the resulting allowance amounts. Accordingly, this SOP sets forth several new disclosure requirements intended to address those concerns.

A.37 Each component of the allowance for credit losses recognized pursuant to FASB Statement No. 5 (collective impairment components) may be measured using a different technique. This SOP's disclosure focus reflects that fact and attempts to provide users of financial statements with additional information sufficient for them to understand period-to-period changes in bad debt expense and the resulting allowance for credit losses, and the information used by the creditor to determine estimates for those amounts. Further, AcSEC believes the new disclosures required by this SOP balance the need for comparability among entities with the need to disclose information that would allow users of financial statements to understand a specific creditor's allowance development process.

A.38 As part of the decision to enhance the disclosures related to the allowance for credit losses, AcSEC reviewed the following documents: (*a*) a March 2000 Board of Governors of the Federal Reserve System Staff Study, "Improving Public Disclosure in Banking"; (*b*) a September 2000 Basel Committee on Banking Supervision report titled "Best Practices for Credit Risk Disclosure"; and (*c*) a January 11, 2001, letter from the Working Group on Public Disclosure to Federal Reserve Governor Laurence H. Meyer. Those documents provided similar recommendations and best practices for improving the disclosures for the allowance for credit losses and credit risk.

A.39 The disclosures required by this SOP are to be provided for each *significant* component of the allowance for credit losses. AcSEC selected a significance threshold of 10 percent of the recorded allowance, with insignificant components limited to 25 percent in the aggregate, by analogy to FASB Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information*. AcSEC acknowledges that the selection of those percentages was somewhat arbitrary. AcSEC believes, however, that making the required disclosures for components meeting the significance threshold will substantially accomplish AcSEC's goal of improved disclosure without obfuscating the financial statement presentation and presenting an undue burden to the preparer.

---

[3] Bad debt expense is often referred to as a *provision* for loan losses by financial institutions and other entities operating in the financial services industry. Although this SOP neither endorses nor prohibits the use of *provision* in describing bad debt expense, AICPA Accounting Terminology Bulletin No. 1, *Review and Résumé*, does not permit the use of the word *provision* for such purposes.

Appendix B—Examples Illustrating the Application of This Statement of Position

B.1 This appendix illustrates how certain of the concepts in this Statement of Position (SOP) would be applied in certain generalized situations. Actual facts and circumstances need to be considered carefully in applying this SOP. The examples herein are not intended to be comprehensive.

COMPONENTS OF THE ALLOWANCE FOR CREDIT LOSSES

B.2 The allowance for credit losses consists only of (*a*) a component for individual loan impairment and (*b*) one or more components of collective loan impairment. The following examples illustrate components of the allowance for credit losses.

Example 1—Components

B.3 Bank A has a loan portfolio consisting of both commercial and consumer loans. Bank A's allowance for credit losses consists of four components as follows:

- An individual loan impairment component for credit losses on commercial loans that are credit risk graded as substandard or doubtful in accordance with the Interagency Policy Statement on the Review and Classification of Commercial Real Estate Loans, dated November 6, 1991, and the Interagency Statement for the Allowance for Loan and Lease Losses, dated December 21, 1993. These loans are evaluated individually as part of the bank's normal credit risk evaluation process and are considered to be individually impaired. Impairment of these loans is measured in accordance with Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 114.
- Three collective impairment components for loans that are not considered in the FASB Statement No. 114 component are as follows:
  —Historical charge-off experience by credit risk grade for commercial loans
  —Historical charge-off experience based on an analysis of the movement of loans from the respective payment status categories (for example, current, past due) to charge-off for consumer loans
  —Current economic environment risk not reflected in the historical period for developing loss factors for commercial and consumer loans

Example 2 —Components

B.4 Bank B has the same components as Bank A and the following additional components:

- A component for those commercial real estate loans that Bank B excludes from the broad-based grading process and assesses independently based on current market leasing data.
- A component for a new, revolving mortgage line-of-credit product that Bank B excludes from the consumer loans component. Bank B uses relevant peer group data to estimate this component.
- A component for certain loans to borrowers in less developed countries (LDC loans) that Bank B excludes from the commercial loan pools and assesses independently based on economic development information concerning the respective regions.

OBSERVABLE DATA

B.5 Observable data is internal or external information that provides a reasonable basis for concluding that it is probable an asset has been impaired because certain loans in a pool of loans will fail to perform pursuant to their contractual terms and for estimating the asset impairment. Furthermore, observable data should be available each time an allowance for credit losses is measured to assure that the measurement is directionally consistent.

B.6 The following examples illustrate types of observable data used to support components of the allowance for credit losses.

Example 1—Observable Data

B.7 Bank A has a portfolio of international loans, with particular exposure to borrowers in Country X. Bank A assesses the impairment of the loans to borrowers in Country X separately, as those loans are deemed to have a risk profile different from other loans in the portfolio. The bank determined, based on an analysis it performed, that changes in certain economic data for Country X are indicative of changes in the ability of the bank's customers in Country X to make required loan payments. Bank A adjusts its historical charge-off experience-based impairment measurement each quarter based on published economic data for Country X.

Example 2—Observable Data

B.8 Bank B performs industry concentration analyses and reviews industry data as part of its ongoing credit monitoring of its loan portfolio. Based on the industry analyses, Bank B determines whether any particular industry segments within the portfolio should be assessed for impairment separately from the bank's credit-risk-grade impairment analysis. During the quarter, Bank B noted a significant decrease in sales revenue in the consumer products industry. The bank determined, based on an analysis it performed, that changes in published sales data for the consumer products industry are indicative of changes in the ability of the bank's customers in the consumer products industry to make required loan payments. Accordingly, Bank B established a new component of its allowance for credit losses for exposure to borrowers within the consumer products industry. To support the consumer products industry risk component, Bank B compared published sales data for the industry for the most recent period with published sales data for preceding periods. Bank B developed its measure of impairment by adjusting the results of historical experience-based impairment measurements for the group of loans by factors derived from the published sales data. The extent of this adjustment is necessarily subjective, requiring the expertise of senior credit management of the bank. The basis for the need for and amount of the adjustment should be documented as part of the allowance analysis.

Example 3—Observable Data

B.9 Bank C has a loan portfolio consisting of commercial and consumer loans. Low wheat and soybean prices are causing agricultural processing site shutdowns and employee lay-offs in the communities within which the bank lends. Bank C has removed individually impaired loans from its population of loans subject to assessment for collective impairment. Bank C has identified three collective impairment components relative to its portfolio of loans that were not deemed to be individually impaired:

- A component for historical charge-off experience related to commercial loans
- A component for historical charge-off experience related to consumer loans
- A component for losses related to an agricultural slowdown that did not exist in the historical period used for commercial and consumer loan loss rate development

B.10 Bank C assesses impairment of its pool of commercial loans (that are not deemed to be individually impaired) based on credit risk grades that are assigned as part of the bank's normal credit risk evaluation procedures. Impairment is measured for this pool based on outstanding loan balances and historical charge-off rates. The historical charge-off rates are based on an analysis of the movement of loans from the respective credit risk grades to charge-off over the loss confirmation period. Bank C assesses the need to adjust its historical experience component to reflect current conditions by reference to changes in domestic economic information issued by the Federal Reserve Board of Governors (FRB). A review of that information for the last five years indicates that, apart from lower prices for agricultural commodities, economic conditions affecting the pool of commercial loans during the historical period on which the loss rates are based were similar to current economic conditions.

B.11 Bank C assesses impairment of its consumer loan pool based on the payment status of the loans by type of loan within the portfolio. Impairment of loans in the consumer pool is measured based on average loss rates derived from an analysis performed annually by Bank C of the movement of loans from the respective payment status categories (for example, past due, current) to charge off over the loss confirmation period. Based on available information, Bank C believes, based on the FRB domestic economic information, that apart from the agricultural slowdown, economic conditions affecting its pool of consumer loans during the historical period on which the loss rates are based were similar to current economic conditions.

B.12 No agricultural slowdown existed during the historical period on which Bank C's initial impairment assessment of either commercial or consumer loans was based. Bank C segregated groups of loans to commercial and consumer borrowers that it determines may be affected by the agricultural slowdown. A component of Bank C's allowance for credit losses reflects its estimate of the effect of the agricultural slowdown, which is a current condition, on those borrowers. The adjustment to Bank C's historical experience-based component for commercial loans is based on changes in wheat and soybean spot prices as provided by the Chicago Commodities Exchange. The adjustment to the historical experience-based component for consumer loans is based on changes in unemployment rates for the counties affected by the agricultural slowdown as reported by the state employment agency.

THE DIRECTIONALLY CONSISTENT CONCEPT

B.13 This SOP states that creditors should consider the directional consistency of the measurement of collective loan impairment components with changes in the relevant observable data for those components from period to period. The following examples illustrate the directionally consistent concept set forth in this SOP.

Example 1—Directionally Consistent Concept

B.14 Bank A has a portfolio of residential one- to four-family mortgage loans. Current unemployment data indicate that unemployment levels have increased in relation to the period on which the bank's historical experience is based. An analysis performed by Bank A of historical charge-off trends and changes in employment levels indicates that as unemployment levels increase, losses on the bank's one- to four-family residential mortgages also increase, and that as unemployment levels decrease, losses on the bank's one- to four-family residential mortgages also decrease. Bank A therefore establishes a second collective loan impairment component to adjust the historical experience-based component for current unemployment conditions. Bank A supports the current-conditions component using unemployment statistics as its observable data. Although the determination of the amount of the current-conditions component will incorporate management's judgment, it would be expected that the component would be a positive amount (that is, that increased levels of unemployment would cause Bank A to increase its overall allowance for credit losses). In these circumstances, measurement of the current-conditions component as a negative amount (that is, a reduction in the allowance for credit losses) would not be directionally consistent with the change in the observable data.

Example 2—Directionally Consistent Concept

B.15 Bank B determined that its historical charge-off rates on credit risk graded loans to customers in the automotive products industry do not consider current positive economic trends that have come to light in the most recent quarter. An analysis performed by the bank indicates that changes in statistics contained in the FRB economic statistical releases for the automotive products industry indicate changes in the ability of the bank's customers in the automotive products industry to make required loan payments. Accordingly, Bank B compares the statistics contained in the FRB economic statistical releases for the automotive products industry for the most recent quarter with the statistics contained in FRB economic statistical releases for the automotive products industry for the period on which the bank's historical

charge-off rates are based. Based on that comparison, the bank establishes a reduction component of its allowance for credit losses for the improved economic conditions in the automotive products industry. Bank B's measurement of the reduction component reflects the change in the FRB economic statistical releases for the automotive products industry.

B.16 At each financial statement date Bank B assesses whether the historical experience-based impairment estimates for the automotive products industry adequately reflect current economic conditions. Based on each such assessment, Bank B performs an analysis using the FRB economic statistical releases for the automotive products industry, adjusting the allowance component in a fashion that is directionally consistent with the underlying economic statistics: If the economic conditions improve, the allowance is reduced further to the extent that the changed conditions are not reflected in the bank's historical experience, and if economic conditions deteriorate, the allowance is increased to the extent that the changed conditions are not reflected in the bank's historical experience.

USE OF PEER DATA

B.17 This SOP requires creditors that have no experience or insufficient experience in certain lending products or markets to use representative peer group experience to develop collective loan impairment estimates. The following example illustrates the use of peer group data.

Example—Peer Data

B.18 Bank G began originating subprime home equity loans during the current year. Bank G has not engaged in subprime lending in the past and therefore has no experience of its own regarding subprime home-equity loans. To estimate collective loan impairment for this portfolio of loans, Bank G reviewed public securitization documents to obtain relevant credit-loss data for the similar kinds of loans. Bank G assessed the credit score distribution of loans within the securitizations and the credit score distribution of loans in its own portfolio and considered them to be similar. Bank G will assess impairment of its subprime portfolio of loans using the securitization credit-loss data during the first two years of subprime origination. In the third year of subprime origination, Bank G will use its own subprime portfolio historical charge-off data to assess collective loan impairment.

DISCLOSURES

B.19 This SOP sets forth additional disclosures that creditors should make related to the allowance for credit losses. Those additional disclosures are illustrated by the italic portions of the following examples. The formats presented and the wording of the notes are only illustrative and are not necessarily the only possible presentations.

Example 1—Disclosure by a Bank Holding Company

NOTE X – Summary of Significant Accounting Policies

Loans. Loans are stated at their principal amount outstanding and interest income is recognized on an accrual basis. Accrued interest is presented separately in the balance sheet, except for accrued interest on credit cards, which is included in the outstanding loan balance. Loan origination fees and costs incurred to extend credit are deferred and amortized over the term of the loan as a yield adjustment. Loan fees representing adjustment of interest rate yield are generally deferred and amortized into interest income over the term of the loan using the interest method. Loan commitment fees are generally deferred and amortized into noninterest income on a straight-line basis over the commitment period. Unearned discounts on consumer loans are recognized by the interest method.

Nonperforming Loans. With the exception of certain consumer and residential real estate loans, loans on which payments are past due for 90 days are placed on nonaccrual status, unless those loans are in the process of collection and, in management's opinion, are fully secured. Residential real estate loans over 120 days past due are placed on nonaccrual status, while other consumer loans are generally written off when deemed uncollectible or when they reach a predetermined number of days past due, depending on loan product, country, terms, and other factors. When a loan is placed on nonaccrual status, uncollected interest accrued in prior periods is charged against the allowance for credit losses and current period accrued interest is reversed to interest income. A loan is returned to accrual status when principal and interest are no longer past due and collectibility is probable. Restructured loans are those on which concessions in terms have been made as a result of deterioration in a borrower's financial condition.

Under the Company's credit policies and practices, individually impaired loans include all nonaccrual and restructured commercial, agricultural, construction, and commercial real estate loans, but exclude certain consumer loans and residential real estate loans classified as nonaccrual. *Loan impairment for individually impaired loans is measured based either on the present value of expected future cash flows discounted at the loan's effective interest rate or, as a practical expedient, at the observable market price of the loan or the fair value of the collateral if the loan is collateral dependent*.

Allowance for Credit Losses. The allowance for credit losses is management's estimate of the amount of probable credit losses in the loan portfolio. The Company determines the allowance for credit losses based on an ongoing evaluation. That evaluation is inherently subjective because it requires material estimates, including the amounts and timing of cash flows expected to be received on impaired loans. Those estimates may be susceptible to significant change. Increases to the allowance for credit losses are made by charges to bad debt expense. Loans deemed to be uncollectible are charged against the allowance for credit losses. Recoveries of previously charged-off amounts are credited to the allowance for credit losses.

The Company's allowance for credit losses is the accumulation of various components that are calculated based on independent methodologies. All components of the allowance for credit losses represent an estimation performed pursuant to either FASB Statement No. 5 or FASB Statement No. 114. Management's estimate of each FASB Statement No. 5 allowance for credit losses component is based on certain observable data that management believes is the most reflective of the underlying credit losses being estimated. Changes in the amount of each component of the allowance for credit losses are directionally consistent with changes in the observable data, taking into account the interaction of the FASB Statement No. 5 components over time. Refer to Note Y for further discussion and descriptions of the individual components of the allowance for credit losses.

A key element of the methodology for determining the allowance for credit losses is the Company's credit risk evaluation process, which includes credit risk grading individual commercial loans. Loans are assigned credit risk grades based on the Company's assessment of conditions that affect the borrower's ability to meet its contractual obligations under the loan agreement. That process includes reviewing borrowers' current financial information, historical payment experience, credit documentation, public information, and other information specific to each individual borrower. Commercial loans are reviewed on an annual or rotational basis or as management becomes aware of information affecting the borrower's ability to fulfill its obligations.

Note Y – Loans and the Allowance for Credit Losses

The following is a summary of loans outstanding as of December 31, 20X2 and 20X1:

(in millions)

	20X2	20X1
Commercial, financial, and industrial	$11,956	$11,311
Real estate–construction and land development	1,005	943
Foreign	1,510	1,459
Real estate–residential mortgage	9,236	8,917
Installment	13,930	11,797
Total loans and leases	37,637	34,427
Unearned discount	(2,112)	(1,773)
Total loans, net of unearned discount	$35,525	$32,654

A summary of changes in the allowance for credit losses is as follows:

(in millions)

	20X2	20X1	20X0
Balance at beginning of year	$649	$644	$628
Bad debt expense	261	212	212
Charge-offs	(229)	(240)	(213)
Recoveries	12	33	17
Net charge-offs	(217)	(207)	(196)
Balance at end of year	$693	$649	$644

The recorded investment in loans by credit risk grade or payment status, and the allowance for credit losses by loan type, at December 31, 20X2 and 20X1 are as follows:

	December 31, 20X2			
	Loan type			
Pool of Loans	*Commercial (including real estate construction and foreign)*	*Residential Mortgage*	*Installment*	*Total*
Credit risk graded loans (1)				
- Grades 1, 2, and 3 (Pass)				
Loan balance	*$12,962*	*-*	*-*	*$12,962*
-Grade 4 (Special Mention)				
Loan balance	*1,267*	*-*	*-*	*1,267*
-Grade 5 (Substandard)				
Loan balance	*153*	*-*	*-*	*153*
-Grade 6 (Doubtful)				
Loan balance	*89*	*-*	*-*	*89*
Consumer loans				
-Current				
Loan balance	*-*	*$7,559*	*$10,048*	*$17,607*
-30 days past due				
Loan balance	*-*	*1,288*	*3,186*	*4,474*
- 60 days past due				
Loan balance	*-*	*288*	*696*	*984*
- 90+ days past due				
Loan balance	*-*	*101*	*-*	*101*
Loan balance	*$ 14,471*	*$ 9,236*	*$13,930*	*$37,637*
TOTAL ALLOWANCE FOR CREDIT LOSSES	*$ 396*	*$42*	*$ 254*	*$ 693*

(1) Loans that are classified as "loss" in the Company's credit risk grading process are immediately charged off. All loans classified as "doubtful" are deemed to be individually impaired.

	December 31, 20X1			
	Loan type			
Pool of Loans:	*Commercial (including real estate construction and foreign)*	*Residential Mortgage*	*Installment*	*Total*
Credit risk graded loans (1)				
- Grades 1, 2, and 3 (Pass)				
Loan balance	*$11,614*	*-*	*-*	*$11,614*
-Grade 4 (Special Mention)				
Loan balance	*1,755*	*-*	*-*	*1,755*
-Grade 5 (Substandard)				
Loan balance	*249*	*-*	*-*	*249*
-Grade 6 (Doubtful)				
Loan balance	*95*	*-*	*-*	*95*
Consumer loans				
-Current				
Loan balance	*-*	*$7,569*	*$8,532*	*16,101*
-30 days past due				
Loan balance	*-*	*1,054*	*2,855*	*3,909*
- 60 days past due				
Loan balance	*-*	*195*	*410*	*805*
- 90+ days past due				
Loan balance	*-*	*99*	*-*	*99*
Loan balance	*$ 13,713*	*$ 8,917*	*$ 11,797*	*$ 34,627*
TOTAL ALLOWANCE FOR CREDIT LOSSES	*$ 453*	*$ 20*	*$ 176*	*$ 649*

(1) Loans that are classified as “loss” in the Company’s credit risk grading process are immediately charged off. All loans classified as “doubtful” are deemed to be individually impaired.

Allowance for Credit Losses Components. *The Company's allowance for credit losses is the sum of various components recognized pursuant to FASB Statement No. 5, as amended (for pools of loans), and FASB Statement No. 114 (for individually impaired loans). The Company's FASB Statement No. 5 allowance for credit losses components include the following: (a) components based on historical charge-off experience by credit risk grade (for commercial loan pools) and payment status (for consumer loan pools), (b) a component based on a consumer bankruptcy loss attribute, (c) a component for industry risk exposure, and (d) a component for foreign exposure. The historical charge-off experience components are the most significant of the FASB Statement No. 5 allowance for credit losses components. All other FASB Statement No. 5 allowance for credit losses components are based on loss attributes that management believes exist within the total portfolio that are not captured in the historical charge-off experience component.*

The FASB Statement No. 114 component of the allowance for credit losses is determined as part of the Company's credit risk grading process. Once it is determined that it is probable that an individual loan is impaired, the Company measures the amount of the impairment for that loan using the expected future cash flows of the loan discounted at the loan's effective interest rate or, as a practical expedient, at the observable market price of the loan or the fair value of the collateral if the loan is collateral dependent.

The FASB Statement No. 5 components relate to pools of loans with similar credit risk characteristics and are supported by and measured based on observable data. There were no significant changes to the observable data used by the Company to measure these components during 20X2 and 20X1.

The consumer bankruptcy component reflects management's assertion that it is probable there are additional incurred credit losses that are not adequately captured in the historical charge-off experience components and represents management's estimate of the losses resulting from the increase in individual consumer bankruptcies in recent years. This component adjusts the historical charge-off experience to reflect management's estimate of the effect of current conditions. The primary observable data used in the measurement of this component is the month-to-month bankruptcy rate in excess of a three-year rolling average bankruptcy rate for each consumer product type.

The industry exposure component reflects management's assertion that it is probable there are additional incurred credit losses related to the agriculture portfolio that are not adequately captured in the historical charge-off experience component. The principal observable data used in the measurement of this component is published wheat prices due to the concentration of agricultural loans to wheat producers.

Credit Risk Grades

The following summarizes the Company's credit risk grades used as part of its credit risk valuation process for commercial loans as presented in the previous tables:

"Pass" Loans (Grades 1, 2, and 3) *are not considered a greater than normal credit risk. Generally, the borrowers have the apparent ability to satisfy obligations to the bank, and therefore the Company anticipates insignificant uncollectible amounts based on its individual loan review.*

Special-Mention Loans *are commercial loans that have exhibited potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in noticeable deterioration of the repayment prospects for the asset or in the institution's credit position.*

Substandard Loans *are inadequately protected by the current financial condition and paying capacity of the obligor or by any collateral pledged. Loans so classified have a well-defined weakness or weaknesses that may jeopardize the collection of the debt pursuant to the contractual*

principal and interest terms. Such loans are characterized by the distinct possibility that the Company may sustain some loss if the deficiencies are not corrected.

Doubtful Loans *have all the weaknesses inherent in those classified as substandard, with the added characteristic that existing facts, conditions, and values make collection or liquidation in full highly improbable. Such loans are currently managed separately to determine the highest recovery alternatives. All doubtful loans are included in the "Individually impaired loans" category and are measured in accordance with FASB Statement No. 114.*

<u>Nonperforming Assets</u>

Total nonperforming assets and 90-day past due loans at December 31 were:

	(in millions)	
Individually impaired loans:	20X2	20X1
- Nonaccrual	$ 89	$ 94
- Restructured	-	1
Total individually impaired loans	89	95
Other nonaccrual loans	13	17
Total nonaccrual and restructured loans	102	112
Other real estate owned	50	43
Total nonperforming assets	$152	$155
Loans past due 90 days and still accruing	$153	$110

The average balances of individually impaired loans for the years ended December 31, 20X2 and 20X1 were $89 million and $95 million, respectively. The allowance for credit losses related to individually impaired loans at December 31, 20X2 and 20X1 was $25 million and $30 million, respectively. No allowance for credit losses was provided for individually impaired loans of $1.8 million and $0.9 million at December 31, 20X2 and 20X1, respectively, because of the net realizable value of loan collateral, guarantees, and other factors.

During December 20X2, the Company learned that an enterprise that is a substantial employer in an area in which the Company lends has announced its intention to relocate its manufacturing operations within the next 18 months. Management believes that commercial and consumer losses will increase over the short term as the consequences of that action result in borrower default. However, there has been no change in relevant observable data and thus no additional component was recorded at December 31, 20X2.

There were no material commitments to lend additional funds to customers whose loans were classified as nonaccrual or restructured at December 31, 20X2.

Example 2—Disclosure by a Consumer Finance Company

Nature of Operations

In our consumer finance operations, we make home equity loans, originate secured and unsecured consumer loans, extend lines of credit, purchase retail sales contracts and provide revolving retail services arising from the retail sale of consumer goods and services by retail merchants, and offer private label services for retail merchants.

Significant Accounting Policies

Finance Receivables. Finance receivables are carried at amortized cost, which includes accrued finance charges on interest-bearing finance receivables, unamortized deferred origination costs, and unamortized net premiums and discounts on purchased finance receivables. These receivables are net of unamortized finance charges and unamortized points and fees. The Company determines delinquency on finance receivables based on contractual terms.

Allowance for Credit Losses. The allowance for credit losses is management's best estimate of the amount of probable credit losses in our existing portfolio. Increases to the allowance are accompanied by corresponding charges to bad debt expense. Recoveries of previously charged off amounts are credited to the allowance.

The Company's policy is to charge off each month non-real estate loans on which little or no collections were made in the prior six months, retail sales contracts that are six installments past due, and revolving retail accounts that are 180 days past due. Foreclosure proceedings are started on real estate loans when four monthly installments are past due. When foreclosure is completed and the Company has obtained title to the property, the real estate is recorded as an asset at fair value, with a charge-off of any loan amount in excess of that value.

Note X – Finance Receivables and the Allowance for Credit Losses

The components of net finance receivables by type were as follows:

	December 31, 20X2			
(in millions)	Non-Real Estate Loans	Real Estate Loans	Retail Sales Finance	Total
Gross receivables	$7,297	$3,366	$1,667	$12,330
Unearned finance charges and points and fees	(854)	(77)	(237)	(1,168)
Accrued finance charges	102	31	22	155
Deferred origination costs	82	4	--	86
Premiums, net of discounts	37	34	1	72
	$6,664	$3,358	$1,453	$11,475

(in millions)	December 31, 20X1 Non-Real Estate Loans	Real Estate Loans	Retail Sales Finance	Total
Gross receivables	$7,087	$2,910	$1,546	$11,543
Unearned finance charges and points and fees	(911)	(64)	(220)	(1,195)
Accrued finance charges	105	25	23	153
Deferred origination costs	90	4	--	94
Premiums, net of discounts	2	42	--	44
	$6,373	$2,917	$1,349	$10,639

Changes in the allowance for credit losses were:

(in millions)	Years Ended December 31, 20X2	20X1	20X0
Balance at beginning of year	$400	$383	$373
Bad debt expense	204	224	230
Charge-offs	(224)	(225)	(231)
Recoveries	14	18	11
Net charge-offs	(206)	(207)	(220)
Balance at end of year	$394	$400	$383

The recorded investment in loans by payment status, and the allowance for credit losses by loan type, at December 31, 20X2 and 20X1 are as follows:

	December 31, 20X2			
(in millions)	*Non-Real Estate Loans*	*Real Estate Loans*	*Retail Sales Finance*	*Total*
Loan Balance				
- Current	*$5,198*	*$2,838*	*$1,279*	*$9,315*
- 30 days past due	*800*	*252*	*73*	*1,125*
- 60 days past due	*399*	*167*	*58*	*624*
- 90 days past due	*167*	*84*	*29*	*280*
- 120+ days past due	*100*	*17*	*14*	*131*
Total	*$6,664*	*$3,358*	*$1,453*	*$11,475*
TOTAL ALLOWANCE FOR CREDIT LOSSES	***$ 321***	***$ 36***	***$ 37***	***$ 394***

[**Note:** Only one year's worth of disclosures are presented here for illustrative purposes. This SOP requires disclosure of this information for each balance sheet presented.]

Allowance for Credit Losses Components. *The Company's allowance for credit losses is the sum of two components recognized pursuant to FASB Statement No. 5. Those components include the following: (a) a component estimate based on historical charge-off experience by payment status (for loan pools) and (b) a component based on a consumer bankruptcy loss attribute. The Company's historical charge-off experience component is the most significant of the allowance for credit losses components.*

Each of the components of the allowance for credit losses is supported by and measured based on observable data. There were no significant changes in the kinds of observable data used by the Company to measure these components during 20X2 and 20X1. The historical charge-off experience component of the allowance for credit losses represents the results of analyses of historical charge-offs for the Company's portfolios of loans.

The consumer bankruptcy component reflects management's assertion that it is probable there are additional incurred credit losses that are not adequately captured in the historical charge-off experience component and represents management's estimate of the losses resulting from the increase in individual consumer bankruptcies in recent years. This component adjusts the historical charge-off experience to reflect management's estimate of the effect of current events and conditions. The primary observable data used in the measurement of this component is the month-to-month bankruptcy ratio in excess of a three-year rolling average bankruptcy rate for each consumer product type.

Example 3 — Disclosure by a Commercial Entity

The Company is in the business of manufacturing and marketing capital equipment to customers throughout the United States and Canada. The Company's main source of revenue is equipment sales.

Significant Accounting Policies

Notes Receivable. Notes receivable are carried at amortized cost, which includes accrued finance charges on interest-bearing finance receivables. The Company determines delinquency on finance receivables based on contractual terms.

Allowance for Credit Losses. The allowance for credit losses is management's best estimate of the amount of probable credit losses in the Company's existing notes receivable portfolio. Increases to the allowance are accompanied by corresponding charges to bad debt expense. Recoveries of previously charged off amounts are credited to the allowance. The Company's policy is to charge-off each month notes receivable that are six installments past due.

Note X – Notes Receivable and the Allowance for Credit Losses

The components of notes receivables are as follows:

	Years Ended December 31,	
(in thousands)	20X2	20X1
Gross receivables	$2,753	$2,345
Unearned finance charges and points and fees, net	(220)	(187)
Accrued finance charges	20	16
	$2,553	$2,174

Changes in the allowance for credit losses were:

(in thousands)	Years Ended December 31, 20X2	20X1	20X0
Balance at beginning of year	$110	$84	$74
Bad debt expense	60	70	39
Charge-offs	(35)	(47)	(33)
Recoveries	4	3	4
Net charge-offs	(31)	(44)	(29)
Balance at end of year	$139	$110	$84

The recorded investments in loans by payment status is as follows:

(in thousands)	*Years Ended December 31, 20X2*	*20X1*
Notes receivable deemed individually impaired	*$ 95*	*$ 61*
Other notes receivable:		
- Current	*2,158*	*1,859*
- 1 installment past due	*330*	*281*
- 2 installments past due	*165*	*141*
- 3+ installments past due	*5*	*3*
Total notes receivable balance	*$2,753*	*$2,345*
TOTAL ALLOWANCE FOR CREDIT LOSSES	*$ 139*	*$ 110*

Allowance for Credit Losses Components. *The Company's allowance for credit losses is the sum of various components. One component is based on a review of individual notes receivable, with impairment estimated in accordance with FASB Statement No. 114. The Company reviews notes receivable individually for impairment if the note is past due more than two installments.*

The other components are for collective impairment of the Company's notes receivable that is recognized pursuant to FASB Statement No. 5. The Company's collective impairment components include the following: (a) components based on historical charge-off experience by payment status and region in which the Company lends and (b) as the Company's customers are primarily in the housing development industry, a component related to a housing-start decline in the Southeast region in 20X2. The Company's historical charge-off experience-based components are the most significant of the allowance for credit loss components.

The FASB Statement No. 5 components are supported by and measured based on observable data. There were no significant changes during 20X2 and 20X1 to the observable data used by the Company to measure the components based on historical charge-off experience by lending region. The historical charge-off experience components represent the results of analyses of historical charge-offs of the Company's notes receivable to companies in those lending regions.

In 20X2, the Company noted a decrease in the level of housing starts in the Southeast region, causing management to believe that additional losses had been incurred in its notes receivable portfolio for notes from customers in that region. All other lending regions appear stable. The housing starts decline—

Southeast component reflects management's assertion that it is probable there are additional incurred credit losses that are not adequately captured in the historical charge-off experience component and represents management's estimate of the losses resulting from the decrease in housing starts in the Southeast during the current year. This component adjusts the historical charge-off experience to reflect management's estimate of the effect of current events and conditions. The primary observable data used in the measurement of this component is the monthly housing starts data released by the Federal Reserve.

Nonperforming Notes Receivable
Total nonperforming notes receivable and 90-day past due notes receivable at December 31 were:

(in thousands) Individually impaired notes receivable:	20X2	20X1
- Nonaccrual	$ 95	$ 61
- Restructured	-	-
Total individually impaired notes receivable	95	61
Other nonaccrual notes receivable	5	3
Total nonperforming assets	$100	$ 64
Notes receivable past due 90 days and still accruing	$ -	$ -

The average balances of individually impaired notes receivable for the years ended December 31, 20X2 and 20X1, were $106,000 and $74,000, respectively. The allowance for credit losses related to individually impaired notes receivable at December 31, 20X2 and 20X1, was $40,000 and $26,000, respectively. No allowance for credit losses was provided for individually impaired notes receivable of $10,000 and $8,000 at December 31, 20X2 and 20X1, respectively, because of the fair value of collateral.

APPENDIX C — Amendments to Existing AICPA Pronouncements

The first and second sentences of paragraph 9.19 of the AICPA Audit and Accounting Guide *Certain Financial Institutions and Entities That Lend to or Finance the Activities of Others* are deleted.

GLOSSARY

Credit risk evaluation or grading process is the process by which a creditor categorizes certain loans within its portfolio based on characteristics of the loan that are indicative of the underlying borrowers' ability to comply with contractual terms of the loan agreement. For a financial institution subject to the Federal Financial Institutions Examination Council (FFIEC) loan classification criteria, this credit risk evaluation process typically results in the classification of loans as pass, special mention, substandard, doubtful, and loss.

Observable data is internal or external information about conditions existing at the balance-sheet date that provides a reasonable basis for concluding that it is probable an asset has been impaired because certain loans in a group will fail to perform pursuant to their contractual terms and for estimating the asset impairment. Observable data do not include opinions or conjecture. Observable data can be either data developed by a creditor or data available from external sources.

Similar credit risk characteristic is an attribute of a loan or a condition affecting a borrower that evidences a kind or degree of loss probability, for example, the fact that a loan has been assigned a certain risk grade as a result of a credit risk evaluation or grading process or the fact that a loan is to a borrower in a distressed industry or economically depressed geographic location. Factors to be considered in determining whether loans have similar credit risk characteristics may include kind of financial asset, kind of collateral, size, interest rate, date of origination, term, and geographic location.