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Auditing Procedure Study

Auditing the Allowance for Credit Losses of Banks

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Auditing Procedure Study

Auditing the Allowance for Credit Losses of Banks

American Institute of Certified Public Accountants

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Foreword

This Auditing Procedure Study, *Auditing the Allowance for Credit Losses of Banks,* is designed to assist auditors of bank financial statements in developing an effective audit approach when auditing the allowance for credit losses. More specifically, the study's objectives are as follows:

- Provide information on the lending process, internal control systems, and other matters that will assist the auditor when planning the audit engagement as it relates to the allowance for credit losses.
- Make practitioners aware of matters to consider when evaluating the adequacy of a bank's allowance for credit losses.
- Describe methods by which the auditor can evaluate the adequacy of management's allowance for credit losses.

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Introduction

In the early 1980s, the number of bank failures in the United States began to increase significantly. Certain failures were well publicized and caused concern, among CPAs performing bank audits, the Securities and Exchange Commission (SEC), and banking regulators, about the effectiveness of bank audits and the adequacy of regulatory supervision.

Representatives of the American Institute of Certified Public Accountants' (AICPA) Committee on Banking met with the Special Investigations Committee of the SEC Practice Section of the AICPA Division for Firms and also with senior officials of the federal bank regulatory agencies to discuss guidance for CPAs performing bank audits. As a result of these meetings, the AICPA Committee on Banking concluded that illustrative guidance on auditing the allowance for credit losses should be developed.

Thus, the AICPA Auditing Standards Division, in conjunction with the AICPA Committee on Banking, undertook a project to develop this Auditing Procedure Study, *Auditing the Allowance for Credit Losses of Banks.* The project encompassed a review of existing authoritative guidance, as well as other information developed by several CPA firms, federal bank regulatory agencies, banking organizations, and other interested groups. The study is designed to assist auditors of bank financial statements in developing an effective audit approach.

Chapter 1

Accounting for Credit Losses

This chapter provides background on accounting for credit losses in the banking industry and describes the applicable authoritative literature in this area.

Under generally accepted accounting principles, banks are required to maintain an adequate allowance for credit losses. The maintenance of an adequate allowance for credit losses is management's responsibility. The CPA is responsible for obtaining reasonable assurance that management has recorded an adequate allowance, based on all relevant factors bearing on the collectibility of the loan portfolio.[1] The allowance is an estimate based on subjective judgment and is difficult to audit. Accordingly, careful planning and execution of the audit procedures are essential in this area.

BACKGROUND

The current method of accounting for credit losses in the banking industry has evolved under the combined influence of authoritative accounting standards, the Internal Revenue Service, and the federal bank regulators (the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Federal Reserve Board). Before 1969, banks typically recorded a provision for credit losses that fell within the amount computed under IRS guidelines. In 1969, banking regulators required that banks charge against income a minimum provision for credit losses. This requirement was consistent with guidance provided in the 1968 Industry Audit Guide *Audits of Banks.*

1. The term *loan portfolio,* when used in this study, refers primarily to loans, leases, standby letters of credit, and other commitments to lend. In addition, banks are developing new financial products that contain elements of credit risk. Accordingly, bank management normally considers including the credit risk associated with these new financial products when determining the adequacy of the allowance for credit losses. Finally, some banks reverse interest receivable against current period income when the receivable is estimated to be uncollectible. Others charge estimated uncollectible interest receivable to the allowance for credit losses. Depending upon the accounting policy of the bank, the allowance for credit losses may contain an allocation for estimated uncollectible interest receivable.

The banking regulators prescribed three methods for calculating the minimum provision, each of which emphasized historical charge-offs. Charges to income computed under the 1969 banking regulations generally were lower than the deduction allowed for tax purposes. Consequently, many banks recorded the amount computed under the tax laws for financial statement purposes. In part, the rationale was that since the addition to the allowance exceeded regulatory minimum levels, it was probably adequate. This reasoning resulted in allowances computed under tax and regulatory guidelines that did not necessarily take into account prevailing economic conditions or the quality of loans in a bank's portfolio.

In 1975, banking regulations were changed so that banks were no longer required to compute a minimum addition to the allowance. Instead, the amount of the allowance was to be determined by the bank's management and its board of directors. The regulations emphasized the bank's responsibility for evaluating all relevant factors in determining the adequacy of the allowance. Banks were also required to document the decision process involved in the calculation. The regulatory guidance was expanded in 1985 to include factors to be considered in the evaluation process. The regulators have continually reiterated the importance of the bank's responsibility for maintaining the allowance at an adequate level, not merely at a certain percentage of loans.

CURRENT ACCOUNTING STANDARDS

Statement of Financial Accounting Standards (SFAS) No. 5, *Accounting for Contingencies,* provides authoritative guidance on the accounting and reporting of loss contingencies, including uncertainty about the collectibility of receivables. SFAS No. 5 discusses the likelihood that, when a loss contingency exists, one or more future events will confirm the loss. An estimated loss from a loss contingency should be accrued by a charge to income if *both* of the following conditions are met:

1. Information available prior to 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.
2. The amount of loss *can be reasonably estimated.*

The 1983 Industry Audit Guide *Audits of Banks* (hereafter referred to as the Bank Audit Guide) provides additional guidance on the application of SFAS No. 5 to a bank's loan portfolio. On page 61, the Bank Audit Guide states the following:

> A bank should maintain a reasonable allowance for loan losses applicable to all categories of loans through periodic charges to operating expenses. The amount of the provision can be considered reasonable when the allowance for loan losses, including the current provision, is considered by management to be adequate to cover estimated losses inherent in the loan portfolio.

The Bank Audit Guide also indicates that the propriety of the accounting treatment should be judged by considering the adequacy of the allowance, not the provision charged against income. Loans should be charged off as soon as they are deemed uncollectible. That is, loan losses should be charged off in the period in which the loans or portions thereof are determined to be uncollectible.

SFAS No. 5 is the primary authoritative document concerning the accrual of an allowance for credit losses. It is important to consider the Bank Audit Guide's phrase "estimated losses inherent in the loan portfolio" in connection with SFAS No. 5's requirements. Accordingly, the allowance should be adequate to cover specifically identified loans, as well as loans and pools of loans for which losses are probable but not identifiable on a specific loan-by-loan basis.

Chapter 2

Audit Objective and Audit Planning

This chapter discusses the audit objective when auditing the allowance for credit losses. It also describes the lending process and the evaluation of internal control.

AUDIT OBJECTIVE

When auditing the allowance for credit losses, the CPA is concerned primarily with the valuation assertion embodied in the financial statements. The audit objective is to determine that the allowance is adequate to cover the estimated amount of loss in the loan portfolio at the date of the financial statements. Statement on Auditing Standards (SAS) No. 31, *Evidential Matter,* describes the relationship between assertions embodied in the financial statements, audit objectives, and substantive audit procedures.

AUDIT PLANNING

The audit procedures performed in connection with the allowance for credit losses typically are time-consuming and are most efficient when initiated early in the fieldwork. Because of the subjective nature of the loan review process, experienced audit personnel, preferably with prior bank auditing experience and, if necessary, with knowledge of industries in which the bank's loans are concentrated, should closely supervise or perform this section of the audit. The assigned audit staff should also understand the lending environment, including credit strategy, credit risk, and the lending policies, procedures, and control environment of the bank, and should be familiar with known related parties and related party transactions.

UNDERSTANDING THE LENDING ENVIRONMENT

To plan and design audit procedures properly, the CPA needs to understand the bank's loan portfolio, lending processes, loan accounting policies, market specialty, and trade area, plus other factors such as economic conditions and government regulations. This section discusses certain characteristics of, and considerations involved in, the lending processes. The specific features will vary from bank to bank.

Credit Strategy

The bank's credit strategy includes its defined goals and objectives for loans, as well as the loan policies written to help achieve those goals and objectives. A guiding principle in credit strategy is to achieve profitable returns while managing risk within the loan portfolio. Credit strategy and policy are usually determined by senior management and approved by the board of directors.

The objectives of a sound credit plan are to identify profitable markets, set goals for portfolio growth or contraction, and establish limits on industry and geographic concentrations. The plan establishes the credit underwriting standards. In addition, procedures and controls are required to monitor loan performance through periodic reporting and review and to identify and monitor problem loan situations.

Credit Risk

The overriding factor in the credit extension process is the amount of credit risk associated with the lending process, which is addressed early in the CPA's review of the bank's business and control environment. For individual loans, credit risk pertains to the borrower's ability and willingness to pay, and is assessed before credit is granted or renewed and periodically throughout the loan term.

Additional risks, however, are involved in the overall credit process, and the bank should assess them when developing credit strategy, defining target markets, and designing proper controls over credit initiation and credit supervision. Those additional risks include the following:

- *Collateral risk.* The bank may be exposed to loss on collateralized loans if the bank's security interest is not perfected or the collateral is not otherwise under the bank's control, or if the value of the collateral declines.
- *Concentration risk.* Inadequate diversification of the loan portfolio in terms of different industries, geographic regions, or number of borrowers may result in significant losses. A high concentration of loans to companies in an industry experiencing economic problems, for example, would constitute a concentration risk.
- *Country or transfer risk.* Economic, social, legal, and political conditions of a foreign country may unfavorably affect a borrower's ability to repay in the currency of the loan. Cross-border loans are those that borrowers must repay in a currency other than their local currency or to a lender in a different country. Losses may result if a

country's foreign exchange reserves are insufficient to permit timely repayment of cross-border loans by borrowers domiciled in that country, even if the borrowers possess sufficient local currency. In addition, foreign government decisions and associated events can affect business activities in a country as well as a borrower's ability to repay its loans.

- *Foreign exchange risk.* Changes in foreign exchange rates may affect lenders unfavorably.
- *Fraud risk.* Loans may expose the bank to loss by not being either bona fide or arms-length transactions.
- *Insider risk.* Loans to executive officers, directors, and principal shareholders of the bank and related interests of such insiders may expose the bank to loss if these loans are made to related individuals, companies, or both with little credit history, or to newly organized or highly leveraged enterprises with insufficient collateral and inadequate financial information.
- *Legal and regulatory risk.* Illegally granted loans, loans with usurious interest rates, and loans with terms that are not adequately disclosed to the borrower may expose the bank to loss.
- *Management risk.* Management's competence, judgment, and integrity in originating, disbursing, supervising, collecting, and reviewing loans could substantially affect the collectibility of loans.
- *Operations risk.* Funds might be disbursed without proper loan authorization, collateral documentation, or loan documentation. Failure to evaluate and monitor potentially uncollectible loans also constitutes an operations risk.

Lending Policies and Procedures

Definitive lending policies, comprehensive procedures for implementing the policies, and sound controls over the lending function and management reporting system are essential for maintaining the quality and safety of the assets and for ensuring the reliability of the financial records. The CPA should be familiar with both the bank's lending environment and its lending policies, procedures, and control environment before designing specific audit procedures.

The lending function can be broadly divided into the categories of (1) credit origination and disbursement, (2) credit supervision, (3) collection, and (4) loan review.

Credit Origination and Disbursement

Credit origination involves all the processes from the original request for credit to the disbursement of funds to the customer. Specific credit origination control features usually include the following:

1. Credit initiation, that is, obtaining complete and informative loan applications, including financial statements and the intended use of proceeds

2. Credit investigation
   - Credit reports or other independent investigations
   - Proper analysis of customer credit information, including determination of projected sources of loan servicing and repayment
3. Loan approval (new and renewed loans)
   - Loan approval limits according to officer expertise, administrative authority, or both
   - Committee approval, board of director approval, or both for loans exceeding prescribed limits
   - Segregation of duties between the loan approval function and the disbursement and collection functions
   - Collateral ownership and control verified, including lien searches and documentation of the priority of security interest
   - Collateral margin determined
4. Documentation of credit, or the inspection of supporting documents for proper form, completeness, and accuracy by someone other than the lending officer
5. Perfection of collateral interest, or proper security filings and recording of liens
6. Disbursement of loan proceeds, or, to the extent possible, control of disbursement to ensure that proceeds are used for the borrower's stated loan purpose

Credit Supervision

Loan officers should closely monitor the loans in their portfolios and bring problem loans to the attention of management. That is, they should obtain and analyze the borrower's periodic financial statements, reassess collateral values, make periodic visits to the customer's place of operation, and generally keep abreast of industry trends and developments and of the customer's financial requirements and ability to perform. Management reports concerning loan activity, renewals, and delinquencies are vital to the timely identification of problem loans.

Input from loan officers is also important for identifying when loans should be placed on nonaccrual status, reserved for, or charged off. Most banks have written policies covering nonaccrual status, the timing of charge-offs, or both. For example, a typical policy requires nonaccrual status when reasonable doubt exists about the full, timely collection of interest or principal, or when interest or principal payments are past due ninety days or more. The federal bank regulators' policy regarding nonaccrual status has been adopted by many banks for financial reporting purposes. The regulators generally require a loan to be placed on nonaccrual status when (1) the loan is maintained on a cash basis because of deterioration in the financial position of the borrower, (2) payment in full of interest or principal is not expected, or (3) interest or principal has been in default for a period of ninety days or more unless the loan is both well secured and in the process of collection.

Collection

Loans identified as problems under the bank's established criteria should be monitored, restructured, or liquidated, as appropriate. The bank normally attempts to work with the customer to remedy a delinquency. Sometimes the debt is restructured to include terms the customer can satisfy; at other times the bank obtains additional collateral to support the loan. However, when the loan is delinquent for a specified period of time, as normally defined in the bank's lending policy, the bank may begin legal proceedings, such as foreclosure or repossession, to recover any outstanding interest and principal.

Loan Review

Periodic review, by bank personnel, of the credit process and of individual loans is essential in assessing the quality of the loan portfolio and the lending process. Loan review preferably should be conducted by bank personnel who are independent of the credit origination, disbursement, supervision, and collection functions. Depending on the complexity of the bank's organizational structure, these personnel report directly to the board of directors or to senior bank management. Loan review may be performed by specifically assigned staff or may be incorporated within an internal audit function.

Loan review includes several distinct activities. The principal emphasis is on determining whether the loan conforms to the bank's loan policies and is likely to perform in accordance with the agreed-on terms and conditions, including compliance with any restrictive covenants in a loan agreement. The review includes analyzing the borrower's financial statements, reviewing performance since origination or last renewal, and determining if sufficient credit information is available to assess the borrower's current financial condition.

Loan file contents should be reviewed to determine if credit reports, appraisals, and other third-party information existed before granting the credit or renewal and if the quality of such information supported, and continues to support, the credit decision. If the loan is secured or guaranteed, the review should also determine that collateral is under control, security interests are perfected, and guarantees have been executed properly. Also, the value of collateral should be estimated at the review date to identify deficiencies in collateral margins.

Loan review may also identify weaknesses in the lending process or in the lending officers' skills in originating, supervising, and collecting loans. Loan review results should be documented, and may be summarized in the form of subjective ratings of individual loans similar to regulatory examination classifications. In addition, loan review may result in the need for a specific allowance allocation.

AUDIT RISK AND MATERIALITY

Audit risk and materiality are considered together in determining the nature, timing, and extent of auditing procedures and in evaluating the results of those procedures. SAS No. 47, *Audit Risk and Materiality in Conducting an Audit,* provides guidance on audit risk and materiality as they relate to planning and performing an audit.

Audit risk and materiality initially are considered at the financial statements level in order to limit the risk of undetected material misstatement of the financial statements taken as a whole to a low level. However, the CPA also needs to consider audit risk at the account level (that is, allowance for credit losses) to assist in determining the scope of auditing procedures for the particular account balance or class of transaction. Because the loan portfolio is usually a bank's largest asset and the allowance for credit losses is, to a significant extent, based on subjective judgments, the allowance is usually a high-risk audit area.

EVALUATION OF THE CONTROL ENVIRONMENT

After the CPA has defined the audit objective and gained proper understanding of the lending environment, the CPA should consider the extent of reliance on internal control when planning particular substantive tests to achieve that objective. The evaluation of internal control would normally include a review and assessment of compliance with the bank's lending policies and practices and the loan review and other systems for identifying, monitoring, administering, and classifying problem loans.

In SAS No. 1, section 320, *The Auditor's Study and Evaluation of Internal Control,* the CPA can find guidance on the purpose and design of a study and evaluation of internal control. The results of the CPA's evaluation of internal control directly affect the extent of substantive testing, including individual loan reviews.

To identify the strengths and weaknesses in internal control, the CPA normally reviews prescribed policies and practices. The reviews might begin with the bank's written loan policies and procedures, followed by a "walk-through" of the system from loan request to collection efforts. Flowcharts, questionnaires, and narratives are some of the tools used in obtaining an understanding of the system's attributes. In particular, the CPA considers the adequacy of the lending and loan review departments' staff resources and expertise.

RELIANCE ON INTERNAL CONTROL

If the preliminary review of internal control indicates the presence of controls on which the CPA can rely, and the CPA intends to rely on controls, the CPA should perform compliance tests of various lending procedures, including internal loan classifications, to determine the extent of reliance.

The preliminary review of internal control may indicate that controls are not adequate to allow reliance thereon. Such a conclusion may result when, for example, (1) client personnel are not following prescribed procedures (such as adequate loan documentation or collateral perfection), (2) management decision-making authority is concentrated in one individual, or (3) segregation of duties is limited. The CPA uses such information as a basis for determining the nature, timing, and extent of substantive tests applied to the account balance of the allowance for credit losses. In addition, the extent and quality of internal loan review normally will influence the CPA's decision about the extent to which individual loans will be reviewed.

LOAN REVIEW AND INTERNAL AUDIT FUNCTIONS

Effective loan review and internal audit departments can provide valuable assistance to the CPA and improve audit efficiency. Discussions with loan review and internal audit staff can provide the CPA with information concerning loan customers, related party transactions, and account histories that may not be readily available elsewhere. Also, because the internal audit department is sometimes directly involved in implementing control systems, it can provide the CPA with important system descriptions.

Sometimes, the loan review and internal audit departments' testing procedures are of such quality that the CPA can consider the loan review and internal audit functions integral components of the system of internal accounting control, and therefore can limit the extent of testing performed. SAS No. 9, *The Effect of an Internal Audit Function on the Scope of the Independent Auditor's Examination,* provides guidance on arrangements with internal auditors and other internal personnel who perform internal audit-type work, such as loan review personnel, on reviewing their competence and objectivity, and on evaluating their work.

Chapter 3

Developing and Performing Audit Procedures

This chapter provides information on developing and performing specific audit procedures that will result in an effective audit of the allowance for credit losses.

As discussed in the Bank Audit Guide, the allowance for credit losses represents an amount that, in management's judgment, approximates the current amount of loans that will not be collected. The CPA is not responsible for calculating the amount of the allowance or determining the collectibility of each loan in the portfolio, but rather for obtaining reasonable assurance that management has recorded an adequate allowance. Therefore, the audit procedures normally are performed primarily on a test basis and designed to determine the overall collectibility of the portfolio.

SCOPE OF WORK

In establishing the scope of the work to be performed, the CPA normally considers the following factors:

1. Composition of the loan portfolio
2. Identified potential problem loans, including loans classified by bank regulatory agencies
3. Trends in loan volume by major categories, especially categories experiencing rapid growth, and in delinquencies, nonaccrual, and restructured loans
4. Previous loss and recovery experience, including timeliness of charge-offs
5. Concentrations of loans to individuals and their related interests, industries, and geographic regions
6. Size of individual credit exposures (few, large loans versus numerous, small loans)
7. Degree of reliance placed on internal loan review and internal audit functions

8. Total amount of loans and problem loans, including delinquent and nonaccrual loans, by officer
9. Lending, charge-off, collection, and recovery policies and procedures
10. Local, national, and international economic and environmental conditions
11. Experience, competence, and depth of lending management and staff
12. Results of regulatory examinations
13. Related party lending

Although the CPA's primary responsibility when reviewing the allowance for credit losses is evaluation of its adequacy as a whole, practical considerations may dictate that the review be directed to the separate categories of loans that constitute the bank's portfolio. Because the risk and other inherent characteristics of primary loan categories vary, the nature and extent of the separate reviews also can be expected to vary.

For example, loan categories represented by large volumes of relatively small loans with similar characteristics, such as residential real estate mortgages, consumer loans, and credit card loans, are generally evaluated on an aggregate or "pool" basis. The CPA is generally more concerned with the effectiveness of and adherence to sound procedures related to such loans than with a critical appraisal of each individual loan. Unless unusual circumstances exist, the testing of procedures and the review of delinquency status reports should permit the CPA to draw a conclusion about the adequacy of the allowance required for those loan categories. In evaluating the adequacy of the portion of the allowance attributable to those loans, use of historical annual charge-off experience should be considered in light of the average remaining lives of loans, consistent application of loan policies, and current and anticipated economic conditions.

Conversely, an evaluation of commercial loans normally requires a more detailed review, since the amount of an individual loan is generally large and the types of borrowers and the purposes of the loans may be dissimilar. More importantly, a relatively small number of potential losses often can significantly affect the adequacy of the allowance. In these circumstances, the CPA selects and reviews in detail a certain number of problem loans.

In addition to identified problem loans, the CPA typically selects other commercial loans to include in the detailed loan file review. The selection of these additional loans generally includes a stratum of large loan balances above specified limits, loans from other sources (such as related parties and industry concentrations), and some loans selected without regard to size or other specific criteria. The CPA should be concerned with the total credit exposure of the borrower, including standby letters of credit and other commitments to lend, rather than with individual loan balances. The number of loans reviewed might be limited when the internal loan review function is deemed adequate, based on the CPA's evaluations and tests, in identifying and classifying problem credits.

Finally, the extent of an individual loan review varies from loan to loan. For example, a loan that has been subjected to a recent management review, an effective internal review, and a recent regulatory review may be reviewed in less detail than a loan that has not had some or all of those reviews.

SOURCES FOR IDENTIFYING PROBLEM LOANS

A number of sources can indicate potential problem loans. Key sources are the regulators' recent Reports of Examination, which disclose classified loans and certain statistics regarding those classifications. Policies of the three federal bank regulatory agencies and many state banking departments allow CPAs access to these reports. The CPA reviews and extracts appropriate information from the reports. Also, with the bank's permission, CPAs are allowed to attend the exit conferences between the examiners and management or the board of directors, discuss examination results directly with the examiners, or both. Such meetings may provide the CPA with additional data concerning classified loans that may be helpful in determining the extent of the CPA's own tests and other inquiries.

The regulatory Reports of Examination are important sources of evidential matter to the CPA in determining the nature, timing, and extent of the CPA's tests. If the bank prohibits the CPA from reviewing the report, the CPA should notify bank management that a scope limitation may result.

Additional sources of information concerning potential problem loans include—

- Various internally generated listings, such as "watch list" loans, past due loans, loans on nonaccrual status, loans to insiders (including directors and officers), and overdrafts.
- Management reports of total loan amounts by borrower.
- Historical loss experience by type of loan.
- Loan files lacking current financial data related to borrowers and guarantors.
- Borrowers experiencing problems such as operating losses, marginal working capital, inadequate cash flow, or business interruptions.
- Loans secured by collateral that is not readily marketable or that is susceptible to deterioration in realizable value.
- Loans to borrowers in industries experiencing economic instability.
- Loan documentation and compliance exception reports.

It should be noted that some of the above information is usually found in reports prepared by management. If it is to be relied upon in substantive tests, the accuracy and completeness of such information should be evaluated by, for example, reviewing loan subsidiary ledgers and tracing delinquencies to the past due reports.

LOAN REVIEW PROCEDURES

Information about a borrower ordinarily is filed in a credit file, a loan documentation file, or both. The CPA should obtain the loan file for each loan selected for review. Loan documentation for new loans or renewals includes such information as loan applications, borrower financial statements, appraisals, and spreadsheets. Exhibit 3.1 details information that may be found in a loan file.

The documentation required to perfect collateral or to obtain guarantees includes security agreements, collateral receipts, loss payable clauses, assignments of interest in assets, and other similar agreements. Those documents may be found in files other than credit files.

Exhibit 3.1

Typical Loan File Contents

Credit Investigation/Application/Supervision Section

Loan application
Credit approval document that summarizes—

- Borrower
- Amount of request/rate/payment terms/fees
- Purpose
- Repayment sources (primary and secondary)
- Collateral description and valuation
- Guarantors
- Other conditions/requirements of approval

Evidence of loan committee or other required approval, and date approval was granted
Financial statements of borrower, guarantor, or both
Spreadsheets and other analyses of the financial situation of the borrower
Borrower's board resolutions concerning loan approval
Credit agency reports and other bank account information reports, as well as direct trade creditor references
Newspaper clippings about borrower
Various other pertinent data, including the borrower's history and forecasts
Internal memoranda
Correspondence
Loan summary sheet, containing information such as—

- Lending committee approval date
- Drawdown amounts and dates
- Interest rates and adjustment dates
- Amount of undrawn commitment
- Rate of commitment fee and due dates
- Date commitment fee received
- Repayment terms
- Name of country risk
- Name and country of any guarantor
- Amount of participation fee (if applicable)
- Indication of overdue payments of interest, fees, or installments

Memorandum to the file, by the lending officer, with description of the credit and commentary on its quality and potential future developments

Loan Documents Section

Signed loan agreement
Legal opinion
Signed note
Signed mortgage or deed of trust, with evidence of recordation
Signed guarantee
Periodic report of collateral, including its location and value
Participation certificates and participation agreements (if applicable)
Evidence of insurance, including loss payable clauses that protect the bank's interest
Appraisals
Security agreements or other collateral pledge agreements, titles, or financing statements recorded in proper jurisdictions to perfect lien position (non-possessory collateral), negotiable collateral (such as stocks and bonds) with proper endorsements/assignments, hypothecation agreement for third-party pledge of collateral
Collateral ledger used to record the instruments (including stocks and bonds, which are probably kept in a bank vault separate from loan files or with an independent custodian) that secure a borrower's indebtedness

Note: The location of the contents listed will vary from bank to bank depending on the particular bank's policies and procedures.

REVIEW OF INDIVIDUAL LOAN FILES

Management normally reviews loans for collectibility on a loan-by-loan basis when individual balances in the loan portfolio are relatively large. Loans may be assigned a rating or grade by individual loan, type of loan, or borrower's industry, and then a potential loss factor or range of loss by rating or grade. In some cases, management may use a combination of the above.

CPAs review individual loan files to gain assurance that management has identified and considered all significant loans with credit weaknesses or other types of potential collection problems. Individual loan reviews normally consider information from credit files, examiners' reports, internal review reports, interviews of loan officers, loan history analyses, and public information. In performing this review, the CPA prepares documentation that will enable conclusions to be summarized in an orderly fashion.

When management uses a uniform classification system that consistently identifies the loss, or range of loss, associated with a loan or a group of loans, the CPA might consider using similar classifications to facilitate testing of the adequacy of the bank's allowance for credit losses. If management has no such system, the CPA uses an independently designed system to arrive at an estimate of the identified potential loss in the loan portfolio.

Bank regulators have a system for categorizing the range of risk identified in the loan review process. Many banks use similar categorization systems in their internal loan review process. The specific criteria of the agency supervising the bank should be reviewed. In general, however, the regulators designate loans, in whole or in part, according to the degree of risk of loss, as follows:

1. *Unclassified* loans are not considered a greater-than-normal risk. The borrower has the apparent ability to satisfy his obligations to the bank, and therefore no loss in ultimate collection is anticipated.
2. *Other loans especially mentioned* are presently protected by the current sound worth and paying capacity of the obligor or by any collateral pledged, but are mentioned by the regulators as being potentially weak and constituting an undue and unwarranted credit risk, though not to the point of justifying the classification of substandard. Examples of such conditions are—

   - Poor lending practices that result in significant defects in the loan agreement, security agreement, guarantee agreement, or other documentation, and the deteriorating condition of or lack of control over collateral. In other words, these are conditions that may jeopardize the bank's ability to enforce loan terms or that reduce the protection afforded by secondary repayment sources.
   - Lack of information about the borrower or guarantors, including stale financial information or lack of current collateral valuations.
   - Economic or market conditions that in the future may affect the borrower's ability to meet scheduled repayments. These may be evidenced by adverse profitability, liquidity, or leverage trends in the borrower's financial statements.

3. *Substandard* loans are inadequately protected by the current sound worth and paying capacity of the obligor or by any collateral pledged. Loans so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected.
4. *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. The possibility of loss is extremely high, but because of certain important and reasonably specific pending factors that may work to the advantage and strengthening of the asset, its classification as an estimated loss is deferred until a more exact status may be determined. Pending factors include merger, acquisition, liquidation procedures, capital injection, additional collateral, new financing sources, or additional guarantors.
5. Loans classified as a *loss* are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the loan has absolutely no recovery or salvage value. Rather, the amount of loss is difficult

to measure and it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be obtained in the future. Loans should be charged off in the period in which they are deemed uncollectible.

The bank regulators use somewhat different classifications for problem cross-border credits, including loss, value-impaired, substandard, and other transfer risk problems. Cross-border credits should be evaluated on a normal credit quality basis as well as on a country risk basis. If the credit quality of a cross-border loan warrants a more severe classification (for example, loss) than the country risk classification (for example, substandard), the more severe classification prevails. For the value-impaired loan classification, the regulators currently have established special reserve requirements for credits to several countries. Such reserves are designated for regulatory purposes as allocated transfer risk reserves or ATRRs.

In determining the amount or range of loss associated with an individual loan, the CPA reviews the expected sources of repayment and the apparent ability of the borrower to generate such repayment. In instances in which the repayment depends on the liquidation of collateral, the CPA, in reviewing the value of the collateral, considers whether the collateral will be liquidated in the normal course of business or in a manner that will cause a lesser value to be realized.

In evaluating loans, the CPA should be careful to avoid the following:

- *Collateral myopia,* or failure to see beyond collateral values to a financial weakness in the borrower. Collateral values and liquidity often tend to decline in periods when they are most needed to protect against loan losses. For example, if an oversupply in the real estate market causes lower-than-projected occupancy rates (creating cash flow problems for the borrower), the protection afforded by the collateral is diminished. Similar scenarios can be drawn for oil and gas reserves when energy prices decline, for specialized equipment during specific industry slowdowns (for example, drilling rigs, mining equipment, farm equipment, steel mills, and construction equipment), for farm land during periods of depressed agricultural commodity and livestock prices, and for accounts receivable of a failing company.
- *Inadequate collateral appraisals,* or failure to critically review appraisals to understand the methods employed, assumptions made, and limitations inherent in the appraisal process, including undue reliance on management appraisals (see discussion on p. 20 under "Using the Work of Specialists"). Appraisal methods and assumptions may be inappropriate for the current circumstances. For example, real estate appraisals made on the income approach are not usually appropriate for incomplete projects or in circumstances in which operating conditions have changed. Going concern values generally are dramatically different from liquidation values.

- *Outdated or unreliable financial information,* or reliance on old, incomplete, or inconsistent data to assess operating performance or financial capacity. Financial information should be current and complete, particularly for borrowers sensitive to cyclical fluctuations or who demonstrate significant growth or changes in operating philosophy and markets.
- *Excessive renewals or unrealistic terms,* or reliance on "current" or "performing as agreed" status when the transaction has been structured to obscure weaknesses. Excessive renewals, unrealistic terms, and interest capitalization may be indications of such a structure. The purpose of a loan and performance against the original agreement should be critically reviewed.
- *Personal bias* of a reviewer for or against industries, companies, individuals, and products. For example, the involvement of a public personality in a venture could influence a reviewer to place more credibility than appropriate on the success of the venture.
- *Overlooking self-dealing* of directors or large shareholders who improperly use their position to obtain excessive extensions of credit on an unsound basis. In this situation, management is often unduly influenced by persons in these positions since management serves at the pleasure of the board and shareholders.
- *Dependence on management representations,* or undue reliance on management representations when there is no supporting evidence. For example, such representations as "the guarantee is not signed but it is still good" or "the future prospects for this troubled borrower are promising" should be critically reviewed.

USING THE WORK OF SPECIALISTS

To properly evaluate the collectibility of certain loans, the CPA may need information outside his usual experience. For example, the CPA might encounter valuation problems that require special knowledge of types of collateral. SAS No. 11, *Using the Work of a Specialist,* provides guidance concerning the CPA's decision to use the work of a specialist. Factors to be considered in selecting a specialist include professional recognition of the specialist's competence in his field, his reputation among peers, and his relationship with the client.

Calling in an appraiser, especially for real estate and other subjectively valued collateral, is one example of using a specialist. The CPA should be familiar with the basic concepts involved in the appraisal process in order to evaluate the competency and qualifications of appraisers. An exposure draft of an AICPA proposed *Guide on the Use of Real Estate Appraisal Information* specifically addresses the understanding of the real estate appraisal process and the CPA's use of real estate appraisal information.

A specialist could also be necessary for loans based on oil and gas reserves. The specialist might review engineering reports on current reserves and production reports if the wells are in production. If fluctuating market conditions exist, a specialist could answer additional inquiries concerning the current status of oil and gas properties. For example, a loan secured by drilling equipment might have only marginal collateral value in a period of declining petroleum prices, even though the loan was highly secured when it was made.

Loans to developing countries are another example of instances in which the CPA may require the assistance of a specialist in order to become familiar with the economic, political, and social factors affecting the country's debt repayment. Sources of such information include International Monetary Fund publications, international economists, and reports provided to banks by the Interagency Country Evaluation Review Committee (ICERC).

If the CPA finds that the appraisal or valuation information is deficient, the CPA should request that management secure additional information. Also, the CPA might consider selecting and hiring the appraiser or consultant directly.

LOAN REVIEW DOCUMENTATION

For each loan selected for review, the CPA normally prepares a loan review worksheet or other memoranda documenting the procedures performed and summarizing the conclusions reached. Exhibit 3.2 is an example of a loan review form that could be used for a commercial loan. It can also be adapted to other types of loans. For loans reviewed previously, the CPA typically updates prior reviews for new information concerning the loan. In addition, the CPA usually reviews correspondence updating classified loans, workpapers prepared by the bank's internal loan review personnel, and any regulatory examiner reports, including those with information on Shared National Credits. Such data often provide additional information concerning the loan and how management considered the loan in calculating the allowance for credit losses.

Exhibit 3.2
Sample Loan Review Form

Client ____

Audit Date ____

Borrower's Name ______________________________________

Nature of Business ____________________________________

____

Purpose of Loan _______________________________________

____

(continued)

Exhibit 3.2 (cont.)

I. Borrower's Notes

Description	*Direct Loan or Participation*	*Maturity Date*	*Line of Credit/ Commitment Amount*	*Outstandings Principal*	*Outstandings Interest*
				______	______
Total loans outstanding at preliminary			__/__/__	______	______
Total loans outstanding at year-end			__/__/__	______	______

Accrual basis (Y/N) ______________

Repayment Schedule: ______________________________________

____

Repayment Status:

	Principal	*Interest*
Amount past due	______	______
Last payment:		
Date	______	______
Amount	______	______

II. Contingencies/Guarantees (e.g., letters of credit, participations sold with recourse)

	______
Total at preliminary	______
Total at year-end	______

III. Related Loans

Obligor	*Relationship*	*Maturity Date*	*Commitment Amount*	*Outstandings*
				______
		Total related loans		______

IV. Collateral Summary

Description	*Gross Value*	*Prior Liens*	*Value to Lender*	*Basis for and Date of Valuation (e.g., appraisal, market value quotes)*
	______	______	______	
Total	______	______	______	

V. Guarantors

VI. Loan Grade

Regulatory		*Bank's In-house*	
Classification	*Amount*	*Classification*	*Amount*
OLEM			
Substandard			
Doubtful			
Loss			
Unclassified			
Total	______		______

VII. Financial Data

Auditors ____________________

Type of opinion __________ Last audit date __________

	Interim		*Fiscal Year*	
	Current Year __ months ended _/_/_	*Prior Year __ months ended _/_/_*	*Current Year __/__/__*	*Prior Year __/__/__*
Current assets				
Current liabilities	______	______	______	______
Working capital	______	______	______	______
Total assets				
Total liabilities	______	______	______	______
Net worth	______	______	______	______
Net sales	______	______	______	______
Net income	______	______	______	______
Cash flow	______	______	______	______

(continued)

Exhibit 3.2 (cont.)

VIII. Loan Officer ______________________________

Comments
(Provide a narrative analysis of collectibility including estimated repayment dates, sources of repayment, adequacy of collateral to cover outstanding principal and interest, financial data on guarantors, and rationale for any estimated allowance allocation, charge-off, or both).

____
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____

Bank's estimated specific allowance allocation, charge-off, or both:

____

IX. CPA's Summary ______________________________

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____

X. Conclusion (including the amount and basis for CPA's estimated loss exposure)

Typically, the CPA discusses the status and background of individual loans reviewed with the responsible loan officers. In addition to providing information about the loans, such discussions could give the CPA some indications of the loan officer's attitudes and degree of awareness of the status of loans for which the officer is responsible. Additional procedures depend on whether the loan is secured or unsecured and on whether a guarantee of repayment by an outside third party is involved.

Unsecured Loans

When the repayment of a loan is based primarily on the borrower's ability to generate funds from profitable operations, the CPA reviews the bank's analysis of the borrower's financial resources, liquidity and future cash flows, and other financial forecasts. These financial data may be measured against the trends and norms, both historical and forecasted, for both the borrower being reviewed and the industry in which the borrower operates. Also, it is preferable that this type of loan be supported by current audited financial statements. However, such loans may be supported by financial statements that have been reviewed or compiled by the borrower's CPA or prepared internally by the borrower.

If the CPA deems the financial information inadequate, the CPA should discuss the situation with the appropriate bank official. The results of such discussion or the inability of the bank to obtain adequate financial information should be considered in evaluating the collectibility of the loan. If adequate financial information is not available for significant loans, the CPA should notify bank management that a scope limitation may result.

Secured Loans

If a loan is secured by collateral, a careful evaluation and valuation of that collateral is necessary. The CPA evaluates the security interest in the collateral to determine if it has been perfected by execution and recording of the appropriate legal documents. The CPA also reviews carefully the reasonableness of the bank's collateral valuation by referring to quoted market prices or other pertinent sources, such as appraisals and engineering reports.

Finally, for collateral that consists of investments in closely held companies or businesses, financial statements, preferably audited, should be on file so that the CPA can evaluate the values assigned to these investments.

The CPA determines the existence of the collateral by physical observation, independent confirmation, or other appropriate procedures, especially when the bank is involved in loans secured by marketable securities or in asset-based lending, which may include loans secured by inventories, equipment, or receivables. For collateral in the form of marketable securities, the CPA determines that such securities are under the bank's control, either in its own vault or in a safekeeping account in the bank's name maintained with an independent, third-party custodian. In the latter case, the CPA may wish to evaluate the independent custodian's ability to perform under its obligation. The AICPA's *Report of the Special Task Force on Audits of Repurchase Securities Transactions* discusses additional considerations applicable to loans collateralized with marketable securities.[1] For other types of collateral, there should be documentation that the bank has verified the existence of the collateral. In the absence of such documentation, the CPA should perform these or other collateral verification procedures, especially for significant loans for which collectibility is otherwise questionable.

Guaranteed Loans

For guaranteed loans, the CPA may perform a review of the borrower's ability to pay. However, if it is obvious that expectations for repayment are based primarily on the creditworthiness of the guarantor, the financial statements and other information about the guarantor also are reviewed as if the guarantor were the borrower. In this case, it is also important to review and evaluate, perhaps in consultation with an attorney, the enforceability and scope of the guarantee.

The substance of a guarantee depends upon 1) the ability of the guarantor to perform under the guarantee, 2) the practicality of enforcing the guarantee in the applicable jurisdiction, 3) the scope of the guarantee (that is, whether it covers all principal and interest or has a limit), and 4) demonstrated intent to enforce the guarantee. Even if the guarantee is legally enforceable, business reasons that might preclude the bank from enforcing the guarantee should be assessed. Those business reasons could include the length of time required to enforce a guarantee, whether it is normal business practice in that jurisdiction to enforce guarantees on similar transactions, or whether the bank must choose between pursuing the guarantee or the underlying collateral, instead of pursuing both.

A loan supported by a guarantee is considered basically unsecured and should be reviewed accordingly. The review should take into account any evidence that indicates that it is probable the guarantee will be honored or that it can be enforced.

1. *Report of the Special Task Force on Audits of Repurchase Securities Transactions* (New York: AICPA, 1985).

Participations

Banks frequently receive loan requests that exceed their willingness or capacity to lend. One way to handle these requests is shared lending, commonly referred to as loan participations. Loan participations involve the sale of a portion of an existing or anticipated loan by one bank ("lead bank") to one or more banks ("participating bank").

The lead bank disburses all funds, supervises the perfection of legal interest in underlying collateral, and usually services the loan. A certificate of participation confirming the arrangement and outlining its terms is issued to the participating bank by the lead bank. The borrower typically deals only with the lead bank and is frequently unaware of the other bank's participation.

Participations pose the same risks as similar direct loans and are reviewed accordingly. Bank management should have the information necessary to authorize, monitor, and review participation loans, much as it should for other credits. Thus, the participating bank may supplement documentation by the lead bank with its own investigations and credit analysis. Documentation for participation loans should include the following:

- Accrual status
- Status of principal and interest payments
- Financial statements, collateral values, and lien status
- Any factual information bearing on the continuing creditworthiness of the obligor

The collectibility of participation loans (whether at the lead bank or at a participating bank) is normally evaluated in light of the amount of the entire loan, not just of the share held by the bank. In addition, the participating bank should not rely on the lead bank to monitor the credit.

The CPA usually confirms the existence and terms of significant participations. In addition, the CPA reviews the related loan file documentation. For participations in which the bank is the lead bank, the loan files will contain the same information as other loan files. However, for participations in which the bank is a participating bank, the loan files may contain little or no documentation other than the certificate of participation. In such circumstances, the CPA should request that management secure additional pertinent information from the lead bank. Refusal of the CPA's request may cause an audit scope limitation.

Loan Review Summary

The CPA should summarize the results of the individual loan reviews. If trends of valuation overstatements or material file deficiencies are identified, additional tests or a reevaluation of the scope of the work performed may be required.

Chapter 4

Evaluating the Adequacy of the Allowance for Credit Losses

This chapter discusses methods by which the auditor evaluates the adequacy of management's allowance for credit losses and its impact on the auditor's opinion.

In estimating its allowance for credit losses, the bank's management should summarize and document its evaluations of the loan portfolio's collectibility, at least on a quarterly basis. Management's considerations should include such factors as changes in the nature and volume of the portfolio; overall portfolio quality; loan concentrations; trends in the level of delinquent and classified loans; specific problem loans, leases, and commitments; and current and anticipated economic conditions that may affect the borrower's ability to pay. It is important that management consider current relevant data in calculating the allowance rather than considering the loan loss exposure only from a historical viewpoint.

There are various methods by which management can estimate its allowance for credit losses; no single method is preferable. The method used should be logical and relevant to the bank's particular circumstances. The calculation should be comprehensive and should take into account the range of risks and the various types of lending. In estimating its allowance for credit losses, management should not rely on calculating the allowance as a percentage of total loans based on similar allowance percentages of peer banks, because such a method does not ensure that an adequate allowance for credit losses has been established.

Management can perform an overall analytical review to test the reasonableness of the allowance. The review may incorporate statistics relating to the allowance for credit losses as compared to related accounts, net-charge-off rates, and nonperforming loans. These statistics for the bank and its peers are included in the Uniform Bank Performance Report (issued quarterly by the Federal Financial Institutions Examination Council), reports prepared by other organizations, or Call Report data.

Although the entire allowance for credit losses is available for losses, the allowance typically consists of the following components:

1. A specific portion for certain identified loans
2. A specific portion for pools of loans (for example, consumer loans, residential real estate mortgages, and credit card loans)
3. A specific portion for pools of classified loans
4. A specific portion for pools of credit instruments (for example, standby letters of credit and other commitments to lend)
5. A general portion for all other loans and credit instruments

Normally, an estimated loss percentage or a range of loss is associated with each component or with each segment within a component. The percentage is then applied to the components or segments, other than the component of specifically identified loans, to determine the estimate of loss for each. Appropriate tests should be performed to provide reasonable assurance that loans are not included in more than one component or segment. The estimated losses associated with the components are added to obtain the total allowance for credit losses.

The amounts specifically provided for individual loans and pools of loans should be supplemented by a general portion for inherent loan portfolio losses. That amount should be based on judgments regarding risk of error in the specific allowance for individual loans and pools of loans, exposures existing in the bank's loan portfolio, and other relevant factors. Exhibit 4.1 is an example of a worksheet for estimating the allowance for credit losses.

THE CPA'S OPINION

In evaluating whether the financial statements are presented fairly in accordance with generally accepted accounting principles, the CPA should aggregate errors that the bank has not corrected in a way that enables the CPA to consider whether, in relation to individual amounts, subtotals, or totals in the financial statements, they materially misstate the financial statements taken as a whole. Qualitative considerations also influence the CPA's conclusion about whether errors are material.

The CPA should determine if management's calculation of the allowance for credit losses is within a range acceptable to the CPA's assessment of materiality to the financial statements taken as a whole. If the calculation is outside the acceptable range, the CPA should ask management to provide additional information that the CPA can use to reassess his evaluation. If management's calculation is still outside the acceptable range, the CPA should attempt to persuade management to make an appropriate adjustment. If the client fails to make an appropriate adjustment, the CPA should consider qualifying the opinion on the financial statements.

Exhibit 4.1
Worksheet for Estimating Allowance for Credit Losses

Category	*Principal Amount*	*Method of Estimating Loss*	*Estimated Allowance* High	*Estimated Allowance* Low
Loans having identified potential losses	$	Specific amounts from loan review worksheets	$	$
Pools of loans Credit card Residential mortgage Consumer Other		Specific amounts or range of estimated loss percentages		
All other loans Category A Category B • • • Category Z		Specific amounts or range of estimated loss percentages		
Credit instruments Standby letters of credit Commitments Other		Specific amounts or range of estimated loss percentages		
General portion		Amounts or range of estimated loss percentages		
Total			$	$

Note: See footnote 1 in chapter 1.

OTHER MATTERS

The CPA's evaluation of internal control and specific loan reviews will probably generate comments for management. The comments may include remarks on the adequacy of and compliance with established loan policies and the documentation supporting management's evaluation of the adequacy of the allowance. Those comments are accumulated and summarized for possible inclusion in a letter to management. SAS No. 30, *Reporting on Internal Accounting Control,* gives guidance concerning the form and content of such a letter.

Appendix **A**

Suggested Accounting and Auditing References

The following are references to specific professional and regulatory guidance on accounting for and auditing of the allowance for credit losses, as well as to statistical sources for identifying trends and portfolio characteristics. The CPA should be aware that other sources not listed here are also available.

Professional Accounting Guidance

FASB Statements of Financial Accounting Standards:

—No. 5, *Accounting for Contingencies.*

—No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings.*

AICPA Industry Audit Guide, *Audits of Banks,* Chapters 7 and 8, "Loans" and "Allowance for Loan Losses," 1983.

AICPA Notice to Practitioners, *Accounting for Foreign Loan Swaps,* May 27, 1985.

AICPA Notice to Practitioners, *ADC Arrangements,* February 10, 1986.

Bank Regulatory Guidance

Comptroller's Handbook for National Bank Examiners:

—Section 215.1, "Classification of Credits."

—Section 217.1, "Allowance for Loan and Lease Losses."

Federal Reserve System's *Commercial Bank Examinaton Manual:*

—Section 217, "Classification of Credits."

—Section 219, "Reserve for Loan Losses."

Comptroller of the Currency Banking and Examining Circulars:

—BC 140, "Uniform Policy for Classification of Consumer Instalment Loans Based on Delinquency Status," May 2, 1980.

—BC 181 (Revised), "Purchases of Loans in Whole or in Part—Participations," August 2, 1984.

—BC 191, "Agricultural Credit Documentation," April 4, 1985.

—BC 194, "Guidelines for Capitalization of Interest on Loans," May 1, 1985.

—BC 195, "Accounting for Restructured Loans and Sales of Foreclosed Property," May 1, 1985.

—BC 200, "Accounting for Loan Swaps," May 22, 1985.

—BC 201, "Allowance for Loan and Lease Losses," May 31, 1985.

—BC 208, "Guidelines for Troubled Real Estate Loans," October 30, 1985.

—EC 222, "Agricultural Loan Classifications," May 21, 1984.

—EC 223, "Guidelines for Collateral Evaluation and Classification of Troubled Energy Loans," August 24, 1984, and Supplement No. 1, June 18, 1986.

Federal Deposit Insurance Corporation Banking Letters:

—BL-17-85, "Allowance for Loan and Lease Losses," May 6, 1985.

—BL-45-85, "Guidelines for Collateral Evaluation and Classification of Troubled Commercial Real Estate Loans," December 3, 1985.

—BL-15-86, "Restructured Loans," April 11, 1986.

Federal Reserve System:

—SR 86-23, "Guidelines for Collateral Evaluation and Classification of Troubled Commercial Real Estate Loans," April 28, 1986.

Statistical Information

Delinquency Rates on Bank Installment Loans. Published quarterly by the American Bankers Association, this publication provides financial ratios of delinquent loans to total loans. It also provides repossession rates for automobile and mobile home loans.

Country Exposure Lending Survey. Published semiannually by the Board of Governors of the Federal Reserve System, this publication surveys foreign lending activities of domestic and foreign branches of U.S. banks.

National Delinquency Survey. Published quarterly by the Mortgage Bankers Association of America, this publication provides delinquency and foreclosure rates on single-family mortgage loans by region of the country and by type of loan.

Report on Domestic and International Loan Charge-Offs. Published annually by Robert Morris Associates, this publication provides data on domestic and international loan charge-offs and recoveries.

Bank financial ratios are available from the following sources:

—*Uniform Bank Performance Report.* Prepared by the Federal Financial Institutions Examination Council. May be ordered by writing to UBPR, Department 4320, Chicago, IL 60673.

—Keefe Bank Computer Analysis from Keefe, Bruyette & Woods, 2 World Trade Center, 85th Floor, New York, NY 10048.

—Bancompare II from Cates Consulting Analysts, Inc., 74 Trinity Place, New York, NY 10006.

—Bank Performance Measurement System from Olson Research Associates, Inc., 6305 Ivy Lane, Greenbelt, MD 20770.

—Sheshunoff & Co., P.O. Box 13203, Capitol Station, Austin, TX 78711.

Annual Statement Studies. Published annually by Robert Morris Associates, these studies present a composite balance sheet, income data, and ratios for over 300 industries.

Retail Bank Credit Report. Published annually by the American Bankers Association, this report presents statistics on consumer credit charge-offs.

Quarterly Statistical Report. This report, published by VISA, provides data on delinquencies, charge-offs, and other information on VISA credit card loans.

Appendix B

Suggested Lending References

The following are references to general and specific information on lending policies, procedures, and practices for credit origination and disbursement, credit maintenance, collection, and loan review, which may assist the CPA in understanding the lending environment. References for specific credit products and respective policies, procedures, and practices are also provided for an understanding of the specific risks or returns associated with the credit product. Lending involves different degrees of complexity among various credit products. The CPA is strongly encouraged to obtain those references that have specific application to the audit engagement, and should be aware that other sources not listed here are also available.

Books (General)

Accounts Receivable and Inventory Lending. D.A. Robinson (Bankers Publishing Co.: Boston, MA), 1981, 2nd ed. Forms, procedures, and checklist for making loans and perfecting collateral.

Bank Credit. H.V. Prochnow, ed. (Harper and Row: New York), 1981. Covers different types of loans, their analysis, and their administration.

The Bankers Handbook. W.H. Baughn and C.E. Walker, eds. (Dow Jones-Irwin: Homewood, IL), 1978. Covers loan administration, policies, and procedures by type of loan.

Commercial Bank Management. F.P. Johnson and R.D. Johnson (Dryden Press: Chicago, IL), 1985. Covers loan administration, flowcharts on different lending processes, types of lending arrangements, credit analysis, and management and control of potential loan losses.

Commercial Problem Loans. R.H. Behrens (Bankers Publishing Co.: Boston, MA), 1983, 2nd ed. How to supervise and collect problem loans, identify high-risk loans, and conduct loan reviews.

Journals

The Credit World

Journal of Commercial Bank Lending

Journal of Retail Banking

Publications of Trade Associations

American Bankers Association. Order Processing Department, American Bankers Association, 44-B Industrial Park Drive, Waldorf, MD 20601.

Consumer Credit Analysis. R.K. Wills, 1983. Test for experienced lenders offers in-depth guidance to the consumer credit process.

Consumer Lending. T.R. Taylor, 1983. Covers credit risk evaluation, policy, loan processing, servicing and collection, compliance, and portfolio management.

Credit Department Management. M.A. Hoffman and G.C. Fisher, 1981. Includes department management, organization and staffing, credit files, statement spreading, credit analysis, loan quality control, and compliance.

International Banking. P.K. Oppenheim, 1983. Covers international lending, letters of credit, collections, and the Eurodollar market.

Introduction to Commercial Loan Documentation. Includes loan documentation of secured and unsecured loans, and provides discussion of commonly used forms and a suggested outline for a loan documentation manual for a medium-sized bank.

Lending to Agricultural Enterprises. T.L. Frey and R.H. Behrens, 1981. Six sections cover industry perspective; the basic concepts, tools, and analysis of lending; making loans; the legal aspects of lending, including the appropriate use of legal documents; specific types of loans with emphasis on livestock, real estate, and agribusiness loans; and leasing, insurance programs, and hedging.

Loan Review Policies and Practices, 1981. Covers traits that all loan review systems have in common and identifies differences according to bank size. Includes policies for banks with a separate loan review department and for banks without a loan review system.

Residential Mortgages Underwriting. Mortgage Systems Corp., 1983. Includes tools for decision making, income analysis, asset and liability analysis, and fundamentals of property appraisal.

Selective Bibliography on Commercial Lending. Covers information available at ABA Library, with subtitles such as asset and liability management, credit analysis, policies, and small business.

Statement Analysis. Programmed instruction covering statement spreading, ratio analysis, trend analysis, funds and cash flow analysis, pro forma statements, and cash budgeting.

Robert Morris Associates. The Philadelphia National Bank Building, Philadelphia, PA 19107.

Classics in Commercial Lending. W.W. Sihler, ed., 1981. Sections include techniques of credit analysis, loan structure and profitability, documentation and legal aspects of lending, problem loan management, credit policy and administration, and aspects of international lending.

Commercial Loan Review Procedures. P.G. Conlin, 1978. Covers size of loans to be reviewed, frequency, what to look for, and qualitative rating systems and special reviews of classified loans.

Effective Loan Management. E.N. Morsman, Jr., 1982.

Guidelines for Upstream/Downstream Correspondent Bank Loan Participations, 1982. Designed for structuring single-instance loan participations.

Lending to Different Industries. Reprints of 36 articles appearing in *Journal of Commercial Bank Lending* cover lending to such businesses as agribusiness, restaurants, independent oil and gas operators, oil and gas producers, small high-technology firms, automobile dealerships, and equipment distributors.

Loan Administration Questionnaire. Provides loan managers with a format to scrutinize all phases of loan administration, including setting priorities and planning and implementing change.

Loan Review. 1984. A special collection of articles from the *Journal of Commercial Bank Lending.*

Offshore Lending by U.S. Commercial Banks (Jointly with Bankers Association for Foreign Trade). Covers country risk; accounting practices; foreign credit analysis; legal aspects; import and export financing; corporate loans to foreign branches, subsidiaries, or affiliates with parent support; lending to foreign local companies; syndications; loans and placements to foreign governments and official entities; and funding risks.

The World Debt Dilemma: Managing Country Risk (With Bankers Association for Foreign Trade). Focuses on external debt problems of developing countries, the use of rescheduling mechanism, and the employment of country risk evaluation and management systems by major international lenders.

Audiotape Cassettes

Robert Morris Associates. The Philadelphia National Bank Building, Philadelphia, PA 19107.

Construction and Real Estate Development Lending. Includes evaluation of risks and how to manage a construction loan portfolio.

Lending to Contractors. Covers current approaches and techniques in building trades lending, including dangers, legal considerations, banker-surety-contractor relations, contractor accounting, and workouts.

Loan Portfolio Management. Emphasizes goals, objectives, portfolio planning, mix, and performance measurements.

Managing Your Loan Examination. Covers changing nature of loan exams, written loan policy considerations, loan loss reserve allocations, and the regulators' perspective on examinations.

Problem Loan Reclamation/Workout. Includes identification and handling of problem loans, workout and recovery techniques, and legal measures to protect the bank.

Real Estate Lending: Control and Loan Service. Includes risk assessment, management and control of real estate loan portfolios, handling of problem loans, and marketing of distressed real estate.

Secured Lending. Covers accounts receivable financing, inventory and equipment lending, documentation, collateral control, audit functions, and dangers.

Term Lending Updated. Includes proper usage, analytical techniques, control, loan maintenance techniques, and when to use term loans, revolving credits, and other extended payment types of credit.

Value and Credit Assessment in Real Estate Lending. Covers loan transaction, mortgage financing and underwriting, appraising, monitoring of a construction loan, credit evaluation, and development of a real estate lending policy.

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