

The Ideas and Analysis Letter: The Sanchez “Take”
November 2014

A New Way to Calculate the “Cushion”

Accountants strive to prepare financial statements that are based on generally accepted principles (GAAP) such as the:

- entity concept
- going concern principle
- stable monetary unit (historical cost) basis
- consistency and comparability principles
- revenue recognition model
- doctrine of conservatism
- materiality principle
- **asset valuation methods**
- full disclosure

This “Take” discusses one of the asset valuation methods, particularly for depository institutions.

Net Realizable Value

Different balance sheet assets have different carrying value methods. For example:

- inventories are carried at the lower of cost or market
- accounts receivable are carried at net realizable value
- fixed assets are carried at historical cost, systematically amortized over time or based on usage

The accounts receivable net realizable value (NRV) notion is important. It requires that dollar amounts of receivables from the sale of goods or services on account (i.e. to be paid by the buyer to the seller in the future) are recorded at the amount expected to be collected.

It is generally a truism that all (100%) of the receivables will not be paid. Some customers will default on payments and the company will not receive in the form of cash the original amount of the sales price for the goods and services. So, if the financial statement reader views accounts receivable at the original sale price, he or she will be misled. The gross receivable has to be adjusted to reduce it to NRV – the amount of the gross receivable expected to be collected.

A reserve, allowance, or “cushion” must be established. That cushion reduces the gross accounts receivable to NRV. The cushion is called the allowance or reserve for bad debts or allowance or reserve for uncollectibles.

The estimate of the amount of cushion to be used to reduce the receivable is based on either a percentage of:

- sales or
- gross receivables

The percentage used is based on empirical evidence. Accountants carefully analyze past activity and future expectations to determine a reasonably accurate estimate of the allowance or reserve. The cushion, like many items on the financial statements, is an estimate; a judgment call based on history and future expectations.

The Depository Institution’s “Cushion”

Banks and other depository institutions have long-term receivables in the form of loan amounts that are to be paid back to the bank by borrowers. The gross amount borrowed will not all be paid. Accordingly, an allowance or reserve for loan losses is needed to reduce loans receivable to NRV. This estimate is easier said than done.

Change in the Depository Institution Approach is Coming

The past experience with estimating the cushion has been less than favorable. On many occasions when the economy slowed down the cushion proved to be too small to absorb loan losses.

Many believe banks simply are not very good at estimating the credit risk associated with defaults on loans. Also, many believe that the cushion is so often “manipulated” to smooth earnings that the “real” estimate gets lost in the shuffle. Using the reserve as a sort of “piggy bank” or free credit that can be used to arbitrarily change the balance to increase or decrease reported earnings has caused estimators to lose sight of the purpose of the reserve – set up a cushion to absorb credit losses.

At this time GAAP uses the incurred loss model. Soon GAAP will call for the current expected credit loss model.

Incurred Loss Model

Under the Incurred Loss Model guidance for the calculation of the allowance is provided in:

- ASU 450-20 – Loss Contingencies
- ASU 310-10-35 – Receivables – Overall – Subsequent Measurement
- FIL 105-2006 – Allowance for Loan and Lease Losses Revised Policy Statement and Frequently Asked Questions

Determination of the Allowance Balance

All banks use the same general methodology for calculating reserves. The specific calculations can differ from bank to bank in many ways.

The first consideration is the ASU 450-20 reserve for loan losses.

ASC 450-20 deals with uncertainty. It requires a **probability threshold** for recognition of a loss contingency. The amount of the loss recorded must be **probable** and **reasonably estimable**. In other words, no provision is recorded unless the loan loss is probable and the amount can be reasonably estimated. According to paragraph 450-20-30-1, when both of those recognition criteria are met, and the reasonably estimable loss is within a range, it requires accrual of the amount that appears to be a **better estimate** than any other estimate within the range, or accrual of the **minimum amount** in the range if no amount within the range is a better estimate.

Loss reserves for small balance homogenous consumer and commercial real estate loans are determined based on analysis of the **pools of similar loans** with similar credit characteristics. Most banks manage retail loan credit risk on a portfolio basis so reserves by portfolio are determined using analytical models that incorporate various factors such as:

- historical delinquency rates
- experienced loss frequencies
- expected loss severities

The second consideration is the ASU 310-10-35 reserve for loan losses, which also deals with uncertainty, probability and reasonable estimates. The difference is that consideration is given to individually large loans rather than pools of similar loans. Generally, reserves for pools of homogeneous loans or large individual loans reflect inherent losses in the portfolio that exist at a balance sheet date.

The method for determining the allowance has become somewhat of an “art form,” and the degree of judgment allowed to

management has been criticized. Nevertheless, the approach should be consistent and should use qualitative factors such as the following that can be properly supported.

1. Lending Policies More liberal or more conservative credit policy.
2. Local Economy Historical charge-offs should be adjusted to reflect changes in local unemployment factors.
3. Loan Volume Large volume of lending usually generates larger risks.
4. Staffing Changes Continuous turnover is a negative sign and increases charge-offs.
5. Credit Quality Changes in the quality of borrowers (e.g., FICO scores) affect quality of credit and should be reflected in the qualitative adjustment factor.
6. Loan Review Systems The effectiveness of early warning systems should be considered.
7. Collateral Values Changes in the value of collateral will affect the amount recovered from foreclosed properties and could also result in a change in delinquency rates. This will result in a change in net charge-offs.
8. Concentrations “All eggs in one basket” is dangerous and should be reflected in the allowance.

Many banks use only **some** of these factors and the various qualitative factors are often best estimates or best guesses. They often are not supported by “hard” (or even “soft”) evidence. Sometimes, at best, they are merely “hunches.”

In addition to the small balances homogeneous loan group, banks also grade their commercial loans on a likelihood of repayment basis. The commercial loans generally are categorized as follows:

- graded pools of commercial loans
- specifically identified commercial loans

Different banks use different systems. Usually the relationship manager responsible for the loans assigns a grade number based on objective and subjective measures. These grade numbers are audited by a loan review function and by bank regulators.

For example a 16-point grading system such as the following is typical:

Credits Rated as Grade #	Category Assigned to Loan	
1 to 11	Pass	Note that loans graded #1 to #13 are unclassified loans
12	Pass-Watch	
13	Special Mention	
14	Substandard	
15	Doubtful	
16	Loss	

Grades 14, 15 & 16 are often called “criticized” loans.

After the careful and lengthy analysis, the reserve balance is determined at each balance sheet date. A journal entry is then made to increase or decrease the reserve balance already on the books. A summary of either entry that is made follows.

Summary	
<u>ASC 450-20 Determinations</u>	
Loss – Small Homogenous Loans	(A)
Loss – Small Homogenous Commercial R.E. Loans	(B)
Loss – Graded Pools of Commercial R.E. Loans	(C)
<u>ASC 310-10-35 Determinations</u>	
Loss - Specifically Identified Loans – All	(D)
Total (A) to (D)	(E)
General Ledger Balance – Reserve Account on Books	(F)
Adjustment to General Ledger Account (E) – (F)	(G)

If (E) – (F) is positive, add to reserve:		
DR: Provision for Loan Losses	\$XXXX	
CR: ALLL		\$XXXX
If (E) – (F) is negative, reduce reserve:		
DR: ALLL	\$XXXX	
CR: Provision for Loan Losses		\$XXXX

Current Expected Credit Loss Model

This new model also strives to estimate contractual cash flows that are not expected to be collected (i.e. the reserve for losses).

This model is more forward looking than the incurred loss model which focuses on current losses inherent in the portfolio of loans that are probable and reasonably estimatable at a point in time. The model will require analyzing information about:

- past events
- current conditions
- reasonable and supportable forecasts about future collectability of contract cash flows

The current expected credit loss model is more dynamic, taking into account the life cycles of loans and the expected future cash flow collections or lack of collections. This is entirely different than the incurred loss model which focuses on balance sheet “as of” determinations.

Summary

During the financial crisis, as more and more loans were becoming past due or non-accruing, the reserve should have gone up. For many banks it did not go up because of management’s very subjective handling of historical loss factors and in some cases other qualitative factors. Some banks used a 3 to 5 year period for historical loss experience; others used 2 years. The earnings

sensitive management seemed to use whatever would produce a lower reserve, lower provision and higher profits. It seemed to be a time of financial engineering at its worst.

For estimated losses (the cushion), it appears that in a very short time, accounting rule makers and regulators will insist on using factors such as:

- Two year historical averages
- 6 or 9 month rolling averages
- A fixed average based on portfolio size, adjusted periodically based on charge-off experience

The expected credit loss model will introduce more flexibility for management, and hopefully better estimates.

The expected loss model will immediately “book” losses expected to occur in the future. This differs significantly from the incurred loss model that “books” only losses that exist (i.e. losses inherent in the portfolio of loans) “as of” the balance sheet date.

We certainly need better estimates of loan loss reserves. The poor showing by management in past years needs significant improvement. If the current expected credit loss model provides better estimates, it is long overdue and very much welcomed.

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