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AUDIT RISK
ALERTS

Banks and Savings Institutions Industry Developments—1993

Complement to AICPA Industry Audit Guide
Audits of Banks
and AICPA Audit and Accounting Guide
Audits of Savings Institutions

AICPA
American Institute of Certified Public Accountants

NOTICE TO READERS

This audit risk alert is intended to provide auditors of the financial statements of banks and savings institutions with an overview of recent economic, industry, regulatory, and professional developments that may affect the audits they perform. This document has been prepared by the AICPA staff. It has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

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The staff of the AICPA is grateful to the members of the AICPA Banking and Savings Institutions Committees for their contribution to this document.

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Banks and Savings Institutions Industry Developments—1993

Industry and Economic Developments

By traditional measures, banks and savings institutions made progress during 1993. With interest rates at twenty-five-year lows and relative improvements in credit quality, the industry overall showed continued profits. This financial progress—achieved through increased interest-rate spreads and reduced credit losses—has also begun to shift the industry's risk focus from credit quality to interest-rate risk.

Just as low interest rates have sustained low funding costs and increased spreads, continued uncertainty about the general economy and inflation has fed uncertainty about how long rates can remain so low. While enjoying relatively wide interest-rate spreads, prudent institutions have been managing their balance sheets to achieve asset/liability mixes that limit exposure to the negative impact of any sudden flattening or upward shift of the yield curve. The potential for such shifts creates risk, particularly for institutions that invest heavily in longer-term, fixed-rate assets. And though credit quality continues to require critical attention, the relative earnings impact of credit losses has declined as institutions have bolstered related allowances. Real estate markets, while not surging into recovery, have generally stopped declining and often shown limited but steady improvement in most regions (Southern California being the major exception).

Developments during 1993, however, highlight a movement by many banks and savings institutions to look beyond interest-rate spreads and credit quality issues in meeting industry challenges. Those institutions are seeking to develop new activities, react creatively to new competition, and rein in regulation.

With commercial loan demand stagnant, the industry has continued its press for authority to enter into new and broader activities (such as insurance and securities) and to expand institutions' geographical limits. At the same time, the number of nonbank institutions competing for savings dollars continues to increase. Finally, many argue that regulations, including limitations and restrictions introduced by the Federal Deposit Insurance Corporation (FDIC) Improvement Act of 1991 (FDICIA), affect institutions' ability to both enter into new activities and compete on a level basis in those and existing activities.

Institutions have dramatically increased fee-based services as a way to fill the void left by declining lending activity. For example, mutual fund activity at banks and savings institutions has increased, in part, to hold ground in the competition for savings, but also to participate in the many fees generated. The new rewards brought by entry into mutual fund activities are accompanied by new risks. Although some view such activity as progress in recapturing business from nonbank competitors, others attribute growth in this area to a simple shifting of traditional deposits and trust and custodial funds. Questions have been raised about the ability of institutions to attract deposit funds back from mutual fund customers. If loan demand rises, some argue, deposits could be more difficult to attract without increasing deposit rates and, therefore, funding costs.

In addition to pursuing the breaking down of regulatory barriers to such new activities, industry representatives have continued a call for the elimination of regulations they believe are overburdening. They argue that many requirements add unnecessary cost and impair institutions' ability to compete with nontraditional competitors for traditional business.

Other trends evident in 1992 continued in 1993. For example, demand for real estate mortgage loans was particularly heavy as borrowers refinanced at lower interest rates. Though some improvements have been made in consumer confidence and spending, demand for all other loans was generally flat. The year 1993 also saw continued consolidation of the industry through mergers and acquisitions.

As part of the planning process, auditors should consider how changes in the business of client institutions in response to industry pressures affect audit risk.

Regulatory and Legislative Developments

Major federal legislative proposals during 1993 centered on consolidation of federal banking and thrift regulatory agencies and repeal of certain FDICIA provisions and other regulations considered burdensome. Little prospect is seen for major banking legislation by the current Congress.

FDIC Improvement Act of 1991

Implementation of the FDICIA was the source of most regulatory developments during the year. The AICPA's Audit Risk Alert, *FDIC Improvement Act Implementation Issues* (No. 022140), provides auditors who serve FDIC-insured banks and savings institutions with an overview of how implementation of the FDICIA affects the engagements

they perform. Under key provisions of the FDICIA, auditors serving covered institutions will be required—for the first time—to attest to managements' assertions about internal controls over financial reporting and compliance with certain laws and regulations. Auditors should become familiar with the new reporting requirements, particularly those that address the auditor's qualifications, exposure to enforcement actions, required communications with client institutions, and interaction with the audit committee. The effects of a number of the law's provisions on a client institution's ability to remain a going concern should also be considered.

The reporting requirements created in new Section 36 of the Federal Deposit Insurance Act, as added by Section 112 of the FDICIA, are discussed in detail in *FDIC Improvement Act Implementation Issues*. To implement Section 36, the FDIC issued both a final regulation and accompanying guidelines and interpretations, which are codified in Section 12 of the Code of Federal Regulations (CFR) Part 363. Information and guidance on implementation of Section 36 developed since issuance of *FDIC Improvement Act Implementation Issues* is presented in the "Audit Issues and Developments" section herein.

Other Regulatory Matters

Other major regulatory developments during 1993 centered on discriminatory lending practices and credit availability. The federal banking agencies set forth several initiatives on fair lending, including those that provide additional guidance for examiners to better the effectiveness of examinations to detect whether or not illegal discrimination has occurred at an institution. In March, the Clinton administration announced an initiative to increase the availability of credit. The initiative included proposals to (1) clarify that examination and rating procedures are not meant to group "special mention" loans with classified loans, (2) review rules on the reporting treatment and classification of loans made to facilitate the sale of other real estate owned, and (3) work with the appropriate authorities to coordinate changes in accounting principles and reporting standards for in-substance foreclosures and for returning certain loans to accrual status. The resulting policy statements, issued jointly by the Office of the Comptroller of the Currency (OCC), the FDIC, the Board of Governors of the Federal Reserve System (FRB), and the Office of Thrift Supervision (OTS) (collectively, the federal banking regulatory agencies) are described below.

Laws and their implementing regulations affect the areas and ways in which banks and savings institutions operate, while creating standards with which those institutions must comply. Some laws and

regulations directly address the responsibilities of auditors. Auditors should be familiar with regulations because of the impact regulations have on the auditor's—

- Acceptance of engagements in the depository institutions industry.
- Planning activities (that is, development of the expected conduct and scope of an engagement).
- Responsibility for detection of errors and irregularities.
- Evaluation of contingent liabilities and related disclosures.
- Consideration of an institution's ability to continue as a going concern.

As required by AICPA Statement on Auditing Standards (SAS) No. 22, *Planning and Supervision* (AICPA, *Professional Standards,* vol. 1, AU sec. 311), auditors should consider matters affecting the industry in which the entity operates, such as government regulations. In that regard, it is helpful for auditors to be familiar with the nature and purpose of regulatory examinations—including the differences and relationship between examinations and financial statement audits.

Finally, an understanding of the regulatory environment in which institutions operate is necessary to complement the auditor's knowledge of existing regulatory requirements. Because the regulatory environment is continually changing, the auditor should monitor relevant regulatory changes and consider their implications in the audit process.

Summarized below are regulatory developments of particular significance in audits of the financial statements of FDIC-insured banks and savings institutions. Other regulatory releases, covering other policy areas such as the Home Mortgage Disclosure Act and the Community Reinvestment Act, are not within the scope of this document. The highlights that follow are not intended to provide a comprehensive discussion of each issue and should not be substituted for a complete reading of related regulations, rulings, or other documents, where appropriate (see the "Information Sources" section herein). References to such documents are provided with each paragraph, as appropriate.

Regulatory Capital

Because of the complexity of capital regulations, their application requires a thorough understanding of specific requirements and the potential impact of any instance of noncompliance—particularly when an institution is involved in complex transactions, investments, or parent-subsidiary relationships. Highlights of major changes in capital regulations are presented below.

Capital Adequacy Guidelines. In addition to the capital matters addressed by the prompt corrective action provisions of the FDICIA, the federal banking regulatory agencies continue to administer minimum capital adequacy requirements. The OCC, the FDIC, and the FRB require institutions to maintain a minimum leverage-capital ratio of Tier I capital (as defined) to total average assets based on bank ratings under the regulatory CAMEL rating system. Banks with composite CAMEL ratings of one that are not anticipating or experiencing significant growth and have well diversified risk are required to maintain a minimum leverage capital ratio of 3.0 percent. An additional 100 to 200 basis points are required for all but these most highly rated institutions.

Beginning December 31, 1992, banks also must maintain a minimum ratio of total capital to risk-weighted assets of 8.0 percent, and a minimum ratio of Tier I capital to risk-weighted assets of 4.0 percent.

The OTS requires savings institutions also to maintain a minimum core-capital ratio (as defined) of 3.0 percent and a minimum tangible capital ratio of 1.5 percent of assets. The determination of tangible capital requires the immediate deduction of all unamortized supervisory goodwill arising from the purchase of a troubled institution prior to April 12, 1989. For core capital calculations, unamortized supervisory goodwill is being deducted on a phased schedule and will be fully deducted by January 1, 1995.

Litigation against the federal government continues to be pursued by numerous savings institutions seeking injunctive relief from the Financial Institutions Reform, Recovery, and Enforcement Act of 1989's phasing out of supervisory goodwill. In August, the U.S. Court of Appeals for the Federal Circuit agreed to rehear one such case after favorable summary judgments were overturned on appeal. The vastly different fact patterns involved in the various cases leave in question the outcome of the litigation and its implications for other institutions with supervisory goodwill.

For savings institutions, the OTS-required minimum total risk-based capital ratio (the total of core and supplemental capital) increased from 7.2 to 8.0 percent effective December 31, 1992. The minimum requirement for core capital included in total thrift risk-based capital increased from 3.6 to 4.0 percent as of December 31, 1992.

Intangible Assets. Under revised rules issued in 1993, institutions must generally deduct from regulatory capital all intangible assets other than limited amounts of purchased mortgage servicing rights (PMSRs) and purchased credit card relationships (PCCRs). PMSRs and PCCRs may be included in regulatory capital only to the extent that, in the aggregate, they do not exceed 50 percent of Tier I capital, as defined. PCCRs are further limited to 25 percent of Tier I capital. For purposes

of calculating Tier I capital, the amount of PMSRs and PCCRs cannot exceed the lesser of 90 percent of the fair market value or 100 percent of the book value. Core deposit intangibles and goodwill are deducted in total from capital. Among other restrictions imposed by the final rule, institutions are required to determine the fair market value—and to review the book value—of their PMSRs and PCCRs at least quarterly. Further, impairment tests for regulatory financial reporting purposes must be made on a discounted basis. The OTS has not yet issued its final rule. The OTS has proposed that PMSRs purchased (or under contract to be purchased) on or before February 9, 1990, not be subject to certain concentration limitations (12 CFR Parts 3, 208, 225, and 325; FDIC Financial Institution Letter [FIL]-8-93; OCC Banking Bulletin [BB] 93-16; OTS Thrift Bulletin [TB] 60).

Deferred Tax Assets Recognized Under FASB Statement No. 109. The agencies are proposing revisions to their capital adequacy guidelines for regulatory treatment of deferred tax assets arising under application of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 109, *Accounting for Income Taxes.* FASB Statement No. 109 addresses recognition of deferred tax assets that arise from either deductible temporary differences, as defined, or carryforwards of net operating losses or tax credits. The Statement requires that a valuation allowance be established to reduce any deferred tax assets to the amount considered more likely than not to be realized. The Federal Financial Institutions Examination Council (FFIEC) has directed that FASB Statement No. 109 be adopted for purposes of FFIEC Consolidated Reports of Condition and Income (Call Reports). In conjunction with this reporting change, the FFIEC recommended that the agencies amend their capital rules to limit the amount of deferred tax assets that may be included in regulatory capital. The FFIEC has also proposed to the federal bank regulatory agencies that deferred tax assets be included in regulatory capital without limit if they can be realized from taxes paid in prior carryback years and from future reversals of existing taxable temporary differences. However, deferred tax assets that are dependent on future taxable income would be limited in regulatory capital to the lesser of the amount expected to be realized within one year (exclusive of tax carryforwards and reversals of existing temporary differences) or 10 percent of Tier I capital (before deduction of any disallowed PMSRs, PCCRs, or deferred tax debits). The FDIC and the FRB have issued and received comments on the proposed limit. The OCC's proposal is forthcoming. Interim guidance requires banks to report the amount of deferred tax assets that would be disallowed under the proposed limit in regulatory reports (12 CFR Parts 208, 225 and 325; FDIC FIL-36-93 and FIL-27-93; OCC BBs 93-2 and 93-15, and Examining Bulletin 93-5; OTS TB 56).

Interest-Rate Risk. Section 305 of the FDICIA requires the federal banking regulatory agencies to revise their risk-based capital guidelines as necessary to ensure adequate consideration of interest-rate risk. The FDIC, the OCC, and the FRB have proposed a measure of interest-rate risk exposure and an approach for assessing capital adequacy for interest-rate risk as revisions to the existing risk-based capital guidelines. Under the proposal, additional reporting would begin with March 1994 Call Reports, with full implementation of the guidelines by December 31, 1994 (FDIC FIL-65-93; OCC BB 93-52).

Effective July 1, 1994, the OTS is adding an interest-rate risk component to its risk-based capital requirements. Institutions with a greater than normal interest-rate exposure, as defined, must take a deduction from the total capital available to meet their risk-based capital requirement, equal to one-half of the difference between the institution's actual measured exposure and a defined normal level of exposure (*Federal Register,* August 31, 1993).

Credit Quality

The allowance for loan and lease losses and liabilities for other credit exposures require critical attention in audits of financial statements of banks and savings institutions. Regulatory releases during 1993 that are specific to credit loss allowances include those noted below.

Review and Classification of Commercial Real Estate Loans. In a joint statement issued on June 10, the federal banking regulatory agencies reaffirmed their November 7, 1991, policy statement to ensure that all supervisory personnel are using that earlier guidance in their review of commercial real estate loans. The November 1991 guidance emphasizes that the evaluation of commercial real estate loans by examiners is based on a review of the borrower's willingness and capacity to repay and on the income-producing capacity of the underlying collateral over time. It states that the value of collateral increases in importance as the loan becomes troubled and the borrower's ability to repay the loan becomes more questionable. The statement emphasizes that it is not regulatory policy to value collateral that underlies real estate loans on a liquidation basis. It also discusses management's responsibility for reviewing appraisal assumptions and conclusions for reasonableness, emphasizing that appraisal assumptions should not be based solely on current conditions that ignore the stabilized income-producing capacity of the property (OCC BB 93-36).

Special Mention Assets. The federal banking regulatory agencies' *Interagency Statement on the Supervisory Definition of Special Mention Assets,* issued June 10, adopts a uniform definition of special mention

assets and emphasizes that special mention assets may be criticized for potential weakness but are not included in or considered classified assets (OCC BB 93-35).

In-Substance Foreclosures. On June 10, a joint statement, *Interagency Guidance on Reporting of In-Substance Foreclosures,* was issued in which the federal banking regulatory agencies concluded that losses on real estate loans for which collateral is considered in-substance foreclosed under existing generally accepted accounting principles (GAAP) criteria should be measured and recognized in regulatory financial reports based on the fair value of the collateral. However, the agencies also affirmed that such loans need not be reported as other real estate owned unless possession of the underlying collateral has been obtained. Rather, they would remain in the loan category (OCC BB 93-37).

Interest Accrual Status of Certain Loans. Another June 10 joint statement, *Revised Interagency Guidance on Returning Certain Nonaccrual Loans to Accrual Status,* conforms federal regulatory policies to permit certain loans restructured through use of multiple notes to be returned to interest accrual status. The policy also provides criteria under which loans that may not be fully current as to principal and interest payments can be returned to interest accrual status (OCC BB 93-37).

Allocated Transfer Risk Reserves. In October 1992, the OCC, the FRB, and the FDIC issued a joint statement concerning the applicability of allocated transfer risk reserves to equity or debt securities resulting from debt-for-equity or debt-for-debt exchanges (OCC BB 92-63).

Troubled, Collateral-Dependent Loans. Effective September 30, 1993, OTS policy requires savings institutions to record certain troubled, collateral dependent loans in OTS Thrift Financial Reports (TFRs) at their present value discounted at the loan's contractual interest rate. Any excess of the loan balance over the present value is to be classified as loss, with the remainder generally classified as substandard.

The OTS policy considers it to be probable that a lender will be unable to collect all amounts due under the contractual terms of a loan when the expected future cash flows, on an undiscounted basis, from the operation and sale of the collateral over a period of time not to exceed five years, are less than the principal and interest payments due according to the contractual terms of the loan (OTS Regulatory Bulletin [RB] 31).

Other Areas of Regulation

Real Estate Lending Standards. Effective March 19, 1993, the federal banking regulatory agencies established uniform regulations prescribing

real estate lending standards. The regulations require subject institutions to maintain various written policies for real estate lending that should reflect consideration of guidelines that outline considerations for portfolio management, underwriting standards, loan administration, loan-to-value limits, and policy exceptions (12 CFR Part 34; OCC BB 92-75).

Loan Documentation. The federal banking regulatory agencies established a policy on loan documentation effective March 30, 1993, to encourage lending to small- and medium-sized businesses. The policy allows certain banks and savings institutions to establish a portfolio of loans exempt from certain documentation requirements. Examiners may not criticize the credit quality of an exempt loan on the basis of documentation and may not classify the loan unless it is more than sixty days delinquent. The institution's management, however, is still required to fully evaluate the collectibility of exempt loans in determining the adequacy of loan loss allowances.

An institution's exempt portfolio could be material to its financial statements. Auditors of the financial statements of banks and savings institutions should be aware that the exemption of such loans from examiner review and criticism does not extend to the auditor's responsibility in financial statement audits or other engagements involving management assertions about the exempt loans. An auditor's assessment of management assertions about credit quality may depend on the availability of certain documentation, including adequate collateral appraisals or current and complete financial information about borrowers or guarantors. The new policy may affect the availability of such documentation. Existing auditing literature provides guidance on determining the scope of procedures to be applied to such loans and cautions auditors against undue reliance on management representations when no supporting evidence exists. This guidance is provided in the AICPA's Audit and Accounting Guide *Audits of Savings Institutions,* Industry Audit Guide *Audits of Banks,* and Auditing Procedure Study *Auditing the Allowance for Credit Losses of Banks* (FDIC FIL-63-93; OCC BBs 93-18, 93-23, and 93-46; OTS TB 61).

Limitations on Activities of State Banks. FDIC-insured state institutions and their majority-owned subsidiaries are prohibited from conducting activities "as principal" that are not permitted for national banks. In late 1992, new restrictions were placed on the ability of such institutions to hold equity investments in corporate stock and mutual fund shares, and to make other investments (for example, in real estate development projects). In February, the FDIC proposed other restrictions on state institutions' activities (12 CFR Part 362; FDIC FIL-80-92, FIL-83-92, and FIL-9-93).

Deposit Insurance Premiums. In June, the FDIC modified the traditional risk-based deposit insurance premium system that took effect on January 1, 1993. Under the modified system, premium rates are based on the risk banks and savings institutions pose to the insurance funds. Institutions pay a premium within a range of 23 to 31 cents per $100 of domestic deposits, depending on the institution's risk classification. The modified system is effective October 1, 1993 for the assessment period beginning January 1, 1994 (12 CFR Part 327; FDIC FIL-48-93 and FIL-47-93).

Interbank Liabilities. FRB regulations that took effect on June 19, 1993 require institutions to evaluate and control the credit and liquidity risk they take on in transactions with other banks and savings institutions (other than institutions under common control). Transactions covered by the rules include those for which the exposed institution must carry capital under risk-based capital adequacy guidelines. The rules require an institution to set limits on its credit and settlement exposure to each individual correspondent institution and establish benchmark limitations based on the exposed institution's capital. Beginning June 19, 1994 the overnight credit exposure of an institution to correspondents that are not at least adequately capitalized, as defined, is limited to 50 percent of the exposed institution's capital. The limitation falls to 25 percent as of June 19, 1995 (12 CFR Part 206; FDIC FIL-10-93; OCC BB 93-3).

Express Determination Letters. Federal tax law permits banks and savings institutions to make bad debt deductions for loans charged off because of uncollectibility. The Internal Revenue Service (IRS) seeks evidence to ensure that loans are being charged off appropriately. In 1992, the IRS issued regulations that permit an institution to obtain evidence from their primary regulators stating that the institution maintains and applies loan review and loss classification standards consistent with the agency's regulations regarding loan charge-offs. The federal banking regulatory agencies issued guidance in late 1992 to implement the express determination letter process (FDIC FIL-76-92; OCC BB 92-57).

Appraisals. In late 1992, the FDIC issued additional guidance on appraisal and evaluation programs for real estate transactions and for conducting appropriate evaluations of real estate for transactions that are exempt from required appraisals by certified or licensed appraisers (12 CFR 323; FDIC FIL-69-92). In June, the federal banking agencies proposed a rule for real estate appraisals that would expand and clarify existing exemptions and identify new exemptions. Included would be an increase in the threshold level for required appraisals to real estate-

related financial transactions (as defined) having a value of $250,000 or greater (12 CFR Parts 34, 225, 323, 545, 563, and 564; FDIC FIL-44-93; OCC BB 93-32).

Mortgage Derivatives. In late 1992, the FDIC issued additional guidance on the supervisory treatment of mortgage derivative products such as collateralized mortgage obligations (CMOs), real estate mortgage investment conduits (REMICs), stripped mortgage-backed securities and residual tranches of CMOs and REMICs. An earlier interagency policy statement applicable to mortgage derivatives obtained on or after February 10, 1992 allows regulatory examiners to require that an institution divest itself of high-risk mortgage derivatives, as defined, that do not reduce an institution's interest-rate risk or are not held in a trading account (see FDIC FIL-7-92). The additional FDIC guidance provides specific guidelines for determining whether a derivative is high-risk and the appropriate regulatory treatment (FDIC FIL-64-92).

Securities Exchange Act Disclosure Rules. Effective November 6, 1992, the OCC revised its regulations to incorporate the Securities and Exchange Commission (SEC) regulations related to the Securities and Exchange Act of 1934 (the Act) by reference, rather than continuing to maintain its own regulations as authorized under Section 12(i) of the Act. Among other results, the change requires registered national banks to have an annual independent financial statement audit and to adopt disclosures prescribed by Securities Exchange Act Industry Guide 3, including SEC criteria for disclosures of loans and extensions of credit to insiders (12 CFR Parts 5, 11 and 16; OCC BB 92-58).

Bank Secrecy Act. OTS Bulletin PA-7a-3 requires savings institutions to provide an auditor's report on procedures and findings relative to compliance with certain provisions of the Bank Secrecy Act and related regulations. The auditor's report has historically been prepared following the guidance of SAS No. 30, *Reporting on Internal Accounting Control.*

SAS No. 30 has been superseded by Statement on Standards for Attestation Engagements (SSAE) No. 2, *Reporting on an Entity's Internal Control Structure Over Financial Reporting* (AICPA, *Professional Standards,* vol. 2, AT sec. 400). SSAE No. 2 is effective for managements' financial reporting control assertions as of December 15, 1993 and thereafter. Further, the OTS is considering withdrawing Bulletin PA-7a-3.

Guidance on performance of engagements required by Bulletin PA-7a-3 is forthcoming.

Unrealized Gains and Losses on Securities. On August 10, the FFIEC announced that it would adopt FASB Statement No. 115, *Accounting for*

Certain Investments in Debt and Equity Securities, for regulatory reporting purposes. The FFIEC announcement also stated that the federal banking regulatory agencies will be requesting comments on whether unrealized gains and losses on securities designated as available for sale under FASB Statement No. 115 should be included in Tier I capital for risk-based and leverage capital purposes (OTS Chief Executive Officer [CEO] Letter dated August 16, 1993).

Accounting for Dispositions of Other Real Estate Owned. On July 16, the federal banking regulatory agencies issued a joint statement revising Call Report instructions for sales of other real estate owned (beginning with the June 30, 1993 report date) to substantially follow GAAP. Once the criteria for sale treatment under FASB Statement No. 66, *Accounting for Sales of Real Estate,* are met, the receivable resulting from the sale of the real estate may be reported as a loan in regulatory financial reports (FDIC FIL-49-93; OCC BB 93-42). The OCC issued a final rule in September to clarify how national banks may dispose of other real estate owned (OCC BB 93-51).

Mortgage Banking. On May 28, the OCC issued an advisory stating its expectation that national banks perform mortgage banking operations in a safe and sound manner. The advisory stressed that national banks have policies and procedures in place to monitor and control mortgage banking activities, such as loan production, pipeline and warehouse administration, secondary market transactions, servicing operations, and management of PMSRs and excess servicing fee receivables. The OCC emphasized that institutions' policies and procedures should address—

- Comprehensive documentation standards for all aspects of mortgage banking activities.
- Accurate financial reporting systems and controls.
- Plans to manage interest-rate risk.
- Impairment analyses that use accurate, realistic assumptions.
- Systems that track and collect required mortgage loan documents.

A related banking circular is expected to be issued in the near future.

Examination Coordination. The agencies issued a joint statement in June outlining a program for coordinating exams of insured banks and savings institutions and inspections of their holding companies by federal banking regulatory agencies. The primary objectives of the policy statement are to eliminate duplication in examinations by multiple agencies, increase coordination between agencies when

duplication is necessary, and establish procedures to centralize and streamline examinations in multibank organizations (OCC BB 93-38).

Purchases of Life Insurance. In August, the FDIC issued guidance to examiners on purchases of life insurance by FDIC-supervised institutions. The guidance, communicated in a Regional Director Memorandum (Transmittal No. 93-125), includes regulatory accounting considerations (FDIC FIL-60-93).

Examination Appeals Process. The OCC revised its appeals process by establishing procedures for review of supervisory decisions through an ombudsman (OCC Banking Circular [BC] 272). The OTS set forth new guidelines for its supervisory review process in September (OTS RB 4a).

New Audit Requirements in Effect for Lenders, Servicers, and Other Participants in Student Financial Assistance. The U.S. Department of Education has issued new audit requirements for lenders, servicers, and guarantors participating in certain federally funded student financial assistance programs. The requirements were included in regulations issued in December 1992 and relate to the Federal Family Education Loan Programs (FFELP) (*Federal Register*, December 18, 1992) and/or in the Higher Education Amendments Act of 1992 (HEAA) relating to Title IV programs, which Congress passed in July 1992.

The regulations require guarantors of loans granted under the programs to have financial compliance audits of FFELP agencies, which previously was a biennial requirement, and annual compliance audits of participating lenders covering the lender's first fiscal year that begins after July 23, 1992. Guarantor audits must be conducted in accordance with either OMB Circular A-128 or A-133, depending on whether the guarantor is a state agency or a not-for-profit organization. Lender audit reports must be completed within six months after the end of an audit period. Implementation guidance on lender compliance audits is currently being drafted and is expected to be available in December 1993.

The HEAA requires each servicer, lender, or guarantor to have a compliance audit at least annually in accordance with Government Auditing Standards and as prescribed in regulations by the Secretary of Education. The new audit requirements are not effective until the Department of Education issues implementing regulations; proposed regulations are expected to be issued for comment with final regulations to be issued next spring. New audit requirements for lenders, guarantors, and FFELP servicers applying for "exceptional performer" designation are also not effective until the regulations are issued.

Audit Issues and Developments

FDIC Improvement Act

Reporting on Multitiered Entities. Guideline 4(c) contained in 12 CFR Part 363 permits management to make an assertion about the financial reporting controls of more than one of its subsidiary institutions within the scope of 12 CFR Part 363 (a covered subsidiary). However, the auditor's report should relate to an assertion about the financial reporting controls of either (1) a holding company and all subsidiary institutions, or (2) a covered subsidiary. That is, the auditor's report should not relate to combined assertions of more than one covered subsidiary unless both subsidiaries are part of a consolidated group and the auditor is reporting on the holding company and all subsidiaries (both covered and not covered).

Reporting of Procedures Performed on Internal Auditor's Workpapers. If, in addition to performing the Section I procedures set forth in 12 CFR Part 363, the auditor applies procedures to internal auditor's workpapers, the following language should be provided in a separate report or included in the Section I attestation report:

Report of Auditors on General Auditor's Assertion Relating to Internal Audit Procedures on Compliance With FDIC-Designated Safety and Soundness Laws and Regulations

To the Board of Directors
XYZ National Bank

We have performed the procedures enumerated below, which were agreed to by XYZ National Bank (the Company) and the Federal Deposit Insurance Corporation (FDIC), solely to assist them in evaluating the Company's [*title of asserter—for example, General Auditor's*] assertion, included in its representation letter dated January 31, 19X4, that: (i) the Company's Internal Audit Department (Internal Audit) performed the procedures listed in Section I of Schedule A of Appendix A to Part 363, Chapter III, Title 12, Code of Federal Regulations, on each of the Company's covered subsidiary banks over $500 million; (ii) Internal Audit tested a sufficient number of transactions governed by the laws and regulations designated under §363.2, Guideline 12, so that the testing is representative of the Company's volume of transactions; (iii) the workpapers prepared as a result of the procedures performed accurately reflect the work performed and the workpapers are complete; and (iv) a report, which describes the procedures performed and the related findings, has been presented to the Company's audit committee. The sufficiency of the procedures presented below is solely the responsibility

of the specified users of the report. Consequently, we make no representation regarding the sufficiency of the procedures described below either for the purpose for which this report has been requested or for any other purpose.

Procedures and Findings

1. We compared Internal Audit's workpapers to the procedures required to be performed under Section I. We did not note any required procedures that were not documented in Internal Audit's workpapers.
2. We compared Internal Audit's sample sizes to the following criteria, to which the FDIC did not object, and found them to be in agreement:

Population Number (N)	*Sample Size*
100 or greater	60
50 to 100	25
0 to 50	*N* or 20, whichever is smaller

3. We compared errors and exceptions listed in Internal Audit's report to the Company's audit committee to those in Internal Audit's workpapers. All such errors or exceptions documented in the workpapers were included in the report.

These agreed-upon procedures are substantially less in scope than an examination, the objective of which is the expression of an opinion on the Company's General Auditor's assertions identified in the first paragraph. Accordingly, we do not express such an opinion. Additionally, we provide no assurance that the procedures described in the Internal Audit's workpapers were effectively carried out or that all error or exception conditions were identified and recorded in the working papers or communicated to the Audit Committee. Furthermore, we did not perform procedures related to the Company's [*title of asserter—for example, General Auditor's*] aforementioned assertion that the workpapers prepared as a result of the procedures performed accurately reflect the work performed and the workpapers are complete. Had we performed additional procedures or had we made an examination of the Company's [*title of asserter—for example, General Auditor's*] assertions identified in the first paragraph, other matters might have come to our attention that would have been reported to you.

This report is intended solely for the information of the audit committee, management, and the parties listed in the first paragraph, and should not be used by those who did not participate in determining the procedures.

Scope of Financial Reporting. Section 36 requires management to include in its annual report a written assertion about the effectiveness

of the institution's internal control structure over financial reporting as of the end of the institution's fiscal year.

Final implementing regulations and guidelines for Section 36 offer no guidance about whether management should consider Call Reports or TFRs for the purposes of reporting under Section 36. When developed, SSAE No. 2 did not contemplate inclusion of controls over call reporting as part of the internal control structure over financial reporting. Some institutions have held that considering Call Reports or TFRs within the scope of management's assertion (and the related independent accountant's attestation) will be burdensome and costly. However, the staff of the FDIC has stated that management's assertion is expected to consider Call Reports or TFRs within the scope of financial reporting controls addressed by management's assertion.

Management assertions. Because of the differing views (discussed above) over the inclusion of call reporting, it is preferable that management's report specify the scope of financial reporting about which management is making its assertions.

Example A—Management report in which scope is financial reporting in conformity with GAAP and Call Report (or TFR) instructions:

Internal Control Structure Over Financial Reporting

Management is responsible for establishing and maintaining an effective internal control structure over financial reporting presented in conformity with both generally accepted accounting principles and the Federal Financial Institutions Examination Council instructions for Consolidated Reports of Condition and Income (call report instructions) [or, *Office of Thrift Supervision instructions for Thrift Financial Reports (TFR instructions)*]. The structure contains monitoring mechanisms, and actions are taken to correct deficiencies identified.

There are inherent limitations in the effectiveness of any structure of internal control, including the possibility of human error and the circumvention or overriding of controls. Accordingly, even an effective internal control structure can provide only reasonable assurance with respect to financial statement preparation. Further, because of changes in conditions, the effectiveness of an internal control structure may vary over time.

Management assessed the institution's internal control structure over financial reporting presented in conformity with both generally accepted accounting principles and call report [or *TFR*] instructions as of December 31, 19XX. This assessment was based on criteria for effective internal control over financial reporting described in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this assessment, management believes

that, as of December 31, 19XX, XYZ National Bank maintained an effective internal control structure over financial reporting presented in conformity with both generally accepted accounting principles and call report [or *TFR*] instructions.

Example B—Management report in which scope is financial reporting in conformity with GAAP:

Internal Control Structure Over Financial Reporting

Management is responsible for establishing and maintaining an effective internal control structure over financial reporting presented in conformity with generally accepted accounting principles. The structure contains monitoring mechanisms, and actions are taken to correct deficiencies identified.

There are inherent limitations in the effectiveness of any structure of internal control, including the possibility of human error and the circumvention or overriding of controls. Accordingly, even an effective internal control structure can provide only reasonable assurance with respect to financial statement preparation. Further, because of changes in conditions, the effectiveness of an internal control structure may vary over time.

Management assessed the institution's internal control structure over financial reporting presented in conformity with generally accepted accounting principles as of December 31, 19XX. This assessment was based on criteria for effective internal control over financial reporting described in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this assessment, management believes that, as of December 31, 19XX, XYZ National Bank maintained an effective internal control structure over financial reporting presented in conformity with generally accepted accounting principles.

Attestation reports. The FDICIA requires that, with respect to any internal control report required of management, the independent accountant shall attest to and report on management's assertions contained in the report.

Standard independent accountant's report. Following is an illustrative independent accountant's report (following SSAE No. 2) for use with either of the management assertions presented as examples A and B above.

Independent Accountant's Report

[*Introductory paragraph*]

We have examined management's assertion [*describe management's assertion as in example A or B*] as of December 31, 19XX, included in the accompanying [*title of management report*].

[*Scope paragraph*]

Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included obtaining an understanding of the internal control structure over financial reporting, testing, and evaluating the design and operating effectiveness of the internal control structure, and such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

[*Inherent limitations paragraph*]

Because of inherent limitations in any internal control structure, errors or irregularities may occur and not be detected. Also, projections of any evaluation of the internal control structure over financial reporting to future periods are subject to the risk that the internal control structure may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[*Opinion paragraph*]

In our opinion, management's assertion [*describe management's assertion as in example A or B*] as of December 31, 19XX, is fairly stated, in all material respects, based on *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

If management's assertion does not specify the scope of financial reporting about which management is making its assertion, the independent accountant should ascertain the scope of management's assertion and discuss with management the preferability of its assertion being explicit as to scope. If management's assertion is not explicit, the accountant's attestation report should describe the scope of management's assertion according to the following example:

Independent Accountant's Report

[*Introductory paragraph*]

We have examined management's assertion that XYZ National Bank maintained an effective internal control structure over financial reporting. Management has informed us that the scope of their assertion includes financial reporting presented in conformity with [*both*] generally accepted accounting principles [*and Federal Financial Institutions Examination Council instructions for Consolidated Reports of Condition and Income;* or, *and Office of Thrift Supervision instructions for Thrift Financial Reports*].

[*Standard scope and inherent limitations paragraphs*]

[*Opinion paragraph*]

In our opinion, management's assertion that XYZ National Bank maintained an effective internal control structure over financial

reporting as of December 31, 19XX (as described above) is fairly stated, in all material respects, based on *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

Reports on limited engagements. In certain cases, management might issue a report similar to that in Example A above (the scope of which includes financial reporting presented in conformity with both GAAP and Call Report or TFR instructions) but might engage the independent accountant only to attest to the assertion as it relates to financial reporting in conformity with GAAP. In such cases, the independent accountant's report should address the limited reporting objective and disclaim an opinion on that portion of management's assertion about the institution's internal control structure over financial reporting presented in conformity with Call Report or TFR instructions.

Following is an example of an explanatory paragraph that should be included in a report issued in these circumstances (or in similar circumstances where management's assertion is not explicit as to its scope):

Independent Accountant's Report

[*Introductory paragraph*]

We have examined management's assertion (included in the accompanying [*title of management report*]) that, as of December 31, 19XX, XYZ National Bank maintained an effective internal control structure over financial reporting presented in conformity with generally accepted accounting principles.

[*Standard scope and inherent limitations paragraphs*]

[*Explanatory paragraph*]

We were not engaged to examine management's assertion as it relates to the internal control structure over financial reporting presented in conformity with the Federal Financial Institutions Examination Council instructions for Consolidated Reports of Condition and Income [or *Office of Thrift Supervision instructions for Thrift Financial Reports*]. Accordingly, we do not express an opinion on that assertion.

[*Opinion paragraph*]

In our opinion, management's assertion that, as of December 31, 19XX, XYZ National Bank maintained an effective internal control structure over financial reporting presented in conformity with generally accepted accounting principles is fairly stated, in all material respects, based on *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

Safeguarding of Assets. SSAE No. 2 addresses "safeguarding of assets," as required by guideline 9.[1] Management's assertion about, and the independent accountant's tests of, financial reporting controls will consider "safeguarding of assets" policies and procedures accordingly. The independent accountant's tests of controls over financial reporting of loans, for example, should include tests of whether the institution is executing transactions in accordance with management's policies for loan underwriting and loan documentation. Such procedures might include, for example, comparing approvals for loan transactions to management's written policy to ascertain whether the loan was approved by an officer or committee consistent with the authority limits specified for that officer or committee in the policy.

Therefore, such policies and procedures are implicit in management's assertion (as illustrated in examples A and B above) and the related independent accountant's opinion.

If, as an integral part of its assertion about the institution's internal control structure over financial reporting, management includes an assertion about safeguarding of assets that goes beyond (for example, to assess the adequacy of management's policies and procedures or its business decisions) the context discussed in paragraph 27 of SSAE No. 2, the independent accountant's report should disclaim an opinion on any assertion that goes beyond the context discussed in paragraph 27 of SSAE No. 2.

Derivatives and Other Potentially High-Risk Investments

In recent years, there has been a growing use of innovative financial instruments that often are very complex and can involve a substantial risk of loss. Users and issuers of such instruments must have the expertise necessary to understand and manage the related risks. As discussed below, auditors should also be familiar with such instruments and the associated risks. One class of these instruments—derivatives—requires particular attention.

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[1]Specifically, paragraph 27 of SSAE No. 2 states:

> In the context of an entity's internal control structure, safeguarding of assets refers only to protection against loss from errors and irregularities in the processing of transactions and the handling of related assets. It does not include, for example, loss of assets arising from management's operating decisions, such as selling a product that proves to be unprofitable, incurring expenditures for equipment or material that proves to be unnecessary or unsatisfactory, authorizing what proves to be unproductive research or ineffective advertising, or accepting some level of merchandise pilferage by customers as part of operating a retail business.

See also appendix D of SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319).

Derivatives are complex financial instruments whose values depend on the values of one or more underlying assets or financial indexes. Derivatives generally fall into at least two categories:

1. Asset-backed securities, which include mortgage-backed securities, interest-only and principal-only strips, and tranches of collateralized mortgage obligations
2. Off-balance-sheet instruments such as forward contracts, interest-rate and currency swaps, futures, options, and other financial contracts

By reconfiguring cash flows associated with underlying assets, an issuer can create asset-backed securities that meet the needs of and are attractive to various potential users by isolating, enhancing, or diluting one or more of credit, liquidity, interest-rate, and other risks inherent in the underlying cash flows. For example, through mortgage-backed securities, the issuer can enhance the marketability of underlying mortgage loans by spreading liquidity and credit risk across broad pools, or by providing a higher yield to those users willing to accept a higher concentration of the risks associated with specific collateral cash flows. Similarly, users find certain derivatives attractive because they can purchase the risks and rewards they desire most, or can synthetically create a security with the desired risk and reward characteristics.

Increased volatility of interest rates, foreign exchange rates, and commodity and other prices, has also fostered tremendous innovation in financial products to meet the needs of users attempting to hedge or alter the related risks. Swaps, for example, are financial contracts in which two parties exchange streams of payments over a period of time. An entity with debt that carries variable interest rates (such as a bank that has short-term certificates of deposit) might swap interest-rate payments on an agreed-upon principal amount with a counterparty by paying a fixed rate and receiving a variable rate. The first entity locks into an interest rate for the term of the swap, reducing the risk that increases in interest rates will increase the entity's cost of funds as its liabilities are refunded or related interest rates are reset. The entity takes on other risks, however, such as the risk that the counterparty could default on its payments. By locking into fixed rates, the entity will no longer benefit from interest-rate decreases during the term of the swap, and it is often costly to terminate a swap. Further, the fair value of derivatives can be volatile in periods of changing market conditions.

Accounting. Accounting for derivatives is complex. Given the constant innovation and complexity of derivatives, accounting literature

does not explicitly cover some derivatives, however, several related projects are underway.

The FASB has been carrying out a major project on the recognition and measurement of financial instruments, which has already resulted in the issuance of FASB Statements No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk,* No. 107, *Disclosures about Fair Values of Financial Instruments,* and No. 115, *Accounting for Investments in Certain Debt and Equity Securities,* and FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts,* that address related issues. The FASB's project includes a comprehensive review of accounting for hedging and risk-adjusting derivatives. Also, the International Accounting Standards Committee is in the process of developing an international accounting standard for financial instruments.

Several accounting issues involving derivatives have also been addressed by the FASB's Emerging Issues Task Force (EITF). Other guidance is provided by FASB Statements No. 52, *Foreign Currency Translation* and No. 80, *Accounting for Futures Contracts.* In addition, AICPA Issues Paper No. 86-2, *Accounting for Options,* discusses various matters related to options.

Auditing. The innovative and complex nature of such investment vehicles may significantly increase audit risk. For example, as more and more financial institutions enter the markets for such instruments, their profitability may diminish. Traders may attempt to compensate for the diminution by increasing the volume of transactions involving such instruments or by further customizing products. An increase in volume may be accompanied by trading with counterparties that have higher credit risk. Customizing transactions may increase valuation difficulties. The propriety of the methods used by the managements of banks and savings institutions to account for transactions involving sophisticated financial instruments and to determine their value should be carefully considered. Understanding the substance of transactions in such instruments is important in determining the propriety of their accounting treatment. In some circumstances, auditors may find it helpful to consult with experts.

SAS No. 22 requires that auditors understand the events, transactions, and practices that, in their judgment, may have a significant effect on the financial statements. Accordingly, auditors should carefully consider the various risks involved with investments in derivatives and other complex securities as they plan their audits and should—

- Assess the level of management's expertise in monitoring, evaluating, and accounting for the securities.

- Ensure that the entity has set appropriate policies and procedures for investment in high-risk securities and that there is adequate oversight by the board of directors.
- Involve specialists, when necessary, in valuing and auditing these investments.

The Audit and Accounting Guide *Audits of Savings Institutions* and the Industry Audit Guide *Audits of Banks,* provide additional information on the credit, liquidity, interest-rate, and other risks associated with financial instruments and related internal control structure considerations.

SEC Actions

Discussed below are several SEC Accounting and Auditing Enforcement Releases (AAERs) that have been issued since September 1992 and that involve banks and savings institutions and auditors of their financial statements. Readers should further consult the cited AAERs for the specific circumstances in each instance.

Credit Losses. Several AAERs have been issued concerning nontimely recognition of losses, including failure to provide loss reserves that are adequate to absorb probable losses in the loan and real estate portfolios; failure to correctly value in-substance foreclosures of real estate; and failure to record losses on foreclosed assets in a timely manner (AAERs 432, 471, and 472).

Auditor Independence. In one instance, the audit engagement partner for a financial institution maintained unsecured loans from the institution at the time of the audit that were clearly material to his net worth. Subsequent to January 1, 1992, interpretations of AICPA independence rules (as set forth in AICPA, *Professional Standards,* vol. 2, ET sec. 101.07) prohibit all loans from financial institution clients except automobile loans and leases, credit card and cash-advance balances that do not in the aggregate exceed $5,000, loans on the cash surrender value of life insurance policies, and loans collateralized by cash deposits (passbook loans). Loans permitted under previous ethics interpretations were grandfathered; however, the value of collateral on a secured loan must equal or exceed the remaining balance of the loan at January 1, 1992, and at all times thereafter (AAER 437).

Intentional Misstatements. In two AAERs, registrants improperly accelerated revenue and deferred costs through intentional errors, including reclassification of current expenses as prepaid assets; accrual of fee income on trust accounts in amounts greater than those supported by the market value of the assets in those accounts; recognition

of the loss on mandatory conversion of preferred stock over several years rather than immediately; recognition of income from loan fees immediately rather than as a yield adjustment; correction of routine accounting errors over a period of months rather than immediately; and failure to accrue expenses as incurred and recognition of income on real estate transactions that was not earned (AAERs 426 and 439).

Inadequate Controls Over Surprise Cash Count. In one instance, an auditor failed to maintain appropriate controls during a surprise cash count to prevent concealment of a large cash shortage by substitution of cash from other locations. The auditor also failed to sufficiently investigate management's explanations of a large reconciling item on the vault general ledger proof sheet (AAER 458).

Real Estate Transactions. In several AAERs, gains were recognized on real estate transactions when criteria of FASB Statement No. 66 and Accounting Principles Board Opinion (APB) No. 29, *Accounting for Nonmonetary Transactions,* had not been met. In one transaction, the selling institution provided the funds for the down payment to the buyer in contravention of the requirements of FASB Statement No. 66. Another transaction involved the simultaneous purchase and sale of land between an institution and a real estate developer which should have been accounted for as a nonmonetary transaction under APB Opinion 29 (AAERs 461, 462, 471, and 472).

Accounting Change. In two AAERs, to avoid recognition of additional losses, institutions improperly changed their method of accounting for a real estate investment from the equity to the cost method without a supporting change in circumstances (AAERs 461 and 462).

Loss Contingencies. The SEC issued Staff Accounting Bulletin (SAB) No. 92, *Accounting and Disclosures Relating to Loss Contingencies,* which expresses certain staff views about accounting and disclosure related to loss contingencies, including environmental liabilities. The guidance is intended to promote timely recognition of loss contingencies and address the diversity in practice on matters such as offsetting probable recoveries against probable contingent liabilities, recognition of liability for costs apportioned to other potential responsible parties, uncertainties in estimation of the extent of environmental liability, the appropriate discount rate for environmental liabilities, whether discounting is appropriate, accounting for exit costs, disclosures, and other issues.

Segment Disclosures. The SEC staff has viewed increasing volumes of fee-based activities at certain institutions to be an expansion of services

beyond traditional banking activities. Accordingly, the SEC staff has asserted that institutions may now be operating in different industry segments as defined by FASB Statement No. 14, *Financial Reporting for Segments of a Business Enterprise.* The SEC staff believes that, if an institution has substantial amounts of revenue from fee-based or other service areas such as mortgage banking, trust, credit card, mutual fund, capital market, or processing businesses, it should consider whether any related disclosures required by FASB Statement No. 14 have been appropriately addressed.

Industry Guide 3. The SEC is working on revisions of its guide for disclosures by banks and savings institutions in public filings. Readers should be alert for any final changes in the required disclosures and their effect on disclosure by publicly held institutions.

Noncompliance With Capital Adequacy and Other Regulatory Requirements

Events of noncompliance with regulatory requirements, such as failure to meet minimum capital requirements or participation in impermissible activities or investments, expose depository institutions to regulatory action. Events of noncompliance may be brought to the auditor's attention during the application of normal auditing procedures, during the review of regulatory examination reports, or as a result of actions required by regulators.

SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards,* vol. 1, AU sec. 341), states that "the auditor has a responsibility to evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited." Noncompliance or expected noncompliance with regulatory capital requirements is a condition, when considered with other factors, that could indicate substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. Other factors that should be evaluated are identified in SAS No. 59.

Asset Quality and Valuation Issues

Credit quality and other asset quality issues associated with commercial and consumer loans, real estate portfolios, troubled debt restructurings, foreclosures and in-substance foreclosures, off-balance-sheet financial instruments, and other assets, require critical attention in audits of the financial statements of banks and savings institutions. Auditors should obtain reasonable assurance that management has

recorded adequate asset valuation allowances and liabilities for other credit exposures based on all relevant factors. The subjectivity of determining asset valuation allowances, combined with continued economic uncertainty, reinforces the need for careful planning and execution of audit procedures in this area.

Lack of an asset impairment evaluation system or failure of an institution to document adequately its criteria and methods for determining asset valuation allowances may indicate a material weakness in the institution's internal control structure, and will generally increase the extent of judgment that must be applied by both regulatory examiners and auditors in evaluating the adequacy of management's allowances, and will increase the likelihood that differences will result. The guidance in SAS No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards,* vol. 1, AU sec. 342), should be followed in auditing asset valuation allowances. Other sources of information on auditing loan loss allowances include the AICPA Industry Audit Guide *Audits of Banks,* the Audit and Accounting Guide *Audits of Savings Institutions* and the Auditing Procedure Study *Auditing the Allowance for Credit Losses of Banks.* The Audit and Accounting Guide *Guide for the Use of Real Estate Appraisal Information* provides guidance to help auditors understand real estate appraisal concepts and information.

As with credit risk, other valuation issues involve many subjective assumptions. For example, the expected effects of prepayments on loans in portfolios and the types of income and expense items included in valuations of loan servicing assets have a significant impact on the recorded values of those assets. High levels of prepayments of mortgage loans, for example, have resulted in impairment of many assets, such as purchased mortgage servicing receivables and interest-only securities. Evaluation and recognition of impairment due to prepayments should include consideration of the institution's aggregation policy, discount rates, and assumptions about future prepayment rates.

Further, falling interest rates have created an environment in which transactions involving gains trading of securities, refinancing of loans, restructuring of nonperforming assets, origination of loans to facilitate the sale of real estate owned, and other asset dispositions all require specific attention. Such transactions require an understanding of the specific situations so that the auditor may carefully assess and control audit risk.

Mortgage Banking Engagements

Auditors who are engaged to report on mortgage banking activities of banks and savings institutions should be aware of the following developments.

MBA USAP. The Mortgage Bankers Association of America (MBA) is revising its Uniform Single Audit Program for Mortgage Bankers (USAP). The program was introduced in 1965 and has gained acceptance by investors as a useful guide for engagements that address the servicing functions of mortgage banking entities. Since the last USAP revision in 1983, changes in auditing standards have redefined the nature and reporting requirements of similar engagements. The MBA is considering revising the USAP as an examination level engagement under the AICPA's Attestation Standards. However, pending completion of the USAP revision, the MBA has suggested that entities follow the reporting and other requirements of the 1983 USAP.

SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (AICPA, *Professional Standards,* vol. 1, AU sec. 324), provides guidance to auditors of service organizations (such as loan servicers) on reporting on certain aspects of the service organizations' internal control structures that can be used by other auditors, and also provides guidance on how other auditors should use such reports.

Freddie Mac. The Federal Home Loan Mortgage Corporation (Freddie Mac) issued a revised *Compliance Reporting Guide* that supersedes its previous guide issued in June 1991. The revised guide addresses the scope of compliance attestation engagements at entities that sell or service mortgage loans under Freddie Mac programs, sets forth certain procedures to be performed, and presents required reporting formats.

The Freddie Mac guide includes an agreed-upon-procedures-level attestation engagement to be performed on the seller/servicer's assertions about its compliance with Freddie Mac eligibility requirements and is effective for reporting on periods ending June 30, 1993 and thereafter. Seller/servicers were given copies of the guide with instructions to provide copies to their auditors.

Accounting Developments

FASB Financial Instruments Project

The FASB's agenda continues to include a project on financial instruments that encompasses three primary segments: disclosures, distinguishing between liabilities and equity, and recognition and measurement. In addition to these three primary segments, the FASB has addressed several narrower issues within the overall scope of the project. Some of the current developments of the project are described in the following sections.

Impairment of a Loan. In May 1993, the FASB issued FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan,* which addresses

the accounting by creditors for impairment of certain loans. The Statement is applicable to all creditors and to all loans, uncollateralized as well as collateralized, except large groups of smaller-balance homogeneous loans that are collectively valued for impairment, loans that are measured at fair value or at the lower of cost or fair value, leases, and debt securities as defined in FASB Statement No. 115. It applies to all loans that are restructured in a troubled debt restructuring involving a modification of terms.

FASB Statement No. 114 requires that impaired loans that are within its scope be measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or as a practical expedient, at the loan's observable market price or the fair value of collateral if the loan is collateral dependent.

The Statement amends FASB Statement No. 5, *Accounting for Loss Contingencies*, to clarify that a creditor should evaluate the collectibility of both contractual interest and contractual principal of all receivables when assessing the need for a loss accrual. The Statement also amends FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*, to require a creditor to measure all loans that are restructured in a troubled debt restructuring involving a modification of terms in accordance with its provisions.

The Statement applies to financial statements for fiscal years beginning after December 15, 1994. Earlier application is encouraged.

Sources of guidance relevant to auditing loan loss allowances are described on page 30.

Some banks and savings institutions may adopt the provisions of the Statement prior to its effective date. Auditors of the financial statements of such banks and savings institutions should carefully consider the implications of applying the new provisions of the Statement on audit risk. Aspects of applying the new Statement that warrant particular consideration include—

- Proper identification of all loans to which the Statement should be applied.
- The reasonableness of estimates of future cash flows and interest rates used in discounting.
- The appropriateness of amounts used to measure impairment if alternatives to present value amounts, such as fair values of collateral or observable market prices, are used.
- The relationship between the identification of impaired loans under the Statement and the classification of loans under regulatory classification systems.
- The presentation of accrued interest receivable and its relationship to valuation allowances.

- The relevance of concepts of performing and nonperforming assets.

Investments in Debt and Equity Securities. In May 1993, the FASB issued FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities,* which addresses the accounting and reporting for investments in equity securities that have readily determinable fair values (previously addressed by FASB Statement No. 12, *Accounting for Certain Marketable Equity Securities)* and for all investments in debt securities. FASB Statement No. 115 does not cover securities accounted for by the equity method and investments in consolidated subsidiaries. FASB Statement No. 115 establishes three categories of reporting debt and marketable equity securities:

- Held-to-maturity securities (debt securities that the bank or savings institution has the positive intent and ability to hold to maturity), to be reported at amortized cost
- Trading securities (debt and equity securities that are bought and held principally for the purpose of selling them in the near future), to be reported at fair value, with unrealized gains and losses included in earnings
- Available-for-sale securities (debt and equity securities not classified as either held-to-maturity or trading), to be reported at fair value, with unrealized gains and losses excluded from earnings and reported in a separate component of equity until realized

Mortgage-backed securities that are held for sale in conjunction with mortgage banking activities (as described in FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities),* are classified as trading securities. Mortgage-backed securities that are currently not held-for-sale in conjunction with mortgage banking activities may be classified in one of the two other categories, as appropriate.

FASB Statement No. 115 also requires banks and savings institutions to determine whether declines in the fair value of individual securities classified as either held-to-maturity or available-for-sale below their amortized cost bases are other than temporary. For example, if it is probable that an investor will be unable to collect all amounts due according to the contractual terms of a debt security not impaired at acquisition, an other-than-temporary impairment is considered to have occurred. If such a decline is judged to be other than temporary, the cost basis of the individual security should be written down to fair value as the new cost basis, with the amount of the write-down included in earnings (that is, accounted for as a realized loss).

The Statement also specifies the accounting treatment for transfers between categories.

The Statement (paragraph 8) indicates that certain changes in circumstances may cause the enterprise to change its intent to hold a certain security to maturity without calling into question its intent to hold other debt securities to maturity in the future. Such circumstances include evidence of a significant deterioration in the issuer's creditworthiness or a change in tax law that eliminates or reduces the tax-exempt status of interest on the debt security. In addition, other events that are isolated, nonrecurring, and unusual for the reporting enterprise that could not have been reasonably anticipated may cause an enterprise to sell or transfer a held-to-maturity security without necessarily calling into question its intent to hold other debt securities to maturity. Such sales and transfers of held-to-maturity securities are expected to be rare.

An entity shall not classify a debt security as held-to-maturity if it has the intent to hold the security for only an indefinite period. Consequently, a debt security should not, for example, be classified as held-to-maturity if the enterprise anticipates that the security would be available to be sold in response to changes in market interest rates and related changes in the security's prepayment risk, needs for liquidity, changes in the availability of and the yield on alternative investments, changes in funding sources and terms, and changes in foreign-currency risk.

FASB Statement No. 115 is effective for fiscal years beginning after December 15, 1993. It specifically prohibits retroactive restatement of prior financial statements. Although typically FASB Statement No. 115 would be initially applied as of the beginning of a fiscal year (such as January 1, 1994), entities are permitted to initially apply the Statement as of the end of an earlier annual period for which financial statements have not been issued (with no restatement of interim periods).

Since all banks and savings institutions with a calendar fiscal year must classify their investments in securities in accordance with FASB Statement No. 115 as of January 1, 1994, those banks and savings institutions will also be able to apply the Statement as of December 31, 1993, if they wish to do so in their 1993 annual financial statements. Thus, auditors should be aware of some of the issues that are likely to arise when the Statement is applied. Auditing financial statements involving the classification of investments in debt and equity securities pursuant to FASB Statement No. 115 may involve a high degree of judgment about such matters as the following:

- How auditors should evaluate subjective exceptions for sales of securities designated as held-to-maturity (including the interpretation of restrictive terms such as *isolated, nonrecurring,* and *unusual*)
- How auditors should evaluate the ability of a bank or savings institution to hold securities to maturity, particularly when going-concern issues arise

- Whether cash flow projections are needed in conjunction with assessing a bank's or savings institution's ability to hold securities to maturity
- How to evaluate whether impairments of investments are other than temporary

Auditors of the financial statements of publicly held institutions should also consider the guidance of SEC SAB No. 74, *Disclosures Regarding Accounting Standards Issued But Not Yet Adopted.*

The Omnibus Budget Reconciliation Act of 1993 included a provision requiring securities dealers to compute their taxable income by marking their inventory of securities to market at the end of each taxable year. The definition of securities dealer appears to encompass many banks and savings institutions that buy and sell securities. Subject institutions must generally identify securities exempt from the mark-to-market provision at acquisition. Identification of securities held at August 10, 1993 (the date of enactment) or acquired between August 10, 1993, and October 31, 1993, may be made by October 31, 1993.

The identification of securities for tax purposes under this provision is not equivalent to the nature and purpose of management's classification of investments in certain debt and equity securities under GAAP (including application of FASB Statement No. 115). However, for those securities subject to the provisions of FASB Statement No. 115, the auditor should consider whether management's identification of securities for tax purposes contradicts its stated intent for GAAP.

Consensus Decisions of the FASB's EITF

The FASB's EITF frequently discusses accounting issues involving financial instruments, real estate, or transactions of similar importance to banks and savings institutions.

In EITF Issue No. 93-5, *Accounting for Environmental Liabilities,* the EITF reached a consensus that, among other things, an environmental liability should be evaluated independently from any potential recovery and that the loss arising from the recognition of an environmental liability should be reduced only when a claim for recovery is probable of realization.

In EITF Issue No. 93-1, *Accounting for Individual Credit Card Acquisitions,* the EITF reached a consensus that credit card accounts acquired individually should be accounted for as originations under FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases,* and EITF Issue No. 92-5 (see the following discussion).

In EITF Issue No. 92-10, *Loan Acquisitions Involving Table Funding Arrangements,* the EITF reached a consensus that a mortgage loan

acquired by a mortgage banking enterprise in a table funding arrangement should be accounted for as a purchase of the loan if the loan is legally structured as an origination by the correspondent and if the correspondent is independent of the mortgage banking enterprise. If any criterion set forth in the consensus is not met, the loan should be accounted for by the mortgage banking enterprise as an originated loan.

In EITF Issue No. 92-5, *Amortization Period for Net Deferred Credit Card Origination Costs,* the EITF reached a consensus that credit card origination costs that qualify for deferral pursuant to paragraph 6 of FASB Statement No. 91 should be netted against the related credit card fee, if any, and the net amount should be amortized on a straight-line basis over the privilege period. If a significant fee (relative to the related costs) is charged, the privilege period is the period that the fee entitles the cardholder to use the card. If there is no significant fee, the privilege period should be one year.

In addition, the EITF reached a consensus that for both purchased and originated credit cards, an entity should disclose its accounting policy, the net amount capitalized at the balance sheet date, and the amortization period(s) of credit card fees and costs.

In EITF Issue No. 92-2, *Measuring Loss Accruals by Transferors for Transfers of Receivables with Recourse,* the EITF reached a consensus that the obligation recorded at the date of sale in connection with the recourse provisions of a transfer of receivables should include all probable losses over the life of the receivables transferred and not only those measured and recognized in conformity with FASB Statement No. 5 prior to the date of transfer. The EITF also reached a consensus that recognition of the recourse obligation on a present value basis, as defined, would be acceptable if the timing of the cash flows can be reasonably estimated. The SEC Observer also offered views on netting and discount rates.

At a September 23, 1993 meeting of the EITF, the SEC Observer made announcements about implementation of FASB Statements No. 114 and No. 115.

The SEC Observer stated that Financial Reporting Release (FRR) 28, *Accounting for Loan Losses by Registrants Engaged in Lending Activities,* requires that in-substance foreclosed (ISF) assets be classified and accounted for as "other real estate owned" (OREO or REO). He also noted that, on June 10, 1993, the banking regulators jointly issued a regulatory credit initiative that is not consistent with the guidance provided in FRR 28 because the regulatory initiative permits the classification of ISF assets as loans rather than an OREO or REO. The SEC Observer said that registrants have asked whether the SEC staff would object to the classification of ISF assets as loans in financial statements and other financial information filed with the SEC.

Even though the classification of ISF assets as loans is not consistent with the guidance contained in FRR 28, the SEC Observer stated that it is the position of the SEC staff that the main objective of FRR 28 is to require a systematic methodology to be applied to the recognition and measurement of ISF assets, and that this objective should be met even if the classification pursuant to the regulatory credit initiative is adopted by registrants. Therefore, the SEC staff would not object to the reclassification of ISF assets as loans, provided—

1. Registrants do not change their recognition and measurement accounting policies for ISF assets.
2. Registrants file with the SEC, in a current report, financial statements and other financial information, including Guide 3 disclosures and Management's Discussion and Analysis, that reflect the effects of the new classification policy for ISF assets for each period for which such statements and other financial information were provided in the most recent 10-K and subsequent interim reports. This means that registrants should present the impact of the new reclassification policy on (*a*) the financial statements for each of the latest three years, (*b*) each quarterly period since the last Form 10-K as well as comparable quarters for the preceding fiscal year, and (*c*) all other financial information, including Guide 3 disclosures and Management's Discussion and Analysis, for each period for which such statements and other financial information were provided.[2]
3. There is disclosure of the reclassification and its effects.

The SEC Observer stated that the SEC staff will object if, because of the adoption of this new regulatory initiative, ISF assets are not classified consistently. Therefore, registrants cannot adopt this initiative on a prospective basis because the financial statements and other financial information would not be presented in a consistent manner.

The SEC Observer noted that FASB Statement No. 115 requires an investment in a security to be classified as held to maturity, available for sale, or trading, based on an enterprise's intent with respect to holding the security. The SEC observer further stated that the SEC staff understands that the anticipated adoption of FASB Statement No. 115 and possible changes in regulatory capital requirements may have caused registrants to change their intent with respect to holding certain securities. As a result, for financial reporting purposes, these registrants may need to change their classification of certain securities to reflect that revised intent.

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[2]The SEC Observer said a current report could, for example, be filed with the SEC using Form 8-K, or alternatively, by amending previously filed documents.

The SEC staff has been asked whether such a change in classification would call into question the prior accounting for securities. The SEC Observer said the staff will not challenge a registrant's prior accounting for securities as a result of a one-time change in the classification of securities on, or prior to, the date of adopting FASB Statement No. 115 if that change is caused by a change in intent because of the anticipated adoption of FASB Statement No. 115 and possible changes in the regulatory capital requirements. Registrants should not, however, change the measurement principles for securities prior to the adoption of FASB Statement No. 115.

Accounting Standards Executive Committee Activities

Accounting for Foreclosed Assets. The Accounting Standards Executive Committee (AcSEC) decided to postpone further consideration of the issues addressed in its exposure draft of a proposed statement of position (SOP), *Accounting for the Results of Operations of Foreclosed Assets,* since the FASB decided to address accounting for assets to be disposed of in its project on impairment of long-lived assets. The AcSEC plans to resume its discussions on the exposure draft after the FASB has made decisions on the issues to be addressed in the project.

Real Estate Investments. In late 1993, the AcSEC issued an exposure draft of a proposed SOP, *Identifying and Accounting for Investments in Real Estate that Qualify as Investments in Real Estate.* The proposed SOP provides related guidance on such loans, which may include real estate acquisition, development, and construction (ADC) loans, loans on operating real estate, convertible mortgages, and shared appreciation (participating) mortgages. The SOP would require real estate loans that do not meet certain criteria to be classified and accounted for as investments in real estate. A loan that is classified and accounted for as an investment in real estate under the SOP would be considered to be the equivalent of an investment by the lender in a hypothetical partnership, the assets of which include the subject real estate. The SOP is proposed to be applied to real estate loans entered into after December 31, 1994, with earlier application encouraged. A final SOP is expected to be issued in 1994.

Ethics Development

The AICPA Professional Ethics Executive Committee has issued the following interpretation, which relates to outsourcing of internal audit activities by clients, including clients that are banks or thrifts:

Ethics Ruling No. 97—Interpretation of Rule 101: Performance of Certain Extended Audit Services

Question: A client is considering engaging a member to assist with the performance of its internal audit activities or extend the member's audit services when the client does not maintain an internal audit function. The activities that the member would be engaged to perform could include, among other things, the following: (1) testing the system of internal controls, confirming accounts receivable, and analyzing fluctuations of income and expense accounts; (2) reviewing loan originations or similar activities as part of the client's approval process or internal control system; and (3) reviewing the client's loan origination or other business processes for their functioning, efficiency or effectiveness and providing recommendations to management. Would independence be considered to be impaired if the member performs any of these services?

Answer: The performance of activities such as those described in (1) above would not impair independence regardless of whether the member assists in the performance or performs all such activities for the client. The activities described in (1) are generally of the type considered to be extensions of audit procedures to be performed in conducting the annual audit, even though the extent of testing may exceed that required by generally accepted auditing standards. The performance of the activities in (2) above would impair independence because the member would be performing a management function. The activities described in (3) above, although not generally considered necessary for conducting the annual audit, are services that would not impair independence as long as the member does not perform management functions or make management decisions.

Guidance from the federal banking and thrift regulatory agencies on supervisory matters related to outsourcing of internal audit activities will be forthcoming.

Information Sources

General

Copies of the FDIC Improvement Act (stock number 869-015-00242-6) are available from the Government Printing Office and can be ordered by calling (202) 783-3238 or by FAXing to (202) 512-2250 (VISA or MasterCard charges only; include expiration date). Price: $4.50.

Regulations of the OCC, the FDIC, the FRB, and the OTS are codified in Section 12 CFR.

OCC supervisory policies and guidance are issued as Advisory Letters, Banking and Examining Bulletins and Circulars, Memoranda, updates to the Division of Supervision Manual of Examination Policies, News Releases, updates to the OCC Policies and Procedures Manual, and other issuances. For information on ordering copies of OCC issuances, call OCC Publications Control at (202) 874-4884.

FDIC policy is communicated in Financial Institution Letters, News Releases, Regional Director Memoranda, and in instructions for FFIEC Call Reports. For information about ordering these issuances, call FDIC Corporate Communications at (202) 898-6996.

Information about FRB publications is available through FRB Publications Services, (202) 452-3245.

OTS supervisory policies and guidance are issued in the form of Thrift Bulletins, Regulatory Bulletins, Transmittals, and in guidance provided to examiners through a multivolume set of agency handbooks. For information on ordering OTS publications, call the OTS Controller's Division at (202) 906-6427.

Copies of SEC publications are available through the SEC's public reference room at (202) 272-7450.

For additional copies or information about Freddie Mac's *Compliance Reporting Guide,* contact Freddie Mac at (703) 903-2186.

Derivatives

The November 1989 issue of *Journal of Accountancy* includes several articles on financial instruments issues. Other publications that provide useful information about financial instruments, complex derivatives, and related risks include:

Derivative Product Activities of Commercial Banks, a joint study by federal banking regulators (January 27, 1993). For copies, call FDIC Corporate Communications at the number above.

A Survey of International Banking, The Economist (April 10, 1993). For reprints, send $3.50 plus applicable sales tax to The Economist Newspaper Group, Inc., Reprints Department, 111 W. 57th St., New York, NY 10019.

Recognition and Measurement of Financial Instruments, a discussion memorandum prepared by the FASB as part of its financial instruments project (No. 109-A, November 18, 1991). A FASB research report, *Hedge Accounting: An Exploratory Study of the Underlying Issues* (1991) and a staff report on related deliberations and tentative conclusions (July 30, 1993) are also available. For copies, call the FASB Order Department at the number below.

Derivatives: Practices and Principles, an overview of global derivatives (July 1993; $110). To order contact Group of Thirty, 1990 M Street, NW, Washington, DC 20036.

Public-sector studies are also underway by the SEC, the General Accounting Office, and the federal banking regulatory agencies.

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This *Audit Risk Alert* replaces *Depository Institutions Industry Developments—1992.*

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Auditors should also be aware of the economic, regulatory, and professional developments that may affect the audits they perform, as described in *Audit Risk Alert—1993,* which may be obtained by calling the AICPA Order Department at the number below and asking for product number 022099.

Copies of AICPA publications referred to in this document may be obtained by calling the AICPA Order Department at (800) TO-AICPA. Copies of FASB publications referred to in this document can be obtained directly from the FASB by calling the FASB Order Department at (203) 847-0700, ext. 10.

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