

1991

Finance companies industry developments - 1991; Audit risk alerts

American Institute of Certified Public Accountants. Auditing Standards Division

Follow this and additional works at: https://egrove.olemiss.edu/aicpa_indev

Part of the [Accounting Commons](#), and the [Taxation Commons](#)

Recommended Citation

American Institute of Certified Public Accountants. Auditing Standards Division, "Finance companies industry developments - 1991; Audit risk alerts" (1991). *Industry Developments and Alerts*. 85.
https://egrove.olemiss.edu/aicpa_indev/85

This Article is brought to you for free and open access by the American Institute of Certified Public Accountants (AICPA) Historical Collection at eGrove. It has been accepted for inclusion in Industry Developments and Alerts by an authorized administrator of eGrove. For more information, please contact egrove@olemiss.edu.

**AUDIT RISK
ALERTS**

Finance Companies Industry Developments—1991

Update to AICPA Audit and Accounting Guide
Audits of Finance Companies

AICPA _____
American Institute of Certified Public Accountants

NOTICE TO READERS

This audit risk alert is intended to provide auditors of financial statements of finance companies 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 upon by a senior technical committee of the AICPA.

Gerard L. Yarnall
Director, Audit and Accounting Guides

William Rea Lalli
Technical Manager, Audit and Accounting Guides

Table of Contents

	<u>Page</u>
Finance Companies Industry Developments—1991	5
Industry and Economic Developments	5
Audit Issues	6
Loan-Loss Allowances	6
In-Substance Foreclosures	7
Accounting Developments	7
FASB Financial Instruments Project	7
Consensus Decisions of the FASB's Emerging Issues Task Force	9
AcSEC Activities	10
Ethics Development	11
Prohibition of Loans to and From Clients	11

Finance Companies Industry Developments—1991

Industry and Economic Developments

Finance companies provide a wide variety of lending and financing services to both consumers and business enterprises. Some limit their lending activities to financing purchases of products produced by a parent company. Others concentrate on lending to consumers. Still others have diversified into higher-risk lending to real estate and take-over ventures, and have come to rival banks and savings institutions.

Finance companies that have limited their lending activities primarily to customers financing purchases of products produced by their parent companies are reporting fairly strong operating results. Indeed, some appear to be doing better than the recession-pressed producers of the products they finance. This segment of the industry has been able to benefit from the widening interest-rate spread or differential between the rates paid to raise capital to lend and the rates charged to borrowers. In addition, the conservative nature of lending only to customers buying company-produced products appears to have lessened credit-quality problems in most instances.

Consumer lending activities, however, are producing lackluster results. Having overborrowed in the 1980s, many consumers are now trying to pay down debt. Generally weak economic conditions and higher-than-usual unemployment figures make consumers even more reluctant to take on new debt, even at the lower interest rates that prevail in the current market. As a result, new borrowing is inhibited and the rate of consumer credit growth has slowed. At the same time, concerns about the asset quality of companies engaged in consumer lending are heightening as personal bankruptcies rise to record levels.

Finance companies that have diversified into higher-risk lending activities, particularly commercial real estate lending, are not faring as well. Such companies are finding themselves exposed to many of the same pressures as banks and savings institutions. Those pressures include the effects of an economy struggling to recover from recession and are reflected in declining credit quality and increasing credit risk.

Auditors of finance companies should fully understand the types of lending activities in which their clients are engaged and carefully consider the risks inherent in each type of activity. Auditors should

also be alert to red flags that indicate increased risk and that require particular audit consideration. Such red flags include—

- Material changes in operations or operating performance that may indicate deteriorating financial strength. Such changes include increasing loan delinquencies or loss chargeoffs, declining interest-rate spreads, lower ratios of loan-loss allowances to nonperforming loans in comparison to industry averages, and practices that reflect a failure to consider changing economic conditions (for example, overreliance on historical data in evaluating allowances for loan losses).
- Material, one-time transactions that may indicate attempts to realize large, short-term benefits, particularly when such transactions occur at or near the end of a reporting period or account for a material portion of reported income. Such transactions may include high-volume purchases or sales of assets (such as mortgage-servicing rights), speculative or unusual off-balance-sheet arrangements, and other high rates of asset growth or disposition. Auditors should give particular attention to the propriety of the accounting treatment of such transactions.
- Highly complex or speculative investments, such as complex mortgage derivatives; investments in noninvestment-grade securities; or complicated, multiple-step transactions involving real estate. Auditors should consider the propriety of management's valuation of such investments and evaluate management's assessment of their recoverability.
- Nontraditional or unusual loan transactions that may expose the company to increased risk. Such transactions include loans with unusual, questionable, or inadequate collateral; loans outside the company's normal lending area; poorly documented loans; loans that pay interest from interest reserves; loans secured by collateral that has dramatically changed in value; significant concentrations of loans; loans to real estate ventures that represent equity investments (acquisition, development, and construction loans); and practices such as routine extension or modification of loan terms or lending activity inconsistent with the stated policies of management.

Audit Issues

Loan-Loss Allowances

The deteriorating credit quality of loans, particularly commercial real estate loans, consumer loans, and other commercial loans, continues

to be a very serious problem for all lenders. Auditing loan-loss allowances is one of the most significant audit areas in every finance company audit. Auditors should obtain reasonable assurance that management has recorded an adequate allowance, based on all factors relevant to the collectibility of the loan portfolio. Loan-loss allowances are based on subjective judgments and are difficult to audit. Accordingly, careful planning and execution of the audit procedures in this area are essential.

The guidance in AICPA Statement on Auditing Standards (SAS) No. 57, *Auditing Accounting Estimates*, is particularly useful in this area. Additional information on auditing loan-loss allowances is provided in the AICPA Auditing Procedure Study *Auditing the Allowance for Credit Losses of Banks*.

In-Substance Foreclosures

Dealing with nonperforming real estate loans for which the fair value of collateral has declined and is less than the amount owed is particularly troublesome. Auditors should consider whether finance companies have identified loans that meet the criteria for in-substance foreclosure set forth in AICPA Practice Bulletin No. 7, *Criteria for Determining Whether Collateral for a Loan Has Been In-Substance Foreclosed*, and in the Securities and Exchange Commission's (SEC's) Financial Reporting Release 28, *Accounting for Loan Losses by Registrants Engaged in Lending Activities*, and whether the accounting treatment of such loans is appropriate.

Accounting Developments

FASB Financial Instruments Project

The Financial Accounting Standards Board's (FASB's) current agenda includes 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 is addressing several narrower issues within the overall scope of the project. Some of the current developments of the project are described below.

Market-Value Disclosures. In December 1990, the FASB issued an exposure draft of a proposed Statement, *Disclosures about Market Value of Financial Instruments*. The proposed Statement would require disclosure of the market value of all financial instruments, both assets and liabilities on and off balance sheet, for which it is practicable to estimate market value. Descriptive information pertaining to estimating the

value of financial instruments for which it is not practicable to estimate market value would also be required to be disclosed. Certain financial instruments (for example, lease contracts, deferred compensation arrangements, and insurance contracts) are excluded from the scope of the proposed Statement. The FASB is expected to issue a final Statement in late 1991. However, the Statement will not be effective for 1991 year-end reporting.

Right of Offset. In June 1991, the FASB issued an exposure draft of a proposed Interpretation of Statement No. 105 and Accounting Principles Board Opinion No. 10 that would prohibit offsetting amounts recognized for swaps, forwards, and similar contracts unless a right of setoff exists. The proposed Interpretation, *Offsetting of Amounts Related to Certain Contracts*, defines right of setoff and specifies conditions that must be met to have that right. The proposed Interpretation also addresses the applicability of the right-of-setoff principle to forward, interest-rate swap, currency swap, option, and similar contracts, and clarifies the circumstances under which related amounts could be offset in the statement of financial position. It also provides an exception to the general principle to permit offsetting of market-value amounts recognized for multiple forward, swap, and similar contracts executed under master netting arrangements. The FASB expects to issue a final Interpretation sometime in 1992.

Investments With Prepayment Risk. In September 1991, the FASB issued an exposure draft of a proposed Statement, *Accounting for Investments with Prepayment Risk*, that would require anticipation of prepayments in the projection of cash flows used in the measurement, after acquisition, of certain investments whose cash flows vary because of prepayments when the prepayments are considered probable, can be reasonably estimated, and have a significant effect on the effective yield. The proposed Statement also specifies that when prepayments are anticipated and actual prepayments differ from those assumed or projections change, the effective yield from inception should be recalculated to reflect actual payments to date and anticipated future payments. The net investments would be changed to the amount that would have existed had the new yield been applied since the acquisition of the investment. The proposed Statement also provides guidance on the calculation of the effective yield for variable-interest-rate instruments subject to prepayment. The FASB expects to issue a final Statement in 1992.

Marketable Securities. The FASB has begun discussion of a project that entails consideration of whether to require that investments in marketa-

ble securities, and perhaps some other financial assets, be measured at market values. As part of the project the FASB will also consider the feasibility of permitting entities the option of reporting some liabilities at market value. This project was added to the FASB's agenda partially in response to requests from the SEC, the AICPA, and others that the FASB undertake a limited-scope project to consider market-value-based accounting for investments in debt securities held as assets. The FASB expects to issue an exposure draft in 1992.

Impairment of a Loan. The FASB is considering whether creditors should measure impairment of loans with collectibility concerns based on the present value of expected future cash flows related to the loan. This issue arose out of requests from the Accounting Standards Executive Committee (AcSEC) and the Federal Deposit Insurance Corporation (FDIC) that the FASB resolve whether creditors should discount expected net future cash flows from the underlying collateral of a loan when determining the appropriate loss allowance for that loan. The FASB is expected to issue an exposure draft in 1992.

Consensus Decisions of the FASB's Emerging Issues Task Force

The Emerging Issues Task Force (EITF) frequently discusses accounting issues involving financial instruments, real estate, or transactions of similar importance to finance companies.

At its July 1991 meeting, the EITF reached a consensus on Issue No. 90-21, *Balance Sheet Treatment of a Sale of Mortgage Servicing Rights with a Subservicing Agreement*, that a sale of mortgage-servicing rights with a subservicing agreement should be treated as a sale with gain deferred if substantially all the risks and rewards inherent in owning the mortgage-servicing rights have been transferred to the buyer. At its September 1991 meeting, the EITF reached a consensus on factors to be considered when determining whether substantially all the risks and rewards inherent in owning the mortgage-servicing rights have not been transferred to the buyer, thereby requiring that the transaction be accounted for as a financing.

As specified in the minutes, the seller's retention of title to the servicing rights or certain guarantees, advances, and indemnifications provided in the transaction are factors that would clearly require the transaction to be accounted for as a financing. Certain other factors are also specified that, if present, create a rebuttable presumption that substantially all the risks and rewards have not been transferred.

In May 1991, the EITF reached a consensus on Issue No. 91-1, *Hedging Intercompany Foreign Currency Risks*, that (a) transactions between

members of a consolidated group with different functional currencies can present foreign currency risks that may be hedged for accounting purposes; (b) the appropriate accounting treatment of such intended hedges of foreign currency risk depends on the type of hedge instrument used; and (c) the provisions of Issue No. 90-17, *Hedging Foreign Currency Risks with Purchased Options*, are applicable to intercompany transactions.

AcSEC Activities

Accounting for Foreclosed Assets. In August 1991, the Accounting Standards Executive Committee approved a proposed Statement of Position (SOP), *Accounting for Foreclosed Assets*, for final issuance. The SOP includes a presumption that foreclosed assets are held for sale and requires foreclosed assets to be classified in the balance sheet as assets held for sale and reported at the lower of (a) fair value minus the estimated costs to sell or (b) cost. In addition, the net amount of revenues and expenses related to foreclosed assets would be charged or credited to income as a net gain or loss on holding foreclosed assets. Capital additions, improvements, or any related capitalized interest would be added to the cost basis of the asset. No depreciation, depletion, or amortization expense related to foreclosed assets would be recognized. The SOP would be applied to all foreclosed assets in annual financial statements for periods ending on or after June 15, 1992. The proposed SOP has been sent to the FASB for clearance prior to final issuance.

ADC Arrangements. An AcSEC task force is developing a proposed Practice Bulletin, *ADC Arrangements and Similar Arrangements That Are Classified as Real Estate Investments or Joint Ventures*, to provide implementation guidance on accounting for acquisition, development, and construction (ADC) arrangements under the February 10, 1986, "Notice to Practitioners on ADC Arrangements." In particular, the proposed Practice Bulletin is expected to address—

- How lenders should report their proportionate shares of income or loss on ADC projects.
- Whether depreciation should be considered in determining the income or loss to be recognized.
- How lenders should report their interest receipts.
- Whether unrealized appreciation of the property should be considered in determining income or loss to be recognized by the lender.

The project is also expected to address the relationship between a lender's proportionate share of income or loss and its "expected residual profit," as described in the Notice to Practitioners.

Ethics Development

Prohibition of Loans to and From Clients

The AICPA Professional Ethics Executive Committee has issued a revised interpretation of the independence rules relating to loans to and from clients. No change was made to the current rule prohibiting loans to and from clients that are not financial institutions. The revised interpretation, effective January 1, 1992, prohibits 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 current ethics interpretations are 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. The revised interpretation was printed in the November 1991 issue of the *Journal of Accountancy*.

* * * *

This Audit Risk Alert supersedes *Finance Companies Industry Developments—1990*.

* * * *

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—1991* (Product No. 022087). *Audit Risk Alert—1991* was printed in the November 1991 issue of the *CPA Letter*. Additional copies can be obtained from the AICPA Order Department.

Copies of AICPA publications may be obtained by calling the AICPA Order Department at (800) 334-6961 (outside New York) or (800) 248-0445 (New York only). Copies of FASB publications may be obtained directly from the FASB by calling the FASB Order Department at (203) 847-0700, ext. 10.

022090