Finance companies industry developments - 1994; Audit risk alerts

American Institute of Certified Public Accountants. Auditing Standards Division

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Finance Companies
Industry Developments—1994

Complement 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, 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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Finance Companies
Industry Developments—1994

Industry and Economic Developments

Finance companies provide a wide variety of lending and financing services to both consumers and business enterprises. It is important to differentiate among the subgroups found within this diverse sector that includes consumer and commercial finance, mortgage banking, credit cards, and leasing. The profits of finance companies are derived from a number of different sources, even though lending, fee-based services, and trading are most common to the group as a whole.

Successive increases in the Federal Reserve's discount rate, federal funds' rates, and related rates resulted in wider interest margins for many finance companies during 1994. For the most part, rising interest rates have yet to materially affect earnings momentum for the group as a whole. However, the rising rate environment, which is expected to continue into 1995, may affect audit risk. For example, rising rates may negatively affect a borrower's cash flows, reducing the borrower's ability to repay loans (particularly restructured loans), and increasing the audit risk associated with allowances for credit losses. Further rate increases will also sustain concerns about the ability of finance companies that invest excess funds in longer term, fixed-rate assets to manage interest-rate risk.

Although it is true to some degree that the credit demand of finance companies is vulnerable to rising interest rates, efforts to expand fee-based income sources are rapidly changing the fundamental operating structures of these companies. As fee-based activities become increasingly important to finance companies, auditors should refer to Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases (FASB, Current Text, vols. 1 and 2, secs. D22, I89, L10, L20, Bt7, Fi4, and Mo4), which addresses the accounting for nonrefundable fees and costs associated with lending activities.

Asset/liability matching, interest-rate swaps, and securitizations are just some of the techniques being used by management to help mitigate the business risks of rising interest rates on margins and the cyclical influences they have on earnings. In recent years, there has been a growing use by finance companies of innovative financial instruments that
often are complex and can involve substantial risk of loss. Auditors should be familiar with such instruments and the associated risks. Derivatives are one class of these instruments that require particular attention.

Customers of finance companies may be individuals or businesses with higher than average credit risk. A number of finance companies have increased their tolerance for risk in an attempt to increase yields. Auditors should be alert to the implications of practices that would place the company at a high level of risk of loss.

In addition, auditors of finance companies should be alert to certain implications of the current climate that may mean added audit risk. For example, auditors should be particularly attentive if companies, in an attempt to strengthen their financial position, are restructuring or reorganizing their business operations. Restructurings may be prompted by competitive pressures that compel some finance companies to focus on niche, and often neglected, areas of the financial marketplace. Actions such as these could significantly affect an entity’s financial statements and should be considered by auditors as they plan their audits in accordance with Statement on Auditing Standards (SAS) No. 22, Planning and Supervision (AICPA, Professional Standards, vol. 1, AU sec. 311). SAS No. 22 requires that, in planning the audit, auditors should consider “matters relating to the entity’s business and the industry in which it operates.”

In assessing risk in auditing the financial statements of a finance company, auditors should consider the environment in which the entity is operating, meaning, largely, the financing activities in which the company is engaged. The following discussion outlines recent developments for two specific kinds of finance companies.

- **Mortgage Finance Companies.** Mortgage loans on real estate are a form of direct consumer lending in which borrowers’ equity interests in their homes make up the collateral. Such mortgage loans differ from purchase money mortgages, in which sellers or third parties grant borrowers mortgages as part of the purchase price. Many mortgage loans issued by finance companies are second mortgage loans that, if borrowers default, are subordinate to the claims of one or more prior lenders.

Mortgage finance companies generally focus on higher profitability at acceptable risk levels. Currently, with increasing interest rates and uncertainty as to the day-to-day movements of interest rates, a number of mortgage finance companies are taking significant losses instead. Auditors of mortgage finance companies should be alert to the changing economic environment and to potential changes in loan acceptance policies.

- **Diversified Finance Companies.** Although the consumer sector gradually upgraded its asset quality during the past decade,
many diversified finance companies followed the lead of com­mercial banks by lending in higher yield, higher risk niches. Although consumer finance companies operated with some indifference to competition from commercial banks, the diversified sector found itself competing more directly with banks. As a result, operating margin pressure has generally been more evident in the diversified sector.

Auditors of diversified finance companies should be aware that the recoverability of asset values is a significant area of audit risk. The subjectivity of determining asset valuation allowances, combined with continued economic uncertainty for the diversified sector, reinforces the need for the careful planning and execution of audit procedures in this area.

Increased competition, credit quality, restructurings, and other economic factors that affect finance companies raise a number of issues that may increase audit risk and should be carefully considered by auditors as they plan their audits. Auditors of finance companies should fully understand the kinds of lending activities in which their clients are engaged and carefully consider the risks inherent in each. These and other issues are addressed further in the “Audit Issues and Developments” section of this Audit Risk Alert.

Regulatory Developments

In general, finance companies are subject to state laws in every state in which they operate. In addition, finance companies generally are compelled to comply with a number of federal laws and regulations governing consumer protection and fair lending.

Regulations affecting finance companies generally are limited to matters such as loan amounts, repayment terms, interest rates, and collateral. Customarily, regulations do not address financial accounting and reporting. The following discussion is intended to help auditors stay abreast of developments that affect the regulation of the finance companies industry.

As previously discussed, SAS No. 22 requires that, in planning their audits, auditors consider matters affecting the industry in which an entity operates, including, among other things, government regulations. Auditors should consider such regulations in light of their potential impact on the financial statements being audited. SAS No. 54, Illegal Acts by Clients (AICPA, Professional Standards, vol. 1, AU sec. 317), distinguishes between the following two kinds of laws and regulations:

1. Those that have a direct and material effect on the determination of financial statement amounts
2. Those that relate more to an entity’s operating aspects than to its financial and accounting aspects and, therefore, have only an indirect effect on the financial statements

Auditors should design their audits to provide reasonable assurance of detecting material misstatements of the financial statements resulting from illegal acts that directly and materially affect financial statement amounts. Nevertheless, an audit performed in accordance with generally accepted auditing standards (GAAS) does not include procedures specifically designed to detect illegal acts that would have only indirectly affected financial statements. Nonetheless, auditors should be aware of the possibility that such illegal acts may have occurred.

Finance companies and the transactions in which they engage have become the focus of increasing governmental regulation. Laws and regulations that affect the finance companies industry are discussed below and in the AICPA Audit and Accounting Guide Audits of Finance Companies (Including Independent and Captive Financing Activities of Other Companies).

**Fair-Lending Laws**

Regulators are continuing to turn up the heat on fair lending. Specifically, mortgage operations need to focus on various fair-lending laws such as the following:

- Fair Housing Act, which prohibits discrimination in lending and servicing
- The Home Mortgage Disclosure Act (HMDA), which seeks to prevent lending discrimination and redlining by requiring disclosure of information about mortgage loan applications
- The Community Reinvestment Act, which seeks to encourage institutions to meet the credit needs of the entire community served by each institution

Regulatory agencies are becoming more stringent in regard to fair lending and are utilizing HMDA data to detect lending discrimination by mortgage finance companies. Auditors should be aware that non-compliance with regulatory requirements exposes finance companies to the risk of regulatory action.

**The Mortgage Bankers Association of America’s Uniform Single Attestation Program for Mortgage Bankers**

The Mortgage Bankers Association of America (MBA) will soon issue a new Uniform Single Attestation Program for Mortgage Bankers (USAP) that may affect certain mortgage finance companies. The USAP will
require an examination-level engagement in accordance with Statement on Standards for Attestation Engagements (SSAE) No. 3, Compliance Attestation (AICPA, Professional Standards, vol. 1, AT sec. 500). SSAE No. 3 provides guidance for reporting on an entity's compliance with laws, regulations, rules, contracts, or grants. SSAE No. 3 is concerned with management's written assertion concerning the following: (1) compliance with specified laws, regulations, rules, contracts, or grants, or (2) the effectiveness of the internal control structure over such compliance matters. Audit Risk Alert—1994 includes a discussion of SSAE No. 3.

The MBA's prior guidance, Uniform Single Audit Program for Mortgage Bankers, was introduced in 1965 and gained acceptance as a useful guide for engagements that addressed the servicing functions of mortgage-banking companies. The related engagements have been redefined to address compliance by mortgage-servicing companies with USAP's specified minimum servicing standards. The USAP will be effective for fiscal years beginning after December 15, 1994, and, thereafter, with earlier application permitted.

Auditors of mortgage finance companies that are contractually required to provide reports under the existing USAP may wish to discuss early application with their clients.

Audit Issues and Developments

Investments in Derivatives

Finance companies sometimes use derivatives as risk management tools (hedges) or as speculative investment vehicles. Over the past several months, however, there has been increased volatility in interest rates, commodity prices, and numerous other market rates and indices from which derivative financial instruments derive their value. As a result, a number of entities that use derivatives have incurred significant losses.

The use of derivatives virtually always increases audit risk. Although the financial statement assertions about derivatives are generally similar to assertions about other transactions, the auditor's approach to achieving related audit objectives may differ because certain derivatives—such as futures contracts, forwards contracts, swaps, options, and other contracts with similar characteristics—are not generally recognized in the financial statements. Many of the unique audit risk considerations presented by the use of derivatives are discussed in detail in Audit Risk Alert—1994.

Asset Quality and Valuation Issues

Auditors of the financial statements of finance companies should give special attention to credit quality and other asset quality issues
surrounding commercial and consumer loans, real estate portfolios, troubled debt restructurings, foreclosures and in-substance foreclosures, off-balance-sheet financial instruments, and other assets. As previously discussed, audit risk may be increasing in this area as some finance companies have begun lending in higher yield, higher risk niches. Many nonbank lenders are focusing on small and midsize companies, a focus that tends to increase risk. Finance companies, which specialize in higher risk business such as equipment finance and accounts receivable lending, have recently been especially aggressive.

Auditors should obtain sufficient competent evidence to evaluate the adequacy of management's valuation allowances and liabilities for credit exposures. The subjectivity of determining such amounts, combined with the issues discussed in the "Industry and Economic Developments" section herein, reinforce the need for the careful planning, execution, and evaluation of audit procedures in this area.

Some troubled debt restructurings could fail as rising interest rates affect the borrower's cash flows and, therefore, the borrower's ability to repay the debt under the restructured terms. This risk is also increased if payment increases have been built into planned payment schedules.

Recent catastrophes, such as earthquakes and floods, may adversely affect local and regional economies or result in the loss of collateral value. A number of institutions may have made significant unsecured advances to borrowers. Auditors should be alert to any related credit quality issues affecting financial reporting, including consideration of lenders' risk concentrations. Auditors should also consider whether concessions made to borrowers have been properly considered against the criteria in FASB Statement No. 15, Accounting by Debtors and Creditors for Troubled Debt Restructurings (FASB, Current Text, vol. 1, sec. D22).

Lack of a system to evaluate credit exposure and other sources of impairment or the failure of an institution to document adequately its criteria and methods for determining loan loss allowances may indicate a reportable condition and, possibly, a material weakness in the finance company's internal control structure over financial reporting. This deficiency generally (1) increases the degree of judgment to be applied by auditors in evaluating the adequacy of management's related allowances and liabilities, and (2) increases the likelihood that differences will result. The guidance in SAS No. 57, Auditing Accounting Estimates (AICPA, Professional Standards, vol. 1, AU sec. 342), is useful when considering this area. Other sources of information on auditing loan loss allowances include the AICPA Audit and Accounting Guides Audits of Savings Institutions and Audits of Credit Unions, the Industry Audit Guide Audits of Banks, 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.

Auditors also should be alert to valuation issues related to the classification and impairments of securities. Paragraph 16 of FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities (FASB, Current Text, vol. 1, secs. F80, I08, I80 and I82), requires that, for individual securities classified as either available for sale or held to maturity (as defined), an institution shall determine whether a decline in fair value below the amortized cost basis is other than temporary and provides related accounting guidance.

In regard to the sale or transfer of a held-to-maturity security, paragraph 69 of FASB Statement No. 115 states, "...if the sale of a held-to-maturity security occurs without justification, the materiality of that contradiction of the enterprise's previously asserted intent must be evaluated." The Securities and Exchange Commission (SEC) staff is interpreting paragraph 69 of FASB Statement No. 115 to mean that if held-to-maturity securities are sold for reasons other than those listed in paragraph 8 of FASB Statement No. 115, the SEC staff will challenge management's (1) previous assertion regarding the classification of those securities, (2) assertions regarding the classification of other held-to-maturity securities, and (3) future assertions regarding the classification of securities purchased subsequently for an extended period of time.

Using the Work of a Specialist

As part of an audit of the financial statements of a finance company, auditors may wish to consider the use of a specialist; for example, during an audit of the financial statements of a finance company, appraisals by specialists of liquidating values of property, plant, and equipment may be helpful to auditors in evaluating security provided by the collateral for a loan. If auditors do use the work of a specialist, they should follow the guidance of SAS No. 73, Using the Work of a Specialist (AICPA, Professional Standards, vol. 1, AU sec. 336). SAS No. 73 is effective for audits of financial statements for periods ending on or after December 15, 1994, with earlier application encouraged.

SAS No. 73 provides guidance to auditors who use the work of a specialist in performing audits in accordance with GAAS. The new standard is not expected to dramatically change the current practice for such auditors. It does, however—

- Clarify the applicability of the guidance.
• Provide updated examples of situations which might require using the work of specialists and types of specialists being used today.
• Provide guidance when a specialist is related to the client.

Audit Risk Alert—1994 contains additional information on SAS No. 73.

Goodwill

Acquisitions are becoming more common, especially in the mortgage finance sector. Given their ample supply of capital, many finance companies are expanding their operations into new geographic territories. In addition, some finance companies are broadening their lines of business through acquisitions. Not only do these companies gain access to new business, which might otherwise not be there, given the possibilities of slowing credit demand, but they are also able to spread their revenues over a smaller expense base once consolidation efforts get under way.

Accounting for goodwill has been an increasingly important issue given this increase in acquisition activity. Auditors should be aware that primary guidance on accounting for goodwill (and related valuation issues) is found in the following:

• FASB Statement No. 72, *Accounting for Certain Acquisitions of Banking or Thrift Institutions* (FASB, *Current Text*, vol. 2, Bt7)
• SEC Staff Accounting Bulletin (SAB) 42 (Topic 2A3), *Acquisitions Involving Financial Institutions*

Service-Center-Produced Records

Finance companies frequently operate in an environment in which service organizations play a critical role in the accounting function. In assessing control risk in such an environment, auditors must carefully consider the functions or processing of information performed by the service organizations. SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324), provides guidance on the factors auditors should consider when auditing the financial statements of an entity that uses a service organization to process certain transactions.

If a finance company uses a service organization, the functions or processing performed by the service organization may have a significant effect on the finance company's financial statements. Because the
processing may be subjected to control policies and procedures that are physically and operationally separate from the finance company, the internal control structure of the finance company may include a component that is not directly under the control and monitoring of its management. SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), requires auditors to obtain a sufficient understanding of an entity's internal control structure to plan an audit. For this reason, planning the audit of a finance company may require that the auditors gain an understanding of the control policies and procedures performed by service organizations. If a finance company relies on a service organization's control policies and procedures over the processing of transactions that are material to the finance company's financial statements, those control procedures should be considered by the auditors. One method of obtaining information about those policies and procedures is to obtain a service auditor's report as described in SAS No. 70.

Auditors frequently inquire whether it is necessary to obtain a service auditor's report when their clients use service organizations. The fact that an entity uses such an organization does not, in itself, require that such a report must be obtained. In certain situations, the finance company may implement control policies and procedures that will obviate the need for a service auditor's report. For example, a finance company using a payroll service may routinely compare the data submitted to the service organization with reports received from the service organization to check the completeness and accuracy of the data processed. The finance company may also recompute a sample of the payroll checks for clerical accuracy and review the total payroll for reasonableness. In such circumstances, the finance company is not relying on the service organization's controls.

Other factors that may be considered in determining whether to obtain a service auditor's report are the following:

- Whether the transactions or accounts affected by the service organization are material to the finance company's financial statements
- The extent to which the user organization retains responsibility for authorizing the transactions and maintaining the related accountability
- The availability of other information (for example, user manuals, system overviews, and technical manuals) at the finance company that may provide the auditor with sufficient information to plan the audit
Accounting Issues and Developments

Financial Accounting Standards Board's Financial Instruments Project

The FASB's ongoing project on financial instruments 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.

FASB Statement on Derivatives. As previously discussed, finance companies regularly employ derivative financial instruments as risk management tools (hedges) or as speculative investment vehicles. These off-balance-sheet instruments are complex financial instruments whose values depend on the volatility of interest rates, foreign currency indices, and commodity and other prices.


FASB Statement No. 119 requires, among other things, disclosures about the amounts, nature, and terms of derivative financial instruments that are not subject to FASB Statement No. 105 because they do not result in off-balance-sheet risk of accounting loss. It requires that a distinction be made between financial instruments held or issued for trading purposes (including dealing and other trading activities measured at fair value with gains and losses recognized in earnings) and financial instruments held or issued for purposes other than trading. It also amends FASB Statement Nos. 105 and 107 to require that distinction in certain disclosures required by those statements.

For entities that hold or issue derivative financial instruments for trading purposes, FASB Statement No. 119 requires the disclosure of average fair value and of net trading gains or losses. For entities that hold or issue derivative financial instruments for purposes other than
trading, it requires disclosure about those purposes and about how the instruments are reported in financial statements. For entities that hold or issue derivative financial instruments and account for them as hedges of anticipated transactions, it requires disclosure about the anticipated transactions, the classes of derivative financial instruments used to hedge those transactions, the amounts of hedging gains and losses deferred, and the transactions or other events that result in recognition of the deferred gains or losses in earnings. FASB Statement No. 119 also encourages, but does not require, quantitative information about market risks of derivative financial instruments, and also of other assets and liabilities, that is consistent with the way the entity manages or adjusts risks and that is useful for comparing the result of applying the entity's strategies to its objectives for holding or issuing the derivative financial instruments.

FASB Statement No. 119 amends FASB Statement No. 105 to require the disaggregation of information about financial instruments with off-balance-sheet risk of accounting loss by class, business activity, risk, or other category that is consistent with the entity's management of those instruments. FASB Statement No. 119 amends FASB Statement No. 107 to require that fair value information be presented without combining, aggregating, or netting the fair value of derivative financial instruments with that of nonderivative financial instruments. In addition, the Statement requires that this information be presented together with the related carrying amounts in the body of the financial statements, a single footnote, or a summary table in a form that makes it clear whether the amounts represent assets or liabilities.

FASB Statement No. 119 is effective for financial statements issued for fiscal years ending after December 15, 1994, except for entities with less than $150 million in total assets. For those entities, FASB Statement No. 119 is effective for financial statements issued for fiscal years ending after December 15, 1995.

Auditors of finance companies that are parties to transactions that involve derivatives should be aware of the requirements of FASB Statement No. 119 and should consider whether the disclosures made by their clients in their financial statements are adequate and appropriate in view of the new requirements.

Accounting by Creditors for Impairment of a Loan. In May 1993, the FASB issued Statement No. 114, Accounting by Creditors for Impairment of a Loan (FASB, Current Text, vol. 1, secs. D22 and I08), 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 Contingencies (FASB, Current Text, vol. 1, sec. C59), 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 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.

Auditors of the financial statements of finance companies should carefully consider the implications of applying the provisions of FASB Statement No. 114 on audit risk. Aspects of applying the 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.

Furthermore, in October 1994, the FASB issued Statement No. 118, Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures (FASB, Current Text, vol. 1, sec. I08). FASB Statement No. 118
amends FASB Statement No. 114 to allow creditors to use existing methods for recognizing interest income on impaired loans. To accomplish that, it eliminates the provisions in FASB Statement No. 114 that describe how creditors should report income on impaired loans.

FASB Statement No. 118 does not change the provisions in FASB Statement No. 114 that require creditors to measure impairment 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 observable market price of the loan or the fair value of the collateral if the loan is collateral-dependent.

FASB Statement No. 118 also amends the disclosure requirements in FASB Statement No. 114 to require the disclosure of information about the recorded investment in certain impaired loans and about how creditors recognize interest income related to those loans.

FASB Statement No. 118 is effective concurrent with the effective date of FASB Statement No. 114, that is, for financial statements for fiscal years beginning after December 15, 1994, with earlier application encouraged.

*Audit Risk Alert—1994* includes a detailed discussion of FASB Statement No. 118.

*Investments in Debt and Equity Securities.* In May 1993, the FASB issued Statement No. 115, 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 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 the following three categories of reporting debt and marketable equity securities:

- Held-to-maturity securities (debt securities that the entity 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 (MBS) that are held for sale in conjunction with mortgage-banking activities, as described in FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities* (FASB, *Current Text*, vol. 2, sec. Mo4), are classified as trading securities. MBS 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 finance companies 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).

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 a 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.

In addition, FASB Technical Bulletin No. 94-1, *Application of Statement 115 to Debt Securities Restructured in a Troubled Debt Restructuring* (FASB, *Current Text*, vol. 1, sec. I80), is effective for financial statements issued after April 30, 1994. This bulletin clarified that, for a loan that was restructured in a troubled debt restructuring involving a modification of terms, FASB Statement No. 115 would be applicable to the accounting by the creditor as long as the restructured loan meets the definition of a security in Statement No. 115.

*Mortgage Servicing Rights.* In June 1994, the FASB exposed for public comment a proposed Statement, *Accounting for Mortgage Servicing Rights and Excess Servicing Receivables and for Securitization of Mortgage Loans*. The proposed Statement requires that an entity recognize as separate assets rights to service mortgage loans for others, however
those servicing rights are acquired. An entity that acquires mortgage-
servicing rights through either the purchase or origination of mortgage
loans and sells those loans with servicing rights retained would allocate
some of the cost of the loans to mortgage servicing rights. Capitalized
mortgage-servicing rights and capitalized excess servicing receivables
would need to be assessed for impairment based on fair value. The
proposed Statement would be applied prospectively in the fiscal years
beginning after December 15, 1995, to transactions in which an entity
acquires mortgage-servicing rights, and to impairment evaluations of
all capitalized mortgage-servicing rights and capitalized excess servic­
ing receivables, whenever acquired. Retroactive application would be
prohibited. Auditors should be alert for the issuance of a final State­
ment, expected in early 1995.

Restructurings

In attempts to ensure their future viability, many finance companies
have undertaken restructurings over the past few years. Among the
actions associated with restructurings have been termination of per­
sonnel, reduction in overhead by selling or leasing excess space, and
elimination of specific product lines or divisions. The auditors’ atten­
tion should be focused on the impact of reductions in personnel on
operations and the internal control structure, the reserves relating to
current restructuring plans, and the appropriate period for reporting
the costs associated with restructurings.

In evaluating the propriety of restructuring charges recorded by their
clients, auditors should consider the consensus reached by the FASB
Emerging Issues Task Force (EITF) on Issue No. 94-3, Liability Recogni­
tion for Costs to Exit an Activity (Including Certain Costs Incurred in a
Restructuring), which provides guidance on whether certain costs
(such as employee severance and termination costs), should be accrued
and classified as part of restructuring charges, or whether such costs
would be more appropriately considered a recurring operating cost of
the company. EITF Issue No. 94-3 provides guidance on the appro­
priate timing of recognition of restructuring charges and prescribes
disclosures that should be included in the financial statements.

In addition, for publicly held finance companies, SEC SAB No. 67
(Topic 5P), Income Statement Presentation of Restructuring Charges,
describes restructuring charges as charges that “typically result from
the consolidation and/or relocation of operations, the abandonment of
operations or productive assets, or the impairment of the carrying
value of productive or other long-lived assets.” As discussed above,
restructuring charges have included costs such as employee benefits
and severance costs, costs associated with the impairment or disposal
of long-lived assets, facility closure costs, and other nonrecurring costs associated with the restructuring, and are required by SAB No. 67 (Topic 5P) to be included as a component of income from continuing operations. As a result of recent increases in the number of companies recording restructuring charges, the SEC staff has been carefully reviewing such charges.

**Consensus Decisions of the FASB’s Emerging Issues Task Force**

The EITF frequently discusses accounting issues involving financial instruments, real estate, or transactions of similar importance to finance companies. A description of recent issues is provided below; nevertheless, readers should consult detailed minutes for additional information.

EITF Issue No. 94-1, *Accounting for Tax Benefits Resulting from Investments in Affordable Housing Projects*, addresses whether an entity that invests in a qualified affordable housing project through a limited partnership should account for its investment as an acquired tax benefit or as an investment in real estate.

EITF Issue No. 94-4, *Classification of an Investment in a Mortgage-Backed Interest-Only Certificate as Held-to-Maturity*, discusses whether mortgage-backed interest-only certificates may be classified as held-to-maturity securities under FASB Statement No. 115.

EITF Issue No. 94-5, *Determination of What Constitutes All Risks and Rewards and No Significant Unresolved Contingencies in a Sale of Mortgage Loan Servicing Rights under Issue 89-5*, involves whether the retention of certain risks would preclude sales treatment for servicing rights.

EITF Issue No. 94-7, *Accounting for Financial Instruments Indexed to, and Potentially Settled in a Company’s Own Stock*, addresses financial instruments that may be settled with a specified number of shares of an entity’s stock or with a cash amount calculated on the basis of the value of a specified number of shares of an entity’s stock. Issues included the following:

- Whether the instrument should be classified as an asset or an equity instrument
- How gains and losses are reported
- Whether the instrument should be accounted for separately if it is embedded in other financial instruments
- How to treat the instrument for earnings-per-share computation

EITF Issue No. 94-8, *Accounting for Conversion of a Loan into a Debt Security in a Debt Restructuring*, discusses how to account for the difference
between the recorded investment in a loan being restructured and the
fair value of debt securities received at the time of conversion.

EITF Issue No. 94-9, *Determining a Normal Servicing Fee Rate for the Sale of an SBA Loan*, discusses accounting issues that arise when a financial institution sells a loan guaranteed by the Small Business Administration (an SBA loan) or an interest in an SBA loan (for example, the guaranteed portion) but retains the right to service the loan. The primary issue is how, for the purpose of applying EITF Issue No. 88-11, *Allocation of Recorded Investment When a Loan or Part of a Loan is Sold*, a financial institution should determine a normal servicing fee rate for SBA loans under FASB Technical Bulletin No. 87-3, *Accounting for Mortgage Servicing Fees and Rights*, in the absence of a major secondary market maker. The secondary issue is how to account for a change in the normal servicing fee rate.

EITF Issue No. 93-18, *Recognition of Impairment for an Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate*, addresses the effect of FASB Statement No. 115 on certain aspects of EITF Issue No. 89-4, *Accounting for a Purchased Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate*. The issue addresses whether FASB Statement No. 115 changes the following:

- The measure of an impairment loss for those instruments addressed in EITF Issue No. 89-4
- The consensus of EITF Issue No. 89-4 about the timing for recognition of an impairment loss for those instruments

The issue also includes whether previously recognized impairment losses for those instruments should be remeasured at fair value for purposes of determining the cumulative catch-up adjustment upon initial adoption of FASB Statement No. 115.

**AICPA Audit and Accounting Literature**

**Audit and Accounting Guide**

The AICPA Audit and Accounting Guide *Audits of Finance Companies (Including Independent and Captive Financing Activities of Other Companies)* is available through the AICPA's loose-leaf subscription service. In the loose-leaf service, conforming changes (those necessitated by the issuance of new authoritative pronouncements) and other minor changes that do not require due process are incorporated periodically. Paperback editions of the guides as they appear in the service are printed annually.
Finance Companies' Financial Reporting Checklist

The AICPA's Technical Information Service has published a revised version of Checklist Supplement and Illustrative Financial Statements for Finance Companies (Product No. 008657MJ) as a tool for preparers and reviewers of financial statements of finance companies. Copies can be obtained by calling the AICPA Order Department.

Technical Practice Aids

Technical Practice Aids is an AICPA publication that, among other things, contains questions received by the AICPA's Technical Information Service on various subjects and the service's responses to those questions. Technical Practice Aids contains questions and answers specifically pertaining to finance companies and is available both as a subscription service and in hardcover form. Order information can be obtained from the AICPA Order Department.

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This Audit Risk Alert replaces Finance Companies Industry Developments—1993.

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Practitioners should also be aware of the economic, regulatory, and professional developments in Audit Risk Alert—1994 and Compilation and Review Alert—1994, which may be obtained by calling the AICPA Order Department at the number below and asking for product number 022141 (audit) or 060668 (compilation and review).

Copies of AICPA publications referred to in this document can 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.