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AUDIT RISK
ALERTS

Finance Companies Industry Developments—1995/96

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, 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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Finance Companies Industry Developments—1995/96

Industry and Economic Developments

Finance companies provide a wide variety of lending and financing services. And though not easily classified, given the diverse nature of the industry, they can be broadly defined as those companies that, at a minimum, provide such services to both consumer and commercial markets. In consumer markets, finance companies may provide mortgage loans—collateralized by the underlying property or, more commonly, the borrower's equity in the property (that is, second mortgages); direct consumer loans—usually collateralized by household goods and repayable in installments; financing for sales of consumer goods and services through retail sales contracts; and increasingly, credit card services. In commercial markets, finance companies may extend working capital and installment loans—usually collateralized by the borrower's accounts receivables or capital assets; provide funding for the acquisition of equipment through leasing arrangements or purchase trade receivables (generally referred to as factoring).

Finance companies typically operate by borrowing money at wholesale and, in turn, lending those funds at retail for many of the purposes described above. Some companies involved in captive finance activities limit their lending to the financing of purchases of products manufactured by an affiliated company, while others have diversified into other related financial services. See "Industry Diversification" below for further discussion.

In the current economic environment interest rates have stabilized and credit demand has been robust in both the commercial and consumer credit markets. Short-term interest rates have stopped climbing, thereby easing some of the pressure on lending margins from rising funding costs earlier in the year. As such, finance companies involved in credit card issuance, as well as commercial and consumer lending, are expected to perform well during 1995.

Loan delinquencies, an important issue in the assessment of audit risk, often track overall economic conditions—rising when the economy weakens and falling as the economy strengthens. Current economic growth is strong and therefore likely to prevent any rapid ascent in problem loans. At the same time, many finance companies have

improved their management of credit risks, reflecting the extensive use of comprehensive credit scoring systems. Accordingly, the expenses of carrying, writing down, and reserving for problem assets continue to decline, although at a slower pace than in the past few years.

Credit Card Services

Individual credit card use has been increasing at a high double-digit rate over the past few years. One major credit card issuer announced that its outstanding credit cards worldwide climbed 23 percent in the first quarter of 1995. Industry analysts expect continued growth from this segment given the trend of credit cards to gain growing acceptance as a major medium of exchange. The trend toward a "plastic-economy" should be bolstered by credit card issuers as they extend incentives (for example, money-back offers, product guarantees, etc.) and as the base of nontraditional merchants outlets that accept credit cards (for example, movie theaters, grocery stores, supermarkets, fast-food restaurants, etc.) grows. Continued expansion is also expected of the co-branded segment of the credit card industry.

Some finance companies involved in credit card issuance have expanded their customer base by issuing co-branded credit cards. These cards, which have become increasingly popular in recent years, typically carry the name of a merchant outlet (for example, a department store or retail chain) and may also include the issuers name. Auditors may wish to consider whether revenue sharing or fee allocation arrangements arise from co-branded credit cards, and if so, whether or not they have any audit or accounting implications. If such contractual obligations exist, auditors should consider the propriety of the accounting treatment used. Issues discussed by The Financial Accounting Standards Board's (FASB's) Emerging Issues Task Force (EITF) relating to credit card services include:

- EITF Issue No. 88-20, *Difference between Initial Investment and Principal Amount of Loans in a Purchased Credit Card Portfolio*
- EITF Issue No. 88-22, *Securitization of Credit Card and Other Receivable Portfolios*
- EITF Issue No. 90-18, *Effect of a "Removal of Accounts" Provision on the Accounting for a Credit Card Securitization*
- EITF Issue No. 92-5, *Amortization Period for Net Deferred Credit Card Origination Costs*
- EITF Issue No. 93-1, *Accounting for Individual Credit Card Acquisitions*

Mortgage Related Services

Last year's earnings for underwriters of residential mortgages were crippled by the Federal Reserve's tough stance against inflation. In the aftermath of successive interest rate increases, mortgage volume collapsed leaving behind an industry deluged with overcapacity. This is no longer the case given the significant increase in credit demand during 1995.

Industry-wide shipments of manufactured homes are expected to increase by approximately 10 percent during 1995, reflecting the growing popularity of such homes as a lower-cost alternative to traditional site built homes. Finance companies involved in funding the purchase of manufactured homes should expect increased growth in this market segment.

Home improvement lending continues to be a source of significant revenue growth for finance companies. This segment of the industry will extend loans amounting to approximately $45 billion in the current year. Many home improvement loans involving major renovations are taken in the form of home equity lines of credit (that is, second mortgages). In assessing the adequacy of the related loan loss allowance, auditors should consider that in the event of default, such loans, although collateralized by the underlying property, are usually subordinate to the claims of other lenders.

Industry Diversification

An industry-wide trend toward diversification is growing as many finance companies broaden their product lines in order to take advantage of new opportunities as well as to offset the risk of economic downturns in other, more traditional lending areas. This activity is likely to fuel business combinations as well-capitalized firms make acquisitions aimed at broadening their product lines and geographic markets. In these circumstances, auditors should consider whether management has appropriately accounted for transactions related to such combinations. Other audit implications of acquisitions, along with other forms of business combinations, are discussed in "Restructuring Charges" under the "Accounting Issues and Developments" section of this Audit Risk Alert (also see EITF Issue No. 95-3, *Recognition of Liabilities in Connection with a Purchase Business Combination*). Additionally, as finance companies embark upon diversification, consideration should be given to whether the auditor has adequate knowledge of matters relating to the entity's new line of business and the industry in which it operates. Some of the areas into which finance companies have expanded, or have an increased presence, are discussed below.

Refund Anticipation Loan (RAL) Program. Some finance companies have expanded into the RAL program whereby taxpayers, expecting refunds on their federal income tax returns, forego a portion of the proceeds in order to receive the funds immediately. In substance, the taxpayer has been extended a loan by a finance company with the reduction in total proceeds they receive representing an interest charge. The growth of this service has been significant given minimal collectibility problems along with interest rates that run as high as 20 percent. At the initiation of this program, the Internal Revenue Service (IRS), with the authorization of the filer, would remit the tax refund directly to the finance company. However, the IRS has changed this policy and instead sends the refund to the filer, who is then responsible for repaying the loan extended by the finance company. The initial effects of this change have caused an increase in collectibility problems and loan defaults. The IRS is making efforts to resolve these problems, however, the nature of their solution is uncertain. Auditors of finance entities participating in the RAL program should be alert to the collectibility problems inherent in refund anticipation loans and carefully consider the adequacy of the related loan loss allowance.

Insurance Services. Finance companies have become more involved in offering life, accident, health and property policies written for borrowers for the purpose of paying off their remaining loan balances, continuing their loan payments or protecting the value of loan collateral. Finance companies may provide these policies through insurance subsidiaries or, more commonly, by acting as insurance brokers. Auditors of finance companies involved in insurance activities should consider whether management has appropriately accounted for transactions related to these activities pursuant to the guidance set forth under relevant pronouncements such as: FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises* (FASB, *Current Text,* vol. 2, sec. In6), FASB Statement No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments* (FASB, *Current Text,* vol. 2, sec. In6), and FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts* (FASB, *Current Text,* vol. 2, sec. In6). The Audit Risk Alert "Insurance Industry Developments—1995/96" contains information that may be relevant to auditors of the financial statements of finance companies with significant involvement in insurance related financial services.

Additional Services. Finance companies whose core business is commercial and consumer lending are seeking to broaden their product

mix by expanding into revolving credit and home equity lending, thus providing cross-selling opportunities to existing customers. Additionally, for those finance companies providing residential mortgages, the acquisition of mortgage servicing entities, which are typically countercyclical to mortgage lending (income generated from loan servicing becomes more reliable in a rising rate environment when prepayment risk typically declines), has become more prominent. Some finance companies are also diversifying their lending mix to consumer and commercial applications, such as financing pianos, boats, motorcycles, tractor trailers and the like.

In general, auditors should be alert to the audit and accounting implications of diversification by their finance clients as they enter into areas that are new or not directly related to the client's existing business. For example, auditors may wish to consider the effects of the development of new product lines or the expansion of existing services, through internal or external means on the entity's:

- existing internal control structure along with the corresponding effect on the auditor's assessment of control risk.
- ability to implement industry specific accounting pronouncements previously inapplicable to the financial services offered as well as other accounting practices common to the industry.
- obligation to comply with regulatory guidelines (for example, state banking or insurance agencies) with which the entity may be unfamiliar. The auditor may wish to consider whether the client has sufficient expertise in this area, and, if not, the impact on the accounting and reporting function.
- financing requirements of diversification, and its impact, if any, on the entity's solvency, along with the possible existence of any restrictive loan covenants. Since finance companies borrow funds to lend to others and thus have debt-to-equity ratios that are generally higher than many other industries, debt incurred to finance diversification may have a significant impact on audit risk.
- modification of credit or documentation standards to accommodate new products. Such actions may increase the audit risk associated with loan loss estimates.

Auditors may also wish to consider whether the entity's diversification will involve the application of auditing standards previously inapplicable to the audit of that entity's financial statements. For example, a finance company that ventures into insurance related areas may require auditors to consider using the work of a specialist, such as an actuary.

Competitive Environment

AICPA Statement on Auditing Standards (SAS) No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311), requires that, in planning their audits, auditors consider matters relating to the entity's business and the industry in which it operates. One such matter for finance companies is the fierce competitive environment in which the industry operates.

For example, the credit card segment of the industry is highly competitive and has become an increasingly saturated market. Many issuers must offer incentives on their cards in order to attract new customers. Low teaser-rates, no annual fees, balance-transfer options, and rebates are often needed to attract borrowers, as too are frequent mailings and promotions, all of which may add significant costs to customer acquisitions. Auditors should consider whether such incentives have been appropriately accounted for. Further, profit margins have come under pressure due to intense pricing by some card issuers in their attempts to gain market share. However, industry-wide growth in receivables has, thus far, been sufficient to offset the shortfall for a number of finance companies offering credit card services. Auditors should note that low teaser-rates are introductory offers that typically expire after several months and then return to their much higher market levels. Auditors may wish to consider the effects such increases could have on the borrowers' ability to repay.

In mortgage banking, even the largest residential mortgage lenders and servicers must contend with pricing competition from lenders willing to write unprofitable loans in order to increase market share. Despite being burdened by severe credit quality problems during the last market downturn, some finance companies have chosen to combat the competitive pressures by sacrificing asset quality to achieve desired levels of volume. Some finance companies may relax lending policies in order to maintain, if not gain, market share. Significant industry-wide credit quality problems have yet to emerge, however, auditors may wish to consider the effects of a finance entity's increase in loan volume on such issues as liquidity, loan receivable collectibility as well as the adequacy of the related loan loss allowance. Additionally, some finance companies may sell securities or loans to generate cash with which to fund higher volume. Auditors should consider the effects of such transactions on management's intent for, classification of, and valuation of securities and loans for financial reporting purposes. Auditors should also be alert to the effects of sales with recourse on credit risk and recognition of gains and losses and the appropriateness of the accounting for the securitization and/or sale of loans or securities.

Industry observers believe that over the coming years growth for finance companies is likely to slow due to the increasing level of competition. Revenue growth has tapered off dramatically for many banks and it is likely that they will attempt to regain lost market share by adding new product lines, or expand existing services, that will compete with services provided by finance companies. Auditors should consider the effects of the competitive nature of the industry on their finance company clients.

Audit Issues and Developments

Asset Quality and Valuation Issues

Auditors of the financial statements of finance companies, especially those adopting new or more aggressive lending strategies, should give special attention to credit quality issues surrounding the loans extended by these entities. Auditors also should give special attention to other asset quality issues related to areas such as real estate, troubled debt restructurings, foreclosed assets and other real estate owned; off-balance-sheet financial instruments, and other assets. Auditors should obtain sufficient competent evidence to evaluate the adequacy of management's loan loss allowance and liabilities for other credit exposures. The subjectivity of determining such amounts reinforces the need for careful planning and execution of audit procedures in this area, as well as evaluation of results of those procedures.

Lack of an effective system to evaluate credit exposure and other sources of impairment, or the failure of a finance company to document adequately its criteria and methods for determining loan loss allowances, may suggest a reportable condition or a material weakness in the finance company's internal control structure over financial reporting. These deficiencies generally would—

1. increase the degree of judgment auditors and regulatory examiners must apply in evaluating the adequacy of management's related allowances and liabilities, and
2. increase the likelihood that differences in judgments 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. The AICPA Auditing Procedure Study *Auditing the Allowance for Credit Losses of Banks* (Product No. 021050) may provide relevant information on auditing estimated credit losses.

Auditors also should be alert to valuation issues related to classification and impairment of securities and other finance company invest-

ments. Paragraph 16 of FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (FASB, *Current Text,* vol. 1, sec. I80), requires that, for individual securities classified either as available-for-sale or held-to-maturity (as defined), a finance company determine whether a decline in fair value below the amortized cost basis is other than temporary.

Regarding the appropriateness of a finance company's classification of securities, paragraph 69 of FASB Statement No. 115 says that "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."

Other factors that may affect audit risk include a finance company's exposure to interest-rate, liquidity, prepayment, and related risks. For example, finance companies heavily invested in fixed-rate assets (or variable-rate assets subject to caps on interest-rate increases) may face narrower spreads in a rising-rate environment. Auditors may wish to consider the effects that interest-rate increases could have on borrowers' ability to repay loans and the effects interest-rate decreases could have on the realization of assets that are sensitive to prepayments (such as mortgage servicing rights and interest-only securities).

Noncompliance With Regulatory Requirements

Events of noncompliance with regulatory requirements by finance companies involved in providing services that are subject to state or federal oversight (for example, participation in impermissible activities or investments), expose finance companies to regulatory action, such as the forced disposition of those impermissible investments. 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 because 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), provides 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." Events of noncompliance with laws and regulations or the need to dispose of substantial assets are conditions, 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. SAS No. 59 identifies examples of other factors that the auditor may evaluate.

Elimination of Uncertainty Reporting

The Auditing Standards Board (ASB) has issued an exposure draft of a proposed SAS, *Amendment to Statement on Auditing Standards No. 58,* Reports on Audited Financial Statements, that would eliminate the requirement that, when certain criteria are met, the auditor add an uncertainties explanatory paragraph to the auditor's report.

The amendment also would expand the guidance in paragraph 37 of SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards,* vol. 1, AU sec. 508), to indicate that "unusually important risks or uncertainties associated with contingencies, significant estimates, or concentrations" are matters that auditors may wish to emphasize in their reports. The amendment retains the option allowing auditors to disclaim an opinion on financial statements due to uncertainties.

The proposal does not affect the provisions of SAS No. 59, which requires that the auditor add an explanatory paragraph to the auditor's report when there is substantial doubt about the entity's ability to continue as a going concern.

Currently, auditors of the financial statements of finance companies may consider it necessary to add an uncertainty explanatory paragraph to their reports when there is a material uncertainty relating to possible regulatory sanctions as discussed above. If the proposed SAS is issued in final form, that requirement will be eliminated. Nonetheless, auditors reporting on financial statements that include such an uncertainty may wish to emphasize that fact by adding an emphasis of a matter paragraph to their reports. Such paragraphs, however, are optional and are added solely at the auditor's discretion.

The ASB hopes to finalize this SAS late this year and to issue an SAS that would be effective for reports issued on or after June 30, 1996. Comments on the proposed SAS were due on October 20, 1995.

Mortgage Banking Engagements

In May 1995, the Mortgage Bankers Association of America (MBA) released its revised *Uniform Single Attestation Program for Mortgage Bankers* (USAP). The USAP supersedes the MBA's existing program (published in 1983) with an opinion-level attestation engagement performed following AICPA Statements on Standards for Attestation Engagements (SSAE) No. 3, *Compliance Attestation* (AICPA, *Professional Standards,* vol. 1, AT sec. 500). Specifically, the MBA redefined the engagement to address mortgage servicing companies' compliance with the USAP's specified minimum servicing standards. The USAP will be effective for fiscal years ending on or after December 15, 1995, and later, with earlier application encouraged.

In a September 27, 1995 letter to its members, the MBA said that commercial and multifamily loan servicers could report using the USAP, except that minimum standards V.4 and VI.1 could be omitted from management's assertion and the auditor's attestation reports. In the letter, the MBA described a project under way to consider amending or expanding the USAP to explicitly address reporting by commercial and multifamily loan servicers.

The USAP addresses reporting on management assertions about an entity's compliance with specified criteria. SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324), provides guidance on factors auditors should consider when auditing the financial statements of entities that use service organizations (such as mortgage bankers that service mortgages for others). Information about the control structure policies and procedures at mortgage bankers or other loan servicing organizations may affect assertions in the user entity's financial statements. Also, some service auditors' reports prepared according to SAS No. 70 include descriptions and results of tests of operating effectiveness of specified control policies and procedures. Accordingly, those SAS No. 70 reports may enable an auditor of the financial statements of a user entity to assess control risk below the maximum of relevant financial statement assertions. Readers should consult SAS No. 70 for additional information on how to use a service auditor's report when auditing the financial statements of a user organization.

The Federal Home Loan Mortgage Corporation (Freddie Mac) sent a September 29, 1995 letter to chief financial officers of its seller/servicers announcing that, effective immediately, Freddie Mac no longer requires an independent accountant's agreed-upon procedures attestation report on compliance with requirements of Freddie Mac's programs. The report previously was required by Freddie Mac's 1993 *Compliance Reporting Guide*. Readers should be alert to a Freddie Mac bulletin that will be issued explaining the change and clarifying Freddie Mac's other independent audit requirements.

SAS No. 70 Auditing Procedure Study

A task force of the ASB has drafted an auditing procedure study that provides guidance to auditors on implementing SAS No. 70. The study provides guidance to a service auditor engaged to issue a report on the control structure policies and procedures of a service organization and to user auditors engaged to audit the financial statements of an entity that uses a service organization. An example of a service organization is a bank trust department that invests and holds assets for employee benefit plans. The task force expects to issue the study in early 1996.

Agreed-Upon Procedures Engagements

In September 1995, the ASB issued SAS No. 75, *Engagements to Apply Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement* (AICPA, *Professional Standards*, vol. 1, AU sec. 622), which supersedes SAS No. 35, *Special Reports—Applying Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement*. The ASB also issued SSAE No. 4, *Agreed-Upon Procedures Engagements* (AICPA, *Professional Standards*, vol. 1, AT sec. 600), which, among other things, in amending agreed-upon procedure reports prepared in accordance with SAS No. 75 and SSAE No. 4:

- Prohibits negative assurance about whether management's assertion is fairly stated from being included in reports on agreed-upon procedures.
- Clarifies that SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 322), does not apply to agreed-upon procedures engagements.
- States that the concept of materiality does not apply to agreed-upon procedures engagements unless the definition of materiality is agreed to by the specified users.

SSAE No. 4 also requires a written management assertion as a condition of engagement performance. SAS No. 75 and SSAE No. 4 are effective for reports dated after April 30, 1996, with earlier application encouraged.

Accounting Issues and Developments

Mortgage Servicing Rights

FASB Statement No. 122, *Accounting for Mortgage Servicing Rights* (FASB, *Current Text*, vol. 2, sec. Mo4), amends FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities* (FASB, *Current Text*, vol. 2, sec. Mo4), to require that finance companies involved in mortgage banking activities recognize as separate assets rights to service mortgage loans for others, however those servicing rights are acquired. Finance companies involved in mortgage banking activities may acquire mortgage servicing rights through either the purchase or origination of mortgage loans. A finance company that acquires mortgage servicing rights through the origination of mortgage loans and sells or securitizes those loans with servicing rights retained is required by FASB Statement No. 122 to allocate the total cost of the mortgage loans

to the mortgage servicing rights and the loans (without the mortgage servicing rights) based on their relative fair values if it is practicable to estimate those fair values. If it is not practicable to estimate the fair values of the mortgage servicing rights and the mortgage loans (without the mortgage servicing rights), the Statement requires that the entire cost of purchasing or originating the loans should be allocated to the mortgage loans (without the mortgage servicing rights) and no cost should be allocated to the mortgage servicing rights.

FASB Statement No. 122 requires that a finance company involved in mortgage banking activities assess its capitalized mortgage servicing rights for impairment based on the fair value of those rights. The Statement requires that a finance company should stratify its mortgage servicing rights that are capitalized after the adoption of the Statement based on one or more of the predominant risk characteristics of the underlying loans. The Statement requires that impairment should be recognized through a valuation allowance for each impaired stratum.

FASB Statement No. 122 applies prospectively in fiscal years beginning after December 15, 1995, to transactions in which a finance company sells or securitizes mortgage loans with servicing rights retained and to impairment evaluations of all amounts capitalized as mortgage servicing rights, with earlier application encouraged. The Statement prohibits retroactive capitalization of mortgage servicing rights retained in transactions in which a finance company originates mortgage loans and sells or securitizes those loans before the adoption.

In July 1995, the FASB staff announced that the Board agreed to clarify the transition provisions of FASB Statement No. 122, noting in FASB's Action Alert No. 95-21 that:

> . . . earlier application is encouraged as of the beginning of a fiscal year for which annual financial statements or annual financial information has not been issued or as of the beginning of an interim period within that fiscal year for which interim financial statements or interim financial information has not been issued. For example, Public Company X issued financial information for the first quarter. In the second quarter, management of Public Company X has two choices for early adoption: (1) adopt as of the beginning of the fiscal year because annual financial statements or annual financial information has not been issued for that fiscal year or (2) adopt as of the beginning of the second quarter because interim financial statements or interim financial information has not been issued for that quarter.

Impairment of Long-Lived Assets

In March 1995, the FASB issued Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed*

Of (FASB, *Current Text*, vol. 1, sec. I08). FASB Statement No. 121 establishes accounting standards for the impairment of long-lived assets, certain identifiable intangibles, and goodwill related to those assets to be held and used and for long-lived assets and certain identifiable intangibles to be disposed of. The Statement requires that long-lived assets and certain identifiable intangibles to be held and used by an entity be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. In performing the review for recoverability, the Statement requires that the finance company estimate the future cash flows expected to result from the use of the asset and its eventual disposition. If the sum of the expected future cash flows (undiscounted and without interest charges) is less than the carrying amount of the asset, an impairment loss is recognized. Otherwise, an impairment loss is not recognized. Measurement of an impairment loss for long-lived assets and identifiable intangibles that an entity expects to hold and use should be based on the fair value of the asset. The fair value of an asset is the amount at which that asset could be bought or sold in a current transaction between willing parties.

The Statement also requires that long-lived assets and certain identifiable intangibles to be disposed of be reported at the lower of carrying amount or fair value less cost to sell, except for assets covered by Accounting Principles Board (APB) Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions* (FASB, *Current Text*, vol. 1, sec. I13). Assets covered by APB Opinion No. 30 will continue to be reported at the lower of the carrying amount or the net realizable value.

Paragraph 16 of FASB Statement No. 121 states that assets to be disposed of that are within the scope of that Statement, such as other real estate owned, should "not be depreciated (amortized) while they are held for disposal."

The Statement is effective for financial statements for fiscal years beginning after December 15, 1995. (Earlier application is encouraged.) Restatement of previously issued financial statements is not permitted by the Statement. The Statement requires that impairment losses resulting from its application be reported in the period in which the recognition criteria are first applied and met. The Statement requires that initial application of its provisions to assets that are being held for disposal at the date of adoption should be reported as the cumulative effect of a change in accounting principle.

Auditors of finance companies should be aware that the current industry climate of diversification has increased the likelihood that events or changes in circumstances that indicate that assets have been

impaired may have occurred. For example, diversification by way of acquisition may result in duplication of branch office locations within certain geographic areas that would compete for business. In these instances, the carrying amounts of recorded assets may not be recoverable and the provisions of FASB Statement No. 121 may need to be applied.

In considering a finance company's implementation of FASB Statement No. 121, auditors should obtain an understanding of the policies and procedures used by management to determine whether all impaired assets have been properly identified. Management's estimates of future cash flows from asset use and impairment losses should be evaluated pursuant to the guidelines set forth in SAS No. 57.

Disclosures About Derivatives

In October 1994, the FASB issued Statement No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments* (FASB, *Current Text*, vol. 1, sec. F25). FASB Statement No. 119 requires disclosures about derivative financial instruments—futures, forward, swap, and option contracts, and other financial instruments with similar characteristics.

The Statement also amends existing requirements of FASB Statement No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk* (FASB, *Current Text*, vol. 1, sec. F25), and FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments* (FASB, *Current Text*, vol. 1, sec. F25). The Statement requires disclosures about 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. Paragraph 12 of FASB Statement No. 119 encourages, but does not require, entities to disclose quantitative information about risks associated with derivatives.

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

The FASB Special Report *Illustrations of Financial Instrument Disclosures* contains illustrations of the application of FASB Statements No. 105, No. 107, and No. 119.

Income Recognition on Impaired Loans

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), which amends FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan* (FASB, *Current Text*, vol. 1, sec. I08), 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 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.

Impairment of a Loan

In May 1993, FASB Statement No. 114 was issued to address the accounting by creditors for impairment of certain loans. A loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. 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 (for example, credit-card, residential mortgage, and consumer installment loans), 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, including groups of smaller balance homogeneous loans that may otherwise have been excluded from the scope of the Statement.

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 impairment is recognized by creating or adjusting a valuation allowance for the impaired loan with a corresponding charge to bad debt expense.

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 the contractual interest and contractual principal of all receivables in assessing the need for a loss accrual. The Statement also amends FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings* (FASB, *Current Text,* vol. 1, sec. D22), 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.

Offsetting

APB Opinion No. 10, *Omnibus Opinion-1966* (FASB, *Current Text,* vol. 1, sec. B10), paragraph 7, says that "it is a general principle of accounting that the offsetting of assets and liabilities in the balance sheet is improper except where a right of setoff exists." FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts* (FASB, *Current Text,* vol. 1, sec. B10), defines *right of setoff* and specifies what conditions must be met to permit offsetting. FASB Interpretation No. 41, *Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements* (FASB, *Current Text,* vol. 1, sec. B10), modifies FASB Interpretation No. 39 (FASB, *Current Text,* vol. 1, sec. B10), to permit offsetting in the statement of financial position of payables and receivables that represent repurchase agreements and reverse repurchase agreements and that meet all of the conditions specified in FASB Interpretation No. 41. FASB Interpretation No. 41 was effective for financial statements issued for periods ending after December 15, 1994.

Consensus Decisions of the FASB's EITF

The EITF frequently discusses accounting issues involving financial instruments, real estate, or transactions of similar importance to finance companies. A description of issues discussed during the year follows; readers should consult detailed minutes for additional information.

- EITF Issue No. 95-5, *Determination of What Risks and Rewards, If Any, Can Be Retained and Whether Any Unresolved Contingencies May Exist in a Sale of Mortgage Loan Servicing Rights,* addresses certain issues related to sales of mortgage loan servicing rights.

- EITF Issue No. 95-3, *Recognition of Liabilities in Connection with a Purchase Business Combination,* addresses what types of direct, integration, or exit costs to accrue as liabilities in a purchase business combination and when to recognize those costs.
- EITF Issue No. 95-2, *Determination of What Constitutes a Firm Commitment for Foreign Currency Transactions Not Involving a Third Party,* addresses what constitutes a significant economic penalty to a consolidated entity under EITF Issue No. 91-1, *Hedging Intercompany Foreign Currency Risks.*
- EITF Issue No. 94-9, *Determining a Normal Servicing Fee Rate for the Sale of an SBA Loan,* discusses how, when applying EITF Issue No. 88-11, *Allocation of Recorded Investment When a Loan or Part of a Loan Is Sold,* addresses how an enterprise should determine a normal servicing fee rate for United States Small Business Administration loans without a major secondary market maker. A secondary issue is how to account for a change in the normal servicing fee rate.
- 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 No. 89-5,* involves issues associated with sales recognition on a transfer of mortgage servicing rights.

Appendix D to the *EITF Abstracts* contains EITF discussions of technical matters that have long-term relevance and do not relate specifically to a numbered EITF Issue. Readers should be alert to the following topics of recent discussion:

- Appendix D-45, *Implementation of FASB Statement No. 121 for Assets to Be Disposed Of,* contains FASB staff views on issues relating to implementation of FASB Statement No. 121.
- Appendix D-44, *Recognition of Other-Than-Temporary Impairment upon the Planned Sale of a Security Whose Cost Exceeds Fair Value,* contains a FASB staff announcement concerning implementation of FASB Statement No. 115.
- Appendix D-43, *Assurance That a Right of Setoff is Enforceable in a Bankruptcy under FASB Interpretation No. 39,* contains FASB staff views on that subject.

Readers should consult the minutes for the following issues to understand the effect of issuance of FASB Statement No. 122 on related consensuses.

- EITF Issue No. 88-11, *Allocation of Recorded Investment When a Loan or Part of a Loan Is Sold*

- EITF Issue No. 86-39, *Gains from the Sale of Mortgage Loans with Servicing Rights Retained*
- EITF Issue No. 86-38, *Implications of Mortgage Prepayments on Amortization of Servicing Rights*

Readers should consult the minutes for the following issues to understand the effect of issuance of FASB Statement No. 121 on related consensuses.

- EITF Issue No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)*
- EITF Issue No. 90-16, *Accounting for Discontinued Operations Subsequently Retained*
- EITF Issue No. 90-6, *Accounting for Certain Events Not Addressed in Issue No. 87-11 Relating to an Acquired Operating Unit to Be Sold*
- EITF Issue No. 87-11, *Allocation of Purchase Price to Assets to Be Sold*
- EITF Issue No. 84-28, *Impairment of Long-Lived Assets*

Risks and Uncertainties

In December 1994, the AICPA's Accounting Standards Executive Committee issued Statement of Position (SOP) 94-6, *Disclosure of Certain Significant Risks and Uncertainties.* SOP 94-6 requires that finance companies include in their financial statements disclosures about (1) the nature of their operations and (2) the use of estimates in the preparation of financial statements. In addition, if specified criteria are met, SOP 94-6 requires financial statement disclosures about (1) certain significant estimates and (2) current vulnerability due to certain concentrations.

Paragraph 18 of SOP 94-6 gives examples of items that may be based on estimates that are particularly sensitive to change in the near term. Besides valuation allowances for business and real estate loans, examples of similar estimates that may be included in financial statements of finance companies include, but are not limited to, the following:

- Impairment of long-lived assets, for example, marginal branch offices.
- Estimates involving assumed prepayments, for example, discounts or premiums on financial assets (such as securities or loans), mortgage servicing rights and excess servicing receivables, and mortgage-related derivatives.

- Lives of goodwill and identifiable intangible assets.

Examples of concentrations that may meet the criteria that require disclosure in the financial statements of finance companies in accordance with paragraph 21 of the SOP include the following:

- Sale of a substantial portion of or all receivables or loan products to a single customer.
- Concentration of sales of loans to a third party.
- Concentration of revenue from mortgage banking activities.

The provisions of SOP 94-6 are effective for financial statements issued for fiscal years ending after December 15, 1995, and for financial statements for interim periods in fiscal years subsequent to the year for which SOP 94-6 is first applied.

Auditors should be alert to the requirements of the new SOP and its impact on the financial statements they audit. Auditors should carefully consider whether all significant estimates and concentrations have been identified and considered for disclosure.

Restructuring Charges

Entities offering financial services have seen an increased rate of mergers and acquisitions given the current industry trend toward diversification. These entities may be seeking access to new markets through acquisition or concentrating on their core business by divesting themselves of unrelated divisions. Greater cost efficiencies and economies of scale are being sought through such vertical and horizontal integrations. Restructuring often accompanies these activities as redundant functions are eliminated and existing areas streamlined. When finance companies implement restructuring programs, auditors should consider the impact of reductions in personnel on operations and on the entity's and internal control structure, the appropriateness and completeness of recorded liabilities relating to current restructuring plans, and the appropriate period for reporting the costs associated with restructurings.

In considering restructuring liabilities and costs, auditors should be aware of EITF Issue No. 94-3 that provides authoritative guidance on the appropriate accounting for restructurings. EITF Issue No. 94-3 also provides guidance on (1) the types of costs that should be accrued, (2) the timing of recognition of restructuring charges, and (3) prescribing disclosures that should be included in the financial statements.

For publicly held entities, Securities and Exchange Commission Staff Accounting Bulletin No. 67 (Topic 5P), *Income Statement Presentation of*

Restructuring Charges, requires that restructuring charges be reported as a component of income from continuing operations.

AICPA Audit and Accounting Literature

Audit and Accounting Guide

The AICPA Audit and Accounting Guide *Audits of Finance 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.

Information Sources

Further information on matters addressed in this risk alert is available through various publications and services listed in the table at the end of this document. Many non-government and some government publications and services involve a charge or membership requirement.

Fax services allow users to follow voice cues and request that selected documents be sent by fax machine. Some fax services require the user to call from the handset of the fax machine, others allow users to call from any phone. Most fax services offer an index document, which lists titles and other information describing available documents.

Electronic bulletin board services allow users to read, copy, and exchange information electronically. Most are available using a modem and standard communications software. Some bulletin board services are also available using one or more Internet protocols.

Recorded announcements allow users to listen to announcements about a variety of recent or scheduled actions or meetings.

All phone numbers listed are voice lines, unless otherwise designated as fax (f) or data (d) lines. Required modem speeds, expressed in bauds per second (bps), are listed data lines.

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This Audit Risk Alert supersedes *Finance Companies Industry Developments—1994.*

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Practitioners should also be aware of the economic, regulatory, and professional developments in *Audit Risk Alert—1995/96* and *Compilation and Review Alert—1995/96*, which may be obtained by calling the AICPA Order Department and asking for product no. 022180 (audit) or 060669 (compilation and review).

Information Sources

Organization	General Information	Fax Services	Electronic Bulletin Board Services	Recorded Announcements
American Institute of Certified Public Accountants (AICPA)	*Order Department* Harborside Financial Center 201 Plaza Three Jersey City, NJ 07311-3881 (800) TO-AICPA or (800) 862-4272 Information about AICPA continuing professional education programs is available through the AICPA CPE Division (ext. 3) and the AICPA Meetings and Travel Division: (201) 938-3232.	*24 Hour Fax Hotline* (201) 938-3787	*Accountants Forum* This information service is available on CompuServe. Some information is available only to AICPA members. To set up a CompuServe account call (800) 524-3388 and ask for the AICPA package or rep. 748.	
Financial Accounting Standards Board (FASB)	*Order Department* P.O. Box 5116 Norwalk, CT 06856-5116 (203) 847-0700, ext. 10			*Action Alert Telephone Line* (203) 847-0700 (ext. 444)
U.S. Securities and Exchange Commission (SEC)	*Publications Unit* 450 Fifth Street, NW Washington, DC 20549-0001 (202) 942-4046 *SEC Public Reference Room* (202) 942-8079	*Information Line* (202) 942-8088, ext. 3 (202) 942-7114 (tty)		
Mortgage Bankers Association of America	1125 15th Street, NW Washington, DC 20005-2766 *Publications Department* (800) 793-MBAA			
Federal Home Loan Mortgage Corporation	8200 Jones Branch Drive McLean, VA 22102-3107 *General Information* (800) FREDDIE			

American Financial Services Association (AFSA)	919 18th Street NW Washington, DC 20006 *General Information* (800) 843-3280			
Commercial Finance Association (CFA)	225 W. 34th Street New York, NY 10122 *General Information* (212) 594-3490			