2001

AICPA Audit and accounting guide: Depository and lending institutions: Banks and savings institutions, credit unions, finance companies and mortgage companies;Depository and lending institutions: Banks and savings institutions, credit unions, finance companies and mortgage companies;Certain Financial Institutions and Entities That Lend to or Finance the Activities of Others; Exposure draft (American Institute of Certified Public Accountants), 2001

American Institute of Certified Public Accountants. Financial Institution Guide Combination Task Force

AICPA Audit and Accounting Guide

Depository and Lending Institutions: Banks and Savings Institutions, Credit Unions, Finance Companies and Mortgage Companies

Prepared by the Financial Institution Guide Combination Task Force

PREFACE

Preface

P-1. This American Institute of Certified Public Accountants (AICPA) Audit and Accounting Guide has been prepared to assist financial institutions in preparing financial statements in conformity with generally accepted accounting principles (GAAP) and to assist independent accountants in reporting on financial statements (and, as discussed in appendix B, other written management assertions) of those entities.

P-2. Chapters of the Guide are generally organized by financial statement line item into four sections:

a. An *Introduction* that describes the general transactions and risks associated with the audit area. (The introduction does not address all possible transactions in each area.)

b. *Regulatory Matters* that may be of relevance in the audit of financial statements. Other regulatory matters may exist that require attention in the audit of financial statements following the general guidance on regulatory matters discussed in chapter 5. Further, the Guide does not address regulations that are not relevant to the audit of financial statements and certain of the regulatory requirements discussed may not be applicable to uninsured institutions.

c. *Accounting and Financial Reporting* guidance that addresses accounting and financial reporting issues (Statement on Auditing Standards [SAS] No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles *in the Independent Auditor's Report* [AICPA, *Professional Standards*, vol. 1, AU sec. 411], establishes the hierarchy of GAAP).[1]

d. *Auditing* guidance that includes objectives, planning, internal control over financial reporting and possible tests of controls, and substantive tests.

Applicability

SCOPE

P-3. Statement of Position (SOP) 01-6, *Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others,* reconciles and conforms, as appropriate, the accounting and financial reporting provisions established by the AICPA Audit and Accounting Guides *Banks and Savings Institutions* (BSI Guide), *Audits of Credit Unions* (CU Guide), and *Audits of Finance Companies* (FC Guide)

P-4. Consistent with the scope of SOP 01-6, this Guide applies to all banks, savings institutions, credit unions, finance companies, and other entities (including entities with trade receivables) subject to the May

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[1] Footnote 3 to SAS No. 69 states, in part, that, for Securities and Exchange Commission (SEC) registrants, rules and releases of the SEC have an authority similar to other officially established accounting principles. For example, Article 9 of Regulation S-X specifies the form and content of and requirements for financial statements filed with the SEC by bank holding companies. Similarly, bank holding companies disclose supplemental statistical disclosures in filings following the guidance of Industry Guide 3, *Statistical Disclosures by Bank Holding Companies*. SEC Staff Accounting Bulletin (SAB) No. 69, *Application of Article 9,* includes the SEC staff view that Article 9 and Industry Guide 3, "while applying literally only to bank holding companies, provide useful guidance to certain other SEC registrants, including savings and loan holding companies, on certain disclosures relevant to an understanding of the registrant's operations." Those rules and interpretive releases, including SEC SABs, are not presented in the Guide; however, readers should consult the applicable requirements as necessary.

1, 2000 AICPA Auditing and Accounting Guides: BSI Guide, CU Guide, and FC Guide, respectively. That population includes the following:

- *a*. Finance companies, including finance company subsidiaries
- *b*. Entities that do not consider themselves to be finance companies that engage in transactions that involve lending to or financing the activities of others (including trade receivables and independent and captive financing activities of all kinds of entities [2])
- *c*. Depository institutions insured by the Federal Deposit Insurance Corporation's (FDIC's) Bank Insurance Fund (BIF) or Savings Association Insurance Fund (SAIF), or the National Credit Union Administration's (NCUA's) National Credit Union Share Insurance Fund (NCUSIF)
- *d*. Bank holding companies
- *e*. Savings and loan association holding companies
- *f*. Branches and agencies of foreign banks regulated by U.S. federal banking regulatory agencies
- *g*. State-chartered banks, credit unions, and savings institutions that are not federally insured
- *h*. Foreign financial institutions whose financial statements are purported to be prepared in conformity with accounting principles generally accepted in the United States
- *i*. Mortgage companies
- *j*. Entities that do not consider themselves to be mortgage companies that engage in transactions that involve mortgage activities or transactions
- *k*. Corporate credit unions
- *l*. Financing and lending activities of insurance companies

P-5. Consistent with the scope of SOP 01-6, this Guide does not apply to the following:

- *a*. Investment companies, broker-dealers in securities, employee benefit plans and similar entities that carry loans and trade receivables at fair value with the unrealized gains and losses included in earnings
- *b*. Governmental or federal entities that follow the principles of the Governmental Accounting Standards Board (GASB) or the Federal Accounting Standards Advisory Board (FASAB)
- *c*. Financing and lending transactions that are subject to category (*a*) of generally accepted accounting principles (GAAP) in the hierarchy established by AICPA Statement on Auditing Standards (SAS) No. 69, *The Meaning of* "Present Fairly in Conformity with Generally Accepted Accounting Principles" *in the Independent Auditor's Report* if the category (*a*) guidance differs from the guidance in SOP 01-6

P-6. As used in this Guide, the term "depository institutions" means banks, credit unions, and savings institutions. The terms "financial institutions" or "institutions" refer to all entities covered by this Guide. The table at the end of this Preface shows how individual chapters apply to the entities covered by this Guide.

P-7. As stated above, this Guide applies to the financing activities of all kinds of enterprises. Certain entities may have financing activities but are not otherwise covered by this Guide – for example, the financing subsidiary, unit, or division of a manufacturing company or retailer. Only those sections and

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[2] The term *enterprises* is used in practice as business enterprises organized for profit. To the extent that a not-for-profit organization, as defined in appendix D of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 116, *Accounting for Contributions Received and Contributions Made*, conducts activities in the scope of paragraph 3, provisions of SOP 01-6 should be applied. The AICPA Industry Audit Guide *Not For Profit Organizations* provides such guidance in Appendix D, paragraph 1.27 as follows: "However, some not-for-profit organizations conduct activities in some of those industries and should apply the guidance concerning recognition and measurement of assets, liabilities, revenues, expenses, gains and losses in those pronouncements to the transactions unique to those industries."

chapters of this Guide related to financing activities are intended to apply to such entities. The remaining portions are not intended to apply to such entities, but may otherwise be useful to auditors.

P-8. Certain terms are used interchangeably throughout the Guide as follows:

- Credit unions often refer to **shares, dividends on shares, and members**, which are equivalent to **deposits, interest on deposits, and customers** for banks and savings institutions.
- Finance companies often refer to **finance receivables**, which are equivalent to **loans** or **loans receivable** for other entities. A **credit officer** of a finance company is the same as a **loan officer.**
- A **supervisory committee** of a credit union is the functional equivalent of an **audit committee** of other entities.

Limitations

P-9. The Guide is intended to highlight significant matters and establish general guidance. It is not intended to provide comprehensive discussion of all possible matters of significance in an audit of financial statements or all audit situations that an independent accountant might encounter in an audit of the financial statements of a financial institution.

P-10. Consulting the accounting and financial reporting and auditing sections of the Guide cannot take the place of a careful reading of specified authoritative literature. Other professional literature and authoritative guidance that may be issued by the Accounting Standards Executive Committee (AcSEC), the Financial Accounting Standards Board (FASB), including its Emerging Issues Task Force (EITF), or the Auditing Standards Board (ASB) may affect audits of the financial statements of financial institutions. Further, the nature, timing, and extent of audit procedures applied in a financial statement audit is ultimately determined by the independent accountant in the circumstances. The procedures discussed in the auditing section of the Guide are not intended to be comprehensive and, performed by themselves, would not necessarily constitute an audit in accordance with generally accepted auditing standards (GAAS). Nor would omission of certain procedures set forth in the Guide necessarily result in a violation of GAAS. Internal control over financial reporting and possible tests of controls are discussed in the context of a financial statement audit. While they may correspond to internal controls that are the subject of procedures performed in an engagement performed in accordance with SSAEs, internal control over financial reporting and possible tests of controls are not presented in that context and are not intended to address the considerations of such an engagement.

Impact on Other Literature

P-11. This Guide supersedes the AICPA Audit and Accounting Guides *Banks and Savings Institutions*, *Audits of Credit Unions*, and *Audits of Finance Companies.* Appendix B provides guidance on certain engagements performed by independent accountants in accordance with SSAEs that might also be requested by financial institutions.

Effective Date and Transition

P-12. For accounting and financial reporting provisions of this Guide that describe other authoritative literature, effective dates should be applied as provided for in the related literature. All other accounting and financial reporting provisions of the Guide, including disclosures about regulatory matters, shall be effective for financial statements issued for fiscal years beginning after **December 15, 2001**, and for interim financial statements issued after initial application. Earlier application of the accounting, financial reporting, and auditing provisions of this Guide is permitted but not required.

P-13. The following table shows how each chapter applies to entities covered by the Guide. Chapters 6-23 relate to typical financial statement line items and specific activities. These chapters or sections thereof, would apply to an entity only to the extent it engages in such activities.

Chapter	**Description**	**Banks & Savings Institutions**	**Credit Unions**	**Finance Companies**	**Mortgage Companies**
1	Industry Overview—Banks and Savings Institutions	X			
2	Industry Overview—Credit Unions		X		
3	Industry Overview—Finance Companies			X	
4	Industry Overview—Mortgage Companies				X
5	Audit Planning Considerations	X	X	X	X
	Regulation and Supervision of Depository Institutions	X	X		
6	Cash and Cash Equivalents	X	X	X	X
7	Investments in Debt and Equity Securities	X	X	X	X
8	Loans	X	X	X	X
9	Credit Losses	X	X	X	X
10	Transfers of Loans and Mortgage Banking Activities	X	X	X	X
11	Real Estate Investments, Real Estate Owned, and Other Foreclosed Assets	X	X	X	X
12	Other Assets, Other Investments, and Other Liabilities	X	X	X	X
13	Deposits	X	X		
14	Federal Funds and Repurchase Agreements	X	X	X	X
15	Debt	X	X	X	X
16	Income Taxes	X	(1)	X	X
17	Equity and Disclosures About Regulatory Capital Matters	X	X		X
18	Derivatives: Futures, Forwards, Options, Swaps, and Similar Financial Instruments	X	X	X	X
19	Business Combinations	X	X	X	X
20	Trust Services and Activities	X	(2)		
21	Insurance Activities	X	(2)	X	X
22	Reports on Audited Financial Statements	X	X	X	X
23	Illustrative Financial Statements				
	Banks and Savings Institutions	X			
	Credit Unions		X		
	Finance Companies			X	
	Mortgage Companies				X
App. A	Background Information and Basis for Conclusions	X	X	X	X
App. B	FDI Act Reporting Requirements	X			
App. C	Regulatory Accounting Principles (RAP) and RAP/GAAP Differences	X	X		
App. D	Information Sources	X	X	X	X

(1) Federal credit unions are exempt from federal and state income tax. State chartered credit unions are also exempt from federal income tax, but may be subject to state income tax.

(2) Federal credit unions are not permitted to engage directly in trust service or insurance activities. However, these activities may be permissible for some state-chartered credit unions or credit union service organizations (CUSO).

CHAPTER 1

Industry Overview – Banks and Savings Institutions

DESCRIPTION OF BUSINESS

1.01 Banks and savings institutions provide a link between entities that have capital and entities that need capital. They accept deposits from entities with idle funds and lend to entities with investment or spending needs. This process of financial intermediation benefits the economy by increasing the supply of money available for investment and spending. It also provides an efficient means for payment and transfer of funds between entities.

1.02 Government, at both the federal and state levels, has long recognized the importance of financial intermediation by offering banks and savings institutions special privileges and protections. These incentives—such as credit through the Federal Reserve System and federal insurance of deposits—have not been similarly extended to commercial enterprises. Accordingly, the benefits and responsibilities associated with their public role as financial intermediaries have brought banks and savings institutions under significant governmental oversight. Federal and state regulations affect every aspect of banks and savings institutions' operations. Similarly, legislative and regulatory developments in the last decade have radically changed the business environment for banks and savings institutions.

1.03 Although banks and savings institutions continue in their traditional role as financial intermediaries, the ways in which they carry out that role have become increasingly complex. Under continuing pressure to operate profitably, the industry has adopted innovative approaches to carrying out the basic process of gathering and lending funds. Management of complex assets and liabilities, searches for additional sources of income, reactions to technological advances, responses to changes in regulatory policy, and competition for deposits have all added to the risks and complexities of the business of banking. These include the following:

- Techniques for managing assets and liabilities that allow institutions to manage financial risks and maximize income have continued to evolve.
- Income, traditionally derived from the excess of interest collected from borrowers over interest paid to depositors, has become increasingly dependent on fees and other income streams from specialized transactions and services.
- Technological advances have accommodated increasingly complex transactions, such as the sale of securities backed by cash flows from other financial assets.
- Regulatory policy has alternately fostered or restricted innovation as, for example, institutions look for new transactions to accommodate changes in the amount of funds they must keep in reserve or to achieve the levels of capital that they must maintain in relation to their assets.

1.04 Increased competition has come from within the industry, but also from nontraditional players such as investment companies, brokers and dealers in securities, insurers, and financial subsidiaries of commercial enterprises. These entities now do business directly with potential depositors and borrowers in transactions traditionally executed through banks and savings institutions. This disintermediation has increased the need for innovative approaches to attracting depositors and borrowers.

1.05 Credit-card operations are an example of a banking activity that reflects the innovations and complexities of today's banks and savings institutions industry. Basically another means of lending, credit-card operations provide additional income through interest charges and related fees. Technological advances have made it possible to trade assets backed by cardholders' outstanding balances. Sales of such securities can be helpful in the institution's management of its other assets and liabilities, as well as in the maintenance of regulatory capital levels. At the same time, competition from credit-card operations outside the banks and savings institutions industry creates pressure for further innovation.

1.06 The innovation and complexity that result from the industry's pursuit of profitable activities create a constantly changing body of business and economic risks. These risk factors, and related considerations for independent accountants, are identified and discussed throughout this Guide.

REGULATION AND OVERSIGHT

1.07 As discussed above, the importance of financial intermediation has driven governments to play a role in the banks and savings institutions industry from its beginning. Banks and savings institutions have been given unique privileges and protections, including federal insurance of their deposits by the Federal Deposit Insurance Corporation (FDIC) and access to the Federal Reserve System's discount window and payments system. Federal oversight of institutions receiving these privileges falls currently to four agencies (collectively, the agencies):

- *a.* The Board of Governors of the Federal Reserve System (FRB), established in 1913 as the central bank of the United States with supervisory responsibilities for bank holding companies, state chartered banks that are members of the Federal Reserve System and foreign banking organizations operating in the United States
- *b.* The FDIC, established in 1934 to restore confidence in the banking system through federal insurance of deposits with supervisory responsibilities for state chartered banks that are not members of the Federal Reserve System
- *c.* The Office of the Comptroller of the Currency (OCC), created in 1863 to regulate and provide federal charters for national banks
- *d.* The Office of Thrift Supervision (OTS), which replaced the Federal Home Loan Bank Board in 1989 as the primary regulator for savings institutions

1.08 The FRB and FDIC are independent agencies of the federal government. The OCC and OTS are separate bureaus of the U.S. Department of the Treasury. Separate banking agencies also exist in most states and other jurisdictions of the United States.

1.09 Although each agency has its own jurisdiction and authority, the collective regulatory and supervisory responsibilities of federal and state banking agencies include—

- Setting out (either directly or as a result of legislative mandate) the rules and regulations that govern institutions' operations.
- Supervising institutions' operations and activities.
- Reviewing and approving organization, conversion, consolidation, merger, or other changes in control of institutions and their branches.
- Appraising (in part through on-site examinations) institutions' financial condition, soundness of operations, quality of management, and compliance with laws and regulations.

1.10 Given the nature of their duties, the banking agencies also play a major role in the development of banks and savings institutions' accounting and reporting practices. For example, the agencies also have certain authority over the activities of independent accountants serving the industry. Further, the federal banking agencies and the National Credit Union Administration constitute the Federal Financial Institutions Examination Council (FFIEC). The FFIEC sets forth uniform examination and supervisory guidelines in certain areas related to banks and savings institutions activities, including those involving regulatory accounting and financial reporting.

1.11 Chapter 5 discusses the current regulatory approach to supervision of banks and savings institutions and provides an overview of major areas of regulation and related regulatory reporting. Legislative efforts over time to regulate, deregulate, and reregulate banks and savings institutions are also addressed in chapter 5. Other specific regulatory considerations are identified throughout this Guide in the relevant chapters.

1.12 In addition to supervision and regulation by the federal and state banking agencies, publicly held holding companies are generally subject to requirements of federal securities laws, including the Securities Act of 1933 and the Securities Exchange Act of 1934 (Exchange Act). Holding companies whose securities are registered under the Exchange Act must comply with its reporting requirements through periodic filings with the Securities and Exchange Commission (SEC). Publicly held institutions that are not part of a holding company are required under section 12(i) of the Exchange Act to make equivalent filings directly with their primary federal regulators. Each of the agencies has regulations that provide for the adoption of forms, disclosure rules, and other registration requirements equivalent to those of the SEC as mandated by the Exchange Act. (See footnote 1 in the Preface.)

1.13 Both the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) and the Federal Deposit Insurance Corporation (FDIC) Improvement Act of 1991 (FDICIA) were geared toward protection of federal deposit insurance funds through early detection of and intervention in problem institutions, with an emphasis on capital adequacy.

1.14 Declining real estate markets in the mid-1980s contributed heavily to widespread losses in the savings institutions industry, evidenced by insolvency of the savings industry's federal deposit insurance fund. FIRREA provided funds for resolution of thrift institutions, replaced the existing regulatory structure, introduced increased regulatory capital requirements, established limitations on certain investments and activities, and enhanced regulators' enforcement authority. FIRREA redefined responsibilities for federal deposit insurance by designating the separate insurance funds, the Bank Insurance Fund (BIF) and Savings Associations Insurance Fund, (SAIF) respectively. FIRREA also established the Resolution Trust Corporation (RTC) to dispose of the assets of failed thrifts.

1.15 As the 1980s came to a close, record numbers of bank failures began to drain the BIF. FDICIA provided additional funding for the BIF but also emphasized least-cost resolution of institutions and improved supervision and examinations. FDICIA also focused the regulatory enforcement mechanism on capital adequacy. Many of FDICIA's provisions were amendments or additions to the FDI Act.

1.16 In 1995, BIF reached its statutorily mandated ratio of insurance funds to insured deposits of 1.25 percent. The Savings Association Insurance Fund (SAIF) was capitalized at a 1.25 percent ratio of insurance funds to insured deposits after passage of the Deposit Insurance Funds Act of 1996.

1.17 A desire to allow banks to serve a broad spectrum of customer financial needs caused Congress to pass new legislation in 1999. The Gramm-Leach-Bliley Act (aka “The Financial Services Modernization Act”) has changed the types of activities that are permissible for bank holding company affiliates and for subsidiaries of banks. The bill created so-called “financial holding companies” that may engage in a broad array of activities. Financial holding company affiliates may now provide insurance as principal, agent, or broker and issue annuities. These affiliates, as well as direct subsidiaries of banks, may now engage in underwriting, dealing in, or making a market in securities. The legislation affirmed the concept of functional regulation. Federal banking regulators will continue to be primary supervisors of the banking affiliates of financial holding companies, but state insurance authorities will supervise the insurance companies, and the Securities and Exchange Commission and securities self-regulatory organizations will supervise the securities business. Each functional regulator will determine appropriate capital standards for the company it supervises. The Treasury and the Federal Reserve Board have the authority to approve additional activities to be permissible for financial holding companies. This authority includes consideration of merchant banking, but financial holding companies are subject to a 5-year moratorium on this activity.

1.18 Key economic issues affecting regulations are centered on the ability of financial institutions to operate profitably—for example, the costs and benefits of regulations, effects of unemployment and future corporate layoff plans, levels of interest rates, and the availability of credit.

1.19 Racial and ethnic disparities in residential lending and the extent of institutions' environmental liability are two of many social issues receiving continuing focus in federal regulation.

REGULATORY CAPITAL MATTERS

1.20 Capital is the primary tool used by regulators to monitor the financial health of insured financial institutions. Regulatory intervention is focused primarily on an institution's capital levels relative to regulatory standards. The agencies have a uniform framework for prompt corrective action, as well as specific capital adequacy guidelines set forth by each agency.[1]

1.21 In addition to assessing financial statement disclosures which are discussed in Chapter 17, the independent accountant considers regulatory capital from the perspective that noncompliance or expected noncompliance with regulatory capital requirements may be a condition, when considered with other factors, that could indicate substantial doubt about an entity's ability to continue as a going concern. This discussion provides an overview to help independent accountants understand regulatory capital requirements. Capital regulations are complex and their application by management requires a thorough understanding of specific requirements and the potential impact of noncompliance. Accordingly, relevant regulations and regulatory guidance should be consulted by the independent accountant as necessary when considering regulatory capital matters.

Capital Adequacy

1.22 The FDIC, Office of the Comptroller of the Currency (OCC), and FRB have historically had common capital adequacy guidelines (which differ in some respects from those of the Office of Thrift Supervision [OTS]) involving minimum (*a*) leverage capital and (*b*) risk-based capital requirements.[2] A summary of the general requirements follows. Specific requirements are set forth in 12 CFR and in instructions for FFIEC Consolidated Reports of Condition and Income and OTS Thrift Financial Reports (collectively, *call reports*). Call reports, which are required to be filed quarterly, contain certain financial information, including that used in calculating regulatory capital amounts.

1.23 The first requirement establishes a minimum ratio of capital as a percentage of total assets. The FDIC, OCC, and FRB require institutions to maintain a minimum leverage ratio of Tier I capital (as defined) to total average assets based on the institution's rating under the regulatory CAMELS rating

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[1] This chapter discusses federal capital requirements. Separate state requirements may exist that also should be considered for purposes of assessing the entity's ability to continue as a going concern.

[2] Savings institution holding companies are not subject to regulatory capital requirements separate from those of their subsidiaries. Bank holding companies do have capital requirements separate from those of their subsidiaries.

system. (The CAMELS rating derives its name from the various components of a depository institution that are rated: capital adequacy, asset quality, management, earnings, liquidity, and sensitivity to interest rates.) The minimum Tier 1 leverage ratio for institutions with CAMELS ratings of 1 is 3.0 percent. For all others the minimum ratio is 4.0 percent.

1.24 The second requirement also establishes a minimum ratio of capital as a percentage of total assets but gives weight to the relative risk of each asset, including off-balance-sheet positions. The FDIC, OCC, and FRB require institutions to maintain a minimum ratio of Tier I capital to risk-weighted assets of 4.0 percent. Banks must also maintain a minimum ratio of total capital to risk-weighted assets of 8.0 percent. Banks are expected to maintain capital above these minimum levels.

1.25 The OTS requires savings institutions with CAMELS rating of 1 to maintain a minimum core capital ratio (as defined) of 3.0 percent. For all other savings institutions, the minimum core (or leverage) capital ratio is 4.0 percent. The OTS also requires all savings institutions to maintain a tangible capital requirement of 1.5 percent of assets. For substantially all OTS-regulated institutions, there is no difference between core capital and tangible capital.

1.26 For savings associations, the OTS-required minimum total risk-based capital ratio (that is, the total of core and supplemental capital) is also 8.0 percent. Tier 2 capital may not exceed 100% of Tier 1 (leverage) capital.

1.27 Risk-based capital standards of the FDIC, OCC, and FRB explicitly identify concentrations of credit risk, risks of nontraditional activities, and interest-rate risk as qualitative factors to be considered in examiner assessments of an institution's overall capital adequacy; however, the standards require no specific quantitative measure of such risks.

1.28 The FDIC, OCC, and FRB have augmented their interest-rate risk requirements through a joint policy statement that explains how examiners will assess institutions' interest-rate risk exposure.[3] The policy statement also suggests that institutions with complex systems for measuring interest-rate risk may seek assurance about the institution's risk management process from external auditors.

1.29 The concept of Tier 3 capital was established when the FDIC, OCC, and FRB amended their respective risk-based capital standards to incorporate a measure for market risk. The effect of this rule is that any bank or bank holding company regulated by the federal banking agencies, with significant exposure to market risk, must measure that risk using its own internal value at risk model, and must hold a commensurate amount of capital. This requirement only applies to banks and bank holding companies whose trading activity on a worldwide consolidated basis equals 10 percent or more of total assets or $1 billion or more. Market risk rules may be applied to any insured state nonmember bank if the FDIC deems it necessary for safety and soundness practices.

1.30 Institutions are required to report certain financial information to regulators in quarterly call reports, which include amounts used in calculations of the institution's various regulatory capital amounts.

Prompt Corrective Action

1.31 FDICIA made capital an essential tool of regulators to monitor the financial health of insured banks and savings institutions. Regulatory intervention is now focused primarily on an institution's capital levels relative to regulatory standards. Through Section 38 of the FDI Act, FDICIA added (to the existing

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[3] *Federal Register* 61, no. 124 [26 June 1996]: 33166. The joint policy statement was transmitted by OCC Bulletin 96-36,FDIC Financial Institutions Letters [FILs] 52-96 and 54-96, and FRB Supervisory Letter (SR) 96-13.

capital adequacy guidelines set forth by each agency) a uniform framework for prompt corrective regulatory action. Holding companies are not subject to the prompt corrective action provisions.

1.32 Section 38 provides for supervisory action at certain institutions based on their capital levels. Each institution falls into one of five regulatory capital categories based primarily on three capital measures: Tier I leverage; total risk-based; and Tier I risk-based capital. These capital ratios are defined in the same manner for Section 38 purposes as under the respective agencies' capital adequacy guidelines and regulations. For savings institutions, Tier I leverage capital is comparable to core capital (as defined).

1.33 Regulations also specify a minimum requirement for tangible equity, which is defined as Tier I capital plus cumulative perpetual preferred stock, net of all intangibles except mortgage servicing assets (MSAs) to the extent that they can be included in Tier 1 capital. In calculating the tangible capital ratio, intangibles (except for qualifying MSAs) should also be deducted from total assets included in the ratio denominator.

1.34 An institution may be reclassified between certain capital categories if its condition or an activity is deemed by regulators to be *unsafe or unsound*. A change in an institution's capital category initiates certain mandatory—and possibly additional discretionary—action by regulators.

1.35 Under Section 38, an institution is considered—

a. *Well capitalized* if its capital level *significantly exceeds* the required minimum level for each relevant capital category.

b. *Adequately capitalized* if its capital level *meets* the minimum levels.

c. *Undercapitalized* if its capital level *fails to meet* the minimum levels.

d. *Significantly undercapitalized* if its capital level *is significantly below* the minimum levels.

e. *Critically undercapitalized* if it has a ratio of tangible equity to total assets (as defined) of 2 percent or less, or otherwise fails to meet the critical capital level (as defined).

1.36 The minimum levels are defined as follows:

Category	*Total Risk-based Ratio (%)*		*Tier I Risk-based Ratio (%)*		*Tier I Leverage Capital Ratio (%)*
Well capitalized	≥10	and	≥6	and	≥5
Adequately capitalized	≥8	and	≥4	and	≥4*
Undercapitalized	<8	or	<4	or	<4*
Significantly undercapitalized	<6	or	<3	or	<3

*3.0 percent for institutions with a rating of one under the regulatory CAMELS or related rating system that are not anticipating or experiencing significant growth and have well-diversified risk (as defined).

1.37 As noted above, critically undercapitalized institutions are those having a ratio of tangible equity to total assets of 2 percent or less.

1.38 An institution will not be considered well capitalized if it is under a capital-related cease-and-desist order, formal agreement, capital directive, or prompt corrective action capital directive.

1.39 Actions that may be taken under the prompt corrective action provisions range from the restriction or prohibition of certain activities to appointment of a receiver or conservator of the institution's net assets.

1.40 Regulators will also require undercapitalized institutions to submit a plan for restoring the institution to an acceptable capital category. For example, each undercapitalized institution is required to submit a plan that specifies—

- Steps the institution will take to become adequately capitalized.
- Targeted capital levels for each year of the plan.
- How the institution will comply with other restrictions or requirements put into effect.
- Types and levels of activities in which the institution will engage.

1.41 Noncompliance or expected noncompliance with regulatory capital requirements may be a condition, when considered with other factors, that could indicate substantial doubt about an entity's ability to continue as a going concern. The implementation of the prompt corrective action provisions warrants similar attention by independent accountants when considering an institution's ability to remain a going concern.

Regulatory Requirements for Independent Reporting Under FDI Act

1.42 The primary source of independent reporting requirements is Section 36 of the FDI Act, as added by the FDICIA. Section 36 establishes reporting requirements for reports by management and independent accountants. It also establishes minimum qualifications for independent accountants serving the affected institutions. The underlying provisions, as summarized below, apply to each FDIC-insured depository institution having total assets of $500 million or greater at the beginning of its fiscal year. Despite the asset threshold, Section 36 does not override any non-FDICIA requirements for audited financial statements or other requirements that an institution exempt from Section 36 must otherwise satisfy.[4]

1.43 Notwithstanding the FDI Act requirements, the FRB requires certain bank holding companies to submit audited financial statements (under authority of 12 CFR Subpart 225.5 [Regulation Y]). Also, the OTS may require audited financial statements from certain savings institutions or savings institutions holding companies in circumstances described in 12 CFR Subpart 562.4.

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[4] The banking agencies have adopted the FFIEC Interagency Policy Statement on External Auditing Programs of Banks and Savings Associations. For the FDIC, it replaces the FDIC's "Statement of Policy Regarding Independent External Auditing Programs of State Nonmember Banks" and is effective for fiscal years beginning on or after January 1, 2000. The other banking agencies have also adopted the interagency policy statement. The interagency policy statement encourages institutions to adopt an annual external auditing program and, where practicable, to establish an audit committee composed entirely of outside directors. The interagency policy statement states that the banking agencies consider an annual audit of an institution's financial statements performed by an independent public accountant to be the preferred type of external auditing program. The statement also describes two alternatives to a financial statement audit that an institution may elect to have performed annually in order to have an acceptable external auditing program.

1.44 To implement the FDICIA requirements, the FDIC issued both a final regulation and accompanying guidelines and interpretations (*guidelines*).[5] The general requirements are summarized below; the side-by-side analysis of the detailed regulation and guidelines presented in appendix D provides more specific information.

1.45 ***Annual Report***. Management is required to prepare, annually, a report that includes the following:[6]

- Financial statements prepared in conformity with generally accepted accounting principles (GAAP).
- A written assertion about the effectiveness at year-end of the institution's internal controls over financial reporting.
- A written assertion about the institution's compliance during the year with (*a*) federal laws and regulations relative to insider loans and (*b*) federal and state laws and regulations relative to dividend restrictions.

1.46 Management also must include a statement about its responsibilities for the financial statements, financial reporting controls, and compliance with laws and regulations. Management must engage an independent accountant to provide the following reports annually:

a. An audit report on financial statements prepared in conformity with GAAP

b. An examination-level attestation report on management's assertion about financial reporting controls

1.47 The financial statement audit is to be performed in accordance with generally accepted auditing standards (GAAS). The examination of management's assertion about financial reporting controls is to be performed in accordance with Statements on Standards for Attestation Engagements (SSAEs).

1.48 The audited financial statements and other reports of management and the independent accountant must be filed with the FDIC and other regulatory agencies within the ninety days following the institution's fiscal year-end. Management must also file any management letter, qualification, or other report within fifteen days following receipt from the independent accountant.

1.49 All of management's reports will be made publicly available. The independent accountant's report on the financial statements and attestation report on financial reporting controls will also be made publicly available. Any management letter, while filed with the FDIC and other agencies, will not be publicly available.

1.50 ***Qualifications of Independent Accountants***. Acceptance of an engagement to report under Section 36 for banks and savings institutions is conditioned on the independent accountant being enrolled in a practice-monitoring program. Membership in the AICPA Division for CPA Firms' SEC Practice Section or Private Companies Practice Section, or enrollment in the AICPA's Peer Review Program, will satisfy this requirement.

1.51 Another condition of the engagement is that the independent accountant agrees to provide regulators with access to working papers related to the two engagement reports. The implementing

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[5] The regulation and guidelines implementing Section 36 of the FDI Act (which have been reproduced in appendix D) are codified in 12 CFR Part 363. The regulation was published in the *Federal Register* on June 2, 1993, and in the FDIC's FIL 41-93. Subsequent changes to the regulation were published in the *Federal Register* on February 21, 1996 and November 1997.

[6] The reporting requirements may be satisfied for certain subsidiaries through reporting by their holding companies. These exemptions are discussed in 12 CFR Subpart 363.1 of the rule and in guidelines 2 through 4 therein.

guidelines also call for providing copies of working papers to regulators, although this requirement is not explicit in the law or regulation. Independent accountants should be familiar with Auditing Interpretation No. 1 of SAS No. 41, *Working Papers*, entitled "Providing Access to or Photocopies of Working Papers to a Regulator" (AICPA, *Professional Standards*, vol. 1, AU sec. 9339).

1.52 The accountant must meet the independence requirements and interpretations of the Securities and Exchange Commission (SEC) and its staff.

1.53 The implementing regulation requires both management and independent accountants to provide certain notifications of changes in an institution's independent accountants within specified time periods. Independent accountants must also file peer review reports within fifteen days of acceptance of the report.

1.54 ***Enforcement Actions Against Accountants***. Section 36 of the FDI Act also provides for enforcement actions against accountants with respect to the Section 36 requirements. However, the FDIC has not yet proposed or published rules or guidelines to implement this statutory requirement.[7]

1.55 ***Communication With Independent Accountants***. As described in paragraph , each institution must provide its independent accountant with copies of the institution's most recent reports of condition and examination; any supervisory memorandum of understanding or written agreement with any federal or state regulatory agency; and a report of any action initiated or taken by federal or state banking regulators.

Other Reporting Considerations

1.56 Banks and savings institutions often engage independent accountants to perform assurance services other than those required by Section 36 of the FDI Act. Such engagements may relate to the following:

- Student Loans – Lenders participating in the Federal Family Education Loan Program may be required to engage an independent accountant to examine and report on management's assertions regarding compliance with certain U.S. Department of Education requirements. This examination is performed in accordance with (1) *Government Auditing Standards* issued by the Comptroller General of the United States, (2) Statement on Standards for Attestation Engagements (SSAE) No. 3, *Compliance Attestation*, and (3) the Audit Guide, *Compliance Audits (Attestation Engagements) for Lenders and Lender Servicers Participating in the Federal Family Education Loan Program*, issued by the U.S. Department of Education. This examination requirement applies to lenders with origination levels exceeding a specified dollar amount.
- Federal Home Loan Bank Borrowings – Banks or savings institutions that are members of the Federal Home Loan Bank system may borrow from their respective district Federal Home Loan Bank. Borrowings are generally secured by the pledging of assets: often in the form in a blanket lien. The district banks maintain separate and distinct credit policies that have varying requirements as to a member bank's engagement of independent accountants to render assurance services relating to the adequacy of collateral maintenance levels. It is incumbent on the independent accountant to ascertain the professional standards that may be applicable to the requested services. The engagement generally takes the form of (1) an agreed-upon procedures engagement performed in accordance with SAS No. 75, *Agreements to Apply Agreed-Upon*

[7] Section 36(g)(4) of the FDI Act states that the FDIC or the appropriate agency may "remove, suspend, or bar an independent public accountant, upon a showing of good cause, from performing audit services" required by Section 36. The agencies are still addressing how to implement this provision.

Procedures to Specified Elements, Accounts, or Items of a Financial Statement, or SSAE No. 4, *Agreed-Upon Procedures Engagements,* or (2) an audit engagement performed in accordance with SAS No. 62, *Special Reports*.

- Loan Servicing – Lenders who service mortgage loans for others may be required to engage an independent accountant to examine management's assertions about compliance with minimum servicing standards set forth in the Uniform Single Attestation Program for Mortgage Bankers. This examination is performed in accordance with SSAE No. 3, *Compliance Attestation*, as further described in paragraphs 4.25 and 4.26.
- HUD Programs- To the extent that a bank or savings institution originates or services HUD loans through a subsidiary that is designated a "non-supervised mortgagee," compliance with the Consolidated Audit Guide for Audits of HUD Programs is required, as further described in paragraphs 4.20 and 4.24.

CHAPTER 2

Industry Overview – Credit Unions

DESCRIPTION OF BUSINESS

2.01 The first credit union in the United States was organized in 1909. Although credit unions were originally organized within communities, greater success was achieved by organizing credit unions to serve employee groups—particularly government employees, teachers, railway workers, and telephone company employees.

2.02 In 1934 Congress passed the Federal Credit Union Act (FCUA), establishing a federal regulatory system. In 1970 the National Credit Union Administration (NCUA), an independent governmental agency, was created by Congress to charter, supervise, and regulate federal credit unions. Other legislative initiatives that have affected credit unions include the following:

- the creation of the National Credit Union Share Insurance Fund (NCUSIF) within the NCUA to insure savings up to applicable limits in all federal credit unions and many state-chartered credit unions
- Depository Institution Deregulation and Monetary Control Act of 1980
- Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA).
- Credit Union Membership Access Act of 1998
- Gramm-Leach-Bliley Act of 1999

2.03 Each credit union is organized around a defined *field of membership*, and each member shares a *common bond* of affiliation with other members. The field of membership is a key characteristic of a credit union, and is defined in its charter or bylaws as those who may belong to it and use its services. The common bond is a characteristic of the members themselves. Congress, in the Federal Credit Union Act, has recognized three types of federal credit union common bonds: occupational, associational, and community. A federal credit union may also consist of a combination of occupational, associational, and, in certain limited circumstances, community groups. For example, the NCUA may charter a federal credit union consisting of employees of a local school district and members of a church group.

2.04 In early 1998, the United States Supreme Court ruled that NCUA had strayed from the original intent of Congress as reflected in the FCUA passed in 1934 relating to common bond affiliation for credit union membership. This ruling had the effect of restricting future membership in federal credit unions. On August 7, 1998, legislation was signed into law that eased membership restrictions on credit unions and allowed them to expand. The legislation, known as the Credit Union Membership Access Act (CUMAA), permits occupation-based credit unions to take in groups of members from unrelated companies under certain circumstances.

2.05 CUMAA also establishes three important new requirements with respect to financial statements and audits. First, all federally insured credit unions with assets of $500 million or more must obtain an annual independent audit of their financial statements by a certified public accountant or licensed public accountant. Second, all federally insured credit unions with assets of $10 million or more must follow generally accepted accounting principles for all reports or statements required to be filed with the NCUA Board. Third, for any federal credit union with assets of more than $10 million that uses an independent auditor who is compensated for his or her services, the audit is subject to state accounting laws, including licensing requirements.

2.06 CUMAA addressed minimum capital requirements and “prompt corrective action” (PCA) to restore capital. New net worth standards based in a percentage of assets was established for insured credit unions, as well as risk-based capital standards for complex credit unions as defined by the NCUA. NCUA also developed PCA regulations, as well as regulations concerning other areas such as new field of membership rules, and supervisory committee audit rules as required by this legislation. In addition, CUMAA placed restrictions on member business lending, mandated more Treasury studies, and restricted conversions to mutual savings banks.

2.07 A credit union relies on volunteers who represent the members. The members direct the formation of credit union policies and practices by electing a board of directors to represent them.

The Board of Directors

2.08 The board of directors establishes the general operation of a credit union and ensures that it follows applicable laws and regulations and adheres to its bylaws. In addition, the board is responsible for ensuring that a credit union maintains its financial stability, follows good business practices, and is properly insured and bonded. As membership organizations, credit unions are democratically controlled. Federal and state laws require that a board of directors be elected on the basis of one member, one vote, by the membership. The board of directors in turn appoints the supervisory committee. The supervisory committee, which is similar to an audit committee, plays a major role in monitoring a credit union's financial affairs. A credit committee may be appointed or elected to oversee the lending transactions. Other committees may include a budget or finance committee, a marketing or member-relations committee, an educational committee, and various *ad hoc* committees. Credit unions depend heavily on member volunteers to set policy, make decisions, and sometimes even to operate them. Some officials (board members and board appointed persons) of state chartered credit unions may receive compensation for services, as allowed by law. However, federally chartered credit unions are generally prohibited from compensating officials.

The Supervisory Committee

2.09 The supervisory or audit committee is responsible for ensuring that member funds are protected, financial records and operations are in order, and elected officials carry out their duties properly. Supervisory committee responsibilities are prescribed in part 715 of the NCUA Rules and Regulations. In addition, the supervisory committee is generally responsible for overseeing the financial reporting process and ensuring that management has established effective internal control. Section 115 of the Federal Credit Union Act states, 12 U.S.C. §1761d:

> The supervisory committee shall make or cause to be made an annual audit and shall submit a report of that audit to the Board of Directors and a summary of the report to the members at the next annual meeting of the credit union; shall make or cause to be made such supplemental audits as it deems necessary or as may be ordered by the Board, and submit reports of the supplementary audits to the Board of Directors.

Similar requirements exist for most state-chartered credit unions. The supervisory committee may engage an independent auditor to audit and report on the credit union's financial statements.

2.10 Supervisory committees play an important role in developing and maintaining strong operational and financial management at credit unions. As credit unions continue to broaden the nature and scope of the activities in which they are involved, it is important that supervisory committees meet regularly and carefully review operational and financial goals, internal control, financial statements, and examiners' and auditors' reports. Lack of supervisory committee involvement in credit union operations may be an early indicator of potential problems for credit unions.

The Credit Committee

2.11 The credit committee (composed of volunteers elected by the membership) establishes and monitors a credit union's lending policies, approves loan applications, and provides credit-counseling services to members. This committee may delegate some of its loan-granting authority to one or more loan officers employed by the credit union in accordance with the bylaws. Many credit unions have amended their by-laws to eliminate the elected credit committee. In these instances, the board of directors assumes credit committee responsibilities and generally delegates its responsibility to loan officers employed by the credit union.

CHARTER, BYLAWS, AND MINUTES

2.12 The NCUA issues charters for federally chartered credit unions and prescribes the form of bylaws of such credit unions. State regulatory authorities establish the form of the charter and bylaws for state-chartered credit unions. The regulatory authorities generally require monthly meetings of the board of directors and other volunteer committees.

Financial Structure

2.13 Because they are nonstock cooperatives, credit unions' primary source of funds is members' share and savings account deposits. To be entitled to membership, each member must generally own at least one share in the credit union. Members' shares, or share accounts, are savings accounts that represent the members' ownership in the credit union. Credit unions pay interest (commonly referred to as dividends) on shares. This interest cannot be guaranteed (as interest on deposits can), but must be declared by the board and may be paid from current earnings or undivided earnings.

2.14 Credit unions use the funds from these shares and other members' savings accounts to make loans to members and to make investments. In general, loans to members make up the bulk of credit union assets. Funds not needed to meet member loan demand and operating expenses are invested.

Deregulation

2.15 Historically, credit unions have operated in a highly regulated environment in which regulations over interest rates on loans and share accounts significantly influenced operating activities. Legislation passed in the early 1980s removed most restrictions on deposit instruments and enabled credit unions to compete more freely for deposits. To enhance member services and profitability, many credit unions have become much more aggressive in the areas of fees and charges, real estate, short-term construction, and business lending. These areas have the potential for higher earnings, but are much higher risk activities than traditional consumer lending.

2.16 As a result of these developments, some credit unions have experienced significant asset growth and have sometimes entered into higher-risk transactions and activities, including aggressive lending, leveraged securities transactions, and acquisitions of complex financial instruments.

2.17 Occasional adverse effects from these transactions and activities have surfaced in the form of asset-quality and liquidity problems.

Credit Union System

2.18 Credit unions—through their state and national trade associations, service organizations, and corporate credit unions—make up the Credit Union System. Most credit unions are affiliated with the system through membership in their state credit union leagues. In turn, credit union leagues belong to the Credit Union National Association, Inc. (CUNA), the principal trade association for credit unions in the United States, while CUNA belongs to the World Council of Credit Unions, an international credit union organization. On the national level, for-profit affiliates of CUNA (including the CUNA Service Group, the CUNA Mutual Insurance Group, and the CUNA Mortgage Corporation) provide a wide variety of products and services to credit unions on a fee basis.

2.19 The National Association of State Credit Union Supervisors (NASCUS) was founded in 1965 and serves both state-chartered credit unions and the state credit union regulators who supervise them. NASCUS represents all 48 state and territorial credit union supervisors and the CEOs of nearly 800 of the nation's more than 4,300 state-chartered credit unions. NASCUS promotes dual chartering system and the advancement of the autonomy and expertise of state credit union regulatory agencies.

2.20 Credit unions also have their own financial system, the Corporate Credit Union Network, consisting of the U.S. Central Credit Union and its member corporate credit unions. These state or regional corporate credit unions make available a wide range of investments and correspondent financial services for credit unions.

2.21 Other national credit union associations include the National Association of Federal Credit Unions (NAFCU), the Credit Union Executives Society (CUES), and other associations serving similar credit unions such as educational, defense-related, or aerospace credit unions. These groups may also provide such services as supplies, marketing, insurance, fund transfers, and investment instruments through their affiliates.

Corporate Credit Union Network

2.22 U.S. Central serves as a financial intermediary for corporate credit unions. In this role, the primary purpose of U.S. Central is to meet the corporate credit unions' short-term and long-term liquidity needs by maintaining access to public and private capital markets and providing loans to them. U.S. Central also offers a variety of investment opportunities for corporate credit union's excess liquidity. It also provides payment, settlement, safekeeping, accounting, correspondent and information services to corporate credit unions. Lines of credit provided by U.S. Central to corporate credit unions consist of both advised and committed lines of credit facilities.

2.23 Corporate credit unions provide services to their member credit unions that are similar to those provided by U.S. Central to the corporate credit unions. In addition to the types of services offered to corporate credit unions by U.S. Central, corporate credit unions provide additional services to member credit unions. These additional services include, but are not limited to, investment alternatives, other liquidity services, coin and currency delivery, and check clearing for the share draft processing.

2.24 While a few corporate credit unions service member credit unions in areas limited to the corporate credit unions' home state or a region, the majority of corporate credit unions have national fields of membership that cover states nationwide. Some also cover certain United States territories.

REGULATION AND OVERSIGHT

Government Supervision

2.25 Credit unions operate under either a federal or state charter and therefore are subject to government supervision and regulation, including periodic examinations by supervisory agency examiners. Federally chartered credit unions are supervised by the NCUA, which is also responsible for administering the NCUSIF. The NCUSIF provides share insurance to all federal credit unions and federally insured, state-chartered credit unions and insures each deposit up to a specified amount. Each federally insured credit union is required to maintain a deposit with the NCUSIF in an amount equal to 1 percent of its total insured shares.

2.26 State-chartered credit unions are supervised by the regulatory agency of the chartering state. Most state-chartered credit unions are required to obtain NCUSIF share insurance coverage. A few credit unions obtain insurance from other sources that are sponsored by a private insurer. Participation in an insurance program is mandatory for most credit unions.

2.27 Credit unions are subject to federal, state, and local laws applicable to financial institutions in general. Such laws include the Uniform Commercial Code, the Truth-in-Lending Laws, the Uniform Consumer Code, Truth-in-Savings regulations, and various federal and state tax codes. As financial institutions, they are also subject to a wide variety of federal regulations issued by such agencies as the Treasury Department, the Federal Reserve Board, and the Internal Revenue Service. Rules and regulations issued by the federal and state regulatory agencies address such issues as accounting practices, qualifications for membership, interest rate controls, permissible investments, consumer-protection issues, liquidity reserves, and other operational aspects.

National Credit Union Administration

2.28 Approximately 60 percent of all credit unions are federally chartered by the NCUA, which issues regulations for both federal credit unions and federally insured, state-chartered credit unions. Federally insured, state-chartered credit unions sign an insurance agreement with the NCUA when they secure federal insurance that stipulates the regulations by which they agree to be bound. NCUA publications that provide useful background information to credit union auditors include the following:

- *Accounting Manual for Federal Credit Unions (*and interim *Accounting Bulletins*)
- *Supervisory Committee Manual for Federal Credit Unions*
- *National Credit Union Administration Rules and Regulations* (and periodic updates)
- *The Federal Credit Union Act*
- *The Federal Credit Union Handbook*
- *Federal Credit Union Manual of Laws*
- *FFIEC Information Systems Manual*

The *Accounting Manual for Federal Credit Unions* had the force of NCUA regulatory authority until 1981, when, except for section 2000 on basic accounting policies and procedures, it was deregulated.

REGULATORY CAPITAL MATTERS

Natural Person Credit Unions

Capital Adequacy

2.29 The Credit Union Membership Access Act of 1998 (CUMAA) was signed into law on August 7, 1998. Title III of this Act established a new system of tiered net worth requirements for all insured credit unions other than corporate credit unions. These requirements did not take effect until August 2000. The Act requires that the National Credit Union Association (NCUA) establish a net worth standard for insured credit unions as well as risk based capital standards for complex credit unions as defined by the NCUA. A separate system of PCA is mandated for "new credit unions". A new credit union is defined as a federally insured credit union that both has been in operation for less than ten years and has $10,000,000 or less in total assets. A summary of general requirements follows. In 2000, the NCUA published PCA guidelines in the Federal Register effective August 7, 2000. On July 20, 2000, the NCUA published PCA guidelines with respect to the risk-based net worth requirement effective January 1, 2001. Specific requirements are set forth in 12 CFR Parts 700, 702, 741 and 747.

2.30 A credit union's net worth, the numerator of the net worth ratio, is defined as retained earnings as determined under generally accepted accounting principles.

2.31 A credit union's total assets, the denominator of the net worth ratio, is calculated in any one of four methods. It may be (1) the average of the quarter-end balances of the four most recent quarters, (2) the monthly average over the quarter, (3) the daily average over the quarter, or (4) the quarter-end balance. A credit union may elect a method from the four options to apply for each quarter. Whatever method is chosen for a quarter must be used consistently for all PCA measures other than the risk-based net worth requirement (RBNWR)..

2.32 Credit unions with less than 7% net worth with respect to total assets and any complex credit union, as defined below, not meeting risk-based standards will be required to increase its net worth quarterly by an amount of earnings equivalent to at least 1/10th percent (0.1%) of its total assets for the current quarter. Earnings are required to be transferred quarterly from current earnings to the statutory reserve. Not all states that have state chartered credit unions permit this transfer. As in some states, legislation may be necessary to enact change. Separate calculations may also be required for state chartered credit unions subject to state imposed capital requirements and may be significantly different from the federal requirements.

Prompt Corrective Action

2.33 In 1998, Congress amended the FCUA to require the NCUA Board to adopt a system of PCA to be applied to federally insured credit unions that become undercapitalized. The new FCUA provision imposes a series of progressively more stringent restrictions and requirements indexed to five net worth categories. The provision also mandates a separate system for new credit unions and additional RBNWRs for complex credit unions.

2.34 A credit union is defined as "complex" and a RBNWR is applicable only if the credit union meets both of the following criteria as reflected in its most recent Call Report:

- The credit union's quarter end total assets exceed $10 million;
- The credit union's RBNWR exceed 6%.

2.35 Under the PCA regulations of the NCUA, a credit union is classified in a net worth category as follows:

- *a.* *Well capitalized* if it has a net worth ratio of seven percent or greater and also meets any applicable risk-based net worth requirement.
- *b.* *Adequately capitalized* if it has a net worth ratio of six percent or more but less than seven percent and meets any applicable RBNWRs.
- *c.* *Undercapitalized* if it has a net worth ratio of four percent or more but less than six percent or fails to meet any applicable RBNWR.
- *d.* *Significantly undercapitalized* if
  - Has a net worth ratio of two percent or more but less than four percent; or
  - Has a net worth ratio of four percent or more but less than five percent and either
    - a. fails to submit an acceptable net worth restoration plan within the time prescribed; or
    - b. materially fails to implement a net worth restoration plan approved by the NCUA Board.
- *e.* *Critically Undercapitalized* if it has a net worth ratio of less than 2 percent.

Exhibit 1: Net worth classifications

Classification	Net Worth Ratio	Prompt Corrective Action
Well Capitalized	7% or greater	None
Adequately Capitalized	> 6% but < 7%	Earnings transfer
Undercapitalized – First tier	> 5 % but < 6%	Mandatory for level
Undercapitalized – Second tier	> 4% but < 5%	Mandatory and discretionary for level
Significantly undercapitalized	Either a. > 2% but < 4% or b. > 4% but < 5% and either: Fails to submit an acceptable net worth restoration plan; or Materially fails to implement a restoration plan approved by the NCUA Board	Mandatory and discretionary for level
Critically undercapitalized	< 2%	Mandatory and discretionary for level

2.36 Determining the net worth category of a credit union (other than a "new" credit union) is a multiple-step process. In the first step, an initial net worth category is determined by calculating the ratio of the credit union's net worth (under GAAP, excluding such factors as "accumulated other comprehensive income") to total assets (computed under any of the four methods described above). This ratio determines an initial category based on the following:

- *a.* *Well capitalized* if it has a net worth ratio of seven percent or greater.
- *b.* *Adequately capitalized* if it has a net worth ratio of six percent or more but less than seven percent.
- *c.* *Undercapitalized* if it has a net worth ratio of four percent or more but less than six percent.
- *d.* *Significantly undercapitalized* if
  - Has a net worth ratio of two percent or more but less than four percent; or
  - Has a net worth ratio of four percent or more but less than five percent and either
    - a. fails to submit an acceptable net worth restoration plan within the time prescribed; or

b. materially fails to implement a net worth restoration plan approved by the NCUA Board.

e. *Critically Undercapitalized* if it has a net worth ratio of less than 2 percent.

2.37 In the second step, the credit union (other than credit unions with less than $10 million in total assets at quarter end) determines its RBNWR. If the RBNWR is less than 6%, the credit union does not have to meet a RBNWR and the credit union's initial net worth category would become its net worth classification under the PCA regulations. If the RBNWR is greater than 6%, but less than the credit union's actual net worth ratio, the credit union would meet its RBNWR and the credit union's initial net worth category would become its net worth classification under the PCA regulations. However, a credit union's net worth category may be downgraded if there exist any supervisory or safety and soundness issues between the credit union and the NCUA or any applicable state regulatory authority

2.38 For a credit union with an initial net worth category of either "well capitalized" or "adequately capitalized", but with a RBNWR which is greater than the initial net worth calculation if not met, the actual net worth classification under PCA regulations would be reduced to the first tier of "undercapitalized." For a credit union with an initial net worth category of "undercapitalized" or lower, any net worth restoration plan submitted by the credit union would have to consider the RBNWR if that requirement were greater than 6%.

2.39 The RBNWR is computed by multiplying the end-of-quarter balances of the credit union's risk-portfolio components (as defined in the regulations) by prescribed percentages (the "standard calculation"). If the standard calculation produces a RBNWR that is larger than the credit union's net worth ratio, the credit union can recalculate its RBNWR using some or all of the "alternative components approach". In the alternative components approach, the maturities of several of the risk-portfolio components are used to produce a more detailed set of calculations, again each with a prescribed risk percentage. If the alternative components approach produces a RBNWR that is less than the credit union's net worth ratio, the credit union would have met it RBNWR. If the alternative components approach produces a RBNWR that is larger than the credit union's net worth ratio, the credit union may apply to the NCUA for a "risk mitigation credit" (explained below) to reduce its calculated RBNWR. If the credit union fails to obtain an adequate amount of "risk mitigation credit" to reduce its RBNWR below its net worth ratio, it would have failed its RBNWR. The RBNW ratio is the sum of all components for each category at the calculation date.

2.40 As noted above, a credit union that fails to meet its applicable RBNWR using both the Standard and Alternative calculations may apply to the Board of the NCUA for a risk mitigation credit against the credit union's RBNWR. A risk mitigation credit may be granted by the Board based upon proof from the credit union of mitigation of credit risk or interest rate risk. The amount of the credit and the period for which the credit can be used by the credit union is up to discretion of the Board of the NCUA. A risk mitigation credit may be denied based on the information presented by the credit union or based on other subjective factors considered by the Board of the NCUA. A risk mitigation credit may be withdrawn by the Board of the NCUA at any time.

2.41 Beyond the net worth and RBNWR related actions noted above, the NCUA Board may reclassify a "well capitalized" credit union as "adequately capitalized" and may require an "adequately capitalized" or "undercapitalized" credit union to comply with certain mandatory or discretionary supervisory actions as if it were in the next lower net worth category in the following circumstances:

- the NCUA Board determines that the credit union is in an unsafe or unsound condition; or
- the NCUA Board determines that the credit union has not corrected a material unsafe and unsound practice of which it was, or should have been, aware.

2.42 Actions that may be taken under the PCA provisions can include both mandatory and discretionary actions for each level of capitalization below "well capitalized" and range from that earnings be set aside to build net worth to the restriction or prohibition of certain activities.

2.43 Credit unions classified as "undercapitalized," "significantly undercapitalized," or "critically undercapitalized" must submit a net worth restoration plan for restoring the credit union to adequate capitalization. Among other things, the plan should:

- Specify a quarterly timetable of steps the credit union will take to become adequately capitalized.
- Contain a specific timetable for increasing net worth for each quarter of the plan.
- Specify the amount of earnings equivalent the credit union will transfer to its reserve account on a quarterly basis.
- Detail how the credit union will comply with other restrictions or requirements put into effect.
- Set forth the types and levels of activities in which the union will engage.
- Include pro forma statements covering the next two years at a minimum.

2.44 Under the FCUA, a "**new"** credit union is classified—

a. *Well capitalized* if it has a net worth ratio of seven percent or greater and also meets any applicable RBNWR.

b. *Adequately capitalized* if it has a net worth ratio of six percent or more but less than seven percent and meets any applicable RBNWRs.

c. *Moderately capitalized* if it has a net worth ratio of three and one half percent or more but less than six percent, or fails to meet any applicable RBNWR.

d. *Marginally capitalized* if it has a net worth ratio of two percent or more but less than three and one half percent.

e. *Minimally capitalized* if it has a net worth ratio of zero percent or greater but less than two percent.

f. *Undercapitalized* if it has a net worth of less than zero percent.

2.45 The NCUA Board may reclassify a "well capitalized," "moderately capitalized," or "marginally capitalized" new credit union to the next lower net worth category if they determine the credit union is in an unsafe or unsound condition, or the credit union has not corrected a material unsafe or unsound condition.

2.46 Actions that may be taken under the PCA provisions for new credit unions include both mandatory and discretionary actions ranging from the restriction or prohibition of certain activities to appointment of a receiver or conservator of the credit union's net assets.

2.47 New credit unions classified as moderately, marginally, minimally, or undercapitalized must file a revised business plan. At a minimum, the revised business plan must:

- Outline steps the credit union will take to become adequately capitalized.
- Set specific quarterly targets for increasing net worth for each year of the plan.
- Set forth the amount of earnings equivalent the credit union will transfer to its reserve account.
- Detail how the credit union will comply with other restrictions or requirements put into effect.

Notice and effective date of net worth classification

2.48 A Federally-insured credit union shall have notice of its net worth ratio (including any applicable RBNWR) and shall be classified within the corresponding net worth category as of the earliest to occur of:

- The last day of the calendar month following the end of the calendar quarter; or
- The date the credit union's net worth ratio is recalculated by or as a result of its most recent final report of examination; or
- The date the credit union received written notice from the NCUA Board or, if State-chartered, the appropriate State official, of reclassification based on safety and soundness grounds.

2.49 A Federally-insured credit union that files its Call Reports semi-annually must give written notice to the NCUA Board and, if State-chartered, to the appropriate State official, of a change in its net worth ratio for the quarters ending March 31 and September 30, if that change places the credit union in a lower net worth category. Credit unions are required to notify the NCUA Board and, if State-chartered, to the appropriate State official, of a change in its net worth ratio that places the credit union in a lower net worth category is required no later than 15 calendar days after the effective date of the change. Written notice to the NCUA Board shall be deemed effective if it is delivered to the appropriate Regional Director and, if State-chartered, to the appropriate State official. Failure to provide such notice to the NCUA Board within 15 calendar days, or failure to provide such notice altogether, in no way alters the effective date of a change of net worth classification, nor the affected credit union' s legal obligations.

2.50 Noncompliance or expected noncompliance with regulatory net worth requirements may be a condition, when considered with other factors, that could indicate substantial doubt about an entity's ability to continue as a going concern. The implementation of the PCA provisions warrants similar attention by independent accountants when considering an institution's ability to remain a going concern. In addition, when a credit union has met its RBNWR through the use of a risk mitigation credit, the subjectivity involved in granting and maintaining the credit may also warrant attention by independent accountants.

Corporate Credit Unions

2.51 Corporate credit unions have regulatory capital requirements that are different from those of other credit unions. Corporate credit unions are not covered by the net worth requirements applicable to other credit unions by virtue of the Credit Union Membership Access Act. By statute, the equity or capital of a corporate credit union consists of all of its shares, reserves and undivided earnings. The NCUA has established a regulatory capital requirement applicable to all corporate credit unions. A state chartered corporate credit union is also subject to its applicable state law capital requirement, if any. For NCUA regulatory purposes, corporate credit union capital consists of the sum the corporate credit union's reserves and undivided earnings, paid-in capital, and membership capital. Paid-in capital and membership capital are typically different types of subordinated share accounts.

2.52 For NCUA purposes, a corporate credit union is required to maintain a monthly minimum capital ratio of four percent. The capital ratio is determined by dividing the corporate credit union's capital by the moving daily average net assets (MDANA). MDANA is defined in Section 704.2 of NCUA Rules and Regulations as the average of daily average net assets for the month being measured and the previous eleven months. Net assets are defined in section 704.2 of NCUA's Rules and Regulations as total assets less various specified types of assets.

2.53 The amount of required transfers to regulatory reserves is determined by the reserve ratio. The reserve ratio represents the corporate credit union's reserves and undivided earnings plus paid-in capital divided by the moving daily average net assets. If the reserve ratio is greater than or equal to four percent, the reserve transfer is optional. If the reserve ratio is less than four percent but greater than or equal to three percent, the reserve transfer rate is a minimum of .10 percent of moving daily average net assets. If the reserve ratio is less than three percent, the reserve transfer rate is a minimum of .15 percent of moving daily average net assets.

2.54 NCUA may also establish a different minimum capital and/or reserve ratio requirements for an individual corporate credit union based on its circumstances.

ANNUAL AUDITS

2.55 As discussed in paragraph 2.05, CUMAA requires:

1. All federally insured credit unions with assets of $500 million or more to obtain an annual independent audit of their financial statements by a certified public accountant or licensed public accountant.
2. All federally insured credit unions with assets of $10 million or more must follow GAAP for all reports or statements required to be filed with the NCUA Board and obtain one of the following four services:
    a. If the credit union is federally insured with assets of $500 million or more, the opinion audit must be performed by an independent accountant licensed by the state or jurisdiction in which the audit is conducted.
    b. If the credit union is federally chartered with assets of more than $10 million but less than $500 million, the credit union has four options:
        i. As required in a) above.
        ii. Obtain an opinion audit on the credit union's balance sheet performed by an independent accountant licensed by the state or jurisdiction in which the audit is conducted.
        iii. Obtain an examination of management's assertions regarding internal controls over call reporting conducted by an independent accountant licensed by the state or jurisdiction in which the audit is conducted,
        iv. Obtain a supervisory committee audit that meets the minimum requirements of the Supervisory Committee Guide. Appendix A of the Supervisory Committee Guide provides a list of minimum procedures that have been deemed to be compliant with 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).♦ Appendix B to this Guide contains a reprint of Appendix A of the Supervisory Committee Guide. See chapter 15 for a detailed analysis of the audit regulations and the SAS No. 75 implications

♦ In February 2001, SSAE No. 10, *Attestation Standards: Revision and Recodification* was issued and is effective when the subject matter or assertion is as of or for a period ending on or after June 1, 2001. Early application is permitted. This Statement supersedes SAS No. 75 and makes SSAE No. 4 applicable to all agreed-upon procedures engagements.

For any federal credit union with assets of more than $10 million that uses an independent accountant who is compensated for his services, the audit is subject to state accounting laws, including licensing requirements.

While GAAP basis accounting is not required for internal reporting, GAAP is required for Call Reports filed with the NCUA Board for credit unions with assets of $10 million or more. As most auditors typically perform financial statement audits at a quarter end and credit unions are required to file quarterly Call Reports, the independent accountant should have GAAP based statements to work with in connection with his audit.

2.56 The minimum requirements for a supervisory committee audit of federally chartered credit unions are prescribed by Part 715 of the NCUA Rules and Regulations. State-chartered credit unions are subject to the audit requirements established by state regulatory agencies if they are more stringent than Part 715 requirements. To satisfy regulatory requirements for a supervisory committee audit, the supervisory committee may perform the required procedures itself or it may engage an independent accountant to perform procedures that are necessary to fulfill the federal or state requirements. Because the types of engagement can differ so significantly, it is important for the independent accountant to establish a clear understanding of the nature of an engagement to perform a supervisory committee audit.

Other Reporting Considerations

2.57 To the extent that a credit union may be (1) originating or holding student loans, (2) servicing residential mortgage loans for others, (3) borrowing from a district Federal Home Loan Bank, or (4) participating in an ATM Network or originating or receiving ACH transactions, the independent accountant may be requested to perform assurance services other than those required by CUMAA.

CHAPTER 3

Industry Overview—Finance Companies

DESCRIPTION OF BUSINESS

3.01 Finance companies provide lending and financing services to consumers (consumer financing) and to business enterprises (commercial financing). Some finance companies engage solely in consumer or commercial financing activities; others provide both types.

3.02 Manufacturers, retailers, wholesalers, and various other business enterprises may provide financing to encourage customers to buy their products and services. Such financing, generally known as *captive finance activity*, may be provided directly by those companies or through affiliated companies. Although most such companies originally financed only their own products and services, many have expanded their financing activities to include a wide variety of products and services sold by unaffiliated businesses.

3.03 Consumer finance activities comprise direct consumer loans, including mortgage loans and retail sales financing. Many companies that provide consumer financing also offer a variety of insurance services to their borrowers.

3.04 Commercial finance enterprises often provide a wide range of services, including factoring arrangements, revolving loans, installment and term loans, floor plan loans, portfolio purchase agreements, and lease financing to a variety of clients, including manufacturers, wholesalers, retailers, and service organizations. Many commercial finance activities are called *asset-based financial services* because of the lenders' reliance on collateral.

3.05 Commercial loans generally are collateralized by various types of assets, including notes and accounts receivable, inventories, and property, plant, and equipment.

3.06 ***Insurance Services***. Many companies engaged in consumer finance activities also offer insurance coverage to their customers. Such coverage may include life insurance to repay remaining loan balances if borrowers; accident and health insurance to continue loan payments if borrowers become sick or disabled for an extended period of time; and property insurance to protect the values of loan collateral against damage, theft, or destruction. Some lenders may provide insurance through subsidiaries. Others act as brokers and, if licensed, often receive commissions from independent insurers. Lenders also may receive retrospective rate credits on group policies issued by independent insurers. In still other instances, policies may be written by independent insurance companies and then reinsured by insurance subsidiaries of finance companies.

3.07 Increased competition has come from within the industry, but also from nontraditional players such as investment companies, brokers and dealers in securities, insurers, and financial subsidiaries of commercial enterprises. These entities now do business directly with potential customers in transactions traditionally executed through finance companies. This disintermediation has increased the need for innovative approaches to attracting customers. It has also led to an increased need for more complex financing structures such as use of tax oriented vehicles, the ability to offer longer term financing than traditional banks, and a higher level of asset knowledge to take more aggressive residual positions and collateral risk.

Debt financing

3.07 The basic activity of finance companies is borrowing money at wholesale interest rates and lend at a markup. Strong credit ratings foster the ability to attract wholesale funds at a competitive cost. Accordingly, in order to qualify for high ratings, it is common for finance companies to structure financing transactions according to predetermined rating agency credit criteria. A credit rating represents a measure of the general creditworthiness of an obligor with respect to a particular debt security or financial obligation, based on relevant risk factors. Over the years, the credit ratings from rating agencies such as Standard and Poor's Rating Services, Duff & Phelps Credit Rating Co., Moody's Investor Service, Inc. and Fitch IBCA, Inc. have achieved wide acceptance as easily usable tools for differentiating credit quality.

3.08 Unlike most depository institutions, finance companies typically do not utilize customer deposits as a significant source of funding. Accordingly, access to a variety of funding sources is vital to market access, liquidity, and funding cost effectiveness. Typical short-term funding sources include commercial paper and bank credit facilities. Senior debt, senior subordinated debt and junior subordinated debt are typical medium to long-term funding sources. It is common for these types of funding sources to contain restrictive covenants.

3.09 Securitization is often utilized by finance companies to diversify funding sources. In some markets, securitization has reduced entry barriers and increased competition. Securitization involves the sale, generally to a trust, of a portfolio of loan receivables. Asset backed certificates are then sold by the trust to investors through a private placement or public offering. Typically the finance company will retain the servicing rights for the loans sold to the trust. A subordinated interest in the trust is also typically retained by the finance company, serving as a credit enhancement to the asset backed certificates. Such structures provide the opportunity for less credit worthy companies to obtain funding at competitive levels through the asset backed and other structural characteristics of securitization vehicles.

3.10 Robert Morris Associates, an organization of bank lending officers, has developed financial information questionnaires for lenders engaged in retail sales financing, direct cash lending, commercial financing, captive financing activities, and mortgage banking. Finance companies generally complete and submit the questionnaires to credit grantors as an integral part of the process of obtaining credit lines with commercial banks and other lenders. The information is used to analyze the quality of the operations and creditworthiness of finance companies.

REGULATION AND OVERSIGHT

3.11 Publicly held finance companies are generally subject to requirements of federal securities laws, including the Securities Act of 1933 and the Securities Exchange Act of 1934 (Exchange Act). Companies whose securities are registered under the Exchange Act must comply with its reporting requirements through periodic filings with the Securities and Exchange Commission (SEC).

3.12 Numerous state and federal statutes affect finance companies' operations. Some statutes apply only to specific types of activities. Regulations affecting finance companies generally are limited to matters such as loan amounts, repayment terms, interest rates, and collateral; they generally do not deal with financial accounting and reporting. Certain of the more significant state and federal laws related to consumer lending are discussed in Chapter 8.

CHAPTER 4

Industry Overview—Mortgage Banking

DESCRIPTION OF BUSINESS

4.01 As a result of the relative imbalance between the supply and demand for residential mortgage funds, mortgage banking enterprises play an integral role in providing mortgage capital in the amounts needed and in the geographic locations required to meet the housing needs of the general public. The market whereby mortgage funds are disseminated to areas other than their originating, or primary, market is referred to as the secondary market.

4.02 The principal participants in the secondary market for residential financing are government-sponsored enterprises (GSEs), such as the Federal Home Loan Mortgage Corporation (Freddie Mac) and the Federal National Mortgage Association (Fannie Mae). Also active in the secondary market are federal agencies such as the Government National Mortgage Association (Ginnie Mae) and the Department of Veterans' Affairs (VA). These entities participate in the secondary market as issuers, investors, or guarantors of asset-backed securities (ABSs) such as mortgage-backed securities (MBSs), real estate mortgage investment conduits (REMICs) and collateralized mortgage obligations (CMOs). Many private entities are also active in the secondary market as issuers and investors. (Chapter [10] describes ABS transactions and considerations for investors in ABSs.)

4.03 Freddie Mac and Fannie Mae primarily purchase conventional fixed- and variable-rate residential mortgage loans, while Ginnie Mae generally purchases pools of government-insured residential mortgage loans. Secondary market participants typically pool the loans that are purchased, securitize them into mortgage-backed securities (MBS), and sell the securities in the secondary market.

4.04 Beginning in the early 1970s, secondary market activities for all mortgage lenders increased substantially as a result of the establishment of Freddie Mac and the new involvement of Fannie Mae and Freddie Mac with the conventional secondary market. Prior to that time, Fannie Mae was one of the few national secondary mortgage markets participants through its whole-loan purchase and sale programs related to government loans.

4.05 Mortgage-backed securities became more prominent with the creation of Ginnie Mae in 1968 and the subsequent issuance of the first GNMA pass-through securities. Non-traditional mortgage investors were more inclined to invest in GNMA pass-through securities as a result of government guarantees on both the underlying mortgage collateral and on the securities themselves. During this same time period, Freddie Mac began selling pass-through securities backed by conventional residential mortgages. By the mid 1970s, residential mortgages had been accepted as viable security collateral by the investment community.

4.06 Today, the securities markets play a significant role in the execution and pricing of residential mortgage securities, and handle an increasing volume of residential mortgage-backed transactions. As a result, securities markets influence mortgage pricing on a national scale and also influence the design of various mortgage products.

4.07 With the dominant role of the mortgage securities markets and economic changes throughout the mortgage lending industry, non-traditional participants in the secondary market (as opposed to the traditional thrift portfolio lenders) continue to evolve. Securities underwriters, commercial banks, insurance companies and non-financial corporate entities, are playing a part in mortgage banking.

4.08 In 1997, the Federal Home Loan Bank of Chicago began the Mortgage Partnership Finance (MPF) Program. The MPF Program is available through most Federal Home Loan Banks (FHLBs) and provides member financial institutions an alternative method for funding home mortgages for their customers. Under the MPF Program, the lender effectively originates loans for, or sells loans to, the respective FHLB. The lender retains the credit risk and customer relationship (through servicing) inherent in the loan, and shifts the interest rate risk and prepayment risk to the FHLB. The lender receives a credit enhancement fee from the FHLB in exchange for managing the credit risk of the loan. Effectively, the FHLBs have offered an alternative funding strategy to the traditional secondary mortgage market.

4.09 Many mortgage banking enterprises are subsidiaries of banks or bank holding companies. Mortgage banking is generally compatible with a bank's financing operations, and the bank is an obvious resource for the mortgage banking entity's financing requirements. A mortgage banker typically requires a warehouse line of credit, whereby mortgage loans are funded by advances from the credit line, and are "warehoused" in portfolio as security for the credit line until it is paid down through the subsequent sale of the mortgage loan into the secondary market. The interest margin at which a mortgage banker can fund its operations and extend mortgage financing is critical to the financial success of the entity.

4.10 In turn, access to the secondary mortgage market is an important source of liquidity for banks and savings institutions. Many institutions have deposit bases that are keyed to variable rates and, therefore, are particularly sensitive to interest-rate risk. A variable-rate deposit base cannot fund long-term, fixed-rate assets without creating significant loss exposure in rising interest-rate environments. Therefore, sales of mortgage loans and servicing rights in the secondary market and the accompanying gains and losses and creation of income streams from servicing and other fees are an important source of funds to many institutions. Access to the secondary market also provides opportunities to restructure existing long-term portfolios.

4.11 Mortgage banking activities primarily consist of two separate but interrelated activities: (1) the origination or acquisition of mortgage loans for the purpose of selling those loans to permanent investors in the secondary market, and (2) the subsequent long-term servicing of those loans. Mortgage loans are acquired for sale to permanent investors from a variety of sources, including in-house origination and purchases from third-party correspondents.

4.12 Residential mortgage loans may be sold to investors with or without the right to service such loans. Servicing offers an entity additional, and potentially significant, sources of income in the form of servicing fees, late-charge fees, float earnings and numerous other ancillary fees. Servicing fees are typically expressed as a percentage of the outstanding loan principal balance, such as 0.25% or 25 basis points.

4.13 The servicing function includes collecting payments from borrowers, transmitting insurance and tax payments to the related recipients, remitting payments to investors, performing the collection function for delinquent loans and initiating foreclosure proceedings. The precise nature of the servicing function is dependent on the specific requirements of the investor.

4.14 The servicing rights attributable to a mortgage portfolio are generally viewed as the primary asset of a mortgage banking enterprise. The value of the servicing asset is a function of the anticipated life of the servicing right (how long the loan is expected to be outstanding and serviced) and the estimated net servicing revenues attributable to the servicing function. As a result of an active market for the purchase and sale of loan servicing rights, there is a certain degree of liquidity to servicing rights. Conversely, servicing portfolios are subject to significant impairment risk as unanticipated periods of rapid pre-payments can cause substantial declines in the value of the servicing asset. Accordingly, the assumptions upon which the value of servicing transactions are based are critical to the financial performance of the servicing entity.

4.15 The magnitude of interest rate movements and the speed with which they can occur make risk management in a mortgage banking enterprise complex and difficult. Strategies and operating plans are required to monitor and control the risk exposure of mortgage banking operations, as well as sophisticated reporting systems that provide the information needed to carry out the plans and strategies.

4.16 In addition to the interest rate risk inherent in an entity's mortgage loan pipeline (the inventory of loans in various stages of process), an entity may be subject to recourse risk. Recourse risk is the risk that an investor may either reject a loan or require the mortgage lender to repurchase the loan if there is a defect in underwriting or documentation, or if the loan becomes delinquent within a specified amount of time after purchase. This risk varies based on the terms of the sale and servicing agreement with each investor.

4.17 Mortgage banking is a complex financial services business requiring analytical skills and financial modeling and forecasting abilities. The required level of computer systems support for mortgage banking operations is significant. Accurate data that is instantly available is paramount in managing the risks of mortgage banking. The resources required to compete effectively have made it difficult for the small, independent firm to survive, and the medium- to large-size mortgage banking operations are often subsidiaries of larger institutions, both financial and non-financial.

REGULATION AND OVERSIGHT

4.18 Publicly held mortgage companies are generally subject to requirements of federal securities laws, including the Securities Act of 1933 and the Securities Exchange Act of 1934 (Exchange Act). Companies whose securities are registered under the Exchange Act must comply with its reporting requirements through periodic filings with the Securities and Exchange Commission (SEC).

4.19 Virtually all states have enacted laws governing the conduct of mortgage lenders and mortgage services, and have created regulatory bodies to oversee the industry. The majority of all jurisdictions have licensing requirements for mortgage brokering, lending and servicing. The scope of these requirements can vary significantly. Certain states simply require that an entity register with a state before participating in a certain mortgage-related activity. Others require compliance with strict regulations concerning record keeping, office location, accounting, and origination and servicing procedures.

4.20 The mortgage lending process is regulated by both state and federal law. Regulations are generally designed to protect the consumer from unfair lending practices, and non-compliance with the regulations may result in financial liability, including the imposition of civil money penalties and reimbursements to the borrower, where applicable. Certain of the more significant regulations are discussed in Chapter 8.

4.21 In addition, in connection with various lending programs that a mortgage lender may be involved in, specific program requirements may be applicable. Certain common requirements are discussed in the following paragraphs.

4.22 U.S. Department of Housing and Urban Development (HUD) sponsors a broad range of programs designed to revitalize urban neighborhoods, stimulate housing construction, encourage home ownership opportunities, and provide safe and affordable housing. The programs are carried out through various forms of federal financial assistance, including direct loans and mortgage insurance. The Federal Housing Administration (FHA) was established by Congress in 1934 and is part of HUD. The FHA was created to encourage lenders to make residential mortgage loans by providing mortgage insurance. To participate in the FHA mortgage insurance program, a mortgage lender must obtain HUD approval by meeting various requirements prescribed by HUD, including maintaining minimum net worth requirements. Net worth requirements vary depending on the program.

4.23 To obtain approval to sell and service mortgage loans for Fannie Mae and/or Freddie Mac, a mortgage lender must meet various requirements including maintaining an acceptable net worth. Upon approval, a mortgage lender enters into a selling and servicing contract and must comply with the terms of the respective selling and servicing guides, which set forth detailed requirements regarding underwriting, mortgage delivery and servicing.

4.24 Ginnie Mae was created by Congress as part of HUD. Ginnie Mae's primary role is to guaranty mortgage-backed securities issued by Ginnie Mae-approved lenders and backed principally by FHA-insured and VA-guaranteed loans. To obtain Ginnie Mae approval, a mortgage lender must be a HUD-approved lender and a Ginnie Mae- or Fannie Mae-approved mortgage servicer with experience necessary to issue and service mortgage-backed securities. A mortgage lender must also meet net worth requirements prescribed by Ginnie Mae.

4.25 Mortgage lenders may also enter into agreements with private investors to sell and service mortgage loans. Such agreements set forth various standards applicable to the transaction and may include minimum financial or net worth requirements.

REPORTING CONSIDERATIONS

HUD Programs

4.26 To participate in HUD programs, a "non-supervised mortgagee" (a lender other than a financial institution that is a member of the Federal Reserve System or whose accounts are insured by the FDIC or the NCUA) must comply with the requirements of the Consolidated Audit Guide for Audits of HUD Programs, issued by the HUD Office of Inspector General. The Guide requires that the engagement be performed in accordance with Government Auditing Standards and contains (1) suggested procedures for testing an entity's compliance with laws and regulations affecting HUD-assisted programs, (2) a requirement to test controls in all HUD-related audits, (3) the basic financial statements and types of supplementary information that must be presented with an entity's basic financial statements, and (4) an auditor's reporting responsibilities and illustrative reports on the basic financial statements and supplementary information, internal control, and compliance with laws and regulations.

Residential Loan Servicing for Investors

4.27 Lenders who service residential mortgage loans for investors may be required to engage an independent accountant to provide assurance relating to management's written assertions about compliance with the minimum servicing standards set forth in the Uniform Single Attestation Program for Mortgage Bankers (USAP). This examination engagement is performed in accordance with SSAE No. 3, *Compliance Attestation*. The USAP was developed by the Mortgage Bankers' Association of America and is intended to provide the minimum servicing standards that an investor should expect a servicing entity to comply with.

CHAPTER 5

Audit Planning Considerations

SCOPE OF SERVICES

5.01 The scope of services rendered by independent accountants generally depends on the types of reports to be issued as a result of the engagement. Early in the engagement, the independent accountant should establish an understanding with the institution's management regarding the scope of services to be performed and the reports to be issued, which may include auditing the institution's financial statements in accordance with generally accepted auditing standards (GAAS). Statement of Accounting Standards No. 83, *Establishing an Understanding With the Client*, as amended by SAS No. 89, *Audit Adjustments* (AICPA, *Professional Standards*, vol. 1, AU sec. 310), states that the understanding with the client should include the responsibilities, and limitation of the engagement. The understanding should be documented in the workpapers, preferably through a written communication with the client. If the accountant believes an understanding with the client has not been established, he or she should decline to accept or perform the engagement. The accountant should consider whether the scope of the work includes the engagements necessary to provide the independent accountants' reports necessary to satisfy relevant regulatory requirements, such as those engagements described in chapter 1 (see paragraph 1.42), as well as any additional legal or contractual requirements, such as—

- Auditing the financial statements of common trust funds and applying agreed-upon procedures related to trust activities. (Chapter 20 includes a description of trust services and activities.)
- Reporting on management's assertions about compliance with the requirements of the Consolidated Audit Guide for Audits of HUD programs, or compliance with the minimum servicing standards set forth in Uniform Single Audit Program for Mortgage Bankers (USAP). (See chapter 4.)
- Applying minimum agreed-upon procedures to assist the supervisory committee in fulfilling its responsibilities. The NCUA wants the supervisory committee to expand the scope of services beyond the minimum if the supervisory committee believes the scope expansion is necessary. (See chapters 2 and 22.)
- Reporting on management's assertions about compliance with certain Department of Education requirements relative to student loan activities. (See chapter 1.)
- Reporting on the processing of transactions by banks and savings institutions or credit union service organizations (CUSOs) functioning as service organizations in accordance with Statement on Auditing Standards (SAS) No. 70, *Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324). (See chapters 10, 13, and 20 as they relate to loan servicing, deposits, and trust activities, respectively.)

Planning a Financial Statement Audit

5.02 The objective of an audit of an institution's financial statements is to express an opinion on whether its financial statements present fairly, in all material respects, its financial position, the results of its operations, and its cash flows in conformity with generally accepted accounting principles (GAAP). To accomplish that objective, the independent accountant assesses the risk that the financial statements contain material misstatements and plans and performs audit procedures to provide reasonable assurance that the financial statements are free of material misstatements. This section on planning the audit of the financial statements of a depository or lending institution addresses the consideration of risk at the financial statement level and general planning considerations. Consideration of audit risk at the account balance and class of transaction level is discussed in subsequent chapters.

5.03 The first standard of field work requires that audit work be adequately planned and that assistants, if any, be properly supervised. SAS No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311), as amended, provides guidance on the considerations and procedures applicable to planning and supervision, including preparing a written audit program and obtaining knowledge of the entity's business. Audit planning also involves developing an overall strategy for the conduct and scope of the audit. SAS No. 22 recognizes that the nature, timing, and extent of planning vary with the size and complexity of the entity whose financial statements are being audited, as well as with the independent accountant's experience with the entity and knowledge of the entity's business. As required by SAS No. 22, independent accountants who undertake audits of financial statements of depository institutions should possess sufficient knowledge of matters that affect such institutions, including applicable regulatory matters.

Knowledge of the Client's Business

5.04 In addition to knowledge of the industry, including matters such as those described in chapters 1 and 2, the independent accountant should have knowledge of matters that are unique to the entity whose financial statements are being audited. With regard to financial institutions, such matters include risk management strategies, organizational structure, product lines and services, capital structure, locations, and other operating characteristics. The independent accountant's knowledge of the institution's business should be sufficient to provide an understanding of events, transactions, and practices that may have a significant effect on the institution's financial statements. For public companies, the independent accountant should also obtain an understanding of the operating segments (as defined by the Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 131, *Disclosures about Segments of an Enterprise and Related Information*, paragraph 10) of the business.

5.05 Knowledge of the institution's business is generally obtained through experience with the client, discussions with predecessor independent accountants (if appropriate), discussion with institution personnel, and review of pertinent documents. Such knowledge may also be obtained or supplemented by reading documents such as—

- The charter and bylaws of the institution.
- Minutes of meetings of the board of directors, audit committee, credit committee or loan officers or both, and other appropriate committees.
- Prior-year and interim financial statements and other relevant reports, such as recently issued registration statements.
- Risk management strategies and reports, such as interest rate, asset quality, and liquidity reports.
- Organizational charts.
- Operating policies, including strategies for lending and investing.
- Regulatory examination reports
- Periodic regulatory financial reports: Federal Financial Institutions Examination Council (FFIEC) Consolidated Reports of Condition and Income; Office of Thrift Supervision Thrift Financial Reports; or National Credit Union Administration (collectively, *call reports*).
- Sales brochures and other marketing materials.
- Capital or business plans.
- Internal reports and financial information utilized by management to make segment–related decisions.

5.06 ***Related Parties.*** Obtaining knowledge of a client's business should also include performing the procedures in paragraph 2 of SAS No. 45, *Omnibus Statement on Auditing Standards—1983* (AICPA, *Professional Standards*, vol. 1, AU sec. 334, "Related Parties"), to determine the existence of related party relationships and transactions with such parties. Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 57, *Related Party Disclosures*, defines *related parties* as—

a. Affiliates of the institution (a party that, directly or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with an institution).

b. Entities for which investments are accounted for by the equity method by the institution.

c. Trusts for the benefit of employees, such as pension and profit-sharing trusts, that are managed by or are under the trusteeship of management of the institution.

d. Principal owners of the institution.

e. Management of the institution.

f. Members of the immediate families of the principal owners of the institution and its management.

5.07 Also included in the FASB Statement No. 57 definitions of related parties are other parties with which the institution may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests. Another party is also a related party if it can significantly influence the management or operating policies of the transacting parties, or if it has an ownership interest in one of the transacting parties and can significantly influence the other to the extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

5.08 SAS No. 45 states that, in auditing related party transactions that are identified during the course of the audit, the independent accountant should be aware that the substance of a particular transaction could be significantly different from its form and that financial statements should recognize the substance of particular transactions rather than merely their legal form. If the institution includes a representation in the financial statements that a related party transaction was consummated on terms equivalent to those that prevail in arm's-length transactions, and the independent accountant believes that the representation is unsubstantiated by management, he or she should express a qualified or adverse opinion because of a departure from GAAP, depending on materiality. (See SAS No. 58, *Reports on Audited Financial Statements* [AICPA, *Professional Standards*, vol. 1, AU sec. 508], as amended.)

Industry Risk Factors

5.09 Independent accountants with clients in the industry should be aware of the general business and economic risk factors that affect the industry.[1] There is no list of risk factors that can cover all of the complex characteristics that affect transactions in the industry. Competition for business, innovations in financial instruments, and the role of regulatory policy were introduced above. Emerging regulatory and accounting guidance are discussed throughout this Guide. Other primary risk factors (discussed below) involve the sensitivity of institutions' earnings to changes in interest rates, liquidity, and asset quality. Independent accountants should consider all such risk factors when planning the audit of an institution's financial statements. Practical considerations of these risk factors for certain transactions are provided in each chapter where appropriate.

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[1] One source of such information is the AICPA's Audit Risk Alert series.

Interest-Rate Risk

5.10 As stated above**,** financial institutions derive their income primarily from the excess of interest collected over interest paid. The rates of interest an institution earns on its assets and owes on its liabilities generally are established contractually for a period of time. Market interest rates change over time. Accordingly, an institution is exposed to lower profit margins (or losses) if it cannot adapt to interest-rate changes.

5.11 For example, assume an institution's assets carry intermediate- or long-term fixed rates. Assume those assets were funded with short-term liabilities. Also assume that interest rates rise by the time the short-term liabilities must be refinanced. The increase in the institution's interest expense on the new liabilities—which carry new, higher rates—will not be offset if assets continue to earn at the long-term fixed rates. Accordingly, the institution's profits would decrease on the transaction because the institution will either have lower net interest income or, possibly, net interest expense. Similar risks exist when assets are subject to contractual interest-rate ceilings, or rate-sensitive assets are funded by longer-term, fixed-rate liabilities in a decreasing-rate environment.

5.12 Several techniques might be used by an institution to minimize interest-rate risk. One approach is for the institution to continually analyze and manage assets and liabilities based on their payment streams and interest rates, the timing of their maturities, and their sensitivity to actual or potential changes in market interest rates. Such activities fall under the broad definition of asset/liability management.

5.13 One technique used in asset/liability management is measurement of an institution's asset/liability gap—that is, the difference between the cash flow amounts of interest-sensitive assets and liabilities that will be refinanced (or repriced) during a given period. For example, if the asset amount to be repriced exceeds the corresponding liability amount for a certain day, month, year, or longer period, the institution is in an asset-sensitive gap position. In this situation, net interest income would increase if market interest rates rose or decrease if market interest rates fell. If, alternatively, more liabilities than assets will reprice, the institution is in a liability-sensitive position. Accordingly, net interest income would decline when rates rose and increase when rates fell. Such gap analysis assumes that assets and liabilities will be repriced only when they mature—it does not consider opportunities to reprice principal or interest cash flows before maturity. Also, these examples assume that interest-rate changes for assets and liabilities are of the same magnitude, whereas actual interest-rate changes generally differ in magnitude for assets and liabilities.

5.14 Duration analysis is a technique that builds on gap analysis by adding consideration of the average life of a stream of cash flows. The duration of an asset or liability is measured by weighting cash flow amounts based on their timing. Accordingly, duration analysis adds a measure of the effect of the timing of interest-rate changes on earnings.

5.15 Another technique used to analyze interest-rate risk involves simulation models. These models measure the effect of changes in interest rates on the market value of an institution under a premise that interest-rate changes are not static but dynamic. Simulation analysis involves the projection of various interest-rate scenarios over future periods. The estimated cash flows for each rate scenario are discounted to arrive at a present value calculation for each rate scenario. The resulting range of probable risk exposures reflects both current and expected interest-rate risk. The rate scenarios often reflect variations of factors such as the mix of assets and liabilities and related pricing strategies. As with gap and duration analyses, if the assumptions are not valid, the results may not provide an accurate reflection of the institution's interest-rate risk.

5.16 Several ways an institution can manage interest-rate risk include—

- Selling existing assets or repaying certain liabilities.
- Matching repricing periods for new assets and liabilities—for example, by shortening terms of new loans or investments.
- Hedging existing assets, liabilities, firm commitments, or forecasted transactions.

5.17 An institution might also invest in more complex financial instruments intended to hedge or otherwise change interest-rate risk. Interest-rate swaps, futures contracts, options on futures, and other such derivative instruments often are used for this purpose. Because these instruments are sensitive to interest-rate changes, they require management expertise to be effective. Accounting and regulatory guidance for these instruments continue to evolve. Chapter 15 discusses specific accounting and regulatory guidance in this area, as well as related audit considerations.

5.18 Financial institutions are subject to a related risk—prepayment risk—in falling rate environments. For example, mortgage loans and other receivables may be prepaid by a debtor so that the debtor may refund its obligations at new, lower rates. Prepayments of assets carrying the old, higher rates reduce the institution's interest income and overall asset yields. Prepayment risk is discussed further in chapter 6.

Liquidity Risk

5.19 A large portion of an institution's liabilities may be short term or due on demand, while most of its assets may be invested in long-term loans or investments. Accordingly, the institution needs to have in place sources of cash to meet short-term demands. These funds can be obtained in cash markets, by borrowing, or by selling assets. Also, the secondary-mortgage, repurchase agreement, and Euro-markets have become increasingly important sources of liquidity for banks and savings institutions. However, if an institution must resort to sales of assets or loans to obtain liquidity, immediate losses will be incurred when the effective rates those assets carry are below market rates at the time of sale. Related audit considerations are addressed in chapter 6.

5.20 The composition of an institution's deposits also affects liquidity and interest-rate risk because large volumes of deposits can be withdrawn over a short period of time. For example, if an institution receives adverse publicity, it may have difficulty retaining deposits and, therefore, become dependent on other forms of borrowing at a higher cost of funds. (Chapter 13 addresses audit considerations for deposits.)

Asset-Quality Risk

5.21 Financial institutions have generally suffered their most severe losses as a result of the loss of expected cash flows due to loan default sand inadequate collateral. For example, significant credit losses on real estate loans have occurred, due largely to downturns in regional and national real estate markets, but also because of other general economic conditions and higher-risk lending activities. Chapter 9 addresses credit losses.

5.22 Other financial assets are subject to other impairment issues—similar to credit quality—that involve subjective determinations. For example, increased prepayments of principal during periods of falling interest rates have a significant impact on the economic value of assets such as mortgage servicing rights.

5.23 Independent accountants who audit financial statements of financial institutions should give particular attention to the assessment of impairment of financial assets. The independent accountant should focus on the methods used, assumptions made, and conclusions reached by management (and outside specialists relied on by management, such as appraisers) in assessing impairment of financial assets. Practical guidance is provided in subsequent chapters.

Fiduciary Risk

5.24 Many financial institutions activities involve custody of financial assets, management of such assets, or both. Fiduciary responsibilities are the focus of activities such as servicing the collateral behind asset-backed securities, managing mutual funds, and administering trusts. These activities expose the institution to the risk of loss arising from failure to properly process transactions or handle the related assets on behalf of third parties. Related audit considerations are addressed in subsequent chapters.

Processing Risk

5.25 Large volumes of transactions must be processed by most financial institutions, generally over short periods of time. Demands placed on both computerized and manual systems can be great. These demands increase the risk that the accuracy and timeliness of related information could be impaired.

5.26 Computers are used in virtually all banks and savings institutions activities that require accurate and timely processing of large volumes of transactions, such as electronic funds transfers and check processing. Related considerations are discussed in subsequent chapters.

Internal Control

5.27 The assets of financial institutions generally are more negotiable and more liquid than those of most other enterprises. As a result, they may be subject to greater risk of loss than are the assets of most other enterprises. In addition, the operations of financial institutions are characterized by a high volume of transactions; as a result, the effectiveness of internal control is a significant audit consideration.[2]

5.28 SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit*, as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), provides guidance on the independent accountant's consideration of an entity's internal control in a GAAS audit of financial statements.[3] Paragraphs 6 and 7 of SAS No. 55, as amended, define internal control; paragraphs 8 through 13 describe the objectives and components of internal control; and paragraphs 19 through 40 explain how an independent accountant should consider internal control in planning and performing an audit. Paragraph 19 of SAS No. 55, as amended, requires that, in all audits, the independent accountant obtain an understanding of each of the five components of internal control (the control environment, risk assessment, control activities, information and communication, and monitoring) sufficient to plan the audit by performing procedures to understand the design of controls relevant to an audit of financial statements and whether they have been placed in operation.

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[2] This section discusses the consideration of internal control in a financial statement audit; it does not address reporting on a written management assertion about financial reporting controls, such as the attestation report discussed in appendix D.

[3] SSAE No. 6, *Reporting on an Entity's Internal Control Over Financial Reporting: An Amendment to Statement on Standards for Attestation Engagements No. 2* (AICPA, *Professional Standards*, vol. 1, AT sec. 400), conforms the description of elements of an entity's internal control to the components of internal control contained in SAS No. 78 and the *Internal Control—Integrated Framework*.

5.29 After obtaining this understanding, the independent accountant assesses control risk for the assertions embodied in the account balance, transaction class, and disclosure components of the financial statements. The independent accountant may assess control risk at the maximum level (the greatest probability that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by the institution's internal control) because the independent accountant believes controls are unlikely to pertain to an assertion, are unlikely to be effective, or because evaluating their effectiveness would be inefficient. Alternatively, the independent accountant may obtain evidential matter about the effectiveness of both the design and operation of a control that supports a lower assessed level of control risk. In such cases, the independent accountant considers whether evidential matter sufficient to support a further reduction is likely to be available and whether performing additional tests of controls to obtain such evidential matter would be efficient. Such evidential matter may be obtained from tests of controls planned and performed in accordance with SAS No. 55, as amended.[4]

5.30 The independent accountant uses the knowledge provided by the understanding of internal control and the assessed level of control risk in determining the nature, timing, and extent of substantive tests for financial statement assertions.

5.31 Paragraph 6 of SAS No. 55, as amended, explains that internal control is a process—effected by an entity's board of directors, management, and other personnel—designed to provide reasonable assurance regarding the achievement of objectives in the following categories: (*a*) reliability of financial reporting, (*b*) effectiveness and efficiency of operations, and (*c*) compliance with applicable laws and regulations.

5.32 Paragraph 7 of SAS No. 55, as amended, says that internal control consists of five interrelated components:

- *a.* *Control environment* sets the tone of an institution, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure.
- *b.* *Risk assessment* is the institution's identification and analysis of relevant risks to achievement of its objectives, forming a basis for determining how the risks should be managed.
- *c.* *Control activities* are the policies and procedures that help ensure management directives are carried out.
- *d.* *Information and communication* are the identification, capture, and exchange of information in a form and time frame that enable people to carry out their responsibilities.
- *e.* *Monitoring* is a process that assesses the quality of internal control performance over time.

5.33 Paragraph 15 of SAS No. 55, as amended, explains that the five components of internal control are applicable to the audit of every institution and that the components should be considered in the context of the following:

- The institution's size
- The institution's organization and ownership characteristics
- The nature of the institution's business
- The diversity and complexity of the institution's operations
- The institution's methods of transmitting, processing, maintaining, and accessing information

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[4] Further guidance is also provided in the AICPA Audit Guide *Consideration of Internal Control in a Financial Statement Audit*.

- Applicable legal and regulatory requirements

5.34 Paragraph 10 of SAS No. 55, as amended, says that, generally, controls that are relevant to an audit pertain to the institution's objective of preparing financial statements for external purposes that are fairly presented in conformity with GAAP or a comprehensive basis of accounting other than GAAP.

5.35 Paragraph 11 of SAS No. 55, as amended, says the controls relating to operations and compliance objectives may be relevant to an audit if they pertain to data the independent accountant evaluates or uses in applying auditing procedures. For example, controls pertaining to detecting noncompliance with laws and regulations that may have a direct and material effect on the financial statements, such as compliance with income tax laws and regulations used to determine the income tax provision, may be relevant to an audit.

5.36 ***Information Technology Considerations.*** Financial institutions operations are characterized by large volumes of transactions and, therefore, generally rely heavily on computers. SAS No. 31, *Evidential Matter*, as amended by SAS No. 80, *Amendment to Statement on Auditing Standards No. 31*, Evidential Matter (AICPA, *Professional Standards*, vol. 1, AU sec. 326), provides guidance for independent accountants who have been engaged to audit an entity's financial statements when significant information is transmitted, processed, maintained, or accessed electronically.

5.37 Paragraph 14 of SAS No. 31, as amended, says the independent accountant may determine, in such circumstances, that it is not practical or possible to reduce detection risk to an acceptable level by performing only substantive tests for one or more financial statement assertions. Paragraph 14 says that, in such circumstances, the independent accountant should perform tests of controls to gather evidential matter to use in assessing control risk, or consider the effect on his or her report, as discussed in paragraph 25 of that Statement. For that reason, information technology is usually an important aspect of an institution's internal control.

5.38 In evaluating an institution's internal control and assessing control risk, control issues involving information technology are significant and should receive considerable attention. The independent accountant should consider matters such as—

- The extent to which information technology is used for significant accounting applications.
- The complexity of the institution's information technology, including whether outside service centers are used.
- The organizational structure for information technology, including the extent to which on-line terminals and networks are used.
- The physical security controls over computer equipment.
- Controls over information technology (for example, program changes and access to data files), operations, and systems.
- The availability of data.
- The use of information technology assisted audit techniques to increase the efficiency of performing procedures. (Using information technology assisted audit techniques may also provide the independent accountant with an opportunity to apply certain procedures to an entire population of accounts or transactions. In addition, in some accounting systems, it may be difficult or impossible for the independent accountant to analyze certain data or test specific control procedures without information technology assistance.)

5.39 Paragraph 18 of SAS No. 31, as amended, addresses situations where some of the accounting data and corroborating evidential matter are available only in electronic form. For example, entities may use Electronic Data Interchange (EDI) or image processing systems. Paragraph 18 explains that in image processing systems, documents are scanned and converted into electronic images to facilitate storage and reference, and the source documents may not be retained after conversion. Certain electronic evidence may exist at a certain point in time. However, such evidence may not be retrievable after a specified period of time if files are changed and if backup files do not exist. Paragraph 18 says, therefore, that the independent accountant should consider the time during which information exists or is available in determining the nature, timing, and extent of his or her substantive tests, and, if applicable, tests of controls.

5.40 The AICPA Auditing Procedure Study *Auditing in Common Computer Environments*, provides guidance to independent accountants when institutions use microcomputers, local area networks, end-user computing, data base management systems, or telecommunications in conjunction with their accounting systems. The Auditing Procedure Study identifies a number of electronic data processing technologies and software applications that may affect the financial statement audit, describes how these technologies and applications work, and discusses possible ramifications for the financial statement audit.

5.41 The AICPA Auditing Procedure Study, *The Information Technology Age: Evidential Matter in the Electronic Environment*, provides more guidance to independent accountants on applying SAS No. 31 in the audit of the financial statements of an institution where significant information is transmitted, processed, maintained, or accessed electronically.

5.42 Information technology may be performed solely by the institution, shared with others, or provided by an independent organization supplying specific data-processing services for a fee. SAS No. 70 provides guidance on the factors that an independent accountant should consider when auditing the financial statements of entities that obtain services from another organization that are part of its information system.

5.43 The independent accountant should consider whether specialized skills are needed to consider the effect of information technology on the audit, to understand the internal control, or to design and perform audit procedures. If specialized skills are needed, the independent accountant should seek the assistance of someone possessing such skills who may be either on the independent accountant's staff or an outside professional. If the use of such a professional is planned, the independent accountant should have sufficient information technology related knowledge to communicate the desired objectives to the information technology professional, to evaluate whether the specific procedures will meet the independent accountant's objectives, and to evaluate the results of the procedures applied as they relate to the nature, timing, and extent of other planned audit procedures.

5.44 System upgrades, conversions, and changes in technology have occurred with increasing frequency in the industry to accommodate the many changes in the nature and complexity of products and services offered, ongoing changes in accounting rules, continually evolving regulations, and mergers and acquisitions. Some system changes may affect internal control. For example, merging institutions with incompatible computer systems can have a significant negative impact on the surviving institution's internal control. In addition to obtaining the understanding of ongoing or planned changes in processing controls that is necessary to plan the audit, the independent accountant may find it necessary to consider the effect of system changes on—

- *a.* Controls over the accurate conversion of data to new or upgraded systems.
- *b.* The effectiveness of data provided to perform analyses, such as those of the institution's performance versus its plan for asset-liability management.
- *c.* The adequacy of the institution's disaster recovery plan and system.

5.45 SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit,* as amended by SAS No. 87, *Restricting the Use of an Auditor's Report,* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), provides guidance on identifying and reporting conditions that relate to an institution's internal control over financial reporting observed during an audit of financial statements in accordance with GAAS. SAS No. 60 requires that "reportable conditions" that are observed during such an audit be communicated to the audit committee, supervisory committee or to individuals with a level of authority and responsibility equivalent to that of an audit committee in organizations that do not have one.

5.46 Reportable conditions are matters coming to an auditor's attention that, in his or her judgment, should be communicated to the audit committee because they represent significant deficiencies in the design or operation of internal control that could adversely affect the institution's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. Such deficiencies may involve the internal control components of (*a*) the control environment, (*b*) risk assessment, (*c*) control activities, (*d*) information and communication, and (*e*) monitoring.

5.47 An appendix to SAS No. 60 includes a list of examples of reportable conditions.

Analytical Procedures

5.48 SAS No. 56, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 329), provides guidance on the use of analytical procedures in audits of financial statements in accordance with GAAS and prescribes the use of analytical procedures in both the planning and review stages for such engagements. For planning purposes, such procedures focus on (*a*) enhancing the independent accountant's understanding of the institution's business and transactions and events that have occurred since the last financial statement audit and (*b*) identifying areas that may present specific risks relevant to the financial statement audit. The objective of analytical procedures is to identify unusual transactions and events, and amounts, ratios, and trends that might indicate matters that have financial statement and audit planning ramifications.

5.49 Analytical procedures used in planning the audit generally use data aggregated at a high level. The nature, extent, and timing of the procedures, which are based on the independent accountant's judgment, may vary widely depending on the size and complexity of the institution. The procedures may consist of reviewing changes in account balances from the prior year to the current year using the general ledger or a preliminary or unadjusted working trial balance. Alternatively, the procedures may involve an extensive analysis of quarterly financial statements, ratios, statistics, and budgeted amounts, including their relationship to performance of the industry as a whole. In either case, the analytical procedures, combined with the independent accountant's knowledge of the business, serve as a basis for additional inquiries and effective planning.

5.50 Ratios, operating statistics, and other analytical information that may be useful in assessing an institution's position relative to other similar institutions and to industry norms, as well as in identifying unusual relationships between data about the institution itself, are generally readily available. Ratios and statistics developed for use by management or regulators often can be effectively used by the independent accountant in performing analytical procedures for planning purposes. Many institutions disclose analytical information in their annual and quarterly reports. Other sources of information that may be useful for planning purposes are the institution's call reports and the disclosures made by publicly held institutions in accordance with the Securities and Exchange Commission's Industry Guide No. 3, *Statistical Disclosures by Bank Holding Companies*. The *Uniform Bank Performance Reports,* published by the FFIEC, and the *Annual Bank Operating Statistics*, published by the Federal Deposit Insurance

Corporation (FDIC), contain industry data and statistics. There are also several sources of industry data published by private companies.

5.51 Analytical procedures involve the comparison of recorded amounts or ratios developed from recorded amounts with expectations developed by the independent accountant. Examples of analytical procedures that may be useful to independent accountants planning an audit of the financial statements of a bank or savings institution include comparison of account balances with budgeted and prior-period amounts as well as analysis of ratios that indicate relationships among elements of financial information within the period and relationships to similar information about other institutions. For overall review purposes, analytical procedures should focus on considering the adequacy of the evidence gathered in response to unusual or unexpected balances or relationships. The objective of the procedures is to help the independent accountant in assessing the conclusions reached and evaluating the overall financial statement presentation. Analytical procedures also may be used as substantive tests to identify potential misstatements. These procedures focus on comparing actual with expected balances and ratios and investigating and evaluating significant differences.

5.52 A number of the ratios that may be useful to the independent accountant in an audit of the financial statements of an institution are listed below with a brief description of the information they provide:

- *Investments to total assets*—measures the mix of earning assets
- *Loans to total assets*—measures the mix of earning assets
- *Investments by type divided by total investments*—measures the composition of investment portfolio
- *Loans to deposits*—indicates the funding sources for the loan base
- *Loans by type to total loans*—measures the composition of loan portfolio and of lending strategy and risk
- *Allowance for loan losses to total loans*—measures loan portfolio credit risk coverage
- *Loan loss recoveries to prior-year write-offs*—indicates write-off policy and measures recovery experience
- *Classified loans to total loans*—indicates asset quality
- *Investment income to average total securities*—measures investment portfolio yield
- *Allowance for loan losses to classified loans*—measures management's estimate of losses
- *Loan income to average net loans*—measures loan portfolio yield
- *Total interest expense to average total deposits*—measures costs of funds
- *Overhead to total revenue (net interest income plus noninterest income)*—measures operating efficiency
- *Net income to average total assets*—measures return on assets
- *Net income to average capital*—measures return on equity
- *Capital ratios*—measures financial strength
- *Noninterest income to total revenue (net interest income plus noninterest income)*—measures the extent of noninterest income
- *Liabilities to shareholders' equity*—measures the extent equity can cover creditors' claims in the event of liquidation

Using the Work of a Specialist

5.53 SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards,* vol. 1, AU sec. 336), provides guidance for independent accountants who use the work of a specialist in audits performed in accordance with GAAS. SAS No. 73 provides examples of situations that might require using the work of specialists and types of specialists being used, and guidance for when a specialist is related to the client.

5.54 SAS No. 73 applies whenever the independent accountant uses a specialist's work as evidential matter in performing substantive tests to evaluate material financial statement assertions, regardless of whether—

- Management engages or employs specialists.
- Management engages a specialist employed by the independent accountant's firm to provide advisory services.
- The independent accountant engages the specialist.

5.55 SAS No. 73 does not apply if a specialist employed by the independent accountant's firm participates in the audit. For example, if the independent accountant's firm employs an appraiser and decides to use that appraiser as part of the audit team to evaluate the carrying value of properties, SAS No. 73 would not apply. In such cases, the independent accountant should refer to SAS No. 22.

5.56 SAS No. 73 requires an independent accountant to evaluate the professional qualifications of the specialist to determine whether he or she possesses the necessary skill or knowledge. SAS No. 73 requires the independent accountant to consider the specialist's experience and the type of work under consideration. For example, if the independent accountant is using an appraisal of commercial real estate values in connection with the audit of a s financial statements, he or she will need to consider not only the appraiser's professional qualifications but also his or her experience with commercial real estate.

5.57 The independent accountant should also understand the nature and purpose of the specialist's work. In a number of cases, the specialist's work may have been prepared for another purpose (such as, an appraiser's report prepared for a loan origination). In these situations, the independent accountant should consider the appropriateness of using the specialist's work to evaluate financial statement assertions. SAS No. 73 acknowledges that, in some cases, an independent accountant may need to contact the specialist to determine whether the specialist is aware that his or her work will be used for corroborating the assertions in the financial statements.

5.58 SAS No. 73 does not preclude the independent accountant from using a specialist who has a relationship with the client, including situations in which the client has the ability to directly or indirectly control or significantly influence the specialist. The Statement does, however, require the independent accountant to evaluate the relationship and consider whether it might impair the specialist's objectivity. If the independent accountant concludes that the specialist's objectivity might be impaired, additional procedures should be performed, possibly including using the work of another specialist.

5.59 The Audit Issues Task Force (AITF) of the Auditing Standards Board has issued an interpretation of SAS No. 73 entitled, “The Use of Legal Interpretation as Evidential Matter to Support Management’s Assertion That a Transfer of Financial Assets Has Met the Isolation Criterion in Paragraph 9(a) of Statement of Financial Accounting Standards No. 125” (AICPA, *Professional Standards*, vol. 1 AU sec. 9336). The Interpretation was issued to provide guidance to auditors relating to evidential mater to support management’s assertion that the condition stated in paragraph 9(a) of FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities, is met, that is, that “the transferred assets have been isolated from the transferor and its creditors, even in bankruptcy or other receivership.” This Interpretation does not apply to transfers of financial assets by banks for which a receiver, if appointed, would be the FDIC or its designee. The AITF has amended the Interpretation to include the form of letter that adequately communicates permission for the auditor to use a legal specialist’s opinion for the purpose of evaluating management’s assertion as well as sample language that does not adequately communicate such permission.

Processing of Transactions by Service Organizations

5.60 Paragraphs 6 through 21 of SAS No. 70, as amended by SAS No. 88, *Service Organizations and Reporting on Consistency*, provide guidance on the user auditor's consideration of the effect of a service organization on internal control of the user organization and availability of audit evidence. That guidance should be considered when planning and performing the audit of the financial statements of an institution that uses a service organization to process transactions (for example, using a mortgage banker to service mortgages).

Consideration of the Possibility of Material Misstatements

5.61 SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1 AU sec. 312), provides guidance on the auditor's consideration of the risk that the financial statements are materially misstated by error or fraud. SAS No. 82, Consideration of Fraud in a Financial Statement Audit (AICPA, *Professional Standards*, vol. 1 AU sec. 316), provides specific guidance to auditors in fulfilling their responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement caused by fraud. SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU Sec 317), prescribes the nature and extent of the consideration an auditor should give to the possibility of illegal acts by a client in an audit of the financial statements. SAS No. 47 states that the auditor has the responsibility to plan and perform the audit to obtain reasonable assurance that misstatements, whether caused by error or fraud, that are material to the financial statements are detected. In obtaining that assurance, there is no important distinction between errors and fraud. There is a distinction, however, in the auditor's response to detected misstatements.

5.62 SAS No. 82 requires the auditor to assess the risk of material misstatements due to fraud and consider the assessment in designing the audit procedures to be performed. In making this assessment, the auditor should consider fraud risk factors that relate to both (a) misstatements arising from fraudulent financial reporting and (b) misstatements arising from misappropriation of assets in the following categories:

Fraudulent Financial Reporting

- Management's characteristics and influence over the control environment
- Industry conditions
- Operating characteristics and financial stability

Misappropriation of Assets

- Susceptibility of assets to misappropriation
- Controls

Auditors should consider the fraud risk factors described in SAS No. 82. In addition, presented below is a list of characteristics that may be indicative of increased risk of possible material misstatements in an audit of the financial statements of a financial institution.

a. Noncompliance with laws and regulations, including—
- Failure to meet regulatory capital requirements or otherwise adhere to capital plans
- Agreements, both formal and informal, between an institution and its regulators

b. Material changes in operations or operating performance, for example—
- Sudden change in management's asset/liability management strategies or activities
- Increased dependence on brokered deposits or short-term borrowings as a source of funds

- Significant changes in the volume of hedging or trading activities
- Increases in overhead ratios to levels that are significantly above industry averages
- Significant increases in non-earning assets
- Severe cost-cutting measures
- Declining net-interest spreads or related changes in interest-rate risk
- Increases in rates on deposits to levels that are significantly higher than those offered by competitors
- Sudden or rapid growth in assets or off-balance-sheet activities

c. Practices that fail to consider changing economic conditions, for example, overreliance on historical data in the evaluation of credit risk.

d. Material one-time transactions, particularly those that (1) account for a material portion of related income or otherwise indicate attempts to realize large, short-term benefits or (2) occur at or near the end of a reporting period. For example—
- High-volume purchases or sales of assets (such as mortgage servicing rights)
- Speculative or unusual transactions
- Sales of loans classified as held for investment
- Sales of debt securities classified as held-to-maturity

e. Highly complex or speculative transactions, such as those involving—
- Complex mortgage securities
- Investments in noninvestment-grade securities
- Complicated, multistep transactions involving real estate

f. Nontraditional or unusual loan transactions, for example—
- Loans with unusual, questionable, or inadequate collateral
- Loans outside the institution's normal lending area
- Poorly documented loans
- Loans where interest is paid from interest reserves
- Loans secured by collateral that has dramatically changed in value
- Significant concentrations of loans (that is, in one industry or geographical area or with one borrower or its related interests)
- Real estate venture loans that may need to be accounted for as equity investments
- A pattern of extension or modification of loan terms
- Lending activities inconsistent with management's stated policies

5.63 The independent accountant should also consider the potential for insider abuse—that is, actions by the institution's officers, directors, or major shareholders intended to benefit themselves or related parties without regard to potential effects on the institution. The potential for insider abuse is often associated with unusual or questionable loan transactions like those described above.

Developing an Overall Audit Plan

5.64 The independent accountant's overall judgment about the level of inherent risk in an engagement affects staffing, the extent of supervision, overall audit scope and strategy, and the degree of professional skepticism applied. As the above discussion underscores, banks and savings institutions are subject to certain risks that are less prevalent in commercial, industrial, and other nonfinancial businesses, and they operate in a particularly volatile and highly regulated environment. Accordingly, the independent accountant should consider staffing those areas of the engagement that involve relatively higher risk with personnel with appropriate relevant experience, providing more extensive supervision, and maintaining a heightened degree of professional skepticism.

5.65 ***Internal Audit Considerations.*** 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), provides guidance on the independent accountant's consideration of the existence of an internal audit function in determining the nature, timing, and extent of auditing procedures to be performed, and on using internal auditors to provide direct assistance to the independent accountant in an audit of financial statements performed in accordance with GAAS.

5.66 ***Timing of the Audit.*** In audits of financial statements, independent accountants often determine that a significant number of audit procedures can be performed prior to the balance-sheet date. SAS No. 45, *Omnibus Statement on Auditing Standards—1983* (AICPA, *Professional Standards*, vol. 1, AU sec. 313, "Substantive Tests Prior to the Balance-Sheet Date"), provides guidance concerning—

a. Factors to be considered before applying principal substantive tests to the details of particular asset or liability accounts as of a date that is prior to the balance-sheet date (an interim date).
b. Audit procedures to provide a reasonable basis for extending audit conclusions from such principal substantive tests from an interim date to the balance-sheet date (the remaining period).
c. Coordinating the timing of auditing procedures.

Compliance With Laws and Regulations

5.67 Paragraph 7 of SAS No. 22 states that, in planning the audit, the independent accountant should consider "matters affecting the industry in which the entity operates, such as economic conditions, *government regulations,* and changes in technology, as they relate to his audit [*emphasis added*]." In performing an audit of financial statements in accordance with GAAS, the independent accountant considers government regulations in light of how they might affect the financial statement assertions.

5.68 SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317), prescribes the nature and extent of the independent accountant's consideration of the possibility of illegal acts by a client in an audit of financial statements in accordance with GAAS.

5.69 The term *illegal* acts refers to violations of laws or governmental regulations. Illegal acts vary considerably in their relation to the financial statements. The independent accountant's responsibility to detect and report misstatements resulting from illegal acts is dependent on the relationship between the law or regulation that is violated and the financial statements.

5.70 Some laws and regulations have a direct and possibly material effect on the determination of financial statement amounts. For example:

- Tax laws affect accruals and the amount recognized as expense in the accounting period.
- Certain laws and regulations place limits on the nature or amount of investments that institutions are permitted to hold. Such laws and regulations may affect the classification and valuation of assets.

5.71 Other laws and regulations relate more to an institution's operating aspects than to its financial and accounting aspects, and their effect on the financial statements is indirect. Examples of such laws and regulations include those related to securities trading, occupational safety and health, food and drug administration, environmental protection, equal employment opportunities, money laundering and antitrust violations. Another example of such laws and regulations are those that require institutions to report certain financial transactions to governmental agencies. The indirect effect of violations of such laws and regulations is normally the result of the need to disclose a contingent liability because of the allegation or determination of illegality.

5.72 The ultimate responsibility for compliance with laws and regulations rests with management of the institution. Nonetheless, throughout the audit, the independent accountant should be aware of the possibility that illegal acts that could have a material effect on the institution's financial statements may have occurred. The independent accountant should design the audit to provide reasonable assurance of detecting misstatements resulting from illegal acts having a direct and material effect on the determination of financial statement amounts. If specific information comes to the independent accountant's attention that provides evidence of other possible illegal acts that could have a material indirect effect on the financial statements, the independent accountant should apply audit procedures specifically directed to ascertaining whether an illegal act has occurred. However, because of the characteristics of illegal acts explained above, an audit conducted in accordance with GAAS provides no assurance that indirect-effect illegal acts will be detected or that any contingent liabilities that may result will be disclosed.

Going Concern Considerations

5.73 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), as amended, requires independent accountants to evaluate—as part of every financial statement audit—whether there is substantial doubt about the ability of the entity 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. The independent accountant's evaluation of an institution's ability to continue as a going concern may be one of the most complex and important portions of the audit. This section describes the unique issues that an independent accountant may encounter in evaluating an institution's ability to continue as a going concern.

5.74 Financial institutions operate in a highly regulated environment. As a result, laws and regulations can have a significant effect on their operations. The enactment of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 and the FDIC Improvement Act of 1991 dramatically changed the regulatory environment in the banking and thrift industries and imposed new regulatory capital requirements that are far more stringent than previous requirements. Chapter 2 includes a discussion of regulatory capital requirements.

5.75 In accordance with SAS No. 59, the independent accountant should consider whether there is substantial doubt about an institution's ability to continue as a going concern for a reasonable period of time in the following manner:

a. The independent accountant considers whether the results of procedures performed in planning, gathering evidential matter relative to the various audit objectives, and completing the audit identify conditions and events that, when considered in the aggregate, indicate there could be substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time.

b. If the above considerations lead the independent accountant to believe that substantial doubt exists about the entity's ability to continue as a going concern for a reasonable period of time, the independent accountant should obtain information about management's plans intended to mitigate the adverse effects of the conditions or events that gave rise to the doubt and assess the likelihood that such plans can be effectively implemented.

c. After evaluating management's plans, the independent accountant concludes whether he or she has substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time.

5.76 SAS No. 59 states that it is not necessary to design audit procedures solely to identify conditions and events that, when considered in the aggregate, indicate there could be substantial doubt about the ability of an entity to continue as a going concern for a reasonable period of time. The results of auditing procedures designed and performed to achieve other audit objectives should be sufficient for that purpose. The following are examples of procedures normally performed in audits of the financial statements of banks and savings institutions that may identify such conditions and events:

- Analytical procedures
- Review of subsequent events
- Review of compliance with the terms of debt and loan agreements
- Reading of minutes of meetings of the board of directors and important committees of the board
- Inquiry of an entity's legal counsel about litigation, claims, and assessments
- Confirmation with related and third parties of the details of arrangements to provide or maintain financial support
- Review of the financial strength and liquidity of the parent company, if applicable
- Review of reports of significant examinations and related communications between examiners and the institution
- Review of compliance with regulatory capital requirements

5.77 In performing such audit procedures, the independent accountant may identify information about certain conditions or events that, when considered in the aggregate, indicate that there could be substantial doubt about the institution's ability to continue as a going concern for a reasonable period of time. The significance of such conditions and events will depend on the circumstances, and some may have significance only when viewed in conjunction with others. The following are examples of such conditions and events that may be encountered in audits of banks and savings institutions:

- Recurring operating losses
- Indications of strained liquidity
- Failure to meet minimum regulatory capital requirements or to adhere to the terms of an approved capital plan
- Concerns expressed or actions taken by regulatory authorities regarding alleged unsafe or unsound practices
- Indications of strained relationships between management and regulatory authorities

5.78 SAS No. 59 states that if, after considering management's plans, the independent accountant concludes that there is substantial doubt about the institution's ability to continue as a going concern for a reasonable period of time, the independent accountant should consider the possible effects on the financial statements and the adequacy of the related disclosures. Some of the information that might be disclosed includes—

- Pertinent conditions and events giving rise to the assessment of substantial doubt about the institution's ability to continue as a going concern for a reasonable period of time.
- The possible effects of such conditions and events.
- Management's evaluation of the significance of those conditions and events and any mitigating factors.
- Possible regulatory sanctions, including discontinuance of operations.
- Management's plans (including information about the institution's capital plan and relevant prospective financial information).
- Information about the recoverability or classification of recorded asset amounts or the amounts or classification of liabilities.

5.79 If, upon consideration of management's plans, the independent accountant concludes that substantial doubt about the institution's ability to continue as a going concern for a reasonable period of time is alleviated, the independent accountant should consider the need for disclosure in the financial statements of the principal conditions and events that initially caused the independent accountant to believe there was substantial doubt. Disclosure should include the possible effects of such conditions and events and any mitigating factors, including management's plans.

5.80 If the independent accountant concludes that substantial doubt about the institution's ability to continue as a going concern for a reasonable period of time remains, the audit report should include an explanatory paragraph (following the opinion paragraph) to reflect that conclusion. The independent accountant's decision about whether modification of the standard report is appropriate may depend also on—

- The institution's existing regulatory-capital position.
- The likelihood that the institution's regulatory-capital position will improve or deteriorate within the next twelve months.
- Whether the plan has been accepted by regulatory authorities.
- The independent accountant's assessment of the institution's ability to achieve its capital plan, if any.

5.81 Paragraph 22.09 discusses circumstances in which the independent accountant might disclaim an opinion.

5.82 The decision about the appropriate form of audit report to issue in particular circumstances is often a complex judgment that requires considerable professional experience. The independent accountant may have to communicate with the regulator to assist with his or her assessment. (Refer to chapter 1 for a discussion of required communications with regulators.) Chapter 22 includes an illustration of a report that includes such an explanatory paragraph.

Client Representations

5.83 SAS No. 85, Management Representations (AICPA, Professional Standards, vol. 1, AU sec. 333), requires that the independent accountant obtain written representations from management as part of an audit financial statements performed in accordance with GAAS and provides guidance concerning the representations to be obtained. Such representations are part of the evidential matter the independent accountant obtains but are not a substitute for the application of auditing procedures. The accountant obtains written representations from management to complement other auditing procedures. Written representations from management should be obtained for all financial statements and periods covered by the accountant's report. The specific written representations to be obtained depend on the circumstances of the engagement and the nature and basis of the presentation of the financial statements. Paragraph 6 of SAS No. 85, as amended by SAS No. 89, *Audit Adjustments*, lists matters ordinarily included in management's representation letter. Additional representations specific to banks and savings institutions that may be obtained include the following:

- All regulatory examination reports, supervisory correspondence, and similar materials from applicable regulatory agencies (particularly communications concerning supervisory actions or noncompliance with, or deficiencies in, rules and regulations or supervisory actions) have been provided to the independent accountant.
- The classification of securities between held-to-maturity, available-for-sale, or trading categories accurately reflects management's ability and intent.
- The methodology for determining fair value disclosures is based on reasonable assumptions.

- Adequate disclosure has been made of the status of the institution's capital plan filed with regulators, if applicable, and management believes it is in compliance with any formal agreements or orders in any memorandum of understanding or cease-and-desist order.
- Contingent assets and liabilities have been adequately disclosed in the financial statements.
- Related party transactions have been entered into in compliance with existing regulations.
- Adequate provision has been made for any losses, costs, or expenses that may be incurred on securities, loans, or leases and real estate as of the balance-sheet date.
- Other than temporary declines in the value of investment securities have been properly recognized in the financial statements.
- Commitments to purchase or sell securities under forward-placement, financial-futures contracts and standby commitments have been adequately disclosed in the financial statements.
- Sales with recourse have been adequately disclosed in the financial statements.
- Proper disclosure has been made regarding the nature, terms, and credit risk of financial instruments with off-balance-sheet risk.
- No transactions or activities are planned that would result in any recapture of the base-year, tax-basis bad debt reserves.
- Proper disclosure has been made regarding financial instruments with (a) significant off-balance-sheet risk and (b) significant individual or group concentrations of credit risk.

5.84 Management's representations may be limited to matters that are considered either individually or collectively material to the financial statements, provided management and the accountant have reached an understanding on materiality for this purpose. The representations should be made as of a date no earlier than the date of the accountant's report. Management's refusal to furnish written representations constitutes a limitation on the scope of the audit sufficient to preclude an unqualified opinion and is ordinarily sufficient to cause an accountant to disclaim an opinion or withdraw from the engagement.

Information Other Than Financial Statements

5.85 An institution may publish various documents that contain information in addition to audited financial statements and the independent auditor's report thereon. SAS No. 8, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 550), provides guidance for the independent accountant's consideration of such other information included in such documents.

5.86 In some circumstances, an independent accountant submits to the client or others a document that contains information in addition to the client's basic financial statements and the auditor's report thereon. Guidance on the form and content of such reporting is provided in SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents,* and SAS No. 52, *Omnibus Statement on Auditing Standards—1987* (collectively, AICPA, *Professional Standards*, vol. 1, AU sec. 551).

5.87 SAS No. 52 also provides guidance on the nature of procedures to be applied to supplementary information required by the FASB and describes the circumstances that would require the auditor to report such information (see AICPA, *Professional Standards*, vol. 1, AU sec. 558, "Required Supplementary Information").

Disclosures of Certain Significant Risks and Uncertainties

5.88 AICPA Statement of Position (SOP) 94-6, *Disclosure of Certain Significant Risks and Uncertainties*, requires institutions to include in their financial statements disclosures about (*a*) the nature of their operations and (*b*) the use of estimates in the preparation of their financial statements. Following are illustrations of application of these disclosure requirements by a bank or savings institution.

> *Nature of Operations*. ABC Institution operates seven branches in rural and suburban communities in the Midwestern United States. The Institution's primary source of revenue is providing loans to customers, who are predominantly small and middle-market businesses and middle-income individuals.
>
> *Use of Estimates in the Preparation of Financial Statements*. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and that affect the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

5.89 If specified disclosure criteria are met, SOP 94-6 also requires institutions to include in their financial statements disclosures about (*a*) certain significant estimates and (*b*) current vulnerability due to certain concentrations. Following are a discussion and illustrations of application of SOP 94-6 by a bank or savings institution to example events and circumstances that meet the disclosure criteria.

Certain Significant Estimates

5.90 Paragraphs 12 and 13 of SOP 94-6 require disclosure regarding estimates used in the determination of the carrying amounts of assets or liabilities or in disclosure of gain or loss contingencies when information available prior to issuance of the financial statements indicates that both of the following criteria are met:

- *a.* It is at least reasonably possible that the estimate of the effect on the financial statements of a condition, situation, or set of circumstances that existed at the date of the financial statements will change in the near term due to one or more future confirming events.
- *b.* The effect of the change would be material to the financial statements.

5.91 Paragraph 14 of SOP 94-6 says the disclosure should indicate the nature of the uncertainty and include an indication that it is at least reasonably possible that a change in the estimate will occur in the near term. Paragraph 14 further requires that, if the estimate involves a loss contingency covered by Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*, the disclosure should also include an estimate of the possible loss or range of loss, or state that such an estimate cannot be made.[5]

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[5] Paragraph 10 of FASB Statement No. 5 requires reporting entities to disclose certain loss contingencies, as follows:
If no accrual is made for a loss contingency because one or both of the conditions in paragraph 8 are not met, or *if an exposure to loss exists in excess of the amount accrued pursuant to the provisions of paragraph 8, disclosure of the contingency shall be made when there is at least a reasonable possibility that a loss or an additional loss may have been incurred*. The disclosure shall indicate the nature of the contingency and shall give an estimate of the possible loss or range of loss or state that such an estimate cannot be made.

5.92 Following is an excerpt from chapter 19 illustrating a disclosure about the allowance for loan losses when no uncertainties meet the disclosure criteria established in SOP 94-6, paragraph 13 and FASB Statement No. 5, paragraph 10.

> *Allowance for Loan Losses.* The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.
>
> The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectibility of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral, and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

5.93 The following illustrates a paragraph that might be added to the illustration in paragraph 1.35 to disclose an uncertainty that meets the disclosure criteria of paragraph 13, is a loss contingency covered by FASB Statement No. 5, and affects the estimate of loan losses for only some portion of the institution's loan portfolio:

> Three of the Institution's seven branches are in communities that were flooded in late 199X. These branches made loans to individuals and businesses affected by the flooding and the Institution considered the flood's effect in determining the adequacy of the allowance for loan losses. No estimate can be made of a range of amounts of loss that are reasonably possible with respect to that event.[6]

5.94 The following illustrates a paragraph that might be added to the illustration in paragraph 1.35 to disclose an uncertainty that meets the disclosure criteria of paragraph 13 and is a loss contingency covered by FASB Statement No. 5:

> The Institution lends primarily to individuals employed at ABC Air Force Base and businesses local to the base. On December 19, 20X1, the President of the United States ratified a plan that includes the closing of the base effective November 20X2. It is reasonably possible that a change in estimated loan losses will occur in the near term. No estimate can be made of a range of amounts of loss that are reasonably possible with respect to the base closing.[7]

5.95 Paragraph 18 of SOP 94-6 gives examples of assets and liabilities and related revenues and expenses, and of disclosure of gain or loss contingencies included in financial statements that, based on facts and circumstances existing at the date of the financial statements, may be based on estimates that are

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[6] If a range of possible loss can be estimated, the last sentence might say:
It is reasonably possible that in the near term loan losses with respect to that event could be $5 million to $7 million more than estimated in the allowance for loan losses.
If the possible loss can be estimated, the last sentence might say:
It is reasonably possible that in the near term loan losses with respect to that event could be $6 million more than estimated in the allowance for loan losses.

[7] See footnote 6 in this chapter.

particularly sensitive to change in the near term. Besides valuation allowances for loans, examples of similar estimates often included in banks' and savings institutions' financial statements include:

- Impairment of long-lived assets, for example, assets related to marginal branches
- Estimates involving assumed prepayments, for example, discounts or premiums on certain financial assets (such as securities or loans), mortgage servicing rights and excess servicing receivables, and mortgage-related securities
- Lives of goodwill and identifiable intangible assets (for example, depositor or borrower relationships)

5.96 For example, during 20X4, DEF Bank evaluated the profitability of its branch operations. DEF Bank determined that it will significantly change the extent or manner in which it uses a group of long-lived assets related to six of its branches. In applying paragraph 6 of FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, DEF Bank determined that the sum of expected future cash flows (undiscounted and without interest charges) is no less than the carrying amounts of the assets, thus, an impairment loss has not been recognized under FASB Statement No. 121. The significant change in the extent or manner in which the assets are used, however, indicates that the estimate associated with the carrying amounts of those assets may be particularly sensitive in the near term.[8] Following is an illustrative disclosure.

> Management of DEF Bank has reevaluated and will significantly change its use of a group of long-lived assets associated with six of its branches. It is reasonably possible that the Bank's estimate of the carrying amounts of these assets will change in the near term. No estimate can be made of a range of amounts of loss that are reasonably possible.[9]

Current Vulnerability Due to Certain Concentrations

5.97 Paragraph 21 of SOP 94-6 requires institutions to disclose the concentrations described in paragraph 22 of the Statement if, based on information known to management prior to issuance of the financial statements, all of the following criteria are met:

a. The concentration exists at the date of the financial statements.
b. The concentration makes the institution vulnerable to the risk of a near-term severe impact.
c. It is at least reasonably possible that the events that could cause the severe impact will occur in the near term.

5.98 SOP 94-6 does not address concentrations of financial instruments. However, as discussed elsewhere in this Guide, FASB Statement No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*, as amended by FASB Statement No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments*, may require disclosures about such concentrations. FASB Statement No.

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[8] Paragraph 4 of FASB Statement No. 121 requires that an institution should "review long-lived assets and certain identifiable intangibles to be held and used for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable." A significant change in the extent or manner in which an asset is used is an example of an event or change in circumstances that (*a*) paragraph 5b of FASB Statement No. 121 says indicates that the recoverability of the carrying amount of an asset should be assessed and (*b*) paragraph 19b of SOP 94-6 says indicates that an estimate associated with the carrying amount of a long-lived asset may be particularly sensitive to change in the near term.

[9] See footnote 6 in this chapter.

133, *Accounting for Derivative Instruments and Hedging Activities*, supersedes FASB Statement Nos. 105 and 119. FASB Statement No. 133 amends FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, to include in FASB Statement No. 107 the disclosure provisions about concentrations of credit risk from FASB Statement No. 105, with modifications. FASB Statement No. 133 is effective for all fiscal quarters of fiscal years beginning after June 15, 1999. On May 20, 1999, the FASB issued an exposure draft, *Deferral of the Effective Date of FASB Statement No. 133*, that would, if adopted, delay that effective date to June 15, 2000. A summary of FASB Statement No. 133 is provided in chapter 18 of this Guide.

5.99 The following concentrations described in SOP 94-6, paragraph 22 require disclosure if they meet the criteria of paragraph 21 of the Statement.

a. Concentrations in the volume of business transacted with a particular customer, supplier, lender, grantor, or contributor.
b. Concentrations in revenue from particular products, services, or fund-raising events.
c. Concentrations in the available sources of supply of materials, labor, or services, or of licenses or other rights used in the entity's operations.
d. Concentrations in the market or geographic area in which an entity conducts its operations.

5.100 Examples of concentrations that may fall in one or more of these categories and that are found at certain financial institutions include:

- Sale of a substantial portion of or all receivables or loan products to a single customer
- Loss of approved status as a seller to or servicer for a third party
- Concentration of revenue from issuances involving a third-party guarantee program
- Concentration of revenue from mortgage banking activities
- Membership in the institution is concentrated with employees of a specific industry or in a region.

5.101 For example, assume a significant portion of GHI Institution's net income is from sales of originated loans. In 20X4, GHI Institution originated $800 million of loans. GHI Institution sold the loans and servicing rights to a substantial portion of these loans to a single servicer, TCB. TCB has historically purchased a substantial portion of the loans and servicing originated by GHI Institution. Following is an illustrative disclosure.

> -A substantial portion of GHI Institution's loan and loan-servicing-right originations are sold to a single servicer.

5.102 Assume a significant portion of JKL Bank's revenues is from origination of loans guaranteed by the Small Business Administration under its Section 7 program and sale of the guaranteed portions of those loans. Funding for the Section 7 program depends on annual appropriations by the U.S. Congress. The customer base for this lending specialization and the resulting profits depend on the continuation of the program. Following is an illustrative disclosure.

> A substantial portion of JKL Bank's revenues is from origination of loans guaranteed by the Small Business Administration under its Section 7 program and sale of the guaranteed portions of those loans. Funding for the Section 7 program depends on annual appropriations by the U.S. Congress.

Segment Reporting

5.103 FASB Statement No. 131 establishes standards for the way that public business enterprises report information about operating segments in annual financial statements and requires that those enterprises report selected information about operating segments in interim financial reports. The independent accountant should refer to FASB Statement No. 131 for more discussion and detail regarding the Statement's requirements. Disclosure examples are provided in chapter 19 of this Guide. Auditing Interpretation No. 4 of SAS No. 31, "Applying Auditing Procedures to Segment Disclosures in Financial Statements" (AICPA, Professional Standards, vol. 1, AU sec. 9326), provides guidance for auditing segment disclosures.

REGULATORY AND SUPERVISION OF DEPOSITORY INSTITUTIONS

Introduction

5.104 Laws and their implementing regulations affect the areas and ways in which certain financial institutions operate while creating standards with which those institutions must comply. Some laws and regulations directly address the responsibilities of independent accountants.[10]

5.105 The primary objective of this section is to explain why and how independent accountants should consider regulatory matters in the audits of certain financial institutions. This chapter also addresses the overall regulatory approach and environment, and the relative responsibilities of those institutions, examiners, and independent accountants. Considerations independent accountants should give to specific areas of regulation are highlighted in subsequent chapters.

5.106 Independent accountants should be familiar with regulations because of the impact regulations have on independent accountants'—

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

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

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

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[10] Although the discussion in this chapter is focused on federal regulation, it also may be useful in considering state regulatory matters, especially the impact of regulatory matters on the independent accountant. Further, the Guide does not address specific state regulations that may be relevant in the audit of financial statements.

5.109 One primary objective of regulation is to maintain the strength of the financial system, in turn, promoting and enforcing the public role of certain financial institutions as financial intermediaries, protecting depositors, and preserving funds for federal deposit insurance. Regulations are generally associated with one or more of the following objectives: capital adequacy, asset quality, management competence, earnings, liquidity, and sensitivity to market risk.

5.110 Many laws and areas of regulation deal with the public role of certain financial institutions. For example, laws and regulations exist to ensure the availability of credit to all creditworthy applicants without discrimination and to satisfy the credit needs of low- and moderate-income neighborhoods in institutions' local communities.

5.111 Other regulations deal directly with these institution's operations and, therefore, have broader financial implications. For example, rules exist that restrict the acceptance and renewal of brokered deposits based on a bank or savings institution's level of capitalization.

5.112 In addition to the specific regulatory matters outlined in subsequent chapters, there are three aspects of the regulatory process that are particularly important to independent accountants: rule making, examinations, and enforcement.

Rule Making

5.113 Regulations are created by the agencies based on their ongoing authority or as specifically mandated by legislation. Proposed rules and regulations are generally published for comment in the *Federal Register*, a daily publication of the federal government. Final rules also appear in the *Federal Register* and are codified in Title 12 of the Code of Federal Regulations (12 CFR). The Federal Register may be accessed at the Government Printing Office Web site at the address shown in Appendix E of this Guide. The rules applicable to a given institution depend on the institution's charter and other factors such as whether it is federally insured and whether it is a member of the Federal Reserve System. Institutions are informed of new rules, policies, and guidance through publications of the agencies (see appendix E of this guide).

5.114 Discussions of specific regulatory matters found throughout this Guide should not be substituted for a complete reading of related regulations, rulings, or other documents where appropriate. Also, independent accountants should keep apprised of recent changes in regulations, as the regulatory environment is constantly changing.

Examinations

5.115 As used in this guide, the term *audit* refers to an audit performed by an independent auditor in accordance with generally accepted auditing standards for the purpose of expressing an opinion on an institution’s financial statements, unless the context in which the term is used clearly indicates that the reference is to an internal audit. The term *examination* generally refers to an examination made by a regulatory authority. The purpose of a regulatory examination is to determine the safety and soundness of an institution.

5.116 Federally insured financial institutions are required to have periodic full-scope, on-site examinations by the appropriate agency. In certain cases, an examination by a state regulatory agency is accepted. Full-scope and other examinations are intended primarily to provide early identification of problems at insured institutions rather than as a basis for expressing an opinion on fair presentation of an institution's financial statements.

5.117 The scope of an examination is generally unique to each institution based on risk factors assessed by the examiner; however, general areas that might be covered include—

- Capital adequacy.
- Asset quality.
- Management.
- Earnings.
- Liquidity.
- Sensitivity to market risk.
- Funds management.
- Internal systems and controls.
- Consumer affairs.
- Electronic data processing.
- Fiduciary activities.

5.118 Examinations are sometimes targeted to a specific area of operations. Separate compliance examination programs also exist to address institutions' compliance with laws and regulations in areas such as consumer protection, insider transactions, and reporting under the Bank Secrecy Act.

5.119 An examination generally begins with a review of various background material and information, including practices, policies and/or procedures established by an institution. The examiner compares these practices, policies and/or procedures to regulatory and supervisory requirements and assesses the institution's adherence to sound fundamental principles in its day-to-day operations. Any additional detailed procedures considered necessary are then applied. A written report of procedures and findings is then prepared by the examiner. The relationship between the work of the examiner and that of the independent accountant is further discussed below. (The term *examiner* as used in this Guide means those individuals—acting on behalf of a regulatory agency—responsible for supervising the performance and/or preparation of reports of examination and, when appropriate, supervisory personnel at the district and national level.)

5.120 Results of examinations are also used in assigning the institution a rating under regulatory rating systems. The Federal Financial Institutions Examination Council (FFIEC) has adopted the Uniform Financial Institutions Rating System, which bases an institution's composite CAMELS rating on component factors addressing capital adequacy, asset quality, management, earnings, liquidity, and sensitivity to market risk. Further, the Board of Governors of the Federal Reserve System (FRB) assigns BOPEC ratings to bank holding companies based on consideration of the bank's CAMELS rating, operation of significant nonbanking subsidiaries, the parent's strength and operations, earnings of the banking organization, and capital of the banking organization. Both systems involve a 5-point rating scale, 1 being the highest possible rating.

Enforcement

5.121 Regulatory enforcement is sometimes carried out through a written agreement between the regulator and the institution—ranging from the least severe commitment letter to a cease-and-desist order. Among other actions that can be taken, the agencies may enforce regulations by—

- Ordering an institution to cease and desist from certain practices or violations.
- Removing an officer or prohibiting an officer from participating in the affairs of the institution or the industry.
- Assessing civil money penalties.
- Terminating insurance of an institution's deposits.

5.122 The examination focus has shifted from complete reliance on transaction testing to an assessment of risks and each of he agencies has issued guidance on "supervision by risk," under which examiners identify the risks a bank faces and evaluate how the institution manages those risks. Derivative activities (including the use of credit derivatives), as well as the trading activities of banks have also received increased scrutiny. In addition, recent losses involving fraud have led to a reemphasis on the identification of significant internal control weaknesses and other potential indicators of fraud.

5.123 Further, insured financial institutions may be subject to other mandatory and discretionary actions taken by regulators under prompt corrective action provisions of the Federal Deposit Insurance Act (FDI Act) and the Federal Credit Union Act. As described in chapters 1 and 2, possible actions range from the restriction or prohibition of certain activities to appointment of a receiver or conservator of the institution's net assets.

5.124 Many enforcement actions—such as civil money penalties—apply not only to an insured financial institution but also to a broader class of institution-affiliated parties, which could include independent accountants. For example, regulatory agencies may assess civil money penalties of up to $1.1 million per day against an institution or institution-affiliated party that violates a written agreement or any condition imposed in writing by the agency, breaches a fiduciary duty, or engages in *unsafe or unsound* practices. Because the term *unsafe or unsound* is not defined in any law or regulation, the potential liability of institution-affiliated parties is great.

5.125 The FDI Act also authorizes the agencies which regulate banks and savings institutions—on a showing of good cause—to remove, suspend, or bar an independent accountant from performing engagements required under the FDI Act. Regulations defining *good cause* have not been proposed or issued.

5.126 Due to the passage of CUMAA in 1998, the NCUA adopted stiffer net worth requirements and prompt corrective action regulations. These regulations will become effective in August of 2000. Practitioners should understand the new regulations and their effect on the credit union.

5.127 The NCUA is required to publicly disclose formal and informal enforcement orders and any modifications to or terminations of such orders. Publication may be delayed for a reasonable time if disclosure would seriously threaten the safety or soundness of the credit union.

5.128 Currently, federal and most state credit union regulators use a letter of understanding and agreement (LUA) or similar contractual arrangement to formalize the negotiated agreement between the regulatory agency or agencies (the regional director represents the NCUA) and the credit union's board of directors concerning problems, the actions to be taken, and the timetable for completing each action. In dealing with a state-chartered, non-NCUSIF-insured credit union, the state regulator will usually involve the appropriate state or private insurer.

Planning

5.129 One of the key factors in planning and supervising an engagement is knowledge of the client's business. The independent accountant should obtain knowledge about regulatory matters and developments as part of the understanding of an institution's business. The independent accountant should also consider the results of regulatory examinations, as discussed above.

Detection of Errors and Fraud

5.130 In planning a financial statement audit, the independent accountant should assess the risk that errors or fraud might cause the financial statements to be materially misstated. Based on that assessment, the independent accountant should design the audit to provide reasonable assurance of detecting errors and irregularities that are material to the financial statements.

5.131 SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), describes the auditor's responsibilities to plan and perform the audit to obtain reasonable assurance as to whether the financial statements are free of material misstatement caused by fraud. Noncompliance with laws and regulations (for example, noncompliance with regulatory capital requirements) is one indicator of higher risk that is especially relevant in the industry. Events of noncompliance are often described in—

- Regulatory reports.
- Cease-and-desist orders or other regulatory actions, whether formal or informal.

5.132 The independent accountant has similar responsibility for detecting misstatements resulting from illegal acts having a direct and material effect on the determination of financial statement amounts. SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317), defines illegal acts as violations of laws or governmental regulations and explains the independent accountant's responsibilities.

Evaluation of Contingent Liabilities and Related Disclosures

5.133 Management's financial statement assertions include those about the completeness, presentation, and disclosure of liabilities. Because some areas of regulation relate more to operations than to financial reporting or accounting, consideration of compliance in those areas would normally be limited to evaluation of disclosures of any contingent liability based on alleged or actual violation of the law.

Going Concern Considerations

5.134 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), as amended, describes the independent accountant's responsibility to evaluate whether there is substantial doubt about an 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. SAS No. 59 states that the independent accountant must consider, in the aggregate, conditions or events that could indicate such substantial doubt. In addition to the matters discussed in paragraphs 5.73 through 5.82, the independent accountant's consideration should include regulatory matters such as—

- Noncompliance with laws and regulations.
- Supervisory actions or regulatory changes that place limitations or restrictions on operating activities.
- Classification of the institution under prompt corrective action provisions of the FDI Act and the Federal Credit Union Act (see chapters 1 and 2).

5.135 For example, regulatory changes in 1992 placed new restrictions on the acceptance of brokered deposits by certain banks and savings institutions. This change had two implications: it potentially limited sources of liquidity and created a compliance requirement. An independent accountant auditing the financial statements of an institution subject to these restrictions would need to evaluate whether the effect on the institution's liquidity, when considered with other factors, raised substantial doubt about the institution's ability to remain a going concern for a reasonable period of time. The independent accountant would also need to consider the financial statement effects of any known event of noncompliance with the requirement itself. Examples of other events or conditions that would warrant the independent accountant's consideration are described in subsequent chapters. They include—

- The continued existence of conditions that brought about previous regulatory actions or restrictions.
- Effects of scheduled increases in deposit insurance premiums.
- Failure to meet minimum regulatory capital requirements.
- Limitations on the availability of borrowings through the Federal Reserve System discount window.
- Exposure to the institution posed by transactions with correspondent banks and related limitations on interbank liabilities.

Regulatory Accounting Practices (RAP) and RAP-GAAP Differences

5.136 General purpose financial statements are prepared in accordance with GAAP. However, financial information provided to regulatory agencies may be prepared on another basis—RAP—to satisfy specific regulatory objectives. Regulations require insured financial institutions to file quarterly call reports. These reports are used by regulators as a basis for supervisory action, a source of statistical information, and other such purposes. In 1997, the banking regulators adopted instructions for these reports that generally follow GAAP.

5.137 FDI Act Section 37(a)(2) requires that reports and other regulatory filings for banks and savings institutions follow accounting principles uniform and consistent with (or no less stringent than) GAAP. Regulators are permitted, for regulatory reporting purposes, however, to prescribe an accounting principle that is more stringent than GAAP if they believe that it will—

a. More accurately reflect the capital of insured banks and savings institutions.
b. Provide for more effective supervision.
c. Better facilitate prompt corrective action and least-cost resolution of troubled institutions.

5.138 With the passage of CUMAA, all federally insured credit unions with assets of $10 million or more must follow GAAP for all reports or statements required to be filed with the NCUA Board. Credit unions with assets under $10 million can use either GAAP or regulatory accounting principles (RAP). In addition, a credit union with over $10 million in assets could still follow RAP for supervisory committee audit regulation purposes.

5.139 Certain differences between RAP and GAAP amounts as computed for regulatory and general purpose reporting, respectively, may warrant consideration by the independent accountant. For example, the Financial Accounting Standards Board's (FASB's) Emerging Issues Task Force (EITF) reached a consensus on Issue No. 85-44, *Differences between Loan Loss Allowances for GAAP and RAP*, that an institution could record different loan loss allowances under RAP and GAAP because those amounts may differ due to the subjectivity involved in estimating the amount of loss or the use of arbitrary factors by regulators. However, independent accountants should be particularly skeptical of such RAP-GAAP differences in loan loss allowances and must justify them based on the circumstances.

5.140 Some of the other areas where accounting practices *for regulatory reporting purposes* differ from GAAP are discussed in Chapters 1 and 2 for banks/savings institutions and credit unions, respectively. Other differences are created by RAP requirements for certain reclassifications of balance sheet and income statement amounts within regulatory financial reports.

Independent Accountant/Examiner Relationship

5.141 Banking regulators conduct periodic on-site examinations to address broader regulatory and supervisory issues. There are some objectives shared by examiners and independent accountants, and coordination in consultation with the institution may be beneficial.

5.142 The primary objective of communicating with examiners is to ensure that independent accountants consider competent evidential matter produced by examiners before expressing an opinion on audited financial statements. In areas such as the adequacy of credit loss allowances and violations of laws or regulations, for example, information known to or judgments made by examiners should be made known to management and the independent accountant before financial statements are issued or an audit opinion is rendered. Such communication will minimize the possibility that a regulatory agency will subsequently require restatement—based on the examiner's additional knowledge or different judgment—of call reports and affect the general purpose financial statements, on which the independent accountant has already expressed an opinion, dated during or subsequent to the period in which a regulatory examination was being conducted.

5.143 FDI Act Section 36(h) requires that each bank and savings institution provide its independent accountant with copies of the institution's most recent call report and examination report (see 12 CFR Subpart 363.403). The institution must also provide the independent accountant with any of the following documents related to the period covered by the engagement:

a. Any memorandum of understanding (MOU) or other written agreement between the institution and any federal or state banking agency

b. The report of any action initiated or taken by any federal or state banking agency, including any assessment of civil money penalties

5.144 The independent accountant should review communications from examiners and, when appropriate, make inquiries of examiners. Specifically, the independent accountant should—

a. Request that management provide access to all reports of examination and related correspondence.

b. Review the reports of examination and related correspondence between examiners and the institution during the period under audit and through the date of the independent accountant's opinion.

c. With prior approval of the institution, communicate with the examiners if their examination is still in process, the institution's appeal of an examination finding is outstanding, or their examination report is still pending.

d. With prior approval of the institution, consider attending, as an observer, the exit conference between the examiner and the institution's board of directors, its executive officers, or both.

5.145 The independent accountant's attendance at other meetings between examiners and representatives of the institution requires prior approval by the regulatory agency.

5.146 Independent accountants may request a meeting with the appropriate regulatory representatives to inquire about supervisory matters relevant to the client institution. Management of the institution would generally be present at such a meeting, and matters discussed would generally be limited to findings already presented to management. Federal regulatory policy also permits meetings between examiners and independent accountants in the absence of the institution's management.[11] In addition, the OTS has established a policy that generally makes OTS examination working papers available for review.[12]

5.147 Management refusal to furnish access to reports or correspondence, or to permit the independent accountant to communicate with the examiner, would ordinarily be a limitation on the scope of a financial statement audit sufficient to preclude an opinion. Refusal by an examiner to communicate with the independent accountant may create the same scope limitation, depending on the independent accountant's assessment of the circumstances (see paragraphs 22 through 26 of SAS No. 58, *Reports on Audited Financial Statements* [AICPA, *Professional Standards*, vol. 1, AU sec. 508], as amended, for additional guidance).

5.148 Examiners might request permission to attend the meeting between the independent accountant and representatives of the institution (for example, the audit committee of the board of directors) to review the independent accountant's report on the institution's financial statements. If such a request is made and management concurs, the independent accountant should be responsive to the request.

5.149 Examiners and others may, from time to time, request auditors of financial statements of banks and savings institutions to provide access to working papers. The FFIEC's Interagency Policy Statement on External Auditing Programs for Banks and Savings Associations states that the independent public accountant or other auditor of an institution should agree in the engagement letter to grant examiners access to all the accountant's or auditor's workpapers and other material pertaining to the institution prepared in the course of performing the completed external auditing program. On March 21, 2000, the FDIC issued guidance concerning the review of external auditor's workpapers (Regional Director Memorandum No. 2000-019, "Reviews of External Auditors' Workpapers," dated March 21, 2000.) Auditors who have been requested to provide such access should refer to Interpretation No. 1 of SAS No. 41. The Interpretation provides auditors with guidance on—

- Advising management that the regulator has requested access to (and possibly photocopies of) the working papers and that the auditor intends to comply with the request.
- Making appropriate arrangements with the regulator for the review.
- Maintaining control over the original working papers.
- Considering submitting to the regulator a letter clarifying that an audit in accordance with GAAS is not intended to, and does not, satisfy a regulator's oversight responsibilities. An example of such a letter is illustrated in paragraph 6 of the Interpretation. In addition, the Interpretation addresses situations in which an auditor has been requested by a regulator to provide access to the working papers before the audit has been completed and the report released. Also, the Interpretation notes that when a regulator engages an independent party, such as another independent public accountant, to perform the working paper review on behalf of the regulatory agency, there are some precautions auditors should observe.

5.150 Information in examination reports, inspection reports, supervisory discussions—including summaries or quotations—is considered confidential. Such information may not be disclosed to any party

[11] Related instructions to examiners were published in a July 23, 1992, *Interagency Policy Statement on Coordination and Communication Between External Auditors and Examiners.* On January 27, 1997 the division of Supervision of the FDIC issued a supervisory memo to encourage each region to improve communications, coordination, and working relationships with IPAs of FDIC-supervised institutions.

[12] See OTS letter to chief executive officers dated September 11, 1992.

without the written permission of the appropriate agency, and unauthorized disclosure of such information could subject the independent accountant to civil and criminal enforcement actions.

CHAPTER 6

Cash and Cash Equivalents

INTRODUCTION

6.01 Cash and cash equivalents include cash items in the process of collection (CIPC), deposits with other financial institutions, including corporate credit unions, balances with Federal Reserve Banks and Federal Home Loan Banks (FHLBs), federal funds sold, and cash and cash equivalents on hand. Instruments that generally meet the definition of cash and cash equivalents in FASB Statement No. 95 are discussed in this Chapter. Investments in debt and equity securities that are accounted for under FASB Statement No. 115 are discussed in Chapter 7. Other investments are discussed in Chapter 12.

Cash Items in the Process of Collection and Cash Equivalents

6.02 CIPC includes customer deposits drawn on other depository institutions that have not yet cleared, matured instruments (such as coupons and bonds), and other matured items temporarily held pending their liquidation. Such assets are received with deposits and other customer transactions. CIPC are eventually cleared through local clearinghouses, correspondent institutions (correspondents), or a Federal Reserve Bank. Collection of these items generally takes between one and five business days.

Deposits with Other Depository Institutions

6.03 Correspondents are depository institutions that hold the account balances of other financial institutions and provide services to those institutions, such as check collection and item processing. Such accounts with balances due from other institutions are generally called "due from banks" and are maintained by depository institutions as a means of more efficient check clearing or to compensate the correspondent for other services provided to the depositor. Institutions that engage in international banking may maintain deposits with foreign depository institutions for the same reasons.

6.04 Many institutions also invest in nonnegotiable or negotiable certificates of deposits of other depository institutions. These balances are generally interest bearing and insured up to $100,000, and have a range of maturity options.

6.05 Many credit unions hold funds in the Corporate Credit Union Network, comprised by the U.S. Central Credit Union and all corporate credit unions. The U.S. Central Credit Union is a state-chartered, uninsured credit union cooperatively owned by the nation’s corporate credit unions. It provides investment, liquidity, and payment services to corporate credit unions. Corporate credit unions often aggregate funds invested by natural person credit unions to acquire investments offered by the Network. Overnight investments include regular daily shares and overnight certificates. Other offered investments, with maturities from two days to five years or longer, includes liquidity, high-yield, redeemable, and variable-rate shares and certificates.

Balances with Federal Reserve Banks and Federal Home Loan Banks

6.06 Federal regulations require depository institutions to set aside specified amounts of cash as reserves against transaction and time deposits. These reserves may be held as vault cash, in a noninterest-bearing account with a district Federal Reserve Bank or FHLB, or as deposits with correspondents. Though one objective of reserve requirements is to safeguard liquidity in the banking system, institutions do not look to their reserves as a primary source of liquidity because regulations permit their depletion for only short periods and in limited circumstances. Rather, reserves are a primary tool of the Board of Governors of the Federal Reserve System (FRB) to effect monetary policy: by increasing or decreasing reserve requirements, the FRB can expand or contract the money supply. Depository institutions also may use a Federal Reserve Bank as a correspondent bank, and lend excess balances overnight and for short periods in the federal funds market.

Cash on Hand

6.07 Cash on hand consists primarily of coin and currency in vaults, in the institution’s automated teller machines (ATMs), and maintained by tellers to meet customers' requests. Cash on hand generally represents a small percentage of a depository institution's cash.

Federal Funds and Repurchase Agreements

6.08 Chapter 14 discusses federal funds and repurchase agreements, which can be either assets or liabilities, depending on which side of the transaction the institution participates.

ACCOUNTING AND FINANCIAL REPORTING

6.09 Restrictions on the use or availability of certain cash balances, such as deposits with a Federal Reserve Bank or FHLB or correspondent financial institutions to meet reserve requirements or deposits under formal compensating balance agreements, should be disclosed in the financial statements.

6.10 Overdrafts of correspondents or other demand deposit accounts that represent borrowings rather than outstanding drafts should be reclassified as liabilities, unless the depositor has other accounts at the same depository institution for which there is the right of setoff. Balances due to and due from a single depository institution, also called reciprocal balances, should also be offset if a right of setoff exists. Financial Accounting Standards Board (FASB) Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts*, defines right of setoff and specifies conditions that must be met to have that right.

6.11 Presentation of deposits in other depository institutions in the balance sheet varies among financial institutions. For example, if all or some portion of such deposits meet the definition of cash equivalent as defined in FASB Statement No. 95, some institutions may combine all or the applicable portion of deposits in other institutions with cash and cash equivalents as the first line item in the balance sheet. Any portion of deposits not meeting the definition of cash equivalent may then be shown separately in the balance sheet, or it may be combined with other short-term investments or other investments (if interest bearing); in either case, presented after cash and cash equivalents in the statement of financial condition. Alternatively, some institutions may segregate interest bearing and non-interest bearing deposits. Non-interest bearing deposits are typically combined with cash equivalents (assuming they meet the definition in FASB Statement No. 95), and interest bearing deposits in other institutions are presently separately in the balance sheet after cash and cash equivalents, or combined with other short-term investments or other investments, regardless of whether all or some portion of such deposits meet the definition of cash equivalent. These practices are generally acceptable, provided that cash and cash equivalents in the balance sheet includes only those instruments meeting the definition of cash equivalents, and as discussed further in paragraph 4.17, the institution discloses its policy used to classify items as cash equivalents. Further, if deposits in other institutions is material, then it should be presented as a separate amount in the balance sheet.

6.12 Investments in negotiable certificates of deposits that meet the definition of a security in FASB Statement No. 115 are subject to the reporting, classification, and other provisions of that Statement. Investments subject to FASB Statement No. 115 are discussed in Chapter 7.

6.13 FASB Statement of Financial Accounting Standards No. 107, *Disclosures about Fair Value of Financial Instruments*, requires the disclosure of fair values of financial instruments for which it is practicable to estimate fair value.* The carrying amount of items classified as cash and cash equivalents generally approximates fair value because of the relatively short period of time between the origination of the instruments and their expected realization.

Classification of Cash Flows

6.14 FASB Statement No. 95, *Statement of Cash Flows*, classifies cash receipts and disbursements into three broad categories: operating cash flows, investing cash flows, and financing cash flows.

6.15 FASB Statement No. 95 sets forth two methods of reporting cash flows from operating activities: the direct method and the indirect method. The Statement encourages, but does not require, the use of the direct method. Under the direct method, the statement of cash flows reports the net cash flow from operating activities by showing the major classes of gross cash receipts (such as interest received and service charges collected) and gross cash disbursements (such as interest paid and operating expenses paid). If the direct method is used, FASB Statement No. 95 requires the presentation of a separate schedule to reconcile net income to the net cash flow from operating activities.

6.16 In contrast, a statement of cash flows prepared using the indirect method reports the net cash flow from operating activities by adjusting the net income for transactions reflected in net income that do not result in operating cash flows. If the indirect method is used, FASB Statement No. 95 requires separate disclosure of interest paid (other than interest capitalized) and income taxes paid**.**

6.17 FASB Statement No. 102, *Statement of Cash Flows Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale*, amended FASB Statement No. 95 by providing, among other things, that cash receipts and cash payments resulting from purchases and sales of securities are to be classified as operating cash flows if the securities are carried at market value in a

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* In December 1996, the FASB issued FASB Statement No. 126, *Exemption from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities*, which makes the disclosures about fair value of financial instruments prescribed in FASB Statement No. 107 optional for entities that meet all of the following criteria specified in paragraph 2 of FASB Statement No. 126:

a. The entity is a nonpublic entity (as defined in FASB Statement No. 126).
b. The entity's total assets are less than $100 million on the date of the financial statements.
c. The entity has no instrument that, in whole or part, is accounted for as a derivative instrument under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, during the reporting period.

Note that FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, replaces paragraph 2 (c) of FASB Statement No. 126 (item *c*. above) with the following—

> The entity has no instrument that, in whole or in part, is accounted for as a derivative instrument under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, during the reporting period.

FASB Statement No. 133, as amended by FASB Statement No. 137, *Accounting for Derivative Instruments and Hedging Activities - Deferral of the Effective Date of FASB Statement No. 133*, is effective for all fiscal quarters of fiscal years beginning after June 15, 2000. On March 3, 2000, the FASB issued an Exposure Draft, *Accounting for Certain Derivative Instruments and Certain Hedging Activities —an Amendment of FASB Statement No. 133*. Readers should be alert to any final pronouncement.

trading account. FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, amended FASB Statement No. 102 to require that cash flows from purchases, sales, and maturities of available-for-sale securities be classified as cash flows from investing activities and reported gross in the statement of cash flows. Similarly, paragraph 9 of FASB Statement No. 102 requires that cash receipts and cash payments that result from loans originated or purchased specifically for resale are also to be classified as operating cash flows if such loans are carried at market value or at the lower of cost or market value. In applying FASB Statement No. 102 for the direct method, gross cash receipts and cash payments from these sources should be reported separately as operating cash flows. If the indirect method is used, only the net increases or decreases in these loans and securities should be reported in reconciling net income to the net cash flow from operating activities.

6.18 Cash flows from investing and financing activities must generally be reported on the basis of gross cash receipts and gross cash disbursements. However, FASB Statement No. 95 permits the net basis of reporting for the following:

- Cash and cash equivalents.
- Items for which turnover is quick, amounts are large, and maturity is short. These items are limited to those with an original maturity when purchased of three months or less, such as—
  - Investment securities not included in cash equivalents.
  - Loans (including demand loans and credit-card loans).
  - CDs.
  - Borrowings.
- Items for which the institution is substantively holding, receiving, or disbursing cash on behalf of its customers, such as:
  - Demand deposits.
  - NOW and Super NOW accounts.
  - Savings deposits.
  - Money-market-deposit accounts.
  - Mortgage escrow funds.
  - Collections and remittances on loans serviced for others.

6.19 FASB Statement No. 104, *Statement of Cash Flows—Net Reporting of Certain Cash Receipts and Cash Payments and Classification of Cash Flows from Hedging Transactions*, amended FASB Statement No. 95 to permit financial institutions to report net cash receipts and cash payments for (*a*) deposits placed with other financial institutions and withdrawals of those deposits, (*b*) time deposits (CDs) accepted and repayments of those deposits, and (*c*) loans originated and principal collections on such loans. FASB Statement No. 104 also provides that cash flows from derivative instruments that are accounted for as fair value hedges or cash flow hedges under FASB Statement No, 133, *Accounting for Derivative Instruments and Hedging Activities*, may be classified in the same category as the cash flows from the items being hedged provided that accounting policy is disclosed.

6.20 Summarized below are some typical investing and financing cash flows for a financial institution.[1]

[1] Paragraph 21 of FASB Statement No. 95 says that operating activities include all transactions and other events that are not defined as investing or financing activities in paragraphs 15 through 20 of the Statement.

Investing Activities

Cash Inflows	*Cash Outflows*
Net loan principal payments	Net loan originations
Loan sale proceeds	Loan purchases
Security sale and maturity proceeds (disclose separately for held-to-maturity securities and available-for-sale securities)	Security purchases (disclose separately for held-to-maturity securities and available-for-sale securities)
Real estate sale proceeds	Investment in real estate held for development
Net deposits withdrawn from other financial institutions	Net deposits placed with other financial institutions
Sales of loan servicing rights	Purchases of loan servicing rights
Net decrease in reverse repos [#] (repos)	Net increase in reverse repos (repos)
Decrease in NCUSIF deposit	Increase in NCUSIF deposit

Financing Activities

Cash Inflows	*Cash Outflows*
Net increase in mortgage escrow deposits	Net decrease in mortgage escrow deposits
Net CDs issued	Net CDs matured
Net increase in other deposit accounts	Net decrease in other deposit accounts
FHLB advances and other borrowings proceeds	Repayment of FHLB advances and other borrowings
Net increase in short-term borrowings (original maturity of three months or less)	Net decrease in short-term borrowings (original maturity of three months or less)
Proceeds from the sale of common stock or other equity instruments	Reacquisition of equity instruments (for example, purchase of treasury stock)

[#] Repurchase agreements are addressed in Chapter 13.

	Dividends and other cash distributions to stockholders
Net increase in repos and dollar repos	Net decrease in repos and dollar Repos

6.21 ***Noncash Investing and Financing Activities.*** Investing and financing activities that are partially or fully noncash transactions must be reported in a related disclosure either (*a*) in narrative form in the notes to the financial statements or (*b*) in a schedule. Examples of noncash investing and financing activities for financial institutions include

- Originating a mortgage loan to finance the sale of foreclosed real estate or real estate held for development.
- Acquiring a real estate property through, or in lieu of, foreclosure of the related loan.
- Converting mortgage or other loans into mortgage-backed or other asset-backed securities (commonly referred to as "securitizing" loans).
- Selling or purchasing branch offices when the buyer assumes deposit liabilities in exchange for loans and other assets received from the seller, in which case only the cash paid, net of cash acquired or received, should be reported as a cash outflow or inflow.
- Converting debt to equity.
- Acquiring assets under capital leases.
- Acquiring another institution using the purchase method of accounting, in which case only the cash paid in the acquisition, net of cash acquired, should be reported as a cash outflow from an investing activity and information concerning the fair value of assets acquired and liabilities assumed should be presented in the supplemental disclosure of noncash activities.

6.22 ***Definition of "Cash and Cash Equivalents."*** The beginning and ending amounts of cash and cash equivalents in the statement of cash flows should agree with the amount shown for similarly titled line items or subtotals in the balance sheet. Cash is defined to include currency on hand, demand deposits with financial institutions, and other deposit accounts with similar characteristics (that is, the ability to deposit additional funds at any time and withdraw funds at any time without prior notice or penalty). Cash equivalents are defined in FASB Statement No. 95 to include instruments that are both

a. Short-term instruments near enough to maturity such that there is an insignificant risk of changes in market value due to changing interest rates. Short-term generally means an original maturity of three months or less. Original maturity to the purchaser is measured from the acquisition date to the maturity date. For example, a three-year U.S. Treasury note purchased three months before maturity would be a cash equivalent, whereas the same note purchased one year before maturity would not be a cash equivalent.

b. Highly liquid instruments readily convertible to known amounts of cash.

6.23 Only instruments that meet both of the above criteria and are used as part of an institution's cash-management activities should be included in cash equivalents. For example, U.S. Treasury bills purchased for an investment account would be part of the institution's investing activities (not cash-management activities) and would therefore be excluded from cash equivalents. Common examples of cash equivalents include ninety-day U.S. Treasury bills and notes, commercial paper, CDs, money-market funds, and federal funds sold.[2]

[2] The applicability of FASB Statement No. 115 to such items is based on whether they are securities (as defined) regardless of whether they are considered cash equivalents.

6.24 Because of the flexibility in classification, FASB Statement No. 95 requires disclosure of the policy used to classify items as cash equivalents. This disclosure is generally included in the accounting policy footnote. A change in this policy is defined as a change in accounting principle that requires a restatement of prior years' financial statements presented for comparative purposes.[3]

AUDITING

Objectives

6.25 The primary audit objectives for cash are to obtain reasonable assurance that—

a. Recorded balances exist and are owned by the institution.
b. Recorded balances are complete and stated at realizable amounts.
c. Balances are properly presented in the financial statements.
d. Restrictions on the availability or use of cash are appropriately identified and disclosed.
e. Cash receipts, disbursements, and transfers between accounts are recorded in the proper period.

Planning

6.26 In planning the audit, the independent accountant should consider the factors influencing inherent risk, which are described in chapter 5, as they relate to financial statement assertions about cash and cash equivalents. Cash and cash equivalents are generally negotiable, involve large volumes of transactions, and affect a large number of financial statement accounts.

Internal Control Over Financial Reporting and Possible Tests of Controls

6.27 SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), provides guidance on the independent accountant's consideration of an institution's internal control in an audit of financial statements performed in accordance with GAAS. It describes the components of internal control and explains how an independent accountant should consider internal control in planning and performing an audit. Paragraph 19 of SAS No. 55, as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55*, requires that, in all audits, the independent accountant obtain sufficient understanding of each of the five components (the control environment, risk assessment, control activities, information and communication, and monitoring) to plan the audit by performing procedures to understand the design of policies and procedures relevant to audit planning and whether they have been placed in operation.

6.28 Because of the negotiability of the items included in cash, the large volume of activity in cash accounts, and the large number of accounts affected by cash transactions, the effectiveness of internal control in this area is an important factor in audit planning. Internal control over financial reporting and possible tests of controls related to the payments function, including wire transfers, are discussed in chapter 13. Examples of control activities for cash balances include the following:

- Currency and coins are periodically counted and are reconciled to recorded amounts on a timely basis.

[3] For purposes of the illustrative consolidated statements of cash flows presented in chapter 19, cash and cash equivalents were defined as those amounts included in the balance-sheet caption "cash and due from banks." For purposes of the illustrative statement of cash flows presented in appendix C of FASB Statement No. 95 (as amended by FASB Statement No. 102), cash and cash equivalents were defined to include cash on hand, amounts due from banks, and federal funds sold. Both policies conform with the requirements of FASB Statement No. 95.

- Surprise counts of teller cash funds, vault cash, and cash items are performed periodically by persons other than those with related day-to-day responsibility.
- Tellers have exclusive access to and custody of their respective cash on hand.
- Access to night depositories (including ATM depositories) is under dual control (the control of more than one person), and at least two persons are present when the contents of depositories are removed, counted, listed, or otherwise processed.
- Cash transaction items are reviewed daily for propriety by an officer or a supervisory employee other than the custodian of the items.
- Each of the functions of draft issuance, register maintenance, and reconciliation is performed by a different employee.
- Confirmation requests received from depository institutions, supervisory examiners, and other parties are processed by an employee who does not also reconcile the subject account.
- Controls exist over access to and execution of official and certified checks.
- Controls exist over consignment items, such as traveler's checks or money orders, that could easily be converted into cash.
- Cash and coin-counting equipment are periodically tested for accuracy.
- Currency that is mutilated or identified as counterfeit is segregated and reported.
- Replenishment of tellers cash is documented and reviewed by another employee.
- Vault cash is under the control of more than one person.
- Procedures exist for the credit evaluation of correspondent banking relationships.
- Records of ATM transactions are reconciled to their recording in books of entry on a daily basis.

6.29 The independent accountant may decide to perform procedures to obtain evidential matter about the effectiveness of both the design and operation of control activities related to financial reporting of cash to support a lower level of assessed control risk. Examples of tests of controls that should be considered include—

- Observing that adequate segregation of duties exists with respect to the handling and reconciliation of cash.
- Reading documentation of surprise cash counts of teller, vault, ATM, and other cash on hand to determine whether documentation supports management's assertion that they are performed periodically and in accordance with the institution's policies.
- Observing maintenance of control over mail receipts and supplies of consigned items.
- Inspecting and testing reconciliations to determine that they are performed and reviewed in a timely manner.

6.30 Possible tests of controls related to electronic funds transfers are discussed in chapter 13.

Substantive Tests

6.31 The independent accountant should determine the nature, timing, and extent of substantive tests based on an assessment of both inherent risk and control risk. Substantive tests that the independent accountant should consider include—

- Counting cash and comparing the balances with tellers' records.
- Testing tellers' records for mathematical accuracy.
- Testing reconciliations between recorded balances of cash due from correspondents and statements received from correspondents.
- Reconciling and reviewing the cutoff of interbank transfers.
- Testing reconciliations of subsidiary ledgers to the general ledger.

- Testing the propriety of authorized accounts and signatures.
- Reviewing the composition of suspense accounts, especially noting the recurring use and aging of reconciling items and any failure or inability to reconcile the cash account.
- Confirming account balances with, and reviewing the creditworthiness of, correspondents.
- Confirming consigned items with consignors.
- Reviewing cash records for unusual transactions or adjustments.
- Testing the propriety of due to and due from accounts set off in the balance sheet.
- Testing fair value disclosures.

CHAPTER 7

Investments in Debt and Equity Securities

INTRODUCTION

7.01 Financial institutions acquire securities for various purposes. In addition to providing a source of income through investment or resale, securities are used to manage interest-rate and liquidity risk as part of an institution's overall asset/liability management strategies. They are also used in certain collateralized transactions. The most common securities acquired by institutions are described below. Investments that meet the definition of a security in FASB Statement No. 115 are discussed in this Chapter. Other investments, including non-marketable equity securities such as investments in Federal Home Loan Bank stock and Federal Reserve Bank stock, that do not meet the definition of a security are discussed in Chapter 12.

7.02 There is generally a *direct* relationship between risk and return. The higher the security's risk, the higher its expected yield. An *inverse* relationship generally exists between the security's liquidity and its yield: less liquid and longer-term securities generally have higher yields. Achieving the proper mix of safety, liquidity, and yield in an investment portfolio is one of the primary tasks of management. In managing their investment portfolios, financial institutions seek to maximize their returns without jeopardizing the liquidity the portfolios provide.

7.03 Management policies, adopted by the board of directors or its investment committee, establish authority and responsibility for investments in securities. Such policies may address investment objectives and guidelines, including specific position limits for each major type of investment, provisions for assessing risks of alternative investments, and policies on evaluating and selecting securities dealers and safekeeping agents. They also may set forth procedures for ensuring that management's investment directives are carried out and for gathering, analyzing, and communicating timely information about investment transactions.

7.04 The institution should have procedures to analyze alternative securities (including complex derivatives) according to the institution's intent, with consideration of the level of management expertise, the sophistication of the institution's control procedures and monitoring systems, its asset/liability structure, and its capacity to maintain liquidity and absorb losses out of capital. For example, analyses prepared for derivative securities prior to purchase would generally include sensitivity analyses that show the effect on the carrying amount and net interest income of various interest-rate and prepayment scenarios. Such analyses may also evaluate the effect of investment securities on the institution's overall exposure to interest-rate risk. An analysis might also be performed to evaluate the reasonableness of interest-rate and prepayment assumptions provided by the selling broker, and management may obtain price quotes from more than one broker prior to executing a trade. Management may also review contractual documents to ascertain the rights and obligations of all parties to the transaction, as well as the recourse available to each party.

U.S. Government and Agency Obligations

7.05 The Department of the Treasury, as fiscal agent for the United States, routinely sells federal government debt securities called *treasuries*. Backed by the full faith and credit of the United States, treasuries are virtually free of credit risk. Because they are traded actively in a large secondary market, treasuries are highly liquid. The income they provide generally is exempt from state and local taxes. Accordingly, treasuries are used by institutions as a primary source of liquidity.

7.06 U.S. Treasury bills (T-bills) are the shortest term obligations, having original maturities of one year or less. T-bills are sold at a discount from their face value; income to T-bill investors is the difference between the purchase price and the face value. U.S. Treasury notes and bonds (T-notes and T-bonds, respectively) are longer-term obligations that earn interest paid in semiannual coupon payments. T-notes have original maturities between one and ten years; T-bonds have maturities of ten years or longer.

7.07 The debt of U.S. government agencies (such as the Government National Mortgage Association, or Ginnie Mae) and government-sponsored enterprises (such as the Federal Home Loan Mortgage Corporation, or Freddie Mac) trades at yields slightly higher than treasury yields. The agencies and government-sponsored enterprises (GSEs) issue debentures, notes, and other debt securities having a wide variety of maturities and other features. Unlike agency debt, GSE debt is not secured by the full faith and credit of the United States. However, because the GSEs play a vital role in the nation's financial markets, many believe the Department of the Treasury would intervene before a GSE could default on its debt. Accordingly, GSE debt is perceived to have minimal credit risk.

Municipal Obligations

7.08 State and local governments and their agencies (such as housing, school, or sewer authorities) issue notes and bonds of various maturities. Many municipal bonds are callable: they may be redeemed by the municipality before the scheduled maturity date. Tax anticipation notes, so named under the expectation that they will shortly be repaid with tax receipts, generally mature within one year and are usually purchased directly from the government at a negotiated price. Revenue and bond anticipation notes are similarly issued and retired with certain expected revenues or proceeds from the expected sale of bonds. Municipal bonds may be either general obligation (that is, backed by the full taxing authority of the issuer) or limited obligation (that is, used to finance specific long-term public projects, such as building a school). Municipal bonds are purchased through a competitive bidding process or in the secondary market.

7.09 Municipal obligations vary significantly in risk. Credit quality depends heavily on the ability and willingness of the municipality to service its debt or the profitability of the particular project being financed. Liquidity also varies - some municipal obligations are traded actively; others are thinly traded. Interest on most municipal obligations is exempt from taxes in the municipality of issue; exemption from federal income taxes depends on the extent to which the obligations benefit private parties rather than the public. (See paragraph 14.11 for additional discussion of tax-exempt income.)

Asset-Backed Securities (ABSs)

7.10 Asset-backed securities (ABSs) are sometimes referred to as derivative securities in that they are repaid with cash flows derived from other financial assets (such as mortgage loans or credit-card receivables).[1] ABSs provide a great level of liquidity to financial markets, allow for a wide variety of

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[1] ABSs do not meet the definition of *derivative financial instrument* for the purposes of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments*. Paragraph 5 of that Statement defines a derivative financial instrument as "a futures, forward, swap, or option contract, or other financial instrument with similar characteristics." FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities,* supersedes FASB Statement No. 119. FASB Statement No. 133 establishes the accounting and reporting standards for derivative instruments and for hedging activities. Some ABSs may be subject to the requirements of FASB Statement No. 133, based on paragraphs 12–14 of that Statement. Derivatives Implementation Group (DIG) Statement 133 Implementation Issue No. C4 entitled, "Scope Exceptions: Interest-Only and Principal-Only Strips," provides further guidance on this issue. Issues addressed by the DIG and the status of related guidance can be found at the FASB's Web site at www.fasb.org. (Reference to FAS 133 Q&A when published.)
Note that loan commitments are not derivative instruments under FASB Statement No. 133 if they require the holder to deliver a promissory note that would not be readily convertible to cash and cannot readily be settled net (see paragraph 291 of FASB Statement No. 133).

FASB Statement No. 133, as amended by FASB Statement No. 137, *Accounting for Derivative Instruments and Hedging Activities - Deferral of the Effective Date of FASB Statement No. 133* is effective for all fiscal quarters of fiscal years beginning after June 15, 2000. A summary of FASB Statement No. 133 is provided in chapter 15 of this Guide. On March 3, 2000, the FASB issued an Exposure Draft, innovative products, and, because they often involve incrementally more risk, offer better yields than treasuries.

7.11 ABSs are highly versatile because cash flows from the underlying assets can be reconfigured through any number of structures for repayment to ABS investors. ABSs allow the issuer to enhance the marketability of the underlying assets, for example, by spreading liquidity and credit risk across broad pools, or by providing a higher yield to those investors willing to accept a higher concentration of the risks associated with specific cash flows from the collateral.

7.12 This chapter focuses on ABSs from the perspective of the security holder. Chapters 10 and 15 discuss matters unique to depository institutions that issue ABSs.

7.13 A given ABS structure involves any number of investment classes (or tranches) with various degrees of risk and reward. Among other common characteristics, ABSs

- Are issued by both governmental and private issuers, including banks and savings institutions.
- Generally include some form of credit enhancement to limit the credit risk of the underlying assets. For example, an issuer or third party may guarantee that the ABS principal and interest will be repaid as scheduled regardless of whether cash is received from payments on the underlying collateral.
- Are often issued in book-entry form. That is, no physical certificates change hands; rather, ownership is recorded on the investor's account.

7.14 The largest volumes of ABSs issued are backed by real estate mortgage loans (mortgages) and are called mortgage-backed securities (MBSs). Other types of collateral that have been used in ABS issuances include credit-card receivables, treasuries, car loans, recreational vehicle loans, and mobile home loans. MBSs and other mortgage securities are discussed below to provide examples of risk characteristics and other matters that may be encountered with various forms of ABSs and their collateral.

7.15 ***Mortgage-Backed Securities***. he simplest form of ABS is the basic (or *plain vanilla*) MBS, created by pooling a group of similar mortgages. Most MBSs are issued with a stated minimum principal amount and a stated interest rate and represent a pro rata share in the principal and interest cash flows to be received as the underlying mortgages are repaid by the mortgagors. The mortgages underlying the issuance typically have—

a. The same type of collateral, such as single-family real estate.
b. Fixed or adjustable interest rates within a specified range.
c. Maturities within a specified range.

7.16 Because repayment of MBSs is contingent on repayment of the underlying collateral, the risk characteristics of specific MBS issuances are driven by the risk characteristics of the collateral. For example, underlying mortgages insured by the Federal Housing Administration (FHA) would typically involve less credit risk than unguaranteed conventional mortgages. A credit enhancement by the issuer would further reduce credit risk.

7.17 ***More Complex MBS Structures.*** However, more complex MBS structures concentrate or dilute risk to create a range of possible investments with unique risks and rewards. As described below, one must understand the structure and nature of a specific mortgage-backed security to understand the related risks.

Accounting for Certain Derivative Instruments and Certain Hedging Activities —an Amendment of FASB Statement No. 133. Readers should be alert to any final pronouncement. The FASB has established the Derivative Implementation Group (DIG) to assist the Board and its staff in providing implementation guidance regarding FASB Statement No. 133. Issues addressed by the DIG and the status of related guidance can be found at the FASB's Web site at www.fasb.org.

7.18 ***Credit risk.*** To make a particular issuance of MBS more attractive to potential investors, the credit risk associated with mortgages underlying MBS is generally reduced by the issuer or third party through some form of *credit enhancement*, such as—

a. A letter of credit.

b. Guarantee of scheduled principal or interest payments, often achieved through a transaction with a federal agency such as Ginnie Mae or a GSE such as Freddie Mac.

c. Insurance of all or a portion of scheduled principal and interest payments through insurance of the pool by a private insurer.

d. Overcollateralization of the issuance, where cash flows from the excess collateral are used to make up for delinquent collateral payments.

e. A senior/subordinated (senior/sub) structure, in which one group of investors holds a subordinated interest in the pool by accepting all or a large portion of the related credit risk in return for a greater yield.

7.19 The degree of protection from credit risk offered by the various types of credit enhancement must be considered in relation to the characteristics of the collateral and, therefore, is unique to each security. Further, when credit risk is addressed through a credit enhancement, the security holder is still at risk that the third-party guarantor or private insurer could default on its responsibility. (The risk that another party to a transaction will default on its obligations under the transaction is referred to as *counterparty risk*.) Many MBS issuances carry credit ratings assigned by an independent rating agency.

7.20 ***Interest-rate risk and prepayment risk.*** The overall return—or yield—earned on a mortgage depends on the amount of interest earned over the life of the loan and the amortization of any premium or discount. Mortgage yields, therefore, are highly sensitive to the fact that most mortgages can be repaid before their scheduled maturity date without penalty. Although the owner of a mortgage receives the full amount of principal when prepaid, the interest income that would have been earned during the remaining period to maturity—net of any discount or premium amortization—is lost.

7.21 As with individual mortgages, the actual maturities and yields of MBSs depend on when the underlying mortgage principal and interest are repaid. If market interest rates fall below a mortgage's contractual interest rate, it is generally to the borrower's advantage to prepay the existing loan and obtain new financing at the new, lower rate. Accordingly, prepayments may be estimated to predict and account for the yield on MBSs.

7.22 In addition to changes in interest rates, actual mortgage prepayments depend on other factors such as loan types and maturities, the geographical location of the related properties (and associated regional economies), seasonality, age and mobility of borrowers, and whether the loans are assumable (as are certain loans insured by the FHA or guaranteed by the Department of Veterans' Affairs).

7.23 Some MBSs are backed by adjustable-rate mortgages (ARMs). Interest rates on ARMs change periodically based on an independent factor plus an interest-rate spread, which is expressed as a specified percentage (1 percent, also referred to as one *point*) or one one-hundredth of a percentage (.01 percent, also referred to as one *basis point*). For example, an ARM might carry a rate that changes every six months based on the average rate on one-year treasuries plus two points. Annual increases in an ARM's interest rate are generally capped, as are total interest-rate increases over the life of the loan.

7.24 While yields on ARMs tend to follow increases in prevailing interest rates, they also follow interest rate declines. This, and the fact that many ARMs are often issued with *teaser* rates that are significantly below market rates as a way to attract borrowers, make it more difficult to predict the overall risk of investments in ARM MBSs. The frequency of interest-rate adjustments, the index, the initial interest rate, and the annual and lifetime caps all should be considered. For example, credit risk may be higher for ARM MBSs than for fixed-rate MBSs because borrowers' payments increase when interest rates are adjusted upward.

7.25 Changes in the indexed rates of certain ARMs lag behind changes in prevailing rates. When interest rates are falling, therefore, adjustable-rate MBSs generally trade at a premium, although frequently they are prepaid as borrowers seek to lock in lower fixed rates. Conversely, when interest rates are rising, adjustable-rate MBSs generally trade at a discount.

7.26 ***Other Mortgage-Backed Securities.*** Other mortgage-backed securities add layers of complexity to the security structure to create investment classes that meet the needs of and are attractive to various potential investors. Security holders find certain investment classes attractive because they can purchase the cash flows they desire most, or can synthetically create a security with the desired interest rate and prepayment characteristics. As discussed above, MBSs offer pro rata shares in principal and interest cash flows with stated principal amounts and interest rates, and subject to credit, prepayment, and other risks. More complex mortgage-backed securities are used to further restructure the cash flows and risks so that investment classes may be offered that feature—

- Different anticipated maturities.
- A single final payment (called a zero-coupon class) rather than monthly, quarterly, or semiannual installments.
- Floating interest rates, even though the underlying assets have fixed rates.
- Repayment on a specified schedule, unless mortgage prepayments go outside a prescribed range (called a *planned amortization class* or PAC).
- Protection against faster but not slower prepayments (called a *targeted amortization class*, or TAC).
- Rights to interest cash flows only, called *interest-only securities* (IOs), or to principal cash flows only, called *principal-only securities* (POs).
- Rights only to those cash flows remaining after all other classes have been repaid (a *residual interest* or *residual*).

7.27 These and other specialized classes—and the fact that many mortgage-backed securities use pools of MBSs rather than pools of mortgages as collateral—make analysis of investments in mortgage-backed securities complex. Accordingly, such instruments could expose an institution to substantial risk if not effectively understood or managed by the institution.

7.28 Two common forms of multiclass mortgage-backed securities are collateralized mortgage obligations (CMOs) and real estate mortgage investment conduits (REMICs). CMOs are bonds secured by (and repaid with) the cash flows from collateral MBSs or mortgages and generally involve some form of credit enhancement. The collateral is generally transferred to a special-purpose entity, which may be organized as a trust, a corporation, or a partnership. The special-purpose entity then becomes the issuer of the CMO. Accordingly, a security holder may invest in a CMO in equity form (for example, trust interests, stock, and partnership interests) or nonequity form (for example, participating debt securities). REMICs are a form of CMO specially designated for federal income tax purposes so that the related income is taxed only once (to the security holder). (See chapter 14.)

7.29 Understanding the risks associated with a particular tranche of a mortgage-backed security or other ABS often requires an understanding of the security structure, as documented in the offering document and related literature.

7.30 ***Risk Analysis.*** A discussion of the risks associated with every possible form of mortgage-backed security or other ABS is beyond the scope of this Guide. A basic understanding of the relationship between interest and principal cash flows, in addition to an understanding of related risks (such as credit risk), is needed to analyze investments in mortgage-backed securities. The discussion below uses IOs, POs, and residuals as examples of ABS classes for this purpose. The discussion of the senior/sub structure used in some issuances also highlights the importance of understanding the structure and the form of credit enhancement when evaluating an investment in mortgage derivatives or other ABSs.

7.31 Investment classes that are focused on interest cash flows (interest classes), such as mortgage-backed security IOs, are extremely interest-rate sensitive and, therefore, carry the risk that the security holder's entire recorded investment could be lost. Investment classes weighted toward principal cash flows (principal classes), such as mortgage-backed security POs, also carry special risks. The discussion below of related risk concepts can be applied to various other investments in mortgage-backed securities or other ABSs.

7.32 ***Interest classes and IOs.*** Interest classes receive all, or substantially all, of the interest cash flows from the underlying collateral mortgages. Accordingly, they have been found to be useful vehicles for managing the interest-rate risk inherent in mortgage portfolios, since prepayments cause the value of IOs to move in the opposite direction from that of mortgages and traditional fixed-income securities. However, because of the sensitivity of IOs to interest rates, the recorded investment in an IO may be lost if actual prepayments are higher than anticipated.

7.33 Changes in the prices (and, therefore, the values) of mortgage-backed securities depend largely on whether collateral interest rates are above or below prevailing interest rates. A mortgage will trade at a discount (a discount mortgage) when it carries an interest rate lower than prevailing interest rates. A mortgage that carries an interest rate above prevailing rates will trade at a premium (a premium mortgage).

7.34 An IO backed by a pool of premium mortgages may be a more useful tool for controlling interest-rate risk than one backed by a pool of discount mortgages, as it shows greater appreciation in value when interest rates increase and does not suffer as significant a decrease in value when interest rates fall. Falling interest rates generally result in greater prepayments. Accordingly, the cash generated from an IO over its life usually decreases because interest is earned on a smaller remaining principal balance. Although the discounting of the stream of interest receipts at a lower interest rate increases the present value of each future dollar of interest, the negative effect of increased prepayments generally outweighs the positive discounting effect, and, therefore, the fair value of the IO generally declines. IOs generally increase in value in a rising rate environment because as prepayments slow, the related mortgage principal balance remains outstanding for a longer period, and, therefore, interest is earned for a longer period (although the present value of each of those future dollars is reduced by the higher discount rate).

7.35 ***Principal classes and POs.*** Principal classes are often issued at deep discounts from the contractual principal amount because the security holder receives no interest. In contrast to zero-coupon bonds, whose entire principal amount is paid at maturity, the principal amount of POs is paid periodically according to repayment of the underlying mortgage principal. If the security holder has the ability to hold the PO to maturity, only credit risk or counterparty default would prevent ultimate recovery of the recorded investment. The fair value of a PO is also dependent on the effects of prepayments and discounting, both of which are dependent on interest rates.

7.36 The fair value of a PO tends to increase as prepayments accelerate, because the security holder receives the return of principal more quickly. Conversely, as prepayments slow, the value of the PO tends to decline. A PO backed by discount mortgages tends to appreciate more as interest rates fall than would a PO backed by premium mortgages. However, when interest rates rise, a PO backed by discount mortgages would not decline in value as much as a PO backed by premium mortgages. The difference in fair values reflects the relationship between prepayment rates and the stated interest rates on the collateral backing the POs. Prepayments on discount POs are generally significantly lower than prepayments on premium POs. As interest rates decline, prepayments on both types of PO will accelerate. However, prepayments on premium

POs do not increase as much, because prepayments on these instruments are usually already at a high level. Conversely, when interest rates rise, prepayments on underlying discount mortgages do not slow significantly, because they are usually already at a relatively low level, but prepayments on underlying premium mortgages decline sharply.

7.37 A decline or increase in interest rates similarly causes the present value of cash flows from POs to increase or decrease, respectively, because of related changes in the discount rate used to determine the present value of any future cash flows.

7.38 Because POs generally increase in value in response to declining interest rates, they are sometimes used to manage the interest-rate risk associated with investments in mortgage servicing rights, CMO or REMIC residuals, and IOs. However, institutions in liability-sensitive positions (that is, institutions whose liabilities will reprice more quickly than their assets) would be negatively affected by an increase in interest rates, and, therefore, the use of POs to manage the interest-rate risk of such assets may be counterproductive because such a strategy may increase the institution's overall exposure to interest-rate risk.

7.39 ***Residual classes*****.** From a legal perspective, residuals represent an ownership interest in the underlying collateral, subject to the first lien and indenture of the other security holders. Residuals entitle the holder to the excess, if any, of the issuer's cash inflows (including reinvestment earnings) over cash outflows (which often include any debt service and administrative expenses). There are typically three sources of residual cash flows:

- *a.* The differential between interest cash flows on the collateral and interest payments on other investment classes
- *b.* Any overcollateralization provided as a credit enhancement
- *c.* Any income earned on reinvestment of other cash flows before they are distributed to other security holders (because payments on collateral mortgages are received monthly but some investment classes are repaid quarterly or semiannually, these receipts are reinvested in the interim)

7.40 Residuals are often designed to reduce the prepayment risk of other classes and to provide security holders with the potential for high yields. Residuals may earn high yields if prepayments of the underlying collateral are not greater than the rate assumed at the time the issuance was structured and sold. Residuals are particularly sensitive to prepayments, and the residual holder's recorded investment may be lost entirely if actual prepayments are higher than anticipated. As with POs and IOs, residuals may contain credit risk and their fair values are dependent on the effect of discounting.

7.41 While other investment classes may receive triple-A credit ratings, residuals are usually not rated, because they are so susceptible to interest-rate risk. Even if a residual is rated triple-A, such a rating often indicates only that the rating agency expects that the minimum required payments of principal, interest, or both will be received (that is, that credit risk is perceived to be low), not that a security holder will realize the anticipated yield.

7.42 As for other investment classes, the return on and fair value of a residual is dependent on the underlying collateral, the security structure, and its performance under varying interest-rate and prepayment scenarios. Residuals sometimes carry fixed or floating interest rates.

7.43 The fair value of fixed-rate residuals typically increases as interest rates increase and decreases as interest rates decline. The main source of cash flow on a fixed-rate residual comes from the interest differential between the interest payments received on the underlying collateral mortgages and the interest payments made on other investment classes. Because short-term classes usually carry lower interest rates than longer-term classes, residual cash flows from the interest differential tend to be greatest in earlier years after issuance, before the short-term classes have been repaid. Accordingly, the longer the lower-rate classes remain outstanding, the greater the cash flow accruing to the residual class. As interest rates decline, prepayments accelerate, the interest differential narrows, and overall cash flows decline. Conversely, as interest rates climb, prepayments slow, generating a larger cash flow to residual holders.

7.44 The fair value of floating-rate residuals usually performs best in a stable interest-rate environment. As with fixed-rate residuals, the main source of cash flow to floating-rate residuals is the interest differential between interest earned on the collateral and interest paid on other investment classes. However, because one or more of the classes is tied to a floating rate, the interest differential changes when the rates on floating-rate classes are reset. For example, when interest rates rise, the rate on the floating-rate class may be reset at a higher rate. More of the cash flows from the underlying collateral would then be paid to the floating-rate classes, leaving less cash flow for the residual. Higher interest rates also tend to cause prepayments to slow, and thereby increase the period over which the interest-differential income is earned by the residual holders. Conversely, when interest rates decline, rates on floating-rate classes decrease, but prepayments of premium mortgages would tend to accelerate. The loss of interest income as a result of prepayments would typically offset a widening of the interest differential stemming from the lower rate on the floating-rate class, thus reducing the cash flow to the residual. Thus, changes in interest rates produce two opposing effects on the fair value of floating-rate residuals. Whether the value of the residual actually declines or rises when interest rates change depends on the interrelationship between the interest on the floating-rate class and mortgage prepayment speeds.

7.45 ***Senior/sub securities.*** The senior/sub form of credit enhancement is often used for conventional mortgages. A senior/sub issuance generally divides the offered securities into two risk classes: a senior class and one or more subordinated classes. The subordinated classes, often retained by the sponsor of the ABS, provide credit protection to the senior class. When cash flows on the underlying mortgages are impaired, the cash is first directed to make principal and interest payments on the senior-class securities. Furthermore, some cash receipts may be held in a reserve fund to meet any future shortfalls of principal and interest to the senior class. The subordinated classes may not receive debt-service payments until all of the principal and interest payments have been made on the senior class and, where applicable, until a specified level of funds has been contributed to the reserve fund.

7.46 Subordinated classes generally carry higher interest rates and are often unrated because of the higher credit risk. Accordingly, subordinated classes are not usually purchased to be held to maturity. The fair value of subordinated securities, like the fair value of other mortgage-backed securities, depends on the nature of the underlying collateral and how changes in interest rates affect cash flows on the collateral. The fair value would also reflect any reserve fund priorities and the increased credit risk associated with the securities.

Issues of International Organizations and Foreign Governments

7.47 International financial institutions and foreign governments and their political subdivisions increasingly rely on international capital markets for funds. A significant portion of international debt securities is denominated in U.S. dollars. The credit risk and liquidity risk vary for different issues, though many are high quality and widely traded. Institutions have also obtained foreign debt securities of financially troubled countries in troubled debt restructurings; such securities are generally lower quality and not widely traded.

Other Securities

7.48 Other securities held by depository institutions, where permitted by applicable laws and regulations, include the following:

- Common-trust or mutual-investment funds

- Investments in negotiable certificates of deposit
- Equity securities, including venture capital investments
- Corporate bonds and commercial paper

The credit quality and risk of these instruments are unique to the particular issuance. The financial strength of the issuer and other counterparties is a major determinant and may be evidenced by an investment rating.

Transfers of Securities

7.49 ***"Short Sales."*** "Short sales" are trading activities in which an institution transfers securities it does not own, with the intention of buying or borrowing securities at an agreed-upon future date to cover the transfer. Securities are "sold short" for protection against losses, for short-term borrowing of funds, for arbitrage, or in anticipation of a decline in market prices.

7.50 ***Borrowing and Lending Securities***. Sometimes an institution will borrow securities from a counterparty or from its trust customers' assets when the institution is obligated to deliver securities it does not own (for example, in a "short sale", to settle a repurchase agreement, or because a counterparty may have failed to deliver securities the institution needed for delivery to another counterparty.) The institution, therefore, uses borrowed securities to fulfill its obligation until it actually receives the securities it has purchased. Institutions also may loan securities to a counterparty.

7.51 An institution may advance cash, pledge other securities, or issue letters of credit as collateral for borrowed securities. The amount of cash or other collateral required may increase or decrease depending on changes in the value of the securities. Cash advances are typically made in an amount greater than the market value of the securities borrowed.

REGULATORY MATTERS

7.52 Federal laws and regulations place certain restrictions on the types of financial instruments that an institution may deal in, underwrite, purchase, and sell. Transactions in certain securities, such as those backed by the full faith and credit of the United States, are generally unrestricted. Holdings of other securities—of any one obligor—are generally limited based on capitalization. Restrictions on dealing in or underwriting in the security may also apply. Additional restrictions may apply to state-chartered institutions.

7.53 ***Banks and Savings Institutions.*** In Thrift Bulletin (TB) 73, the OTS states that trust preferred securities (TPSs) that otherwise meet the requirements of corporate debt securities are permissible investments for federal savings associations. They are, however, prohibited from purchasing TPSs or any other type of security from the parent holding company or any other affiliate. TB 73 should be consulted for additional limitations and requirements for holding these securities. National banks and state nonmember banks are permitted to invest in trust preferred stock within certain limitations. (See OCC Interp. Letter No. 777, April 8, 1997; FDIC Financial Institution Letter 16-99, February 16, 1999).

7.54 The Federal Financial Institutions Examination Council (FFIEC) issued a supervisory policy statement dated April 23, 1998, that was adopted by all of the federal banking agencies, on investment securities and end-user derivative activities. The policy statement provides guidance to financial institutions on sound practices for managing the risks of investment securities and end-user derivatives activities. The guidance describes the practices that a prudent manager normally would follow, but it emphasizes that it is not intended to be a checklist and management should establish practices and maintain documentation appropriate to the institution's individual circumstances.

7.55 The guidance applies to all securities in held-to-maturity and available-for-sale accounts as described in FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, certificates of deposit held for investment purposes, and end-user derivative contracts not held in trading accounts. This guidance covers all securities used for investment purposes, including money market instruments, fixed-rate and floating-rate notes and bonds, structured notes, mortgage pass-through and other asset-backed securities, and mortgage-backed security products. Similarly, the guidance covers all end-user derivative instruments used for non-trading purposes, such as swaps, futures, and options.

7.56 This policy describes sound principles and practices for managing and controlling the risks associated with investment activities. Institutions should fully understand and effectively manage their investment activities. The policy emphasizes that failure to understand and adequately manage the risks in these areas constitutes an unsafe and unsound practice.

7.57 Board of director and senior management oversight is an integral part of an effective risk management program. The board of directors is responsible for approving major policies for conducting investment activities, including the establishment of risk limits. Senior management is responsible for the daily management of an institution's investments. Institutions with significant investment activities should ensure that back-office, settlement, and transaction reconciliation responsibilities are conducted or managed by personnel who are independent of those initiating risk taking positions.

7.58 An effective risk management process for investment activities includes: (1) policies, procedures, and limits, (2) the identification, measurement, and reporting of risk exposures, and (3) a system of internal control. The policy statement identifies sound practices for managing specific risks involved in investment activities. These risks include:

- Market risk
- Credit risk
- Liquidity risk
- Operational (transaction) risk
- Legal risk

In addition, institutions are reminded to follow any specific guidance or requirements from their primary supervisor related to these activities.

7.59 On December 13, 1999, the federal banking agencies jointly issued the Interagency Guidelines on Asset Securitization which highlight the risks associated with asset securitization and emphasize the agencies' concerns with certain retained interests generated from the securitization and sale of assets. The guidelines set forth the supervisory expectation that the value of retained interests in securitizations must be supported by objectively verifiable documentation of the assets' fair market value, utilizing reasonable, conservative valuation assumptions. Retained interests that do not meet such standards or that fail to meet the supervisory standards outlined in the guidance will be disallowed as assets of the bank for regulatory capital purposes. The guidance stresses the need for bank management to implement policies and procedures that include limits on the amount of retained interests that may be carried as a percentage of capital. Institutions that lack effective risk management programs or engage in practices deemed to present other safety and soundness concerns may be subject to more frequent supervisory review, limitations on retained interest holdings, more stringent capital requirements, or other supervisory response.

7.60 ***Credit Unions***. Federal regulations describe investments allowed for federal credit unions. These regulations explicitly prohibit federal credit unions from: (a) purchasing stripped mortgage-backed securities, residual interests in CMOs and REMICs, mortgage servicing rights, commercial-mortgage-related securities, or small-business-related securities, (b) purchasing a zero-coupon investment with a maturity date that is more than 10 years from the settlement date, (c) purchasing or selling financial derivatives, futures, options, swaps or forwards except for certain put options on Ginnie Mae, Fannie Mae, and Freddie Mac mortgage-backed securities, and (d) engaging in adjusted trading or short sales.

7.61 Federally-insured state-chartered credit unions are required under terms of the insurance agreement to establish an investment valuation reserve (displayed as an appropriation of retained earnings) for non-conforming investments. Nonconforming investments are those investments permissible under state law for a state-chartered credit union, but which are impermissible for federally-chartered credit unions.

ACCOUNTING AND FINANCIAL REPORTING

7.62 FASB Statement No. 115 addresses accounting and reporting for investments in equity securities that have readily determinable fair values and for all investments in debt securities.[2, 3] Paragraph 6 of FASB Statement No. 115 requires that those investments be classified in three categories. Paragraphs 7 and 12 of the Statement specify the accounting for securities classified in each of the three categories as follows:

a. Held-to-maturity securities (only those debt securities for which the institution has the positive intent and ability to hold to maturity) are reported at amortized cost.[4]

b. Trading securities (debt and equity securities that are bought and held principally for the purpose of selling them in the near term) are reported at fair value, with unrealized gains and losses included in earnings.[5]

c. Available-for-sale securities (debt and equity securities that are not classified as either held to maturity or trading) are reported at fair value, with unrealized gains and losses excluded from earnings and reported as other comprehensive income until realized except as indicated in the following sentence. All or a portion of the unrealized holding gain and loss of an available-for-sale security that is designated as being hedged in a fair value hedge shall be recognized in earnings during the period of the hedge, pursuant to paragraph 22 of Statement 133.[6]

7.63 FASB Statement No. 130, Reporting Comprehensive Income, requires that all components of comprehensive income be displayed in a financial statement that is displayed with the same prominence as

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[2] See paragraph 137 of FASB Statement No. 115 for related definitions of security, debt security, and equity security.

[3] The FASB also published a FASB Special Report, *A Guide to Implementation of Statement 115 on Accounting for Certain Investments in Debt and Equity Securities*.

[4] Paragraph 7 of FASB Statement No. 115, as amended by FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, and FASB Statement No. 135, *Rescission of FASB Statement No. 75 and Technical Corrections*, says a security may not be classified as held-to-maturity if that security can contractually be prepaid or otherwise settled in such a way that the holder of the security would not recover substantially all of its recorded investment. A debt security with those characteristics should be evaluated in accordance with paragraphs 12-16 of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (FASB Statement No. 133, as amended by FASB Statement No. 137, is effective for all fiscal quarters of all fiscal years beginning after June 15, 2000.)

[5] MBSs that are held for sale in conjunction with mortgage banking activities (as described in FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*) are classified in accordance with the provisions of FASB Statement No. 115. However, a mortgage banking enterprise must classify as trading any retained mortgage-backed securities that it commits to sell before or during the securitization process. (See FASB Statement No. 134, *Accounting for Mortgage-Backed Securities Retained After the Securitization of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise)*

[6] Paragraph 36 of FASB Statement No. 109, *Accounting for Income Taxes*, provides guidance on reporting the tax effects of unrealized holding gains and losses reported in other comprehensive income. Specifically, paragraph 36(b) of FASB Statement No. 109 says that the tax effects of gains and losses that occur during the year and are included in comprehensive income but excluded from net income (for example, changes in the unrealized holding gains and losses of securities classified as available-for-sale under FASB Statement No. 115) are charged or credited directly to the related component of shareholders' equity.

other financial statements that constitute a full set of financial statements. The Statement divides comprehensive income into net income and other comprehensive income. Paragraph 17 of the Statement requires that items included in other comprehensive income be classified based on their nature and recognizes, for example, that under existing accounting standards, other comprehensive income includes unrealized gains and losses on certain investments in debt and equity securities. Paragraph 18 of the Statement requires that adjustments be made to avoid double counting in comprehensive income items that are displayed as part of net income for a period that also had been displayed as part of other comprehensive income in that period or earlier periods. For example, gains and losses on investment securities that were realized and included in net income of the current period that also had been included in other comprehensive income as unrealized holding gains and losses in the period in which they arose must be deducted through other comprehensive income of the period in which they are included in net income to avoid including them in comprehensive income twice.

7.64 Paragraph 8 of FASB Statement No. 115 addresses changes in circumstances that may cause the enterprise to change its intent to hold a certain security to maturity without calling into question its intent to hold other debt securities to maturity.

7.65 For individual securities classified as either available for sale or held to maturity, paragraph 16 of FASB Statement No. 115 requires institutions to determine whether a decline in fair value below the amortized cost basis is other than temporary. (If a security has been the hedged item in a fair value hedge, the security's "amortized cost basis" shall reflect the effect of the adjustments of its carrying amount made pursuant to paragraph 22(b) of Statement 133.) For example, if it is probable that the 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 shall be 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).[7] The new cost basis shall not be changed for subsequent recoveries in fair value.

7.66 Paragraph 15 of the Statement specifies accounting for transfers between categories.

7.67 FASB Technical Bulletin No. 94-1, *Application of Statement 115 to Debt Securities Restructured in a Troubled Debt Restructuring*, clarifies that any loan that was restructured in a troubled debt restructuring involving a modification of terms, including those restructured before the effective date of FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*, would be subject to the provisions of FASB Statement No. 115 if the debt instrument meets the definition of a security (as provided in FASB Statement No. 115).

Premiums and Discounts

7.68 An institution will often pay less (or more) for a security than the security's face value.[8] Accretion of the resulting discount (or amortization of the premium) increases (or decreases) the effective rate of interest on the security, thereby reflecting the security's market yield. FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of*

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[7] A decline in the value of a security that is other than temporary is also discussed in Statement on Auditing Standards (SAS) No. 81, *Auditing Investments* (AICPA, *Professional Standards*, vol. 1, AU sec. 332), and in Securities and Exchange Commission (SEC) Staff Accounting Bulletin No. 59, *Accounting for Noncurrent Marketable Equity Securities*. Note that the ASB expects to issue during the third quarter of 2000 a new Statement on Auditing Standards entitled *Auditing Derivatives, Hedging Activities, and Investments in Securities* that will supersede SAS No. 81. Readers should be alert to any final pronouncement.

[8] FASB Statement No. 115 does not affect the methods used for recognizing and measuring the amount of dividend and interest income (see paragraph 14 of FASB Statement No. 115).

Leases, specifies that discounts or premiums associated with the purchase of debt securities should be accreted or amortized using the interest method, that is, to arrive at periodic interest income at a constant effective yield on the net investment in the receivable (that is, the principal amount of the receivable adjusted by unamortized fees or costs and purchase discount or premium).

7.69 The period of amortization or accretion for debt securities should generally extend from the purchase date to the maturity date, not an earlier call date. Paragraph 19 of FASB Statement No. 91 permits expected maturity dates to be used only for holdings of large numbers of similar loans for which prepayments are probable and the timing and the amount of the prepayments can be reasonably estimated. Certain ABSs may meet those conditions, and institutions should consider estimates of prepayments in determining the amortization period for calculation of the constant yield. If the institution anticipates prepayments in applying the interest method and a difference arises between the anticipated prepayments and the actual prepayments received, the effective yield should be recalculated to reflect actual payments to date and anticipated future payments. The net investment should be adjusted to the amount that would have existed had the new effective yield been applied since purchase. The investment should be adjusted to the new balance with a corresponding charge or credit to interest income.

7.70 ***POs.*** In general, purchase discounts on POs are recognized by the interest method over the contractual life of the related instrument in conformity with FASB Statement No. 91. However, POs ordinarily meet the criteria in paragraph 19 of FASB Statement No. 91 that permit accretion of discounts using expected maturity dates.

Special Areas

7.71 As listed below, several specialized accounting issues involving investments have been addressed by the FASB's Emerging Issues Task Force (EITF).

7.72 ***Loan Conversions.*** EITF Issue No. 94-8, *Accounting for Conversion of a Loan into a Debt Security in a Debt Restructuring*, addresses accounting for such conversions.

7.73 ***Impairment of Certain Mortgage Securities.*** 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 issues associated with impairment of such instruments.

7.74 ***More Complex Mortgage-Backed Securities.*** EITF Issue No. 89-4, *Accounting for a Purchased Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate*, as amended by EITF Issue No. 93-18, applies to CMOs, IOs, and REMICs and addresses—

- Which factors should be considered in determining whether to account for certain securities as equity or non-equity.
- What attributes of certain non-equity high-risk securities distinguish them as a group of instruments that should be accounted for similarly.
- Accounting for certain non-equity high-risk securities in subsequent periods.

7.75 ***Sales of Marketable Securities With Put Arrangements.*** As discussed beginning in paragraph 5.79, FASB Statement No. 125 addresses transfers of financial assets, including marketable securities. Transfers of marketable securities with put arrangements are further addressed in EITF Issues No. 84-5, *Sale of Marketable Securities with a Put Option*, and No. 85-25, *Sale of Preferred Stocks with a Put Option*.

7.76 ***Mutual funds.*** Accounting for investments in certain mutual funds is addressed in EITF Issue No. 86-40, *Investments in Open-End Mutual Funds That Invest in U.S. Government Securities*.

7.77 ***Investments Required to be Divested.*** EITF Issue No. 89-18, *Divestitures of Certain Investment Securities to an Unregulated Commonly Controlled Entity under FIRREA* (as amended by FASB Statement No. 115), addresses accounting for such securities.

7.78 EITF Issue No. 89-18 did not address accounting for the subsequent sale of the securities to an affiliate or accounting in consolidated financial statements; however, the SEC staff observer at the EITF meeting noted that gain recognition would not be appropriate when the securities are sold to an affiliate. Further, paragraph 6 of Accounting Research Bulletin No. 51, *Consolidated Financial Statements*, states that consolidated financial statements should not include gain or loss on transactions among the companies in the group.[9]

7.79 EITF Issue No. 89-18, as amended, requires that investments in securities required to be divested should be reported as available for sale at fair value (see paragraph 5.59). The fair value for these securities can be difficult to determine, depending on the availability of third-party quotations that are limited at times because of a lack of market activity in these securities. Junk bonds, for example, are often issued by companies without long track records of sales and earnings, by established companies the profitability of which has declined, or by entities with questionable credit. Additionally, junk bonds have been used to finance leveraged corporate acquisitions in which the assets of the company being acquired serve as collateral for the securities. Institutions have been attracted to the potentially higher yields on junk bonds relative to higher-grade bonds.

7.80 ***Hedges of Available-for-Sale Marketable Equity Security.*** EITF Issue No. 97-7, Accounting for Hedges of the Foreign Currency Risk Inherent in an Available-for-Sale Marketable Equity Security, provides guidance on how to account for foreign currency transaction gains or losses on a foreign currency forward exchange contract or foreign-currency-denominated liability that is designated as, and is effective as, a hedge of an available-for-sale marketable equity security. [10]

7.81 ***Other Issues.*** Appendix D-52 to the EITF Abstracts contains a discussion of the impact of FASB Statement No. 125 on numerous EITF Issues. Appendix D-66 discusses the effect of a special-purpose entity's powers to sell, exchange, repledge, or distribute transferred financial assets under FASB Statement No. 125. Appendix D-67 contains guidance on the isolation of assets transferred by FDIC insured institutions under FASB Statement No. 125. Appendix D-69 discusses gain recognition on transfers of financial assets under FASB Statement No. 125. Appendix D-75 discusses the issue of when to recognize gains and losses on assets transferred to a qualifying special purpose entity.

7.82 Appendix D-44 to the *EITF Abstracts* includes a discussion of when an institution should recognize an other-than-temporary impairment if it has decided to sell a specifically identified available-for-sale debt security at a loss shortly after the reporting date.

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[9] The FASB has issued an Exposure Draft, *Consolidated Financial Statements: Purpose and Policy*, that would require business enterprises and not-for-profit organizations that control other entities to include those subsidiaries in their consolidated financial statements. *Control* would be defined as the nonshared decision-making ability of one entity to direct the policies and management that guide the ongoing activities of another entity so as to increase its benefits and limit its losses from that other entity's activities.The FASB anticipates issuing a Final Statement during 2000. Readers should be alert to any final pronouncement.

[10] Readers who are implementing FASB Statement No. 133 are reminded that FASB Statements are category "a" sources of generally accepted accounting principles (GAAP) and EITF Issues are category "c" sources of GAAP, as stated in SAS No. 69, The Meaning of *Present Fairly in Conformity With Generally Accepted Accounting Principles* in the Independent Auditor's Report (AICPA, *Professional Standards*, vol. 1, AU sec. 411). Accordingly FASB Statements are higher sources of GAAP than EITF Issues.

7.83 Readers may want to read EITF Appendix D-74*, Issues Concerning the Scope of the AICPA Guide on Investment Companies*. This appendix discusses some of the FASB's concerns about the scope of the AICPA Audit and Accounting Guide *Audits of Investment Companies*.

Transfers and Servicing of Securities

7.84 FASB Statement No. 125 provides accounting and reporting standards for transfers and servicing of financial assets, including securities.[11] The Statement is based on consistent application of a *financial-components approach* that focuses on control. FASB Statement No. 125 describes that, under that approach, after a transfer of financial assets, an entity recognizes the financial and servicing assets it controls and the liabilities it has incurred, derecognizes financial assets when control has been surrendered, and derecognizes liabilities when extinguished. FASB Statement No. 125 provides consistent standards for distinguishing transfers of financial assets that are sales from transfers that are secured borrowings.

7.85 Under FASB Statement No. 125, a transfer of financial assets (or all or a portion of a financial asset) in which the transferor surrenders control over those assets is accounted for as a sale to the extent that consideration other than beneficial interests in the transferred assets is received in exchange. Paragraph 9 of the Statement says a transferor has surrendered control over transferred assets if and only if all of the following conditions are met:

a. The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership (paragraphs 23 and 24 of the Statement give related guidance). [12]

b. Either (1) each transferee obtains the right—free of conditions that constrain it from taking advantage of that right (paragraph 25 of the Statement) —to pledge or exchange the transferred assets or (2) the transferee is a qualifying special-purpose entity (paragraph 26 of the Statement) and the holders of beneficial interests in that entity have the right—free of conditions that constrain them from taking advantage of that right (paragraph 25 of the Statement) —to pledge or exchange those interests.

c. The transferor does not maintain effective control over the transferred assets through (1) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity (paragraphs 27-29 of the Statement) or (2) an agreement that entitles the transferor to repurchase or redeem transferred assets that are not readily obtainable (paragraph 30 of the Statement).

7.86 Paragraph 10 of FASB Statement No. 125 requires that, upon completion of any transfer of financial assets, the transferor shall:

a. Continue to carry in its statement of financial position any retained interest in the transferred assets, including, if applicable, servicing assets (paragraphs 35-41 of the Statement give related guidance), beneficial interests in assets transferred to a qualifying special-purpose entity in a securitization (paragraphs 47-58 of the Statement), and retained undivided interests (paragraph 33 of the Statement).

b. Allocate the previous carrying amount between the assets sold, if any, and the retained interests, if any, based on their relative fair values at the date of transfer (paragraphs 31B34 of the Statement).

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[11] The FASB has published a Special Report entitled, *A Guide to Implementation of Statement 125 on Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities—Questions and Answers—Third Edition*.

[12] Appendix D-67 to the EITF Abstracts contains guidance on the isolation of assets transferred by FDIC insured financial institutions under FASB Statement No. 125.

7.87 Paragraph 11 of FASB Statement No. 125 requires that, upon completion of a transfer of assets that satisfies the conditions to be accounted for as a sale (paragraph 5.80), the transferor (seller) shall:

a. Derecognize all assets sold.

b. Recognize all assets obtained and liabilities incurred in consideration as proceeds of the sale, including cash, put or call options held or written (for example, guarantee or recourse obligations), forward commitments (for example, commitments to deliver additional receivables during the revolving periods of some securitizations), swaps (for example, provisions that convert interest rates from fixed to variable), and servicing liabilities, if applicable (paragraphs 31, 32, and 35B41 of the Statement give related guidance).

c. Initially measure at fair value assets obtained and liabilities incurred in a sale (paragraphs 42B44 of the Statement) or, if it is not practicable to estimate the fair value of an asset or a liability, apply alternative measures (paragraphs 45 and 46 of the Statement).

d. Recognize in earnings any gain or loss on the sale.

7.88 Paragraph 11 of FASB Statement No. 125 requires that the transferee recognize all assets obtained and any liabilities incurred and initially measure them at fair value (in aggregate, presumptively the price paid).

7.89 If a transfer of financial assets in exchange for cash or other consideration (other than beneficial interests in the transferred assets) does not meet the criteria for a sale in paragraph 9 of FASB Statement No. 125 (paragraph 5.80), paragraph 12 of the Statement requires that the transferor and transferee account for the transfer as a secured borrowing with pledge of collateral (see paragraph 5.87 herein).

7.90 ***Recognition and Measurement of Servicing Assets and Liabilities.*** Paragraph 13 of FASB Statement No. 125 requires that:

> Each time an entity undertakes an obligation to service financial assets it shall recognize either a servicing asset or a servicing liability for that servicing contract, unless it securitizes the assets, retains all of the resulting securities, and classifies them as debt securities held-to-maturity in accordance with FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. If the servicing asset or liability was purchased or assumed rather than undertaken in a sale or securitization of the financial assets being serviced, it shall be measured initially at its fair value, presumptively the price paid. A servicing asset or liability shall be amortized in proportion to and over the period of estimated net servicing income (if servicing revenues exceed servicing costs) or net servicing loss (if servicing costs exceed servicing revenues). A servicing asset or liability shall be assessed for impairment or increased obligation based on its fair value (paragraphs 35-38 [of the Statement provide additional guidance]).

7.91 ***Financial Assets Subject to Prepayment.*** Paragraph 14 of FASB Statement No. 125 requires that, except for those instruments that are within the scope of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities,*[13] interest-only strips, loans, other receivables, or retained interests in securitizations that can contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment shall be subsequently measured like investments in debt securities classified as available-for-sale or trading under FASB Statement No. 115, as amended by paragraph 233 of FASB Statement No. 125 and FASB Statement No. 135, *Rescission of FASB Statement No. 75 and Technical Corrections*. A debt security with those characteristics should be evaluated in accordance with paragraphs 12-16 of FASB Statement No. 133 to determine whether it contains an embedded derivative that must be accounted for separately.

[13] FASB Statement No. 133, as amended by FASB Statement No. 137, is effective for all fiscal quarters of fiscal years beginning after June 15, 2000. On March 3, 2000, the FASB issued an Exposure Draft, *Accounting for Certain Derivative Instruments and Certain Hedging Activities —an Amendment of FASB Statement No. 133*. Readers should be alert to any final pronouncement.

7.92 ***Secured Borrowings and Collateral.*** .[Ψ] Paragraph 15 of FASB Statement No. 125 says:
A debtor may grant a security interest in certain assets to a lender (the secured party) to serve as collateral for its obligation under a borrowing, with or without recourse to other assets of the debtor. An obligor under other kinds of current or potential obligations, for example, interest rate swaps, also may grant a security interest in certain assets to a secured party. If collateral is transferred to the secured party, the custodial arrangement is commonly referred to as a pledge. Secured parties sometimes are permitted to sell or repledge (or otherwise transfer) collateral held under a pledge. The same relationships occur, under different names, in transfers documented as sales that are accounted for as secured borrowings (paragraph 12). The accounting for collateral by the debtor (or obligor) and the secured party depends on whether the secured party has taken control over the collateral and on the rights and obligations that result from the collateral arrangement:

a. If (1) the secured party is permitted by contract or custom to sell or repledge the collateral and (2) the debtor does not have the right and ability to redeem the collateral on short notice, for example, by substituting other collateral or terminating the contract, then
   - (i) The debtor shall reclassify that asset and report that asset in its statement of financial position separately (for example, as securities receivable from broker) from other assets not so encumbered.
   - (ii) The secured party shall recognize that collateral as its asset, initially measure it at fair value, and also recognize its obligation to return it.

b. If the secured party sells or repledges collateral on terms that do not give it the right and ability to repurchase or redeem the collateral from the transferee on short notice and thus may impair the debtor's right to redeem it, the secured party shall recognize the proceeds from the sale or the asset repledged and its obligation to return the asset to the extent that it has not already recognized them. The sale or repledging of the asset is a transfer subject to the provisions of this Statement.

c. If the debtor defaults under the terms of the secured contract and is no longer entitled to redeem the collateral, it shall derecognize the collateral, and the secured party shall recognize the collateral as its asset to the extent it has not already recognized it and initially measure it at fair value.

d. Otherwise, the debtor shall continue to carry the collateral as its asset, and the secured party shall not recognize the pledged asset.

7.93 Paragraphs 61 through 65 of FASB Statement No. 125 discuss application of the Statement to securities lending transactions. Application of the Statement to repurchase agreements and wash sales are discussed in paragraphs 66 through 71 of the Statement.

[Ψ] The FASB has issued an Exposure Draft, *Accounting for Transfers of Financial Assets —an amendment of FASB Statement No. 125*, that would revise standards for transfers of financial assets by modifying criteria and guidance for determining whether the transferor has relinquished control of assets and the transfer is therefore accounted for as a sale. The FASB anticipates issuing a final Statement during 2000. Readers should be alert to any final pronouncement.

7.94 ***Trade Date Accounting.*** Regular-way purchases and sales of securities, as defined in paragraph 10 of FASB Statement No. 133, should be recorded in the balance sheet on the trade date. Gains and losses from regular-way security sales or disposals should be recognized as of the trade date in the statement of operations for the period in which securities are sold or otherwise disposed of.[14] FASB Statement No. 115 states that sales or transfers from securities classified as held to maturity should be rare, except for sales or transfers due to changes in circumstances identified in the Statement.

7.95 ***Short Sales.*** The obligations incurred in short sales should be reported as liabilities and adjusted to fair value through the income statement at each reporting date. Such liabilities are generally called "securities sold, not yet purchased." Interest on the short positions should be accrued periodically and reported as interest expense.

7.96 ***Offsetting***. Balances arising from secured borrowings should be reported gross on the balance sheet unless the provisions of FASB Interpretation No. 39, *Offsetting Amounts Related to Certain Contracts*, are met. FASB Interpretation No. 41, *Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements*, does not apply to secured borrowings.

Troubled Debt Restructurings

7.97 FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*, applies to troubled debt restructurings involving debt securities, including instances in which there is a substitution of debtors. FASB Statement No. 114 sets forth accounting for troubled debt restructurings involving a modification of terms of a receivable. This topic is discussed in more detail in chapter 8.

Amortization of Discounts on Certain Debt Securities

7.98 The Accounting Standards Executive Committee (AcSEC) issued AICPA Practice Bulletin 6, *Amortization of Discounts of Certain Acquired Loans*, in 1989 to provide guidance on the accounting and reporting by purchasers of certain acquired loans or other debt securities (as defined).[15] For acquired loans or other debt securities within its scope, Practice Bulletin 6 includes guidance on (*a*) amortization of discounts that reflect impairment due to credit risk, (*b*) initial and subsequent recognition of principal and interest, and (*c*) assessing collectibility. For loans within the scope of FASB Statement No. 114, Practice Bulletin 6's provisions on recognition and measurement of impairment are inconsistent with certain provisions of FASB Statement No. 114, as amended by FASB Statement No. 118, *Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures*, (and related amendments of FASB Statement No. 5, *Accounting for Contingencies*, and No. 15) and FASB Statement No. 115. AcSEC has a Statement of Position (SOP) project underway that would supersede Practice Bulletin 6; however, FASB Statements No. 114, No. 115, and No. 118 take precedence for loans and debt securities within their scope. An exposure draft for a proposed SOP, *Accounting for Discounts Related to Credit Quality,* was issued by AcSEC in December 1998. Readers should be alert to any final SOP.

Financial Statement Presentation and Disclosure

7.99 The notes to the financial statements should include an explanation of the institution's accounting policy for securities, including the basis for classification.

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[14] Paragraph 8.14 of the Guide discusses accounting for transfers of loans that have not been previously securitized.

[15] Related financial reporting by liquidating banks is beyond the scope of Practice Bulletin 6 and was addressed in EITF Issue No. 88-25, *Ongoing Accounting and Reporting for a Newly Created Liquidating Bank.*

7.100 * Paragraphs 19 and 20 of FASB Statement No. 115 require that the following information about held-to-maturity and available-for-sale securities be disclosed separately for each of those categories:

a. For each statement of financial position presented, the fair value, gross unrealized holding gains, gross unrealized holding losses, and amortized cost[16] basis by major security type. Major security types include, but are not limited to, the following:
- Equity securities
- Debt securities issued by the U.S. Treasury and other U.S. government corporations and agencies
- Debt securities issued by states within the United States and political subdivisions of the states
- Debt securities issued by foreign governments (including those classified as loans)
- Corporate debt securities
- Mortgage-backed securities
- Other debt securities

b. Information about the contractual maturities of securities as of the date of the most recent statement of financial position. Maturity information may be combined in appropriate groupings.[17] These disclosures should include the fair value and amortized cost[^] of debt securities based on at least the four following maturity groupings:
- Within one year
- After one year through five years
- After five years through ten years
- After ten years

7.101 [+] For each period for which the results of operations are presented, paragraph 21 of FASB Statement

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* FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, amends paragraph 19 of FASB Statement No. 115, to require that for securities classified as available–for-sale, all reporting enterprises shall disclose the aggregate fair value, the total gains for securities with net gains in accumulated other comprehensive income, and the total losses for securities with net losses in accumulated other comprehensive income, by major security type as of each date for which a statement of financial position is presented. For securities classified as held-to-maturity, all reporting enterprises shall disclose the aggregate fair value, gross unrealized holding gains, gross unrealized holding losses, the net carrying amount, and the gross gains and losses in accumulated other comprehensive income for any derivatives that hedged the forecasted acquisition of the held-to-maturity securities, by major security type as of each date for which a statement of financial position is presented.
FASB Statement No. 133, as amended by FASB Statement No. 137, *Accounting for Derivative Instruments and Hedging Activities - Deferral of the Effective Date of FASB Statement No. 133* is effective for all fiscal quarters of fiscal years beginning after June 15, 2000. On March 3, 2000, the FASB issued an Exposure Draft, *Accounting for Certain Derivative Instruments and Certain Hedging Activities —an Amendment of FASB Statement No. 133*. Readers should be alert to any final pronouncement.

[16] Amortized cost is the face amount of the security increased or decreased by unamortized premium, discount, finance charges, or acquisition fees and costs and may also reflect a previous direct write-down of the security.

[17] Securities not due at a single maturity date, such as MBSs, may be disclosed separately rather than allocated over several maturity groupings; if allocated, the basis for allocation should be disclosed.

[^] FASB Statement No. 133 by amending paragraph 20 of FASB Statement no. 115, replaces “amortized cost” with “net carrying amount (if different than fair value)”. FASB Statement No. 133, as amended by FASB Statement No. 137, is effective for all fiscal quarters of fiscal years beginning after June 15, 2000. On March 3, 2000, the FASB issued an Exposure Draft, *Accounting for Certain Derivative Instruments and Certain Hedging Activities —an Amendment of FASB Statement No. 133*. Readers should be alert to any final pronouncement.

[+] FASB Statement No. 133 amends paragraphs 21 and 22 of FASB Statement No. 115, to require that for each period for which the results of operations are presented, institutions are required to disclose—

a. The proceeds from sales of available-for-sale securities and the gross realized gains and gross realized losses that have been included in earnings as a result of those sales.

b. The basis on which cost of a security sold or the amount reclassified out of accumulated other comprehensive income into earnings was determined (that is, specific identification, average cost, or other method used).

c. The gross gains and gross losses included in earnings from transfers of securities from the available-for-sale category into the trading category.

d. The amount of the net unrealized holding gain or loss on available-for-sale securities for the period that has been included in accumulated other comprehensive income and the amount of gains and losses reclassified out of accumulated other comprehensive income into earnings for the period.

e. The portion of trading gains and losses for the period that relates to trading securities still held at reporting date.

For any sales of or transfers from securities classified as held-to maturity, the net carrying amount of the sold or transferred security, the net gain or loss in accumulated other comprehensive income for any derivative that hedged the forecasted acquisition of the held-to-maturity security, the related

No. 115 requires that the institution disclose—

a. The proceeds from sales of available-for-sale securities and the gross realized gains and gross realized losses on those sales.

b. The basis on which cost was determined in computing realized gain or loss (that is, specific identification, average cost, or other method used).

c. The gross gains and gross losses included in earnings from transfers of securities from the available-for-sale category into the trading category.

d. The change in net unrealized holding gain or loss on available-for-sale securities that has been included in the separate component of shareholders' equity during the period.[18]

e. The change in net unrealized holding gain or loss on trading securities held at period-end that has been included in earnings during the period.

For any sales of or transfers from securities classified as held to maturity, paragraph 22 of FASB Statement No. 115 requires the amortized cost amount of the sold or transferred security, the related realized or unrealized gain or loss, and the circumstances leading to the decision to sell or transfer the security should be disclosed in the notes to the financial statements for each period for which the results of operations are presented. Such sales or transfers should be rare, except for sales and transfers due to the changes in circumstances identified in FASB Statement No. 115, subparagraphs 8aBf, or sales that are considered maturities in accordance with the criteria in paragraph 11.

7.102 ± FASB Statement No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*, requires certain disclosures of financial instruments with off-balance-sheet credit or market risk and disclosure of significant concentrations of credit risk for all financial instruments. The concentrations-of-credit-risk disclosures apply to debt securities as well as loans and are discussed further in paragraphs 8.109 and following. (Off-balance-sheet risk disclosures are discussed in chapters 8 and 17.)

7.103 FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, requires all entities to disclose the fair value of financial instruments for which it is practicable to estimate fair value.*

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realized or unrealized gain or loss, and the circumstances leading to the decision to sell or transfer the security shall be disclosed in the notes to the financial statements for each period for which the results of operations are presented. FASB Statement No. 133, as amended by FASB Statement No. 137, is effective for all fiscal quarters of fiscal years beginning after June 15, 2000. On March 3, 2000, the FASB issued an Exposure Draft, *Accounting for Certain Derivative Instruments and Certain Hedging Activities —an Amendment of FASB Statement No. 133*. Readers should be alert to any final pronouncement.

[18] FASB Statement No. 109 requires that income tax expense or benefit for the year be allocated among continuing operations, discontinued operations, extraordinary items, and items charged or credited directly to shareholders' equity (such as changes in the unrealized holding gains and losses of securities classified as available for sale [see chapter 14].

± FASB Statement no. 133 supercedes FASB Statement No. 105. FASB Statement No. 133 amends FASB Statement No. 107 to include in FASB Statement No. 107 the disclosure provisions about concentrations of credit risk from FASB Statement No. 105, with modifications. FASB Statement No. 133, as amended by FASB Statement No. 137, is effective for all fiscal quarters of fiscal years beginning after June 15, 2000. A summary of FASB Statement No. 133 is provided in chapter 15 of this Guide. On March 3, 2000, the FASB issued an Exposure Draft, *Accounting for Certain Derivative Instruments and Certain Hedging Activities —an Amendment of FASB Statement No. 133*. Readers should be alert to any final pronouncement. The FASB has established the Derivative Implementation Group (DIG) to assist the Board and its staff in providing implementation guidance regarding FASB Statement No. 133. Issues addressed by the DIG and the status of related guidance can be found at the FASB's Web site at www.fasb.org.

* In December 1996, the FASB issued FASB Statement No. 126, *Exemption from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities*, which makes the disclosures about fair value of financial instruments prescribed in FASB Statement No. 107 optional for entities that meet all of the following criteria specified in paragraph 2 of FASB Statement No. 126:

a. The entity is a nonpublic entity (as defined in FASB Statement No. 126).

b. The entity's total assets are less than $100 million on the date of the financial statements.

c. The entity has not held or issued any derivative financial instruments, as defined in FASB Statement No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments*, other than loan commitments, during the reporting period.

d. The entity has no instrument that, in whole or in part, is accounted for as a derivative instrument under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, during the reporting period.

7.104 If an entity has entered into repurchase agreements or securities lending transactions, paragraph 17a of FASB Statement No. 125 requires that the entity disclose its policy for requiring collateral or other security. If assets are set aside after the effective date of FASB Statement No. 125 solely for satisfying scheduled payments of a specific obligation, paragraph 17c of the Statement requires that the entity disclose a description of the nature of restrictions placed on those assets. Paragraph 17d of the Statement requires that, if it is not practicable to estimate the fair value of certain assets obtained or liabilities incurred in transfers of financial assets during the period, the entity should disclose a description of those items and the reasons why it is not practicable to estimate their fair value.

7.105 Except for transactions within the scope of paragraph 15(a) of FASB Statement No. 125, the carrying amount of investment assets pledged to secure public funds, securities sold under repurchase agreements, and for other borrowings should also be disclosed in the notes to the financial statements.

AUDITING[φ]

Objectives

7.106 The primary objectives of audit procedures in this area are to obtain reasonable assurance that—

a. Securities, accrued interest, and discounts and premiums of the institution—
- Exist at the balance-sheet date (definitive securities are on hand or held by others in custody or safekeeping for the account of the institution) and are owned by the institution.
- Have been properly classified, described, and disclosed in the financial statements at appropriate amounts (including consideration of any other-than-temporary declines in value and disclosure of any securities pledged as collateral for other transactions).

b. Sales of securities and other transactions that—
- Have been recorded have occurred during the given period.
- Should be presented in the financial statements are so included.

c. Realized and unrealized gains and losses, and interest (including premium amortization and discount accretion), dividend, and other revenue components—
- Have been included in the financial statements at appropriate amounts.
- Are properly classified, described, and disclosed.

Planning

7.107 In planning the audit, the independent accountant should consider the factors influencing inherent risk, which are described in chapter 5, as they relate to financial statement assertions about investments. The primary inherent risks—interest-rate risk, credit risk, and liquidity risk—are interrelated. For example, increases in market interest rates may affect other risk factors by decreasing marketability (that is, liquidity) or by increasing the credit risk of the issuer's obligations. The independent accountant should have an understanding of the relationship between the interest-rate environment and the market values of securities. The institution's asset/liability and other risk management policies may provide useful information about the possible effects of interest rate and liquidity risks on the institution's securities.

[φ] The Auditing Standards Board (ASB) expects to issue during the third quarter of 2000 a new SAS entitled *Auditing Derivatives, Hedging Activities, and Investments in Securities.* This new SAS will supersede SAS 81 and provide guidance on audit procedures in this area. In addition, the ASB expects to issue shortly after the new SAS a new Audit Guide by the same title that will provide authoritative detailed implementation guidance. Readers should be alert to any final pronouncement and Guide.

7.108 Another risk inherent to complex investments is the business risk that the institution does not properly understand the terms and economic substance of a significant complex investment. Such misunderstandings could result in the incorrect pricing of a transaction and improper accounting for the investment or related income. (Related guidance on learning the extent of derivatives use is given in Chapter 19.) Inquiry of a specialist should be considered by the independent accountant if a financial institution is actively engaged in holding or trading such complex securities.

7.109 Classification of investments in securities among the held-to-maturity, available-for-sale, and trading categories is important because it directly affects the accounting treatment. The classification of securities, which must occur at acquisition, should be consistent with the institution's investment, asset/liability, and other risk management policies. Paragraph 5 of SAS No. 81* says the independent accountant should ascertain whether the accounting policies adopted by the entity for investments are in conformity with generally accepted accounting principles (GAAP). In planning the audit, the independent accountant should consider reading the current year's interim financial statements, investment policy, and other financial information related to securities. The level of inherent risk for securities varies widely from institution to institution depending on, among other things, the nature and complexity of the securities and the extent and effectiveness of the institution's accounting and operational policies and procedures, as well as management's understanding and awareness of the risks. The following factors related to securities may, considered in the aggregate, indicate higher inherent risk:

a. Significant concentrations of credit risk with one counterparty or within one geographic area
b. Significant use of complex securities, particularly without relevant in-house expertise
c. Borrowing or lending of securities
d. Relatively high volatility in interest rates
e. Changes in the terms of government guarantees
f. Actual prepayment experience that differs significantly from that anticipated
g. Declines in the values of collateral underlying securities
h. Changes in guarantors' claims processing
i. Significant conversion options related to the collateral (for example, variable to fixed rates)
j. Sales and transfers from the held-to-maturity securities portfolio
k. Uncertainty regarding the financial stability of an ABS servicer or of guarantors
l. Uncertainty regarding the financial stability of a safekeeping agent or other third party holding the institution's securities
m. Changes in accounting systems, including software and manual processes

Internal Control Over Financial Reporting and Possible Tests of Controls

7.110 SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), provides guidance on the independent accountant's consideration of an institution's internal control in an audit of financial statements performed in accordance with GAAS. It describes the components of internal control and explains how an independent accountant should consider internal control in planning and performing an audit. Paragraph 19 of SAS No. 55, as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55*, requires that, in all audits, the independent accountant obtain sufficient understanding of each of the five components (the control environment, risk assessment, control activities, information and communication, and monitoring) to plan the audit by performing procedures to understand the design of policies and procedures relevant to audit planning and whether they have been placed in operation.

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* AcSEC has a project underway to amend SAS No. 70 and SAS No. 81. Readers should be alert to any final pronouncement.

7.111 Effective internal control, as it relates to financial reporting of investments in securities, should provide reasonable assurance that—

a. Management's policies are adequate to provide for financial reporting in accordance with generally accepted accounting principles.

c. Physical securities are on hand or held in custody or safekeeping by others in accordance with management's authorization.

d. Misstatements caused by error or fraud in the processing of accounting information for investments in securities are prevented or detected, and corrected in a timely manner.

e. Securities are monitored on an ongoing basis to determine whether recorded financial statement amounts require adjustment.

7.112 Control activities that would contribute to internal controls over financial reporting in this area include maintenance of management policies, adopted by the board of directors or its investment committee, that establish authority and responsibility for investments in securities. The regulatory policy statement discussed beginning in paragraph 7.54 establishes regulatory requirements that may affect such policies.

7.113 Other control activities that contribute to strong internal control over financial reporting of securities include the following:

- Procedures exist to identify and monitor credit risk, prepayment risk, and impairment.
- The board of directors—generally through an investment committee—oversees management's securities activities.
- Accounting entries supporting securities transactions are periodically reviewed by supervisory personnel to ensure that classification of securities was made and documented at acquisition (and date of transfer, if applicable) and is in accordance with the institution's investment policy and management's intent.
- Recorded securities are periodically reviewed and compared to safekeeping ledgers and custodial confirmations, on a timely basis, including immediate and thorough investigation and resolution of differences and appropriate supervisory review and approval of completed reconciliations.
- Current fair values of securities are obtained and reviewed on a timely basis.
- Securities loaned to other entities or pledged as collateral are designated as such in the accounting records.
- Lists of authorized signers are reviewed and updated periodically, and transaction documentation is compared to the authorized lists.
- There is appropriate segregation of duties among those who (*a*) execute securities transactions, (*b*) approve securities transactions, (*c*) have access to securities, and (*d*) post or reconcile related accounting records.
- Buy and sell orders are routinely compared to brokers' advices.
- Adjustments to securities accounts (for example, to recognize impairments) are reviewed and approved by the officials designated in management's policy.
- Periodic tests of interest and dividend income are performed by reference to supporting documentation, which may include using analytical procedures commonly referred to as yield analysis. (With this approach, actual yields during the period are compared to expected yields based on previous results and current market trends. Any significant differences should be investigated and explained.)
- Securities are monitored on an ongoing basis and factors affecting income recognition and the carrying amount of the securities are analyzed periodically to determine whether adjustments are necessary.

7.114 Many of the control activities for securities are often performed directly by senior management. While management's close attention to securities transactions can be an effective factor in internal control, the independent accountant should be alert to potential abuses and override of policies and procedures when such circumstances exist.

7.115 The independent accountant also should consider the guidance of SAS No. 70, *Service Organizations*, as amended by SAS No. 88, *Service Organizations and Reporting on Consistency* (AICPA, *Professional Standards*, vol. 1, AU sec. 324), if the institution obtains services from another organization that are part of its information system.

7.116 The independent accountant may decide to perform procedures to obtain evidential matter about the effectiveness of both the design and operation of controls to support a lower level of assessed control risk. Examples of tests of controls that might be considered include:

- Reading minutes of meetings of the board of directors (and any investment committee) for evidence of the board's periodic review of securities activities made so that the board may determine adherence to the institution's policy.
- Comparing securities transactions, including transfers, to the institution's accounting policy to determine whether the institution is following its policy. For example, the independent accountant may include—
  - — Testing that transactions have been executed in accordance with authorizations specified in the investment policy.
  - — Evaluating evidence that securities portfolios and related transactions (including impairments) are being monitored on a timely basis and reading supporting documentation.
  - — Testing recorded purchases of securities, including that classification of the securities and prices and entries used to record related amounts (for example, use of trade versus settlement date, and treatment of commissions, premiums and discounts).
- Recalculating a sample of premium and discount amortization amounts and gains and losses on sales.
- Reviewing controls over accumulating information necessary for financial statement disclosures.
- Testing the reconciliation process. The independent accountant might test whether reconciling differences are investigated and resolved and whether the reconciliations are reviewed and approved by supervisory personnel.
- Examine evidence that the company takes physical inventory and confirms safekeeping on a periodic basis, including reconciliation of differences.

Substantive Tests

7.117 ***Existence, Ownership, and Completeness.*** Paragraph 4 of SAS No. 81 says that the procedures the independent accountant performs to obtain evidence about the existence, ownership, and completeness of investments will vary depending on the types of investments involved and the independent accountant's assessment of audit risk. Paragraph 4 indicates that these procedures should include one or more of the following:

- Physical inspection
- Confirmation with the issuer
- Confirmation with the custodian
- Confirmation of unsettled transactions with the broker-dealer
- Confirmation with the counterparty
- Reading executed partnership or similar agreements

Paragraph 4 also directs the independent accountant to consider the guidance in SAS No. 70 if the entity obtains either or both of the following services from another organization:

a. Executing investment transactions and maintaining the related accountability.

b. Recording investment transactions and processing the related data.

7.118 ***Physical Inspection and Confirmation***. The independent accountant may consider physically inspecting and counting securities owned by the institution and held at the institution's premises noting that securities recorded in the accounting records are on hand. The independent accountant should consider confirming any securities pledged or held for the institution by third-party custodians. Book-entry securities may be confirmed with the trustee. SAS No. 67, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1, AU sec. 330), provides guidance on the use of confirmations.

7.119 ***Classification.*** The independent accountant should evaluate the classification of securities. FASB Statement No. 115 describes (*a*) circumstances under which a debt security should not be classified as held to maturity (subparagraphs 9a-e) and (*b*) circumstances in which the sale or transfer of a held-to-maturity security is not considered to be inconsistent with its original classification (subparagraphs 8a-f). Paragraph 14 of FASB Statement No. 125 addresses the accounting for securities subject to prepayment risk. Paragraph 8 of SAS No. 81 says the appropriate classification of investments depends on management's intent in purchasing and holding the investment, on the entity's actual investment activities, and, for certain debt securities, on the entity's ability to hold the investment to maturity. Paragraph 8 also says that, in determining the nature, timing, and extent of the independent accountant's substantive procedures, the independent accountant should obtain an understanding of the process used by management to classify investments.

7.120 Paragraph 9 of SAS No. 81 states that, in evaluating management's intent related to an investment, the independent accountant should consider whether investment activities corroborate or conflict with management's stated intent. For example, sales of investments classified in the held-to-maturity category, for reasons other than those identified in paragraphs 8 and 11 of FASB Statement No. 115, should cause the independent accountant to question the appropriateness of management's classification of other investments classified into that category as well as future classifications of investments into that category. Paragraph 9 says also that when considering investment activities, the independent accountant ordinarily should examine evidence such as written and approved records of investment strategies, records of investment activities, instructions to portfolio managers, and minutes of the board of directors or the investment committee.

7.121 Paragraph 10 of SAS No. 81 addresses the independent accountant's evaluation of an entity's ability to hold a debt security to maturity. Paragraph 10 says the independent accountant should consider factors such as the entity's financial position, working capital needs, operating results, debt agreements, guarantees, and other relevant contractual obligations, as well as laws and regulations. Paragraph 10 says the independent accountant also should consider whether existing operating and cash flow projections or forecasts provide relevant information about an entity's ability to hold an investment to maturity.

7.122 Paragraph 11 of SAS No. 81 says that, in addition to performing other auditing procedures, the independent accountant ordinarily should obtain written representations from management confirming that the entity has properly classified securities as held-to-maturity, trading, or available-for-sale, and, with respect to held-to-maturity debt securities, that management has the intent and the entity has the ability to hold such investments to maturity.

7.123 ***Valuation.*** As discussed in the "Accounting and Financial Reporting" section of this chapter, securities are carried at amortized cost or fair value depending on their classification. Further, fair values should be disclosed for all securities that are not carried at fair values. Paragraph 23 of SAS No. 81 states that the independent accountant should obtain evidence about the cost of investments if the entity carries its investments at cost or amortized cost or is required to make certain disclosures about the cost basis of investments carried at fair value and realized and unrealized gains and losses. Paragraph 23 says the procedures performed to obtain evidence about cost may include inspection of documentation indicating the purchase price of the security, confirmation with the issuer or custodian, and recomputation of discount or premium amortization.

7.124 If investments are carried at fair value or if fair value is disclosed for investments carried at other than fair value, paragraph 24 of SAS No. 81 states that the independent accountant should obtain evidence corroborating the fair value. Paragraph 24 notes that, in some cases, the method for determining fair value is specified by GAAP. For example, GAAP may require that the fair value of an investment be determined using quoted market prices or quotations as opposed to estimation techniques. Paragraph 24 says that, in those cases, the independent accountant should evaluate whether the determination of fair value is consistent with the required valuation method.

7.125 Paragraphs 25 through 30 of SAS No. 81 provide guidance on audit evidence that may be used to corroborate assertions about fair value, which should be considered in the context of specific accounting requirements. Paragraph 26 notes that quoted market prices obtained from financial publications or from national exchanges and the National Association of Securities Dealers Automated Quotations System (NASDAQ) are generally considered to provide sufficient evidence of the fair value of investments. However, for certain investments, such as securities that do not trade regularly, paragraph 26 says the independent accountant should consider obtaining estimates of fair value from broker-dealers or other third-party sources. Paragraph 26 also says that, in some situations, the independent accountant may determine that it is necessary to obtain fair-value estimates from more than one pricing source. For example, this may be appropriate if a pricing source has a relationship with an entity that might impair its objectivity. For fair value estimates obtained from broker-dealers and other third-party sources, paragraph 27 says the independent accountant should consider the applicability of the guidance in SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards,* vol. 1, AU sec. 336), or SAS No. 70.

7.126 Paragraph 28 of SAS No. 81 says that, in the case of investments valued by the entity using a valuation model, the independent accountant generally should assess the reasonableness and appropriateness of the model. Paragraph 28 states that the independent accountant should also determine whether the market variables and assumptions used are reasonable and appropriately supported. Further, paragraph 28 says the independent accountant should determine whether the entity has made appropriate disclosures about the method(s) and significant assumptions used to estimate the fair values of such investments. Paragraph 29 notes that the independent accountant may consider it necessary to involve a specialist in assessing the entity's fair-value estimates or related models in some cases.

7.127 Paragraph 30 of SAS No. 81 notes that negotiable securities, real estate, chattels, or other property is often assigned as collateral for investments in debt securities. Paragraph 30 says if the collateral is an important factor in evaluating fair value and collectibility of the investment, the independent accountant should obtain evidence regarding the existence, fair value, and transferability of such collateral as well as the investor's rights to the collateral.

7.128 ***Impairment***. Paragraph 32 of SAS No. 81 says the independent accountant should evaluate whether management has considered relevant information in determining whether an other-than-temporary impairment condition exists. Paragraph 32 lists the following examples of factors that may indicate an other-than-temporary impairment condition:

- Fair value is significantly below cost.
- The decline in fair value is attributable to specific adverse conditions affecting a particular investment.

- The decline in fair value is attributable to specific conditions, such as conditions in an industry or in a geographic area.
- Management does not possess both the intent and the ability to hold the investment for a period of time sufficient to allow for any anticipated recovery in fair value.
- The decline in fair value has existed for an extended period of time.
- A debt security has been downgraded by a rating agency.
- The financial condition of the issuer has deteriorated.
- Dividends have been reduced or eliminated, or scheduled interest payments on debt securities have not been made.

7.129 Paragraph 33 of SAS No. 81 says the independent accountant should evaluate management's conclusions about the existence of an other-than-temporary impairment condition. Paragraph 33 says that in evaluating management's conclusions, the independent accountant should obtain evidence about conditions, such as those listed in paragraph 5.123 above, that tend to corroborate or conflict with such conclusions.

7.130 SAS No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1, AU sec. 342), provides guidance on auditing estimates (such as estimates of fair values). SAS No. 57 discusses how an independent accountant obtains an understanding of how management developed estimates, concentrating on the key factors and assumptions used. It also discusses how an independent accountant may evaluate the reasonableness of management's estimate through use of one or a combination of the following approaches: (*a*) reviewing and testing the process used by management to develop an estimate, (*b*) developing an independent expectation of the estimate, (*c*) reviewing subsequent amounts of transactions occurring prior to the completion of fieldwork.

7.131 ***Securities Gains and Losses.*** The independent accountant should consider obtaining schedules of securities activity, including beginning balances, additions, sales, principal repayments, prepayments, and ending balances, and then determine the nature, timing, and extent of procedures for testing additions and sales. Such tests might include comparison of recorded purchases and sales of securities (and any resultant gains, losses, premiums, or discounts) to purchase or sale advice received from brokers.

7.132 ***Accrued Interest Receivable and Interest Income.*** Information technology assisted audit techniques are often an effective and efficient way to test accrued interest receivable, unamortized discounts and premiums, and interest income. While analytical review procedures may provide evidence about the reasonableness of these amounts, it is normally difficult to develop expectations to be used in analyzing yields on investments. Significant differences between expected and actual yields should be investigated to ensure they were adequately resolved. Interest income tests can be supplemented with monthly analytical tests by type of investment. Accrued interest receivable may be vouched to the subsequent receipt of the accrued interest.

7.133 ***Analytical Procedures.*** In using analytical procedures as a substantive test, the independent accountant should consider the implications of changes in important relationships and the extent of the difference between actual and expected results that can be accepted without further investigation. It is normally difficult to develop expectations to be used in analyzing yields on securities as a substantive test of related income amounts. Accordingly, analytical procedures in this area should generally be considered only as a supplement to other substantive procedures, except where an expected yield can be known with some precision.

7.134 The reasons for variations from expectations should be identified, analyzed, and investigated. The independent accountant should be alert to unusually high or low yields. High yields are often an indication of high interest rate, liquidity, or credit risk. Low yields are often an indication of declines in the value of securities. Additional guidance on the use of analytical procedures is provided by SAS No. 56, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 329). Analytical procedures that the independent accountant may consider include the following:

- Comparison of current-year interest and dividend income, related accruals, and prepayment experience to expectations based on average asset balances during the year and prior year's income
- Review of detailed securities listings and subsidiary ledgers to ascertain changes in mix between kinds of securities to facilitate adequate disaggregation for developing estimates about accruals and yields
- Computation of average yield throughout the period for each kind of security on a monthly or quarterly basis and comparison of results against contractual and effective yields
- Comparison of current-year activity in the trading, available-for-sale, and held-to-maturity categories to the institution's investment policy and stated intent at acquisition
- Comparison of yields during the period with expected yields based on previous results and current market trends

7.135 ***Other Procedures.*** Other audit procedures related to securities that the independent accountant may generally consider performing include the following:

- Examine transactions for evidence of short sales and if they exist, evaluate whether they have been properly accounted for in the financial statements.
- For certain complex derivative securities, review information considered necessary to gain an understanding of the nature and risks of individual securities (such as offering circulars, contracts, descriptions, and reports from the broker).

CHAPTER 8

Loans

INTRODUCTION

8.01 Loans usually are the most significant assets of financial institutions and generate the largest portion of revenues. Like investments, an institution's management of its loans is an integral part of its asset/liability management strategy (which is discussed in chapter 1). Institutions originate loans, purchase loans or participating interests in loans, sell loans or portions of loans, and securitize loans (the latter two activities are discussed in chapter 9). Because lending activities are influenced by many factors, including the type of institution, management's objectives and philosophies regarding diversification and risk (credit strategy), the availability of funds, credit demand, interest-rate margins, and regulations, the compositions of loan portfolios differ considerably among institutions. Further, the composition of a particular institution's loan portfolio may vary substantially over time.

The Lending Process

8.02 To plan and design audit procedures properly, the independent accountant needs to understand the institution's loan portfolio, lending processes, loan accounting policies, market specialty, and trade area, as well as other factors such as economic conditions. This section discusses certain characteristics of, and considerations involved in, the lending process. The specific features will vary from institution to institution.

Credit Strategy

8.03 The institution's credit strategy includes its defined goals and objectives for loans, as well as the loan policies written to help achieve those goals and objectives. A guiding principle in credit strategy is to achieve profitable returns while managing risk within the loan portfolio. Credit strategy and policy are usually determined by senior management and approved by the board of directors.

8.04 The objectives of a sound credit plan are to identify profitable markets, set goals for portfolio growth or contraction, and establish limits on industry and geographic concentrations. The plan establishes the institution's credit underwriting standards. In addition, management procedures and controls are required to monitor loan performance through periodic reporting and review and to identify and monitor problem loan situations.

Credit Risk

8.05 The overriding factor in making a loan is the amount of credit risk associated with the loan in relation to the potential reward. For individual loans, credit risk pertains to the borrower's ability and willingness to pay; it is assessed before credit is granted or renewed and periodically throughout the loan term.

8.06 An institution's credit exposure may be affected by external factors, such as the level of interest rates, unemployment, general economic conditions, real estate values, and trends in particular industries and markets. Internal factors—such as an institution's underwriting practices, credit practices, training, risk management techniques, familiarity and experience with its loan products and customers, the relative mix and geographic concentration of its loan portfolio, and the strength of its internal control—also have a significant effect on an institution's ability to control and monitor its credit exposure.

8.07 Additional risks, however, are involved in the overall credit process, and the institution should assess them when developing credit strategy, defining target markets, and designing proper controls over credit initiation and credit supervision. Those additional risks include the following:

- *Collateral Risk*. The institution may be exposed to loss on collateralized loans if its security interest is not perfected or the collateral is not otherwise under the institution's control, if the value of the collateral declines, or if environmental contingencies impair the value of the collateral or otherwise create liability for the institution.
- *Concentration Risk*. Inadequate diversification of the loan portfolio in terms of different industries, geographic regions, or number of borrowers may result in significant losses. A high concentration of loans to companies in a single industry would constitute a concentration risk.. For example, membership of credit unions may be limited to employees of one organization or to individuals of a geographic region. If the credit union's sponsoring organization is experiencing financial problems or is anticipating layoffs of employees, the credit union could be exposed to significant losses.
- *Country or Transfer Risk*. Economic, social, legal, and political conditions of a foreign country may unfavorably affect a borrower's ability to repay in the currency of the loan. Cross-border loans are those that borrowers must repay in a currency other than their local currency or to a lender in a different country. Losses may result if a country's foreign exchange reserves are insufficient to permit timely repayment of cross-border loans by borrowers domiciled in that country, even if the borrowers possess sufficient local currency. In addition, foreign government decisions and associated events can affect business activities in a country as well as a borrower's ability to repay its loans.
- *Foreign Exchange Risk*. Changes in foreign exchange rates may affect lenders unfavorably. Fluctuations in foreign exchange rates could reduce the translated value of the cash flows, earnings and equity in foreign currency denominated subsidiaries. Foreign exchange rate movements, if not effectively hedged, could also increase the funding costs of foreign operations as it is not uncommon for foreign operations to be funded by borrowings in currencies different than their functional currency.
- *Fraud Risk*. Loans may expose the institution to loss by not being bona fide transactions.
- *Insider Risk*. Loans to executive officers, directors, and principal shareholders of the institution and related interests of such insiders may expose the institution to loss if these loans are made to related individuals or companies, or both, with little credit history; if they lack an identified source of funds for repayment; or if they are made to newly organized or highly leveraged enterprises with insufficient collateral and inadequate financial information.
- *Interest-Rate Risk*. The maturity and repricing characteristics of loans can have a significant impact on the interest-rate risk profile (and, therefore, interest income) of an institution. For example, an institution that holds primarily fixed-rate loans could be adversely affected by a significant increase in interest rates.
- *Legal and Regulatory Risk*. Illegally granted loans, loans with usurious interest rates, and loans with terms that are not adequately disclosed to the borrower may expose the institution to loss.
- *Management Risk*. Management's competence, judgment, and integrity in originating, disbursing, supervising, collecting, and reviewing loans could substantially affect the collectibility of loans.
- *Operations Risk*. Funds might be disbursed without proper loan authorization, collateral documentation, or loan documentation. Failure of the institution to evaluate and monitor potentially uncollectible loans also constitutes an operations risk.

Lending Policies and Procedures

8.08 Definitive lending policies and comprehensive procedures for implementing such policies can contribute significantly to the institution's internal control over financial reporting as it relates to the lending process.

8.09 The lending function can be broadly divided into the categories of (*a*) credit origination and disbursement, (*b*) credit supervision, (*c*) collection, and (*d*) loan review.

8.10 ***Credit Origination and Disbursement.*** Credit origination involves all the processes from the original request for credit to the disbursement of funds to the customer. Specific control features to meet operational—rather than financial reporting—objectives for credit origination usually include the following:

- Credit initiation, that is, obtaining complete and informative loan applications, including financial statements and the intended use of proceeds
- Credit investigation
  - — Credit reports or other independent investigations
  - — Proper analysis of customer credit information, including determination of projected sources of loan servicing and repayment
- Loan approval (new and renewed loans)
  - — Loan approval limits according to officer expertise, administrative authority, or both
  - — Committee approval or board of director approval, or both, for loans exceeding prescribed limits
  - — Segregation of duties between the loan approval function and the disbursement and collection functions
  - — Collateral ownership and control verified, including lien searches and documentation of the priority of security interest
  - — Collateral margin determined
- Documentation of credit, or the inspection of supporting documents for proper form, completeness, and accuracy by someone other than the lending officer
- Perfection of collateral interest or proper security filings and recording of liens
- Disbursement of loan proceeds or, to the extent possible, control of disbursement to ensure that proceeds are used for the borrower's stated loan purpose

8.11 ***Credit Supervision.*** Loan officers are responsible for closely monitoring the loans in their portfolios and bringing problem loans to the attention of management. Their duties normally include obtaining and analyzing the borrower's periodic financial statements and credit histories, reassessing collateral values, making periodic visits to the customer's place of operation, and generally keeping abreast of industry trends and developments and of the customer's financial requirements and ability to perform. Management reports concerning loan activity, renewals, and delinquencies are vital to the timely identification of problem loans. Input from loan officers is also important for identifying when loans should be reserved for or charged off.

8.12 ***Collection.*** Loans identified as problems under the institution's established criteria should be monitored, restructured, or liquidated, as appropriate. The institution normally attempts to work with the customer to remedy a delinquency. Traditional mortgage collection procedures are not as effective in high LTV products. Delinquent borrowers who have little or no equity in the property may not have the incentive to work with the lender; therefore, high LTV lenders must intervene early to reduce the risk of default and loss. Sometimes the debt is restructured to include terms the customer can satisfy; at other times, the institution obtains additional collateral to support the loan. However, when the loan is delinquent for a specified period of time, as normally defined in the institution's lending policy, the institution may begin legal proceedings such as foreclosure or repossession to recover any outstanding interest and principal.

8.13 ***Loan Review.*** Periodic review by institution personnel of the credit process and of individual loans is essential in assessing the quality of the loan portfolio and the lending process. Loan review preferably should be conducted by personnel who are independent of the credit origination, disbursement, supervision, and collection functions. Depending on the complexity of the organizational structure, these personnel report directly to the board of directors or to senior management. Loan review may be performed by specifically assigned staff or may be incorporated within an internal audit function.

8.14 Loan review may identify weaknesses in the lending process or in the lending officers' skill in originating, supervising, and collecting loans. Loan review results should be documented and may be summarized in the form of subjective ratings of individual loans similar to regulatory examination classifications. In addition, loan review may reveal the need for a loss accrual, as discussed in chapter 9.

Types of Lending

8.15 Lending institutions offer a variety of loan products to meet borrowers' needs and as part of their overall credit strategy and asset/liability management strategy. Loans may be made on a line-of-credit, installment, demand, time, or term basis. A brief description of each of those kinds of arrangements follows.

a. *Line-of-Credit Arrangements*. The institution provides the borrower with a maximum borrowing limit for a specified period. Lines of credit may be structured in a variety of ways. Letters of credit, which are commonly used as credit enhancements for other forms of borrowing (such as commercial paper or trade financing), are agreements to lend a specified amount for a specified period (usually less than one year). Revolving credit agreements, which are commonly used in credit-card lending, are agreements to lend up to a specified maximum amount for a specified period, usually more than one year, and provide that repayment of amounts previously borrowed under the agreement are available to the borrower for subsequent borrowing. Repayment schedules may be on an installment, demand, time, or term basis, as discussed below. Other line-of-credit arrangements are applied to—
- *Construction*, where the borrower may draw on the line as necessary to finance building costs to supplement (or pending the securing of) a construction loan.
- *Liquidity*, used by the borrower in overall management of its liquidity needs.
- *Warehousing*, used by borrowers engaged in mortgage banking activities to fund origination of mortgage loans, generally pending sale of the loans to a secondary market investor.

b. *Installment Loans*. These require periodic principal and interest payments. Installment loans may be made on either a simple interest or a discounted basis. The discounted basis means that interest (discount), credit-life insurance premiums, and other charges are generally added to the amount advanced to arrive at the face amount of the note. The discount, called *unearned interest*, is netted against the face amount of the note on the balance sheet and accreted into income over time to achieve a level yield.

c. *Demand Loans*. These have no fixed maturity date, are payable on demand of the lender, and generally have interest rates that change periodically. Demand loans generally require periodic (for example, monthly) interest payments.

d. *Time Loans*. These are made for a specific period of time. Interest is payable periodically, and principal is usually due at maturity. Such loans are often renewed at maturity in what is known as a "rollover." Interest rates, if fixed during the loan period, reprice when the loan is rolled over.

e. *Term Loans*. These are made for a specified term, generally in excess of one year, at a rate of interest that either is fixed or floats based on an independent index, such as the London Interbank Offered Rate (LIBOR), or prime or treasury rates. Repayment schedules are structured in a variety of ways. Some term loans are amortized on a regular installment schedule; others contain provisions for a large portion of the loan to be paid at maturity (a *balloon payment*); and still others may call for installments of irregular size and timing based on cash-flow projections.

8.16 Loans may be categorized in a variety of ways, depending on the institution. Institutions group loans in ways that are meaningful in their particular circumstances; for most, the groupings are based on the kind of borrower and the purpose of the loan. Some common categories of loans include (*a*) commercial, industrial, and agricultural; (*b*) consumer; (*c*) residential real estate; (*d*) lease financing; (*e*) trade financing, (*f*) commercial real estate and construction; and *(g)* foreign.

Commercial, Industrial, and Agricultural Loans

8.17 Despite changes in corporate borrowing practices (and increased competition from other kinds of financial institutions), commercial, industrial, and agricultural loans (sometimes called *C and I* or *business loans*) are an important part of many institutions' business. There are a wide variety of commercial, industrial, and agricultural loans. They include—

- Factoring the purchase, usually without recourse, of trade accounts receivable.
- Revolving loans or short-term working capital loans, which are generally used by manufacturing companies to finance the purchase of raw materials and other production needs until the finished goods are sold.
- Asset-based financing, usually secured by current assets such as accounts receivable or inventories, including receivable portfolio purchases.
- Seasonal loans, which are used to provide cash to businesses (such as farms and retailers) during low-revenue periods of the year.
- Floor-plan financing, which is used by automobile and durable goods dealers to finance inventories.
- Long-term working capital loans.
- Loans and leases to finance the purchase of equipment.
- Loans to finance major projects, such as the construction of refineries, pipelines, and mining facilities.

8.18 Large commercial loans may involve more than one lender (see the discussion of loan participations that follows). Commercial loans may be secured (that is, the institution holds a lien against pledged assets, such as securities, inventories, property and equipment, or accounts receivable) or unsecured. Also, such loans may be guaranteed or endorsed by third parties, including agencies of the U.S. government such as the Small Business Administration. Compensating-balance arrangements and commitment fees are often associated with commercial, industrial, and agricultural lending and are important factors in determining the interest rates on such loans. Commercial loans include demand loans, term loans, and line-of-credit arrangements.

8.19 ***Factoring.*** Factoring is the purchase, usually without recourse, of trade accounts receivable. A company that purchases trade accounts receivable is commonly called a factor. Factors buy trade accounts receivable from clients. Clients' customers send their payments directly to factors, often by means of a lockbox arrangement. Factored accounts receivable are not collateral for loans to clients; rather, the receivables are purchased outright. Except in certain instances involving advance factoring, as described below, no loan is made. However, clients continue to remain contractually responsible for customer claims related to defective merchandise.

8.20 Factors buy clients' invoices, net of trade and cash discounts granted to customers, and provide clients with services that include assuming the clients' responsibilities of credit review, bookkeeping, and collection. Factors also assume risks of credit losses when customer credit is approved before clients ship goods. If factors do not approve customers' credit, shipments usually are made at clients' risk. Factors buying accounts with recourse, however, provide bookkeeping and collection services and assume no credit risk, unless both the client and its customers become insolvent. Factors receive fees for services rendered to the client, usually computed as a percentage of net receivables bought.

8.21 Factoring usually requires that customer notification be placed on the face of invoices, indicating that accounts have been sold and that factors are to be paid directly. Under nonnotification contracts, customers continue to pay clients and normally are unaware of factor ownership of the related accounts.

8.22 Two types of factoring arrangements are maturity and advance. Maturity factoring requires factors to pay clients only when related accounts are due (generally based on average due dates) or collected. In contrast, advance factoring allows clients to draw cash advances against the balance of the receivables before they are due or collected. Factors charge interest from the date on which advances are drawn to the date on which receivables are due or collected, at rates usually based on a stipulated percentage over commercial banks' prime rates.

8.23 In calculating limits for payments under advance factoring arrangements, factors generally retain a reserve against unpaid receivables to cover claims, returns, allowances, and other adjustments. Reserves ordinarily are a percentage of outstanding receivables based on factors' experience and judgment. Overadvances occur when clients draw cash advances that exceed uncollected receivable balances. Factors may permit overadvances to finance clients' seasonal business requirements. Such overadvances often can be anticipated. Overadvances also may result from unanticipated chargebacks, such as those resulting from defective merchandise and price disputes, because clients continue to remain contractually responsible for such problems. Overadvances may be collateralized by other assets, such as inventory or fixed assets, or may be secured by personal guarantees. In certain circumstances, overadvances also may be unsecured. Overadvances generally are reduced when receivables from additional sales are factored.

8.24 ***Revolving Loans.*** Revolving loans, sometimes called working capital loans, generally provide borrowers with cash needed for business operations. The loans usually are collateralized by accounts receivable and generally cannot exceed agreed percentages of the face values of those receivables. Such loans may be referred to as accounts receivable loans. Collections against such receivables usually are remitted daily by borrowers to the lenders. Depending on the terms of the agreements, new accounts receivable acquired by borrowers and pledged to lenders may immediately qualify as collateral.

8.25 Lenders' policies may permit eligible collateral for revolving loans to be expanded to include inventories if borrowers require additional cash. In such cases, additional advances may be referred to as inventory loans. Inventory loans supplementing accounts receivable loans are common when seasonal businesses generate relatively low amounts of accounts receivable but require large inventories in anticipation of the selling season. When the inventories are sold, loans are paid off or accounts receivable generated by the sales replace inventories as collateral for such loans.

8.26 ***Receivables Portfolio Purchase Agreements.*** Unlike factoring arrangements, receivables portfolio purchases are bulk purchases of trade accounts or finance receivables, often intended to provide sellers with cash for operations or improved financial ratios. Because the buyers usually assume all credit risks, a stipulated percentage of the purchase price is often retained to absorb credit losses. Credit losses in excess of that amount are borne by the purchasing finance company.

8.27 Terms of portfolio purchase agreements vary. Some provide for single purchases; others provide for continuing purchases on a revolving basis. In addition, customers may not be notified of purchases or may be notified and required to pay the finance company directly. Receivables acquired under this type of agreement generally are accounted for as assets owned by the purchasing finance company and are not considered to represent collateral for loans made to sellers.

8.28 ***Floor Plan Loans.*** Floor plan loans, commonly called wholesale loans, are made to businesses to finance inventory purchases. Some finance companies make floor plan loans primarily to induce dealers to allow the finance companies to buy the retail contracts generated from sales of inventories. Inventories serve as collateral for floor plan loans, the amounts of which usually are limited to the wholesale values of the inventories. Unlike revolving loans collateralized by inventory, floor plan loans generally are collateralized by specific inventory items. They also require minimum payments known as curtailments, with balances becoming due when collateral is sold or at the end of stipulated periods.

Consumer Loans

8.29 Consumer loans are loans to individuals for household, family, and other personal expenditures. Commonly, such loans are made to finance purchases of consumer goods, such as automobiles, boats, household goods, vacations, and education. Interest rates and terms vary considerably depending on many factors, including whether the loan is secured or unsecured. The two most significant kinds of consumer lending are installment loans and revolving credit arrangements (credit-card lending).

8.30 ***Installment Loans.*** Consumer installment loans, which are generally secured by the item purchased, may be acquired directly from an institution's customers (direct paper) or indirectly from a dealer's customers (indirect paper or retail sales contracts).

8.31 ***Retail Sales Contracts.*** Many sales of consumer goods and services are financed through retail sales contracts. Those contracts are made, directly or through retailers and dealers, with individual consumers. The contracts often are sold to a finance company. Retail sales contracts commonly are called three-party paper because they involve three parties: an individual borrower, a dealer or distributor, and a finance company.

8.32 Retail sales contracts usually are sold at a discount to a finance company under terms that permit dealers or distributors to share a portion of the finance charges paid by borrowers. Provisions for dealers' shares of finance charges vary among finance companies and dealers. Dealers' shares of finance charges may be based on stipulated percentages of the finance charges or the principal amounts of the retail contracts, on a fixed amount for each contract, or on other negotiated terms.

8.33 Some agreements provide for a portion of amounts due to dealers to be withheld to cover certain contingencies. Other agreements provide no such conditions. Amounts withheld from dealers may either be limited to or greater than the dealers' shares of finance charges. Dealer reserves represent liabilities for unpaid portions of dealers' shares of finance charges on retail contracts bought from dealers. Dealer holdbacks, which are not limited to dealers' shares of finance charges, also represent liabilities, but usually are for amounts withheld from dealers on retail contracts with greater-than-normal credit risk. Such risks may relate to factors such as the types of collateral, excessive loan periods, or credit ratings of the borrowers involved. Dealer reserves and holdbacks may be required even if applicable contracts are bought with recourse.

8.34 ***Credit Cards.*** Credit-card lending is a major business for many institutions. Institutions may participate in the credit-card market in various ways. Some institutions may issue or make credit cards available directly to customers. Institutions may also sponsor cards that are issued by another institution. The sponsoring institution may take credit applications, perform credit checks, and have its name printed on the cards, but the issuing institution records the consumer loans and assumes the credit risk. Most credit-card lending is on an unsecured basis, although some secured programs exist. Within geographic areas there are service companies that centralize card issuance, process transactions, and maintain customer accounts.

8.35 Credit-card holders receive prenumbered cards under a prearranged line of credit with the institution issuing the card. Though the terms of credit cards vary, an annual fee is often charged for the use of the card and interest is charged on outstanding balances. Cards typically carry a twenty- to thirty-day grace period during which no interest is charged if outstanding balances are paid in full. Furthermore, merchants are generally charged a transaction fee.

8.36 Many institutions that issue credit cards have agreements with one of the two major international bank card systems, Visa and Interbank (MasterCard). However, a number of financial institutions have independent plans. The main functions that the bank card systems perform are enrolling merchant members and providing authorization and clearing systems. The main functions that the issuing institutions perform are issuing cards, setting credit limits, billing, collections, and customer service.

8.37 ***Overdraft Protection.*** Another type of revolving credit is overdraft protection on checking accounts. Overdraft protection is an agreement between an institution and its customer to provide a prearranged line of credit that is automatically drawn if the customer writes checks greater than the amount in his or her deposit account. Interest is charged on amounts outstanding.

Residential Real Estate Loans

8.38 Loans secured by one- to four-family residential property of the borrower are generally referred to as *residential mortgage loans*. Repayment terms for residential mortgage loans may vary considerably. Such loans may be structured to provide for full amortization of principal, partial amortization with a balloon payment at a specified date, or negative amortization. Interest rates may be fixed or variable. Variable-rate loans generally are referred to as adjustable-rate mortgages (ARMs). In addition, institutions may require borrowers in certain circumstances to purchase private mortgage insurance to reduce the institution's credit risk.

8.39 Many different types of first and second lien residential mortgage loans have become popular, including:

- Reverse mortgages, which provide homeowners with monthly payments in return for decreasing equity, wherein the institution may eventually gain ownership of real estate.
- Second-lien fixed-term (or closed end) loans through which homeowners borrow a portion of their equity (property value in excess of the first-lien balance) and repay such over a fixed period of time with fixed or variable interest rates.
- Home equity lines of credit allow the homeowner to borrow on demand, a portion of their equity, repay such and reborrow, if desired.
- 125 loans allow the homeowner to borrow amounts in excess of their equity, for example, up to 125 percent of the property value.

8.40 The Federal Housing Administration (FHA) insures and the Department of Veterans' Affairs (VA) partially guarantees many residential real estate mortgages. The FHA sets minimum down payments and interest rates for FHA loans. FHA-insured borrowers pay an annual insurance premium computed each year on the loan balance at the beginning of the year. The VA guarantee program, which was initiated to enable veterans to obtain homes when they return from military service, provides certain features, including an interest-rate ceiling that is generally lower than prevailing market rates, a partial guarantee to the lender, a low (or no) down payment, and a prohibition against mortgage brokers' commissions. Residential mortgage loans that are not FHA-insured or VA-guaranteed are called *conventional loans*.

8.41 Chapter 9 includes further discussion of residential real estate loans.

Lease Financing

8.42 Institutions also may be involved in direct lease financing, in which an institution owns and leases personal property for the use of its customers at the customers' specific request. A typical lease agreement contains an option providing for the purchase of the leased property, at its fair value or at a specified price, by the lessee at the expiration of the lease. Such leases may be financing transactions (see paragraph 8.97). Despite similarities between leases and other forms of installment loans, continuing legal and tax changes have resulted in language and procedures unique to leasing activities.

8.43 ***Operating Leases.*** An operating lease is a rental agreement in which asset ownership resides with the lessor. At the end of the lease term, the lessee may renew the lease, purchase the equipment or return it to the lessor. During the course of the lease, the lessee expenses the rental payment made. As these types of agreements are in substance usage agreements, the debt is allowed to remain off the lessee's balance sheet. The lessor records the equipment as an asset of this balance sheet and is required to depreciate it. Operating leases generally run for periods considerably shorter than the useful lives of related assets. At the expiration of such leases, the assets generally are sold or leased again.

8.44 Direct financing leases are similar to other forms of installment lending in that lessors generally do not retain benefits and risks incidental to ownership of the property subject to leases. Such arrangements are essentially financing transactions that permit lessees to acquire and use property.

8.45 ***Leveraged Leasing.*** Leveraged leasing involves at least three parties: a lessee, a long-term creditor, and a lessor (commonly called the equity participant). The lessor may, however, be represented by an owner trustee. Finance companies frequently enter into leveraged lease transactions as lessors or equity participants. A substantial portion of the purchase price of assets is supplied nonrecourse by unaffiliated long-term lenders. If a lessee defaults on lease payments, the long-term lender has no recourse to the lessor, but usually has recourse to the specific property being leased. The gross return to a finance company is measured using the discounted net cash receipts generated from investment tax credits and tax effects of timing differences resulting principally from use of accelerated depreciation in tax returns, rental payments minus debt service costs, and the estimated residual values of equipment leased.

8.46 Leasing arrangements also may be categorized as transactional, involving direct negotiations between a lessor and lessee, and as vendor leasing. Transactional lease financing tends to be a time-consuming and expensive process that is economically feasible only for transactions sufficiently large to generate profits in excess of the costs of preparing custom-made leases. Vendor leasing has developed to finance asset acquisitions that would not be profitable to finance with transactional leasing arrangements. Vendor leasing involves a third-party lessor that offers a vendor's or manufacturer's customers a basic finance package. The lessor usually establishes interest rates within given dollar ranges and uses a standardized credit scoring process to approve credit and keep documentation simple. As a result, vendors are promptly paid for sales and avoid the need to perform in-house financing operations. Some lenders also may serve as *lease brokers*—that is, as intermediaries between lessors and lessees for a fee.

Trade Financing

8.47 Trade financing is a specialized area of commercial lending frequently used by businesses that engage in international activities. Such financing includes open account financing, sales on consignment, documentary collections, advances against collections, letters of credit, bankers' acceptances, factoring, and forfeiting. Lending institutions charge fees for such arrangements. The most commonly used of these arrangements is the letter of credit.

8.48 The two primary types of letters of credit are the commercial letter of credit and the standby letter of credit. A commercial letter of credit represents a commitment by a bank or savings institution (the issuing institution) to make payment for a specified buyer (the importer) to a specified seller (the exporter) in accordance with terms stated in the letter of credit. Under a standby letter of credit, the issuing institution guarantees that the buyer will make payment. The issuing institution is not ordinarily expected to make payment; however, if it does make payment, the buyer is obligated under the agreement to repay the institution. Standby letters of credit are also used to guarantee the performance of U.S. companies under contracts with foreign corporations and foreign or domestic governments. Depending on the nature of the agreement, these transactions may involve a high degree of credit risk.

Commercial Real Estate and Construction Loans

8.49 Loans made on real property such as office buildings, apartment buildings, shopping centers, industrial property, and hotels are generally referred to as commercial real estate loans. Such loans are usually secured by mortgages or other liens on the related real property. Repayment terms on commercial real estate loans vary considerably. Interest rates may be fixed or variable, and the loans may be structured for full, partial, or no amortization of principal (that is, periodic interest payments are required and the principal is to be paid in full at the loan maturity date). Some give the institution recourse to third parties, who guarantee repayment of all or a portion of the loans. Others are nonrecourse, that is, if the borrower cannot repay the loan, the lender has only the collateral as a source of repayment—the lender does not have recourse to any other source of repayment.

8.50 Construction lending involves advances of money from a bank or savings institution to finance the construction of buildings or the development of raw land. The institution generally agrees to a specified loan amount, part of which will be disbursed to the borrower at the inception of the project and part of which will be disbursed as construction progresses, based on specified milestones that were agreed to by the institution and the borrower. Construction loans are generally made for the construction period only, which generally runs from one to seven years. Often, both interest and principal are payable at maturity. After construction is completed, the borrower usually obtains long-term mortgage financing from another financial institution. Large commercial real estate and construction loans may involve more than one lender (see paragraph 8.53).

8.51 Certain real estate loan arrangements, in which the lender has virtually the same risks and potential rewards as those of the owners of the property, should be considered and accounted for as investments in real estate. Certain real estate acquisition, development, and construction (ADC) arrangements that should be accounted for as investments in real estate are discussed in chapter 11.

Foreign Loans

8.52 Foreign (or cross-border) loans are made primarily by larger institutions and consist of loans to foreign governments, loans to foreign banks and other financial institutions, and commercial and industrial loans. Foreign loans also include consumer and commercial lending, including real estate loans, made by foreign branches. Such loans may contain certain risks, not associated with domestic lending, such as foreign exchange and country or transfer risks, as described in paragraph 6.07. This type of lending exposes the institution to cross-border risk, which is the possibility that the borrowing country's exchange reserves are insufficient to support its repayment obligations.

Loans Involving More Than One Lender

8.53 Institutions sometimes receive requests for loans that exceed the institution's capacity or willingness to lend. In response, shared lending arrangements were created. In a syndication lending arrangement, groups of institutions agree to participate in a particular loan, with each institution being a direct creditor of the borrower but with uniform lending terms applied by all the institutions. One institution is typically appointed as the agent, or lead institution, having primary responsibility for communication and negotiation with the borrower. The lead institution may also service all loans in the group. In a participation lending arrangement, a lead institution originates a loan for the entire amount and sells to other lenders (participating institutions) portions of the loan it originated. The lead institution disburses all funds, supervises the perfection of legal interests in the underlying collateral, and usually services the loan. Loan participations may be negotiated on either a recourse or nonrecourse basis. Also, a participation may be sold on terms that differ from the original loan terms.

8.54 In a loan syndication, the participating institutions arrange a lending syndicate in which the lead syndicator and participants in the syndication fund their respective portions of the loan. A syndication typically involves less risk to a lead institution than a participation because the lead institution funds only its portion—rather than the entire amount—of the loan at origination. The difference between syndications and participations affects the accounting by the agent/lead institution.

REGULATORY MATTERS

Real Estate Lending Standards

8.55 The federal banking agencies have established real estate lending standards and related guidelines that describe the factors management should address in its real estate lending policies.[1] Each institution is required to adopt and maintain written policies that establish limits and standards for extensions of credit related to real estate. The lending policies must establish—

a. Portfolio diversification standards.
b. Underwriting standards, including loan-to-value (LTV) ratio limitations.
c. Loan administration policies.
d. Documentation, approval, and reporting requirements to monitor compliance and appropriateness.

8.56 Management's policies are to be appropriate to the size of the institution and the nature and scope of its operation, and the board of directors of the institution is to review and approve the policies at least annually.

8.57 In supplementary guidelines, the agencies outline considerations for loan portfolio management, underwriting standards, loan administration, LTV ratios, and policy exceptions. (See Office of the Comptroller of the Currency [OCC] Banking Bulletin 92-75.)

8.58 On October 8, 1999, the federal banking agencies jointly issued the Interagency Guidelines on High LTV Residential Real Estate Lending, which highlight the risks inherent in this activity and issue supervisory limits and capital considerations. The guidelines set forth the supervisory expectation that high LTV portfolios, as defined, will not exceed 100 percent of total capital. Institutions that approach this limit will

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[1] See Title 12 of the Code of Federal Regulations (12 CFR), Parts 34 (OCC); 208 (FRB); 365 (FDIC); and 560(OTS).

be subject to increased supervisory scrutiny. If the limit is exceeded, then its regulatory agency will determine if the activity represents a supervisory concern and take action accordingly. Policy and procedure guidelines provided in the 1992 Interagency Guidelines for Real Estate Lending Policies apply to these transactions.

8.59 ***Appraisals***. The federal banking agencies require an appraisal by a certified or licensed appraiser for real estate-related financial transactions (as defined) having a value of $250,000 or greater. The appraisal rules exempt certain transactions.[2] The NCUA requires an appraisal by a certified or licensed appraiser for real estate-related transactions having a value of $100,000 or more.

RETAIL CREDIT LOANS AND RESIDENTIAL MORTGAGE LOANS

8.60 On June 6, 2000, the federal banking agencies issued the Uniform Retail Credit Classification and Account Management Policy, which instructs institutions on the review and classification of retail credit loans and residential mortgage loans. Institutions should adopt the standards contained in the policy as part of their loan review program. The guidelines include requirements for the classification and charge-off of retail credit and mortgage loans, as well as fraudulent loans and bankruptcy cases. (See FRB Supervisory and Regulatory Letter (SR) 00-8.)

Subprime Lending

8.61 On March 1, 1999, the federal banking agencies issued the Interagency Guidelines on Subprime Lending. The guidelines remind banks of the risks inherent in subprime lending and outline the types of controls that are expected before an institution enters this field of lending. In light of the higher risk, the agencies may impose higher minimum capital requirements on institutions engaging in subprime lending. If the risks associated with the activity are not properly controlled or the bank's capital level is inadequate given the magnitude of the risk assumed, then the institution's subprime lending program may be considered unsafe and unsound. Subprime lending is defined as extending credit to borrowers who exhibit characteristics indicating a significantly higher risk of default than traditional bank lending customers. Default risk may be measured in terms of traditional credit risk (credit/repayment history, debt/income levels, etc.) or by alternative measures such as credit scores.

INCOME RECOGNITION ON PROBLEM LOANS

8.62 Following issuance of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 118, *Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures*, the federal banking agencies announced they would retain its existing nonaccrual policies governing the recognition of interest income.[3]

8.63 NCUA guidelines state that loans delinquent for three months or more should be placed on nonaccrual status and that accrual of interest on loans should be reversed when the loan is determined to be a loss or when it becomes twelve months delinquent, whichever occurs first. State credit union regulators may also have specific requirements for the discontinuance and reversal of accrued income.

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[2] See Title 12CFR Parts 34 (OCC); 225 (FRB); 323(FDIC); and 564 (OTS).

[3] The announcement was published in the *Federal Register* on February 10, 1995.

Credit Union Lending Restrictions

8.64 Credit unions can generally only make loans to members. Further restrictions include, but are not limited to, loan to value limits, limits on loans to one borrower, limits on member business loans (NCUA Regulation 701.21(h)), and limits on loans to officers, directors, and employees.

Lending Statutes

8.65 Certain of the more significant federal and state statutes related to consumer and mortgage lending activities follow:

- Home Mortgage Disclosure Act (HMDA) – HMDA requires that mortgage lenders compile, and report to the institution's regulatory agency, certain information applicable to applications for home acquisition and improvement loans. The objectives of the regulation are to provide information to the public regarding whether the institution is serving the credit needs of the neighborhoods it serves, and to assist public officials in targeting private-sector investments to the areas where they are most needed.
- Fair Lending statutes – These statutes include the Equal Credit Opportunity Act and the Fair Housing Act which prohibit discrimination in lending and housing-related activities, and the Fair Credit Reporting Act which regulates consumer credit reporting activities.
- Real Estate Settlement Procedures Act (RESPA) – RESPA is administered by the U.S. Department of Housing and Urban Development (HUD) and requires the disclosure to mortgage loan applicants of information about the costs and procedures involved in loan settlement.
- Truth-in-Lending Act – This Act requires that information be provided to consumers about the cost of credit to enable them to compare different credit programs.
- Direct Consumer Lending -- State laws regulating consumer finance operations are designated as licensed-lending, small-loan, or consumer-financing statutes. Diverse state statutes usually regulate mortgage loans and other direct consumer loans. Usually, each branch office of a company that makes direct consumer loans must be licensed by the state in which the office is located. State licensing authorities, many of which are divisions of state banking departments, examine loans to ascertain that they comply with statutory provisions and to determine whether rebates and refunds are properly computed.
- Retail Sales Financing -- Laws governing retail sales financing may require offices to be licensed or registered. The laws vary widely among states. For example, all goods statutes may govern consumer goods loans; other goods laws may govern loans for consumer goods excluding automobiles. Additional statutes may affect revolving credit arrangements.
- Federal Consumer Credit Protection Act -- The Federal Consumer Credit Protection Act (Truth in Lending Act), through Federal Reserve Regulation Z, requires disclosure of finance charges and annual percentage rates so that consumers can more readily compare various credit terms. It does not set maximum or minimum rates of charges.

Uniform Commercial Code

8.66 The Uniform Commercial Code (UCC), fully adopted by all states, is a set of statutes designed to provide consistency among state laws concerning various commercial transactions. Article 9 of the UCC, which deals with secured transactions, contains especially significant laws that affect financing activities. It applies to two-party collateralized loan transactions as well as to sales of accounts receivable and retail sales contracts, which are essentially three-party transactions.

8.67 Article 9 generally provides certain rights to the secured parties and the debtors involved in secured transactions. The definition of a secured party includes a lender who obtains a security interest as well as a buyer of trade accounts receivable or retail sales contracts. Similarly, the definition of a debtor includes both the individual obligor and the seller of trade accounts receivable or retail sales contracts.

8.68 Under Article 9, all transactions creating a security interest are treated alike. The Article sets forth various procedures necessary to safeguard, or *perfect*, the potential creditor's interest in collateral against the interests of other creditors. Those procedures generally require that the creditor file a *financing statement* at a specified public office. The statement, available for public inspection, provides legal notice of a perfected security interest. Consequently, before making collateralized loans, prospective lenders generally search the public files to determine if other lenders have already filed financing statements against the collateral.

8.69 For certain commercial financing activities, Article 9 permits *continuing general lien arrangements*, in which a security interest applies continuously to all present and future collateral of the type described in the financing statement for as long as the financing statement is effective. That provision simplifies, for example, maintaining security interests in purchased receivables and in collateral securing revolving loans. The underlying collateral becomes subject to the security interest as soon as it comes into existence or into the debtor's possession.

8.70 The financing statement is generally effective for five years from the date of filing and then lapses, unless a *continuation statement* is filed within the six-month period before the expiration date. The continuation statement extends the security interest for another five years.

ACCOUNTING AND FINANCIAL REPORTING

8.71 Loans that management has the intent and ability to hold for the foreseeable future or until maturity or payoff should be reported in the balance sheet at outstanding principal adjusted for any charge-offs, the allowance for loan losses, any deferred fees or costs on originated loans, and any unamortized premiums or discounts on purchased loans.[∗] (Chapter 9 deals with the allowance for loan losses.) Loans, interest only strips, other receivables, or retained interests in securitizations that can be prepaid or otherwise settled in such a way that the institution would not recover substantially all of its recorded investment shall be subsequently measured like debt securities classified as available for sale or trading under FASB Statement No. 115.

8.72 Mortgage loans held for sale should be reported at the lower of cost or market value in conformity with FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*.[+] After the securitization of mortgage loans held for sale, an entity engaged in mortgage banking activities should classify the resulting mortgage-backed securities or other retained interests based on its ability and intent to sell or hold those investments. Other loans held for sale should be reported at the lower of cost or market value.

∗ AcSEC has a project underway to update Practice Bulletin No. 6. The proposed SOP, *Accounting for Discounts Related to Credit Quality*, affects the accounting, disclosure, and presentation of purchased loans within its scope. That proposed SOP introduces new terminology related to discounts on purchased loans, of which readers should be aware.

+ FASB Statement No. 133 amends the FASB Statement No. 65 to require that if a mortgage loan has been the hedged item in a fair value hedge, the loan's "cost" basis used in the lower-of-cost-or-market accounting shall reflect the adjustments of its carrying amount made pursuant to paragraph 22(b) of FASB Statement No. 133. FASB Statement No. 133, as amended by FASB Statement No. 137, *Accounting for Derivative Instruments and Hedging Activities - Deferral of the Effective Date of FASB Statement No. 133*, is effective for all fiscal quarters of fiscal years beginning after June 15, 2000. A summary of FASB Statement No. 133 is provided in chapter 15 of this Guide. On March 3, 2000, the FASB issued an Exposure Draft, *Accounting for Certain Derivative Instruments and Certain Hedging Activities —an Amendment of FASB Statement No. 133*. Readers should be alert to any final pronouncement. The FASB has established the Derivative Implementation Group (DIG) to assist the Board and its staff in providing implementation guidance regarding FASB Statement No. 133. Issues addressed by the DIG and the status of related guidance can be found at the FASB's Web site at www.fasb.org.

8.73 Transfers of receivables under factoring arrangements meeting the sale criteria of paragraph 9 of FASB Statement No. 125 are accounted for as purchased receivables. The acquisition of receivables and accounting for purchase discounts such as "factoring commissions" should be done in accordance with FASB Statement No. 91 and AICPA Practice Bulletin No. 6*. Transfers not meeting the sale criteria are accounted for as financings (that is, loans collateralized by customer accounts or receivables). Factoring commission under these arrangements should be recognized over the period of the loan contract in accordance with FASB Statement No. 91. That period begins when the finance company approves a customer's credit and ends when the customer's account is settled. If the factor obtains control of the collateral as described in paragraph 15 of FASB Statement No. 125, the factor must record on its balance sheet the collateral and its obligation to return the collateral.

8.74 Transfers accounted for as sales are addressed in Chapter 9.

Interest Income

8.75 Interest income on loans should be accrued and credited to interest income as it is earned, using the interest method. Disclosures about the recorded investment in certain impaired loans and about how a creditor recognizes interest income related to those impaired loans are established in FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*, as amended by FASB Statement No. 118.

8.76 Transactions in which captive finance companies offer favorable financing to increase sales of related companies are not exempted from the scope of APB Opinion No. 21 by paragraph 3(d) of that Opinion. APB Opinion No. 21 provides accounting guidance to use if the face amount of a note does not reasonably represent the present value of the consideration given or received in an exchange.

8.77 Delinquency fees should be recognized in income when chargeable assuming collectibility is reasonably assured.

8.78 Prepayment penalties should not be recognized in income until loans are prepaid, *except that the possibility of prepayment penalties may effect the application of paragraph 18(a) of FASB Statement No. 91.*

8.79 Rebates are cancellations of portions of the precomputed finance charges on discount loans that occur when loan payments are made ahead of schedule. Rebate calculations generally are governed by state laws and may differ from unamortized finance charges on discount loans because many states require rebate calculations to be based on the Rule of 78s or other methods instead of the interest method. Accrual of interest on discount loans should not be affected by the possibility that rebates may be calculated on a method different from the interest method, *except that the possibility of rebates affects the application of paragraph 18(a) of FASB Statement No. 91.* Differences between rebate calculations and accrual of interest income merely adjust original estimates of interest income and should be recognized in income when loans are prepaid or renewed.

Loan Fees, Costs, Discounts, and Premiums

8.80 FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, establishes the accounting for loan origination fees and costs.[4] In general, loan origination fees net of direct loan origination costs should be deferred and

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* AcSEC expects to issue during 2000 a final SOP entitled *Accounting for Certain Purchased Loans*. It is anticipated that this proposed SOP will supercede AICPA Practice Bulletin 6. Readers should be alert to any final pronouncement.

[4] The staff of the FASB has also published a FASB Special Report, *A Guide to Implementation of Statement 91 on Accounting for Nonrefundable*

recognized over the contractual life of the loan as an adjustment of yield using the interest method. However, for certain homogeneous pools of loans for which prepayments are probable and the timing and amount of prepayments can be reasonably estimated, the institution may consider estimates of prepayments in the calculation of the constant effective yield necessary to apply the interest method. Direct loan origination costs include only incremental direct costs incurred in transactions with independent third parties and certain costs directly related to specified activities performed by the lender. Deferred costs include only the direct costs of completed loans and must be deferred irrespective of the existence of related loan fees. Direct costs of unsuccessful loan origination efforts and all indirect costs are charged to expense as incurred.

8.81 FASB Statement No. 91 requires that fees received for a commitment to originate or purchase a loan or group of loans should be deferred except for certain retrospectively determined fees. If the commitment is exercised, the commitment fee should be recognized as an adjustment of yield over the related loan's life. If the commitment expires unexercised, the commitment fee should be recognized in income upon expiration of the commitment. However, commitment fees for which the likelihood of exercise is remote should be recognized over the loan commitment period on a straight-line basis.

8.82 FASB Statement No. 91 considers that for purchased loans, the initial investment includes the amount paid to the seller, net of fees paid or received. All other costs related to the purchase of loans are charged to expense as incurred. Premiums and discounts on purchased loans are recognized as an adjustment of yield over the contractual life of the loan. If the institution holds a large number of similar loans for which prepayments are probable and the timing and amount of prepayments can be reasonably estimated, paragraph 19 of FASB Statement No. 91 allows the institution to consider estimates of future principal prepayments in calculation of the constant effective yield necessary to apply the interest method.

8.83 FASB Statement No. 91 also provides guidance on accounting for fees and costs related to loans with no scheduled payment terms (demand loans) and revolving lines of credit. The Statement stipulates that net deferred fees and costs on demand loans should be recognized on a straight-line basis over (*a*) a period consistent with the institution's understanding with the borrower or (*b*), if no understanding exists, an institution's estimate of the period over which the loan will remain outstanding. Fees and costs on revolving lines of credit should be recognized in income on a straight-line basis over the period the revolving line of credit is active, assuming that borrowings are outstanding for the maximum term provided in the loan contract.

8.84 Paragraph 12 of FASB Statement No. 91 requires that the accounting for net fees or costs related to refinancings or restructurings (other than troubled debt restructurings) be based on whether the terms of the new loan are at least as favorable to the lender (based on effective yield) as the terms of comparable loans. FASB Statement No. 91 also discusses a variety of other amortization issues, including the treatment of increasing, decreasing, and variable-rate loans.

8.85 Discussion by the FASB's Emerging Issues Task Force (EITF) of Issues No. 88-20, *Difference Between Initial Investment and Principal Amount of Loans in a Purchased Credit Card Portfolio*, No. 92-5, *Amortization Period for Net Deferred Credit Card Origination Costs*, No. 93-1, *Accounting for Individual Credit Card Acquisitions*, and No. 97-3, *Accounting for Fees and Costs Associated with Loan Syndications and Loan Participations after the Issuance of FASB Statement 125*, provide related guidance. EITF Topic No. D-52, *Impact of FASB Statement No. 125 on EITF Issues*, discusses the impact of FASB Statement No. 125 on various issues previously discussed by the FASB's EITF. The AICPA Accounting Standards Executive Committee has a project underway that is considering whether the objectives and guidance offered in the AICPA's Practice Bulletin (PB) 6, Amortization of Discounts on Certain Acquired Loans, continue to be

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Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases: Questions and Answers.

relevant given a number of FASB pronouncements issued subsequent to PB 6 to address various related issues.[5]

Amortization of Discounts on Certain Acquired Loans

8.86 AcSEC issued AICPA Practice Bulletin 6, *Amortization of Discounts on Certain Acquired Loans*, in 1989 to provide guidance on the accounting and reporting by purchasers of certain acquired loans or other debt securities (as defined).[6] For acquired loans or other debt securities within its scope, Practice Bulletin 6 includes guidance on (*a*) amortization of discounts that reflect impairment due to credit risk, (*b*) initial and subsequent recognition of principal and interest, and (*c*) assessing collectibility. Practice Bulletin 6's provisions on these issues are inconsistent with certain provisions of FASB Statements No. 114, as amended by FASB Statement No. 118 (and related amendments of FASB Statements No. 5, *Accounting for Contingencies*, and No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*) and FASB Statement No. 115. AcSEC expects to issue during 2000 a final SOP entitled *Accounting for Certain Purchased Loans*. It is anticipated that this proposed SOP will supersede AICPA Practice Bulletin 6. Readers should be alert to any final pronouncement. FASB Statements No. 114, No. 115, and No. 118 take precedence for loans and debt securities within their scope.

Troubled Debt Restructurings

8.87 FASB Statement No. 15, as amended by FASB Statements No. 114 and No. 121, *Accounting for Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, establishes the accounting for troubled debt restructurings (TDRs). For creditors, TDRs include certain modifications of terms of loans and receipt of assets from debtors in partial or full satisfaction of loans.

8.88 Outstanding loans whose terms have been modified in TDRs are accounted for under the provisions of FASB Statement No. 114, as amended by FASB Statement No. 118.[7]

8.89 ***Modifications of Terms.*** Paragraph 5(c) of FASB Statement No. 15 says that modifications of terms of debt may include one or a combination of the following:

- *a.* Reduction (absolute or contingent) of the stated interest rate for the remaining original life of the debt
- *b.* Extension of the maturity date or dates at a stated interest rate lower than the current market rate for new debt with similar risk
- *c.* Reduction (absolute or contingent) of the face amount or maturity amount of the debt as stated in the instrument or other agreement
- *d.* Reduction (absolute or contingent) of accrued interest

Creditors should account for modifications of terms of loans in accordance with FASB Statements No. 15 and No. 114.

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[5] AcSEC expects to issue during 2000 a final SOP entitled *Accounting for Certain Purchased Loans*. It is anticipated that this proposed SOP will supercede AICPA Practice Bulletin 6. Readers should be alert to any final pronouncement.

[6] Related financial reporting by liquidating banks is beyond the scope of Practice Bulletin 6 and was addressed in EITF Issue No. 88-25, *Ongoing Accounting and Reporting for a Newly Created Liquidating Bank.*

[7] Paragraph 27 of FASB Statement No. 114 allows institutions to continue to account for certain restructured loans in accordance with the provisions of FASB Statement No. 15 prior to its amendment by FASB Statement No. 114. Specifically, paragraph 27 applies if a loan that was restructured in a troubled debt restructuring involving a modification of terms before the effective date of FASB Statement No. 114 is not impaired based on the terms specified by the restructuring agreement.

8.90 ***Receipts of Assets.*** Paragraph 28 of FASB Statement No. 15, as amended by paragraph 24 of FASB Statement No. 121, says:

> A creditor that receives from a debtor in full satisfaction of a receivable either (i) receivables from third parties, real estate, or other assets or (ii) shares of stock or other evidence of an equity interest in the debtor, or both, shall account for those assets (including an equity interest) at their fair value at the time of the restructuring (see paragraph 13 [of FASB Statement No. 15] for how to measure fair value). A creditor that receives long-lived assets that will be sold from a debtor in full satisfaction of a receivable shall account for those assets at their fair value less cost to sell as that term is used in paragraphs 15-17 of [FASB Statement No. 121]. The excess of (i) the recorded investment in the receivable satisfied over (ii) the fair value of assets received (less cost to sell, if required above) is a loss to be recognized. For purposes of this paragraph, losses, to the extent they are not offset against allowances for uncollectible amounts or other valuation accounts, shall be included in measuring net income for the period.

8.91 Paragraphs 9.08 and following discuss the accounting for and reporting of foreclosed assets established by FASB Statements No. 15 and No. 121, and AICPA SOP 92-3, *Accounting for Foreclosed Assets*.

8.92 Paragraph 34 of FASB Statement No. 15, as amended by FASB Statement No. 114, requires that:

> A troubled debt restructuring that is in substance a repossession or foreclosure by the creditor, that is, the creditor receives physical possession of the debtor's assets regardless of whether formal foreclosure proceedings take place, or in which the creditor otherwise obtains one or more of the debtor's assets in place of all or part of the receivable, shall be accounted for according to the provisions of paragraphs 28 and 33 and, if appropriate, 39.

Paragraphs 28 and 33 of FASB Statement No. 15 are described in paragraphs 6.57 and 6.60 herein, respectively. Paragraph 39 of FASB Statement No. 15 says:

> A receivable from the sale of assets previously obtained in a troubled debt restructuring shall be accounted for according to *APB Opinion No. 21* regardless of whether the assets were obtained in satisfaction (full or partial) of a receivable to which that Opinion was not intended to apply. A difference, if any, between the amount of the new receivable and the carrying amount of the assets sold is a gain or loss on sale of assets.

8.93 ***Combination of Types.*** For TDRs involving receipt of assets (including an equity interest) in partial satisfaction of a receivable and a modification of terms of the remaining receivable, paragraph 33 of FASB Statement No. 15, as amended by FASB Statement No. 121, requires that the assets received should be accounted for as prescribed in paragraph 28 of the Statement (see paragraph 6.57) and the recorded investment in the receivable should be reduced by the fair value less cost to sell of the assets received.

8.94 FASB Technical Bulletin No. 94-1, *Application of Statement 115 to Debt Securities Restructured in a Troubled Debt Restructuring*, clarifies that any loan that was restructured in a TDR involving a modification of terms, including those restructured before the effective date of FASB Statement No. 114, would be subject to the provisions of FASB Statement No. 115 if the debt instrument meets the definition of a security (as provided in FASB Statement No. 115).

8.95 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.

Real Estate Investments

8.96 The AICPA's Notice to Practitioners on ADC arrangements [8] requires that certain loans be accounted for as investments in real estate or real estate joint ventures, rather than as loans in situations where the lender has taken on virtually the same risks and potential rewards as an owner. Loans that are accounted for as real estate investments or joint ventures should not be reported or accounted for as loans and are usually classified in other assets or other real estate owned (see chapter 11).

Lease Financing

8.97 Accounting for leases by lessees and lessors is established by FASB Statement No. 13, *Accounting for Leases*, as amended by FASB Statement No. 98, *Accounting for Leases: Sale-Leaseback Transactions Involving Real Estate, Sales-Type Leases of Real Estate, Definition of the Lease Term, Initial Direct Costs of Direct Financing Leases*. Other interpretive pronouncements address additional circumstances.

Foreign Loans

8.98 Accounting for foreign loans is generally the same as for single-jurisdiction, domestic loans. However, unique issues arise regarding the accounting for restructured debt of developing countries and the recognition of interest income on such loans.

8.99 AICPA Practice Bulletin 4, *Accounting for Foreign Debt/Equity Swaps*, was issued in 1988 to address exchanges of public- or private-sector loans to debtors in financially troubled countries for equity investments in companies in the same countries. Such transactions are referred to as *debt/equity swaps*. In a typical debt/equity swap, holders of U.S. dollars-denominated debt of a particular country convert that debt into approved equity investments in that country, based on the official exchange rate at the time of the transaction. A discount from the official exchange rate is usually charged on the transaction. Such debt/equity swaps are considered exchanges of monetary assets for nonmonetary assets, which should be accounted for at fair value at the date on which both parties agree to the transaction. Because prices in the secondary markets for the debt of financially troubled countries may not be the best indicator of value, Practice Bulletin 4 also provides guidance on determining fair values of debt/equity swap transactions.

8.100 AICPA Practice Bulletin 5, *Income Recognition on Loans to Financially Troubled Countries*, was issued in 1988 to address whether an institution should credit receipt of interest payments on nonaccrual loans to the principal balance of the loan or to income when the loan has been placed on nonaccrual status.

Commitments

8.101 Commitments to originate loans in the ordinary course of business generally have no immediate accounting effect, though institutions should consider such commitments when evaluating the liability for other credit exposures. (Chapter 10 addresses commitments to sell loans.) (Paragraphs 9.30 and following address accounting for loss contingencies in conformity with FASB Statement No. 5.)

8.102 Institutions sometimes enter into forward standby commitments to purchase loans at a stated price in return for a standby commitment fee. In such an arrangement, settlement of the standby commitment is the option of the seller and results in delivery only if the contract price exceeds the market price of the underlying loan or security on the settlement date. A standby commitment differs from a mandatory commitment in that

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[8] The Notice appears as exhibit I in AICPA Practice Bulletin 1, *Purpose and Scope of AcSEC Practice Bulletins and Procedures for Their Issuance*.

the institution assumes all the market risks of ownership but shares in none of the rewards. A standby commitment is, in substance, a written put option that will only be exercised if the value of the loans is less than or equal to the strike price. Many institutions use standby commitments to supplement their normal loan origination volume. If the settlement date is within a reasonable period (for example, a normal loan commitment period) and the institution has the intention and ability to accept delivery without selling assets, standby commitments are generally viewed as part of the normal production of loans, and institutions record loans purchased under standby commitments at cost on the settlement date and amortize the standby commitment fee over the estimated life of the loans, in conformity with FASB Statement No. 91. However, if the settlement date is not within a reasonable period or the institution does not have the ability to accept delivery without selling assets, the standby commitment generally is accounted for as a written put option. In that case, the option premium received (standby commitment fee) should be recorded as a liability representing the fair value of the standby commitment on the trade date. Thereafter, the liability should be accounted for at the greater of the intital standby commitment fee or the fair value of the written put option. Unrealized gains (that is, recoveries of unrealized losses) or losses should be credited or charged to current operations.

8.103 Fixed-rate loan commitments and certain variable-rate loan commitments have characteristics similar to options and, therefore, fall within the scope of FASB Statement No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments*.[+]

Financial Statement Presentation and Disclosure

8.104 Management's disclosure in the summary of significant accounting policies should include—

- The basis of accounting for loans and lease financings, both held in a portfolio and held for sale.
- The classification and method of accounting for interest only strips, loans, and other receivables, or retained interest in securitizations that can be contractually prepaid or otherwise settled in a way that the holder would not recover substantially all of its recorded investment.
- The method of determining carrying amounts of *non-mortgage* loans held for sale (required for mortgage loans by paragraph 29 of FASB Statement No. 65).
- The methods and significant assumptions used to estimate the fair value of loans (as required by paragraph 10 of FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*).*

[+] FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities,* supercedes FASB Statement no. 119. FASB Statement No. 133 establishes the accounting and reporting standards for derivatives instruments and for hedging activities. (Intervening text) Note that loan commitments are not derivatives under FASB Statement No. 133 if they require the holder to deliver a promissory note that would readily convertible to cash and cannot readily be settled net (see paragraph 291 of FASB Statement No. 133).
FASB Statement No. 133, as amended by FASB Statement No. 137, is effective for all fiscal quarters of fiscal years beginning after June 15, 2000. A summary of FASB Statement No. 133 is provided in chapter 15 of this Guide. On March 3, 2000, the FASB issued an Exposure Draft, *Accounting for Certain Derivative Instruments and Certain Hedging Activities —an Amendment of FASB Statement No. 133*. Readers should be alert to any final pronouncement. The FASB has established the Derivative Implementation Group (DIG) to assist the Board and its staff in providing implementation guidance regarding FASB Statement No. 133. Issues addressed by the DIG and the status of related guidance can be found at the FASB's Web site at www.fasb.org.

* In December 1996, the FASB issued FASB Statement No. 126, *Exemption from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities*, which makes the disclosures about fair value of financial instruments prescribed in FASB Statement No. 107 optional for entities that meet all of the following criteria specified in paragraph 2 of FASB Statement No. 126:

a. The entity is a nonpublic entity (as defined in FASB Statement No. 126).
b. The entity's total assets are less than $100 million on the date of the financial statements.
The entity has not held or issued any derivative financial instruments, as defined in FASB Statement No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments*, other than loan commitments, during the reporting period.

Note that FASB Statement No. 133 replaces paragraph 2c of FASB Statement No. 126 (item c. above) with the following -- The entity has no instrument that, in whole or in part, is accounted for as a derivative instrument under FASB No. 133, *Accounting for Derivative Instruments and Hedging Activities*, during the reporting period. FASB Statement No. 133, as amended by FASB Statement No. 137, is effective for all fiscal

- The method of estimating credit losses (see chapter 7).
- The method of recognizing interest income on loans, including a statement about the institution's policy for the treatment of loan fees and costs, including the method of amortizing net deferred fees or costs. This disclosure should include the institution's policy for recognizing interest income on impaired loans, including how cash receipts are recognized (as required by paragraph 20 of FASB Statement No. 114, as amended by FASB Statement No. 118).
- The policy for placing loans on nonaccrual status (or discontinuing accrual of interest), recording payments received on nonaccrual loans, and resuming accrual of interest.
- The policy for determining past due or delinquency status (that is, whether past due status is based on how recently payments have been received or contractual terms).
- EITF Issue No. 96-22, *Applicability of the Disclosures Required by FASB Statement No. 114 When a Loan Is Restructured in a Troubled Debt Restructuring into Two (or More) Loans*, says that "when a loan is restructured in a troubled debt restructuring (as defined in FASB Statement No. 15) into two (or more) loan agreements, the restructured loans should be considered separately when assessing the applicability of the disclosures in paragraphs 20 (a) and 20 (c) of [FASB Statement No. 114], as amended, in years after the restructuring because they are legally distinct from the original loan. The creditor would continue to base its measure of loan impairment on the contractual terms specified by the *original* loan agreement in accordance with paragraphs 11–16" of FASB Statement No. 114.

8.105 Loans are typically presented on the balance sheet as an aggregate amount. However, loans held for sale should be a separate balance-sheet category. Major categories of loans should be presented separately either in the balance sheet or in the notes to the financial statements. The allowance for credit losses, unearned income, unamortized premiums and discounts, and net unamortized deferred fees and costs should be disclosed in the financial statements.[9]

8.106 The total amount of loans placed on nonaccrual status as of each balance sheet date should be disclosed. The total amount of loans past due 90 days or more (or other policy limit) and still accruing should also be disclosed.

8.107 Except for transactions within the scope of paragraph 15(a) of FASB Statement No. 125, the carrying value of loans pledged as collateral for borrowings should be disclosed.

8.108 FASB Statement No. 13 requires certain disclosures by lessors when leasing is a significant part of a lessor's business activities in terms of revenue, net income, or assets.

8.109 FASB Statement No. 105,[#] *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*, as amended by FASB Statement No. 119, requires disclosure of (*a*) the extent, nature, and terms of financial instruments with off-balance-sheet risk (paragraph 17); (*b*) credit risk of financial instruments with off-balance-sheet credit risk (paragraph 18); and (*c*) concentrations of credit risk of all financial instruments (paragraph 20). The disclosure

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quarters of fiscal years beginning after June 15, 2000.

[9] If the institution continues to account for certain restructured loans based on paragraph 27 of FASB Statement No. 114, it should include those disclosures required by paragraphs 40 and 41 of FASB Statement No. 15 prior to its amendment by FASB Statement No. 114. See footnote 7 in this chapter.

[#] FASB Statement No. 133 supercedes FASB Statement No. 105. FASB Statement no. 133 amends FASB Statement No. 107 to include in FASB Statement No. 107 the disclosure provisions about concentrations of credit risk from FASB Statement No. 105, with modifications. FASB Statement No. 133, as amended by FASB Statement No. 137, is effective for all fiscal quarters of fiscal years beginning after June 15, 2000.

requirements set forth in paragraph 17 of FASB Statement No. 105 similarly are required for financial instruments without off-balance-sheet risk by paragraph 8 of FASB Statement No. 119.[*] Examples of financial instruments with off-balance-sheet risk discussed in this chapter include loans sold with recourse (with or without a floating-interest-rate provision), fixed-rate and variable-rate loan commitments, financial guarantees, note issuance facilities at floating rates, and letters of credit.

8.110 For financial instruments with off-balance-sheet credit risk,10 except for those instruments within the scope of FASB Statement No. 133, insurance contracts, lease contracts, or financial instruments of a pension plan, an entity should disclose the following information:

(1) The face or contract amount
(2) The nature and terms, including, at a minimum, a discussion of (1) the credit and market risk of those instruments, (2) the cash requirements of those instruments, and (3) the related accounting policy pursuant to APB Opinion No. 22, Disclosure of Accounting Policies
(3) The entity's policy for requiring collateral or other security to support financial instruments subject to credit risk, information about the entity's access to that collateral or other security, and the nature and a brief description of the collateral or other security supporting those financial instruments.

Examples of activities and financial instruments with off-balance-sheet credit risk include obligations for loans sold with recourse (with or without a floating-interest-rate provision), fixed-rate and variable-rate loan commitments, financial guarantees11, note issuance facilities at floating rates, and letters of credit.

8.111 Paragraph 20 of FASB Statement No. 105[#] requires disclosure of significant concentrations of credit risk arising from all financial instruments, whether from an individual counterparty or group of counterparties. Group concentrations of credit risk exist if a number of counterparties are engaged in similar activities and have similar economic characteristics that would cause their ability to meet contractual obligations to be similarly affected by changes in economic or other conditions. For example, credit unions, because of their unique field of membership requirements, may experience significant concentrations of credit risk.

8.112 FASB Statement No. 107,[Δ] as amended by FASB Statement No. 119, requires disclosure of the fair value of financial instruments for which it is practicable to estimate that value. Paragraph 11 of FASB Statement No. 107 says, in part, that

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[*] FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, supercedes FASB Statement No. 119. FASB Statement No. 133, as amended by FASB Statement No. 137, establishes the accounting and reporting standards for derivative instruments and for hedging activities and is effective for all fiscal quarters of fiscal years beginning after June 15, 2000. A summary of FASB Statement No. 133 is provided in Chapter 18 of this Guide.

10 *Off-balance sheet credit risk* refers to credit risk on off-balance sheet loan commitments, standby letters of credits, and financial guarantees, and other similar instruments, including certain derivatives prior to the adoption of FASB Statement No. 133. Credit risk related to derivative instruments carried at fair value in accordance with FASB Statement No. 133 will be included in the fair value measure of the derivative.

11 A guarantor is required to disclose and account for a financial guarantee under EITF Issue 85-20, "Recognition of Fees for Guaranteeing a Loan".

[Δ] In December 1996, the FASB issued FASB Statement No. 126, *Exemption from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities*, which makes the disclosures about fair value of financial instruments prescribed in FASB Statement No. 107 optional for entities that meet all of the following criteria specified in paragraph 2 of FASB Statement No. 126:
a. The entity is a nonpublic entity (as defined in FASB Statement No. 126).
b. The entity's total assets are less than $100 million on the date of the financial statements.
c. The entity has not held or issued any derivative financial instruments, as defined in FASB Statement No. 119 other than loan commitments, during the reporting period.

Note that FASB Statement No. 133 replaces paragraph 2.c. of FASB Statement No. 126 (item c. above) with the following -- The entity has no quoted market prices, if available, are the best evidence of the fair value of financial instruments. If quoted market prices are not available, management's best estimate of fair value may be based on the quoted market price of a financial instrument with similar characteristics or on valuation techniques.

8.113 Paragraph 26 of FASB Statement No. 107 says, in part, that

If no quoted market price exists for a category of loans, an estimate of fair value may be based on (*a*) the quoted market price of a financial instrument with similar traded loans with similar credit ratings, interest rates, and maturity dates, (*b*) current prices (interest rates) offered for similar loans in the institution's own lending activities, or (*c*) valuations obtained from loan pricing services offered by various specialist firms or from other sources.

8.114 If it is not practicable to estimate the fair value of a financial instrument or a class of financial instruments, FASB Statement No. 107 requires the disclosure of (*a*) information pertinent to estimating the fair value of that financial instrument or class of financial instruments, such as the carrying amount, effective interest rate, and maturity, and (*b*) the reasons why it is not practicable to estimate fair value.

8.115 FASB Statement No. 57, *Related Party Disclosures*, contains guidance on disclosures about transactions with various related parties. Institutions frequently make loans to parent and affiliated companies, directors, officers, and stockholders, as well as to entities with which directors, officers, and stockholders are affiliated. The aggregate amount of such loans should be disclosed.

8.116 As required by paragraph 40(b) of FASB Statement No. 15, institutions should disclose the amount of commitments, if any, to lend additional funds to debtors owing receivables whose terms have been modified in troubled debt restructurings.

8.117 Accounting and financial reporting matters related to sale or other dispositions of loans are addressed in chapter 10.

AUDITING

Objectives

8.118 The primary objectives of audit procedures in the loan area are to obtain reasonable assurance that—

a. Loans exist and are owned by the institution as of the balance-sheet date.
b. The allowance for credit losses is adequate for estimated losses inherent in the loan portfolio. (Audit procedures to satisfy this objective are discussed in chapter 7.)
c. Loans are properly classified, described, and disclosed in the financial statements, including fair values of loans and concentrations of credit risk.
d. Recorded loans include all such assets of the institution and the financial statements include all related transactions during the period.
e. Loan transactions are recorded in the proper period.
f. Loans held for sale are properly classified and are stated at the lower of cost or market value.

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instrument that, in whole or in part, is accounted for as a derivative instrument under FASB No. 133, *Accounting for Derivative Instruments and Hedging Activities*, during the reporting period.
FASB Statement No. 133, as amended by FASB Statement No. 137, is effective for all fiscal quarters of fiscal years beginning after June 15, 2000.

g. Interest income, fees, and costs and the related balance-sheet accounts (accrued interest receivable, unearned discount, unamortized purchase premiums and discounts, and unamortized net deferred loan fees or costs) have been properly measured and recorded.

h. Gains and losses on the sale of loans have been properly measured and properly recorded.

i. Credit commitments, letters of credit, guarantees, recourse provisions, and loans that collateralize borrowings are properly disclosed in the financial statements.

j. Transfers of loans have been properly accounted for under FASB Statement No. 125.

Planning

8.119 In planning the audit, the independent accountant should consider factors influencing inherent risk, which are described in chapter 5, as they relate to financial statement assertions about loans. As described earlier in this chapter, credit risk is normally the principal risk inherent in lending. The composition of an institution's loan portfolio, which can vary widely from institution to institution, is one of the most important factors in assessing inherent risk related to loans. For example, the risks associated with construction lending are very different from the risks associated with credit-card lending. The current year's interim financial statements and other financial information (for example, board of directors' minutes, asset-classification reports, credit management reports, and reports of the institution's regulators) should be helpful in understanding an institution's credit strategy and loan portfolio characteristics and, thereby, in assessing the related inherent risk. Those reports generally include information about such items as dollar amounts and types of loans; the volume of current originations by type and related net deferred loan fees or costs; identification of TDRs; ADC arrangements; purchases and sales of loans, including gains and losses; and wash sales, among others. The independent accountant should consider discussing this information with management and inquiring about other business developments affecting the institution that affect inherent risk in this area.

8.120 The following factors related to loans may be indicative of higher inherent risk (and, often, higher control risk) for loans and related amounts:

- Lack of a formal written lending policy
- High rate of growth in the loan portfolio
- Concentration of lending authority in one individual
- Lack of personnel with skills and knowledge of a particular kind of loan, such as credit card or construction
- Significant changes in the composition of an institution's portfolio
- Poor loan documentation
- Poor recordkeeping and monitoring of principal and interest receipts
- Significant nontraditional lending activities that involve a higher degree of risk, such as highly leveraged lending transactions
- Significant originations or purchases of loans outside the institution's normal activities or market area
- Sales of loans with significant recourse provisions
- Ambiguous transactions involving the sale or transfer of loans, especially when there is a lack of analysis prior to the transactions
- Failure of personnel to follow management's written lending policies for underwriting and documentation
- Loans that are continuously extended, restructured, or modified
- Loans that are of a type, customer, collateral, industry, or geographical location not authorized by management's written lending policies
- Loans of unusual size or with unusual interest rates or terms
- Significant concentrations of loans in a particular industry or geographic area

- The potential for insider abuse because of significant loans to the institution's officers, directors, shareholders, or other related parties that do not meet normal underwriting standards, such as nominee loans, loans with questionable collateral, and multiple transactions with a single related party or group of affiliated parties.

Internal Control Over Financial Reporting and Possible Tests of Controls

8.121 SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), provides guidance on the independent accountant's consideration of an institution's internal control in an audit of financial statements performed in accordance with GAAS. It describes the components of internal control and explains how an independent accountant should consider internal control in planning and performing an audit. Paragraph 19 of SAS No. 55, as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55*, requires that, in all audits, the independent accountant obtain sufficient understanding of each of the five components (the control environment, risk assessment, control activities, information and communication, and monitoring) to plan the audit by performing procedures to understand the design of policies and procedures relevant to audit planning and whether they have been placed in operation.

8.122 An understanding of internal control over financial reporting of loans should include controls over transactions such as granting credit, disbursing loan funds, applying loan payments, amortizing discounts, and accruing interest income as those transactions relate to each significant type of lending activity.

8.123 Effective internal control over financial reporting in this area should provide reasonable assurance that errors or fraud in management's financial statement assertions about the loan portfolio—including those due to failure to execute lending transactions in accordance with management's written lending policies—are prevented or detected. For example, failure to document a second lien as required by management's written loan documentation policy could affect financial statement assertions about ownership and valuation.

8.124 Factors that contribute to an effective control environment may include—

- A board of directors that takes an active role in monitoring lending policies and practices.
- A well-defined lending approval and review system that includes established credit limits, limits and controls over the types of loans made, and limits on maturities of loans.
- A reporting system that provides the institution with the information needed to manage the loan portfolio.

8.125 During planning, the independent accountant should obtain knowledge about the institution's accounting system as it relates to loans receivable, including the methods used by the institution when processing and recording new loans, applying loan payments, accruing interest, and amortizing discounts.

8.126 In addition, the auditor should obtain knowledge about the controls that management has established to provide reasonable assurance that specific financial reporting objectives will be achieved. Typical controls relating to loans include the following:

- All loans and credit lines (including all new loans, renewals, extensions, and commitments) are approved by officers or committees in conformity with management's written lending policies and authority limits.
- An inventory of required loan documents, including evidence of collateral and of the recording of liens, is monitored to ensure timely receipt of required documents.
- Pertinent loan information is entered into the data-processing system on a timely basis and is independently tested to ensure accuracy.
- Subsidiary ledgers and trial balances are maintained and reconciled with the general ledger

on a timely basis, differences found are investigated and resolved, and appropriate supervisory personnel review and approve completed reconciliations on a timely basis.

- Loans held for sale are properly identified in the accounting records.
- Payments due for principal or interest are monitored for their eventual receipt, aging of delinquencies, and follow-up with late payers.
- There is segregation of duties among those who *(a)* approve loans, (*b*) control notes and collateral, (*c*) receive payments, *(d)* post subsidiary ledgers, and (*e*) reconcile subsidiary and general ledgers.
- Procedures are periodically performed to ensure that interest income is properly accrued and recorded.
- Notes and collateral on hand are kept in secure, locked, fireproof compartments. Negotiable collateral is kept under dual access control. Physical inventory and other processes are in place to identify losses or impairment of collateral.
- Construction loan advances are documented to be captured for financial reporting purposes, and periodic on-site inspections of properties are made to ensure the accuracy of those reported amounts that are based on construction progress.

8.127 ***Loan Files.*** Complete and accurate loan files are an element of internal control over financial reporting of loans. Paragraph 6.95 details information that may be found in a loan file. The contents of the files vary, depending on the type of loan, the requirements of local law, and whether the institution intends to hold the loan or not. However, all loan files should generally contain a signed note. An inspection of the files supporting loans originated in prior audit periods, as well as new loans (including some of the loans still in the process of disbursement), generally permits the independent accountant to understand the institution's internal control in this area as a basis for planning substantive tests. It may also be useful to design dual-purpose tests in this area.

8.128 For commercial loans, a credit file is commonly maintained. This file usually contains the borrower's financial statements, memoranda about the borrower's financial or personal status, financial statements of guarantors (individual or corporate), internally prepared analyses of the credit, copies of supplemental agreements between the institution and the borrower, and other loan-related correspondence.

8.129 Files supporting either direct or indirect installment loans should generally include the borrower's application, discount sheet (loan computations), credit information, title or financing statement, evidence of the existence of an in-force insurance policy payable to the institution, and the note. Credit files are also maintained on dealers from whom the institution has purchased loan paper.

8.130 Mortgage loan files generally include, but are not necessarily limited to, the note, loan application, appraisal report, verifications of employment and assets, deed of trust, mortgage, title insurance or opinion, insurance policy, settlement statement, and VA guarantee or FHA insurance, if applicable.

8.131 Following are items a loan file may contain. The location of the contents listed will vary from one institution to another depending on the type of loan and a particular institution's policies and procedures.

a. *Credit Investigation/Application/Supervision Section*

(1) Loan application

(2) Credit approval document that summarizes—

- Borrower.
- Amount of request/rate/payment terms/fees.
- Purpose.
- Repayment sources (primary and secondary).

- Collateral description and valuation.
- Guarantors.
- Other conditions/requirements of approval.

(3) Evidence of loan committee or other required approval and date approval was granted

(4) Financial statements of borrower, guarantor, or both

(5) Spreadsheets and other analyses of the financial situation of the borrower

(6) Borrower's board resolutions concerning loan approval

(7) Credit agency reports and other account information reports, as well as direct trade creditor references

(8) Newspaper clippings about borrower

(9) Various other pertinent data, including the borrower's history and forecasts

(10) Internal memoranda

(11) Correspondence

(12) Loan summary sheet, containing information such as—
- Lending committee approval date.
- Drawdown amounts and dates.
- Interest rates and adjustment dates.
- Amount of undrawn commitment.
- Rate of commitment fee and due dates.
- Date commitment fee received.
- Repayment terms.
- Name of country risk.
- Name and country of any guarantor.
- Amount of participation fee (if applicable).
- Indication of overdue payments of interest, fees, or installments.

(13) Memorandum to the file, by the lending officer, with description of the credit and commentary on its quality and potential future developments

b. *Loan Documents Section*

(1) Signed loan agreement

(2) Legal opinion

(3) Signed note

(4) Signed mortgage or deed of trust, with evidence of recordation

(5) Signed guarantee

(6) Periodic report of collateral, including its location and value and any related environmental studies

(7) Participation certificates and participation agreements (if applicable)

(8) Evidence of insurance, including loss payable clauses that protect the bank's interest

(9) Approvals

(10) Security agreements or other collateral pledge agreements, titles, or financing statements recorded in proper jurisdictions to perfect lien position (nonpossessory collateral), negotiable collateral (such as stocks and bonds) with proper endorsements/assignments, hypothecation agreement for third-party pledge of collateral

(11) Collateral ledger used to record the instruments (including stocks and bonds, which are probably kept in a vault separate from loan files or with an independent custodian) that secure a borrower's indebtedness

8.132 Specific procedures the independent accountant should consider performing to test the operating effectiveness of controls for loans include—

- Inspecting loan documents to determine whether the institution's lending policies and procedures are being followed, for example, to test whether loans are being approved by authorized officers or committees in accordance with the institution's lending policies, whether credit investigations are performed, whether credit limits are adhered to, whether the institution's procedure to capture all required loan documents is functioning, and whether the information recorded in the institution's data-processing system and used for management reporting is being tested by personnel independent of the preparer and is accurate.

- Testing the institution's reconciliation process. This might include the daily activity balancing process as well as the reconciliation of subsidiary ledgers with the general ledger. The independent accountant should test whether reconciling differences are appropriately investigated and resolved in a timely manner and whether the reconciliations are reviewed and approved by appropriate supervisory personnel.
- Testing the accuracy and performing a review of delinquency reports to determine whether the institution initiates follow-up procedures on delinquent loans in accordance with its policies and whether the system identifies potentially troubled loans for purposes of assessing impairment.
- Checking the accuracy and performing a review of concentration reports (such as loans to one borrower, in a particular region, or in a specific industry) and related party loan reports.
- Reviewing internal audit, loan review, and examination reports to identify control weaknesses and exceptions.
- Observing or otherwise obtaining evidence that a proper segregation of duties exists among those who approve, disburse, record, and reconcile loans.
- Performing detailed tests of initial recording of loans, application of cash receipts, and changes in loan details (such as adjustment of rates for ARMs).

8.133 ***Credit-Card Activities.*** To the extent the institution is involved in credit-card operations, including credit-card issuance and processing of transactions, the independent accountant should consider internal control over financial reporting of credit-card activities. Audit procedures for testing financial statement assertions related to credit-card activities depend on the degree of the institution's involvement in such activities. If the institution owns the customer receivables, a review of lending policies, confirmation of customer balances, and tests of interest and service charges, collections, delinquencies, and chargeoffs may be appropriate. If the institution only processes merchants' deposits and the resulting receivables are owned by other institutions, a review of the arrangements and a test of service fee income is generally performed.

8.134 As discussed in chapter 3, to the extent the institution relies on other enterprises for some processing activities, the independent accountant should consider the guidance in SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324).

Substantive Tests

8.135 The independent accountant should determine the nature, timing, and extent of substantive tests based on an assessment of both inherent risk and control risk. Substantive tests that the independent accountant should consider follow.

8.136 ***Analytical Procedures.*** SAS No. 56, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 329), provides guidance on the use of analytical procedures. In performing these procedures, the independent accountant should be careful not to review trends entirely from a historical perspective; current environmental and business factors, as well as local, regional, and national trends, should be considered in determining whether the institution's trends appear reasonable. Analytical procedures that the independent accountant may apply in the loan area include the analysis and evaluation of the following:

- Changes in the mix between different types of loans in the portfolio
- Comparison of aging of past-due loans with similar aging of prior year
- Comparison of loan origination volume by month with that of prior periods
- Current-year income compared with expectations and prior-year income
- Average loan balances by type in the current year compared with those of the prior year
- Comparison of yields on loans to the institution's established lending rates or pricing policies
- Reasonableness of balance-sheet accruals based upon underlying terms and amounts of corresponding loans
- Average yield throughout the period computed for each loan category on a monthly or quarterly basis

8.137 In using analytical procedures as a substantive test, the independent accountant should consider the implications of changes in important relationships and the extent of the difference between actual and expected results that can be accepted without further investigation. It is normally difficult to develop expectations to be used in analyzing yields on aggregated loans as a substantive test of related income amounts. Accordingly, analytical procedures in this area should generally be considered only as a supplement to other substantive procedures, except where an expected yield can be known with some precision.

8.138 ***Subsidiary Records.*** The independent accountant should generally obtain detailed schedules of loan principal balances and related accounts (accrued interest receivable, unearned discount, net deferred loan fees and costs, and so on) and reconcile ending balances with the trial balance, general ledger, and subsidiary records. The independent accountant should test significant reconciling items.

8.139 ***Confirmation.*** Guidance on the extent and timing of confirmation procedures is found in SAS No. 39, *Audit Sampling* (AICPA, *Professional Standards*, vol. 1, AU sec. 350), and SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312). Guidance on planning, performing, and evaluating samples is included in SAS No. 45, *Omnibus Statement on Auditing Standards—1983* (AICPA, *Professional Standards*, vol. 1, AU sec. 313, "Substantive Tests Prior to the Balance-Sheet Date"). SAS No. 67, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1, AU sec. 330), discusses the relationship of confirmation procedures to the assessment of audit risk, the design of confirmation requests, the performance of alternative procedures, and the evaluation of confirmation results. SAS No. 67 stresses the importance of understanding the substance of transactions when determining information to include on confirmation requests. It sets forth criteria that must be met for the use of negative confirmations. SAS No. 67 also establishes a presumption that the independent accountant will request the confirmation of a financial institution's loans unless certain conditions are met.

8.140 In designing confirmation requests, the independent accountant should consider the types of information respondents will be readily able to confirm, since the nature of the information being confirmed may directly affect the competence of the evidence obtained as well as the response rate. For example, respondents may not be able to confirm the balances of installment loans, but they may be able to confirm whether their payments are up-to-date, the amounts of the payments, the interest rate, and the term of their loans.

8.141 Independent accountants may use either positive or negative forms of confirmation requests to confirm loans. SAS No. 67 indicates that negative forms may be used when (*a*) the combined assessed level of inherent and control risk is low, (*b*) a large number of small balances is involved, and (*c*) the auditor has no reason to believe that the recipients of the requests are unlikely to give them consideration. Auditors should consider performing other substantive procedures to supplement the use of negative confirmations. Positive confirmation procedures should be used for larger loans and for loans that require additional assurance or other related information in addition to the loan balance, such as amount and type of collateral.

8.142 ***Inspecting Loan Documents.*** Loan files vary considerably in content depending on the type of loan. Inspection of loan documents may provide evidence about the existence and ownership of the loan. If performing an inspection of loan documents, the independent accountant should be alert to notations or other indications of problems that merit further investigation or follow-up. When loan documents are in the possession of an attorney or other outside parties, the independent accountant should consider confirming the existence and ownership of such documents.

8.143 When inspecting loan documents, the independent accountant should consider testing the physical existence and reading any evidence of assignment to the institution of the collateral that supports collateralized loans. For certain loans, the independent accountant should consider inspecting collateral in the custody of the borrower, such as floor-plan merchandise. However, the independent accountant may conclude that a review of the reports of institution personnel who inspect collateral is sufficient audit evidence. The independent accountant should also consider examining or requesting confirmation of collateral not on hand. An inspection of loan documentation should include tests of the adequacy of both the current value of collateral in relation to the outstanding loan balance and, if needed, insurance coverage on the loan collateral.

8.144 While inspecting loan documents, the independent accountant should consider the audit objectives discussed in chapter 7. For example, for guaranteed loans, the independent accountant should read the financial statements and other evidence of the financial condition of cosignatories and guarantors and consider the institution's historical experience with enforcing guarantees.

8.145 While inspecting loan documents, the independent accountant should look for evidence of approvals by the board of directors or loan committee as required by management's written lending policies, a comparison of loan amounts with appraisals, and an inspection of whether hazard and title coverage meets coverage requirements set in management's written policy. For loans generated under certain governmental programs and other special arrangements, the independent accountant may be engaged to perform additional procedures required under the specific trust or servicing agreement.

8.146 ***Construction Loans.*** Audit procedures should be responsive to the institution's construction lending practices. The independent accountant should consider performing tests to determine whether construction loans are properly classified as loans rather than real estate investments. The independent accountant should consider testing origination, approval, inspection, and disbursements made based on progress on the particular construction project. The independent accountant should consider performing on-site inspections of significant construction projects to review the collateral and to determine whether construction has progressed in accordance with the loan terms.

8.147 ***Lease Financing.*** When confirming basic lease terms, the confirmation requests should include cancellation provisions, if any. Confirmation should ordinarily be requested from the lessee. For leveraged leases, material aspects of the lease agreement, including information required for income tax purposes, may be requested from the lease trustee. Although alternative methods may be used for reporting income for tax purposes, the independent accountant should determine that income for book purposes is being recorded in conformity with FASB Statement No. 13.

8.148 ***Whole Loans or Participations Purchased.*** Audit procedures for purchased loans should be similar to those for direct loans, except that requests for confirmation of balances, collateral, and recourse provisions, if any, are usually sent to the originating or servicing institution. Loan files for purchased participations should be available at the institution and should contain pertinent documents, or copies of them, including credit files supporting loans in which the institution has purchased participations from other banks or savings institutions. The independent accountant should consider confirming the actual status of borrower payments with the servicer. Although it is usually not practicable to confirm balances of serviced loans with the individual borrowers, the servicer's independent accountants often perform audit procedures on individual loans, such as confirmation with borrowers and examination of loan documents. SAS No. 70 provides guidance to independent accountants of a service organization on issuing a report on certain aspects of the service organization's internal control that can be used by other independent accountants and provides guidance on how other independent accountants should use such reports. The independent accountant should obtain copies of any reports issued under SAS No. 70 by the servicer's independent accountants when planning the extent of test work necessary in the loan area. Depending on the nature and type of the report, audit procedures performed at the servicer's site may be necessary. In some cases, the independent accountant may wish to request certain information, such as the scope and findings of the audit procedures performed by the servicer's independent accountants, directly from the servicer's independent accountant. The independent accountant should also consider reviewing the institution's files on the servicer to observe the general reliability of the servicer. The latest remittance report from the servicer should be reconciled with the records of the institution.

8.149 ***Accrued Interest Receivable and Interest Income.*** Provided that a basis exists to rely on loan data recorded in the loan accounting system, interest income may be tested using information technology assisted audit techniques, recomputation of accrued amounts for individual accounts, analytical procedures, or some combination thereof. If interest rates were relatively stable during a period, interest income can often be tested effectively by using analytical tests by type of loan. The independent accountant should consider average balances in principal accounts, related yields as compared to averages of rates offered and of rates on existing loans, and other factors and relationships. As discussed in paragraph 6.102, the effectiveness of such analytical procedures may vary.

8.150 ***Computer Assisted Audit Techniques.*** Computer-assisted audit techniques may also be used to perform "exception/limit" checks of individual files for unusual or questionable items meriting further investigation. Examples include identifying unusual interest rates, balances, and payments, or testing the accuracy of delinquency reports.

8.151 ***Balance-Sheet Classification of Loans.*** The independent accountant should consider whether any portion of loans is being held for sale and, therefore, whether a corresponding valuation allowance or write-down to lower of cost or market value is necessary. Previous loan sale activity, types of loans sold, transactions subsequent to year-end, pending contracts, and management's intentions are factors that should be considered in identifying loans held for sale.

8.152 ***Loan Fees and Costs.*** The independent accountant should consider reviewing and testing the propriety of the institution's deferral of loan origination fees and costs in accordance with FASB Statement No. 91. The independent accountant should also consider performing a test of the accretion of net deferred loan fees or costs.

8.153 ***Undisbursed Portion of Mortgage Loans.*** Financial institutions sometimes record loans at the gross amount with an offsetting account entitled loans in process (LIP). As funds are disbursed, the LIP account is charged. Interest or fees on construction loans also may be debited to this account. The LIP account should be cleared when the loan is fully disbursed. LIP detailed ledgers should be reviewed to determine the propriety of accounting, including that for complex interest calculations. Unusual LIP balances, such as debit balances or balances outstanding for an excessive period of time (for example, over a year), may be indicative of problem loans.

8.154 A review of the LIP detailed activity may be done in connection with the examination of the current-year loan files. Loans selected for testing may be traced to the LIP account. Construction loans selected for testing may be traced to the LIP ledger, and disbursements may be reviewed in connection with the percentage of completion noted on inspection reports. In addition, if loan fees or interest are being capitalized (added to the loan balance) during construction, a review of the LIP ledgers may point out areas of concern. The independent accountant should consider whether to send confirmations to the borrower on any undisbursed loan balances.

8.155 ***Troubled Debt Restructurings.*** The independent accountant should consider performing procedures to identify TDRs and evaluate whether they have been accounted for in conformity with FASB Statements No. 15 and No. 114. Such tests may include procedures to determine whether possession of collateral has been taken without formal foreclosure proceedings (as discussed in paragraph 34 of FASB Statement No. 15, as amended).

8.156 ***Fair Value Disclosures.*** For loans for which there is a market price, the independent accountant may test fair value disclosures by reference to third-party market quotations, including information received from brokers or dealers in loans. Fair value estimates of loans for which there is no market price are highly subjective. There are a variety of methodologies that may be used by institutions to estimate fair values of loans. Most derive a fair value by discounting expected cash flows using appropriate interest rates. Some methodologies are relatively simple, such as methods that derive much of their data from the information used in estimating the allowance for credit losses, and some are relatively complex, such as option pricing models. As with all accounting estimates, the independent accountant's objective is to obtain sufficient competent evidential matter to provide reasonable assurance that the fair value estimates are reasonable in the circumstances and that they are presented in accordance with generally accepted accounting principles, including proper disclosure. SAS No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1, AU sec. 342), provides relevant guidance. The independent accountant may decide to use the work of a specialist in assessing the entity's fair value estimates. SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol.1, AU sec. 336), provides guidance on using the work of a specialist. As described in paragraphs 3.36 through 3.41, the guidance of SAS No. 73 applies when an independent accountant uses a specialist's work as evidential matter in performing substantive tests to evaluate material financial statement assertions.

CHAPTER 9

Credit Losses

INTRODUCTION

9.01 Financial institutions accept and manage significant amounts of credit risk. Loans and underlying collateral have traditionally been the source of most credit losses incurred by financial institutions. The allowance for loan losses is an accounting estimate of credit losses inherent in an institution's loan portfolio that have been incurred as of the balance-sheet date.

9.02 Institutions may also have off-balance-sheet financial instruments, such as commitments to extend credit, guarantees, and standby letters of credit, that are subject to credit risk. Though liabilities related to credit losses associated with such off-balance-sheet instruments are not part of the allowance for loan losses, institutions' processes for evaluation and estimation of the credit losses may include consideration of credit risk associated with those off-balance-sheet instruments, especially when the counterparty to an off-balance-sheet instrument is also a borrower. The information and guidance in this chapter, while generally referring to *loan* losses, may equally be useful in evaluating and estimating credit losses for off-balance-sheet instruments.

9.03 Chapter 8 discusses the various kinds of loans institutions make or purchase, the lending process and related internal controls, financial reporting for loans, and audit procedures for loans. However, because of the significance to an institution's financial statements of the allowance and the provision for loan losses and any separate liability for other credit losses, the high degree of subjectivity involved in estimating these amounts, the high degree of regulatory guidance and oversight directed toward institutions' estimates of credit losses, and, consequently, the relatively high inherent audit risk associated with auditing such estimates, careful planning and execution of audit procedures is essential in this area.

Management's Methodology

9.04 Management is responsible for estimating credit losses. Estimating credit losses is unavoidably subjective, and, accordingly, management must make careful judgments about collectibility and estimates of losses. Management's judgments should consider micro- and macro-economic factors; past, current, and anticipated events based on facts in evidence at the balance-sheet date; and realistic courses of action it expects to take.*

9.05 An institution's method of estimating credit losses is influenced by many factors, including the institution's size, organizational structure, business environment and strategy, management style, loan portfolio characteristics, loan administration procedures, and management information systems. While different institutions may use different methods, there are certain common elements that should be included in any methodology for it to be effective. The method should—

a. Include a detailed and regular analysis of the loan portfolio and off-balance-sheet instruments with credit risk.

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* The FASB Staff issued a Viewpoints article in April 1999 providing additional guidance on accounting for loan losses.

b. Include procedures for timely identification of problem credits.
c. Be used consistently.
d. Consider all known relevant internal and external factors that may affect collectibility.
e. Consider all loans (whether on an individual or pool-of-loans basis) and other relevant credit exposure.
f. Consider the particular risks inherent in the different kinds of lending.
g. Consider current collateral fair values, where applicable.
h. Be performed by competent and well-trained personnel.
i. Be based on current and reliable data.
j. Be well documented, with clear explanations of the supporting analyses and rationale.

9.06 Methods that rely solely on mathematical calculations, such as a percentage of total loans based on historical experience or similar allowance percentages of peer institutions, generally fail to contain the essential elements, because they do not involve a detailed analysis of an institution's particular transactions or consider the current economic environment.

9.07 As discussed below, creditors have traditionally identified loans that are to be evaluated for collectibility by dividing the loan portfolio into different segments. Each segment should contain loans with similar characteristics, such as risk classification, past-due status, and type of loan.

9.08 A key element of most methodologies is a credit classification process. The classification process involves categorizing loans into risk categories. The categorization should be based on relevant information about the ability of borrowers to service their debt, such as current financial information, historical payment experience, credit documentation, public information, and current trends. Many institutions classify loans using a rating system that incorporates the regulatory classification system.[†] These definitions are as follows:

a. *Substandard.* Loans classified as substandard are inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.
b. *Doubtful.* Loans classified as doubtful have all the weaknesses inherent in those classified as substandard, with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.
c. *Loss.* Loans classified as loss are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the loan has absolutely no recovery or salvage value but, rather, that it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be effected in the future.

9.09 Some loans are also identified for a special mention. Such a loan has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or of the institution's credit position at some future date. Special-mention loans are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification.

[†] See *Interagency Policy Statement on Review and Classification of Commercial Real Estate Loans*, June 10, 1993.

9.10 Examples of such potential weaknesses are—

- Poor lending practices that result in significant defects in the loan agreement, security agreement, guarantee agreement, or other documentation and the deteriorating condition of or lack of control over collateral. In other words, these are conditions that may jeopardize the institution's ability to enforce loan terms or that reduce the protection afforded by secondary repayment sources.
- Lack of information about the borrower or guarantors, including stale financial information or lack of current collateral valuations.
- Economic or market conditions that in the future may affect the borrower's ability to meet scheduled repayments. These may be evidenced by adverse profitability, liquidity, or leverage trends in the borrower's financial statements.

9.11 Institutions generally analyze large loans and loans not conducive to pool analysis on an individual basis by classifying the loans as to credit risk and estimating specific losses. This analysis may be performed by loan officers subject to review by an internal loan review department, or may be performed by a loan review department. The loan review focuses on determining whether individual loans are properly classified as to credit risk and were made in accordance with the institution's written lending policies and whether the borrower is likely to perform in accordance with its contractual terms and conditions. The review typically includes analysis of (*a*) loan performance since origination or the last renewal, (*b*) the current economic situation of a borrower or guarantor, and (*c*) estimates of current fair values of collateral. Borrower and guarantor financial statements are generally reviewed as to financial resources, liquidity, future cash flows, and other financial information pertinent to the ability to repay the debt. Collateral is reviewed to determine whether it is under the institution's control, whether security interests have been perfected (which is a legal determination), and whether the value is greater than the amount owed. Loan file contents are generally reviewed for completeness and conformity with the institution's written policies for loan documentation. The absence of an internal loan review function may constitute a reportable condition, as defined in SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit.* In addition, the lack of an internal loan review and classification system may be considered to be an unsafe and unsound practice by regulators.

9.12 Foreign loans should be reviewed but they require special consideration because of the transfer risk associated with cross-border lending. Certain foreign loans are required by the Interagency Country Exposure Risk Committee (ICERC) pursuant to the International Supervision Act of 1983 to have allocated transfer risk reserves (ATRRs). ATRRs are minimum specific reserves related to loans in particular countries. Such reserves are minimums, and institutions may determine that a higher allowance is necessary based on its assessment of the probable losses.

Groups of Homogeneous Loans and Leases

9.13 Loans not evaluated individually are included in groups of homogeneous loans. The focus of the pool approach is generally on the historical loss experience for the pool. Loss experience, which is usually determined by reviewing the historical loss (chargeoff) rate for each pool over a designated time period, is adjusted for changes in trends and conditions. Trends and conditions that the institution should consider in determining how historical loss rates should be adjusted include—

- Levels of and trends in delinquencies and impaired loans.
- Levels of and trends in recoveries of prior chargeoffs.
- Trends in volume and terms of loans.
- Effects of any changes in lending policies and procedures.
- Experience, ability, and depth of lending management and other relevant staff.

- National and local economic trends and conditions.
- Credit concentrations.

Estimating Overall Credit Losses

9.14 Institutions may use a method that results in a range of estimates for the allowance for individual loans and large groups of loans and must apply careful judgment regarding the risks as well as other relevant factors for each segment of loans to determine the amount to record. Paragraph 3 of FIN 14 states "when some amount within the range appears at the time to be a better estimate than any other amount within the range, that amount shall be accrued. When no amount within the range is a better estimate than any other amount, however, the minimum amount in the range shall be accrued." (However, the measure of impairment under Financial Accounting Standards Board [FASB] Statement of Financial Accounting Standards No. 114, *Accounting by Creditors for Impairment of a Loan*, is based on a single best estimate and not a range of estimates.) The institution's conclusions about the appropriate amount should be well documented.

9.15 Management often considers credit losses associated with certain off-balance-sheet financial instruments (such as commitments to extend credit, guarantees, and letters of credit) at the same time it considers credit losses associated with the loan portfolio. While it is generally practical to consider credit losses on loans and other financial instruments at the same time, allowances necessary for off-balance-sheet instruments should be reported separately as liabilities and not as part of the allowance for loan losses.

9.16 Management should consider its overall loan loss allowance and liability for other credit exposures to be adequate only if such amounts are considered adequate to cover estimated losses inherent in the loan portfolio and the portfolio of other financial instruments, respectively. An illustration of a worksheet for an allowance and liability calculation is shown in exhibit 9.1.

Exhibit 9.1

Worksheet for Estimating Credit Losses

		Estimated Credit ***Loss Amount***†	
Category	*Recorded* ***Investment****	***High***	***Low***
	$	$	$
Allowance for Estimated Loan Losses			
I Individually evaluated for impairment:§			
Impairment identified‡			
No impairment identified		N/A	N/A
II Large groups of smaller-balance homogeneous loans collectively evaluated for impairment:"			
Credit card			
Residential mortgag			
Consumer			
Other			
III Other large groups of loans containing unidentified,impaired loans[x]			
IV Loans measured at fair value or at the lower of cost or fair value		N/A	N/A
Total allowance for estimated			

loan losses	$__________	$__________
Liability for Losses on Credit Instruments and Other Credit Exposures		
Futures,forward,swap and option contracts and other financial instruments with similar characteristics (such as interest rate caps or floors)		
Standby letters of credit		
Commitments		
Loans sold with recourse		
Other		
Total liability for credit instruments *and other credit exposures*	$__________	$__________

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* The total of amounts in this column generally should correspond to the institution's total loan (and lease) portfolio.

[†] For purposes of this worksheet the estimated credit loss amount may be a specific amount or a range of estimated amounts. However, the measure of impairment under FASB Statement No. 114 is based on a single best estimate and not a range of estimated amounts.

[§] This category includes loans evaluated for impairment in conformity with FASB Statement No. 114.

[‡] This subcategory includes loans for which it is probable that the creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement and, accordingly, for which impairment is measured in conformity with FASB Statement No. 114.

" This category comprises large groups of smaller-balance homogeneous loans and leases that are collectively evaluated for impairment.

[x] This category comprises large group of all other loans and leases not addressed in categories I or II and not individually considered impaired by that, on a portfolio basis, are believed to have some inherent but unidentified impairment.

[**] Note that upon implementation of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, credit exposure for these items will be part of fair value considerations and not included in this summary. FASB Statement No. 133, as amended by FASB Statement No. 137, *Accounting for Derivative Instruments and Hedging Activities—Deferral of the Effective Date of FASB Statement No. 133*, is effective for all fiscal quarters of fiscal years beginning after June 15, 2000. A summary of FASB Statement No. 133 is provided in chapter 15 of this Guide. On March 3, 2000, the FASB issued an exposure draft, *Accounting for Certain Derivative Instruments and Certain Hedging Activities—an Amendment of FASB Statement No. 133*. Readers should be alert to any final pronouncement. The FASB has established the Derivative Implementation Group (DIG) to assist the Board and its staff in providing implementation guidance regarding FASB Statement No. 133. Issues addressed by the DIG and the status of related guidance can be founded at the FASB's Web site at www.fasb.org.

9.17 Loan evaluations by management (and tests of such by independent accountants to the extent they are performed as part of the engagement) should avoid the following:

- *Collateral myopia.* This is the failure to see beyond collateral values to a financial weakness in the borrower. Collateral values and liquidity often tend to decline in periods when they are most needed to protect against loan losses. For example, if an oversupply in the real estate market causes lower-than-projected occupancy rates (creating cash flow problems for the borrower), the protection afforded by the collateral is diminished. Similar scenarios can be drawn for oil and gas reserves when energy prices decline, for specialized equipment (for example, drilling rigs, mining equipment, farm equipment, steel mills, and construction equipment) during specific industry slowdowns, for farmland during periods of depressed agricultural commodity and livestock prices, and for accounts receivable of a failing company.
- *Inadequate collateral appraisals.* This is the failure to critically review appraisals to understand the methods employed, assumptions made, and limitations inherent in the appraisal process, including undue reliance on management appraisals. Appraisal methods and assumptions may be inappropriate in the current circumstances. Going concern values generally are dramatically different from liquidation values. For example, real estate appraisals made on the income approach are not usually appropriate for incomplete projects or in circumstances in which operating conditions have changed.

- *Outdated or unreliable financial information*. This is the reliance on old, incomplete, or inconsistent data to assess operating performance or financial capacity. Financial information should be current and complete, particularly for borrowers sensitive to cyclical fluctuations or who demonstrate significant growth or changes in operating philosophy and markets.
- *Excessive renewals or unrealistic terms*. This is the reliance on current or performing-as-agreed status when the transaction has been structured to obscure weaknesses. Excessive renewals, unrealistic terms, and interest capitalization may be indications of such a structure. The purpose of a loan and performance against the original agreement should be critically reviewed.
- *Personal bias*. This is the bias of a reviewer for or against industries, companies, individuals, and products. For example, the involvement of a public personality in a venture could influence a reviewer to place more credibility than appropriate on the success of the venture.
- *Overlooking self-dealing*. This concerns directors or large shareholders who improperly use their position to obtain excessive extensions of credit on an unsound basis. In this situation, management is often unduly influenced by persons in these positions since management serves at the pleasure of the board and shareholders.
- *Dependence on management representations*. This is undue reliance on management representations when there is no supporting evidence. For example, such representations as "the guarantee is not signed but it is still good" or "the future prospects for this troubled borrower are promising" should be critically reviewed.

REGULATORY MATTERS

9.18 The federal banking agencies' December 21, 1993, *Interagency Policy Statement on the Allowance for Loan and Lease Losses* discusses (*a*) the nature and purpose of the allowance, (*b*) the related responsibilities of the board of directors and management and of the examiners, (*c*) loan review systems, and (*d*) international transfer risk matters. Included in the discussion of examiner responsibilities is an analytical tool for assessing the reasonableness of management's loss allowance methodology. The tool involves comparison of the reported loss allowance against the sum of specified percentages (based on industry averages) applied to certain loan classifications. Related regulatory guidance strongly cautions examiners against using the tool as a rule of thumb or as a substitute for a full and thorough analysis of the bank's loan portfolio, in part because such comparisons do not take into account the often significant differences between institutions, their portfolios, underwriting and collection practices, and credit-rating policies.

9.19 The determination of loan loss allowances is necessarily a highly subjective process. Accordingly, management's use of the specified percentages as the primary basis for establishing loss allowances ordinarily would be questionable. Independent accountants should be alert to the risk that management may, inappropriately, rely on the tool to establish the loss allowance for certain loans instead of gathering the information and applying the judgment necessary to determine the adequacy of the loss allowance for those loans. In such circumstances, independent accountants should ask management to justify that loss allowances have been established in conformity with generally accepted accounting principles (GAAP) rather than in accordance with the specified percentages.

9.20 The Office of the Comptroller of the Currency (OCC) provides regulatory and accounting guidance to its examiners in its June 1996 booklet *Allowance for Loan and Lease Losses*. Banking Circular 201 (Rev.), *Allowance for Loan and Lease Losses* has been rescinded because the information contained in that circular has been incorporated into this booklet. The booklet also incorporates a discussion of FASB Statement No. 114. The booklet discusses the responsibility of a national bank's management (a) to have a program to establish and regularly review the adequacy of its allowance; (b) to implement an effective internal process that will ensure maintenance of an adequate allowance; (c) to maintain effective systems and controls for identifying, monitoring and addressing asset quality problems in a timely manner; (d) to maintain the allowance at a level that is adequate to absorb all estimated inherent losses in the loan and lease portfolio at its evaluation date; and (e) to document its evaluation process sufficiently to establish the methods used and the factors considered by the bank provide a satisfactory basis for determining an adequate level for the allowance. Practitioners serving national banks should be familiar with this booklet.

9.21 Practitioners should also be familiar with the Federal Deposit Insurance Corporation's May 7, 1991, memorandum, *Allowance for Loan and Lease Losses*, which provides guidance to agency examiners on assessing the adequacy of loan loss allowances and discusses related accounting literature. The memorandum also helps examiners highlight differences between regulatory and institution allowance rationales.

9.22 As discussed in paragraph 9.82, independent accountants should be skeptical if differences exist between the amounts of loan loss allowances estimated by management for regulatory purposes and for reporting in conformity with GAAP and should be prepared to justify such differences based on the circumstances.

9.23 Other guidance was provided to examiners in the agencies' November 7, 1991, joint issuance, in which they clarified regulatory policy in the areas of real estate loan valuation and classification, emphasizing that it is not regulatory policy to value real estate loans on a liquidation basis but, rather, on the income-producing capacity of loan collateral over time. Other matters addressed include—

- General principles examiners follow in reviewing commercial real estate loan portfolios.
- Indicators of troubled real estate markets, projects, and related indebtedness.
- Factors examiners consider in their review of individual loans, including the use of appraisals in the determination of collateral value.
- Approaches to valuing real estate, especially in troubled markets.
- Classification guidelines followed by the agencies, including the treatment of guarantees.
- Factors considered in the evaluation of an institution's allowance for loan and lease losses.

9.24 Management is required to provide independent accountants with regulatory examination reports, which generally disclose classified loans and certain statistics regarding those classifications. When a regulatory examination is in process, the independent accountant should discuss the status and preliminary findings of the examination with institution management and the examiners. (Communications with regulators are discussed further in chapter 5.)

9.25 The agencies established a policy on loan documentation effective March 30, 1993, to encourage lending to small and medium-sized businesses. The policy allows certain banks and savings institutions to establish a portfolio of loans exempt from certain documentation requirements. Examiners may not criticize the credit quality of an exempt loan on the basis of documentation and may not classify the loan unless it is more than sixty days delinquent. The institution's management, however, is still required to fully evaluate the collectibility of exempt loans in determining the adequacy of loan loss allowances. (See paragraph 9.68.)

Credit Unions

9.26 Federal credit unions are required by part 702 of the NCUA *Rules and Regulations* to establish and maintain an allowance for loan losses. Federally insured state-chartered credit unions are usually required by their insurance agreement with the National Credit Union Share Insurance Fund to establish and maintain an allowance. The requirements for state-chartered credit unions that are not federally insured vary by state and insurer.

9.27 Credit unions should not base the justification of a lower allowance for loan losses on the maintenance of the regular reserve. Regulators have historically stated that the regular reserve has been established to cover loan losses. Although this may be true in a regulatory sense, the regular reserve constitutes an appropriation of undivided earnings and should not be considered in determining the amount of the allowance for loan losses.

9.28 Some credit unions record a provision for loan losses equal to what would normally be transferred to the regular reserve from undivided earnings. Since the regular reserve may be reduced by the amount equal to the provision made, no regular reserve transfer is effectively made. The consequences of these actions may result in an overstatement of the allowance account. A credit union's allowance may be materially overstated due to strict adherence to this process.

9.29 For regulatory purposes, credit unions have historically used either the experience method or the adjustment method to calculate their allowance for loan losses. In July 1992, the NCUA issued Accounting Bulletin No. 92-1, which provides guidance to credit unions for establishing and maintaining the allowance for loan losses. Although the application of the NCUA's methods may or may not result in substantially the same allowance as management's estimate for the allowance, management should report an allowance in the financial statements prepared under GAAP that is adequate to cover all estimated losses incurred at the statement-of-financial-condition date in the loan portfolio.

ACCOUNTING AND FINANCIAL REPORTING

9.30 FASB Statement No. 114 (as amended by FASB Statement No. 118, *Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures*), and FASB Statement No. 5, *Accounting for Contingencies*, are the primary sources of guidance on accounting for the allowance for loan losses. In addition, the banking agencies and the SEC have issued three interagency statements on the allowance (November 1998, March 1999, and July 1999), which remind depository institutions of the requirement to record and report their allowance for loan and lease losses in accordance with GAAP.

9.31 FASB Statement No. 5 is the primary guidance on the accounting and reporting of loss contingencies, including credit losses.[‡] It requires that a creditor evaluate the collectibility of both contractual interest and principal of all receivables when assessing the need for a loss accrual. FASB Statement No. 5 requires that an estimated loss from a loss contingency should be accrued by a charge to income if both of the following conditions are met:

a. Information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements. It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss.

b. The amount of loss can be reasonably estimated.

[‡] Other examples of loss contingencies (provided in paragraph 4 of FASB Statement No. 5) include—
Collectibility of receivables other than loans.
Guarantees of indebtedness of others.
Obligations of commercial banks under standby letters of credit.
Agreements to repurchase receivables (or to repurchase the related property) that have been sold.

9.32 FASB Statement No. 5 states that when a loss contingency exists, the likelihood that the future event or events will confirm the loss or impairment of an asset (whether related to contractual principal or interest) can range from remote to probable. *Probable* means the future event or events are likely to occur; however, the conditions for accrual are not intended to be so rigid that they require virtual certainty before a loss is accrued. The conditions may be considered in relation to individual loans or groups of loans. However, if the conditions are met, a loss should be recognized even though the particular loans that are uncollectible may not be identifiable, such as large groups of loans for which credit losses have been incurred but which have not been associated with specific loans.

9.33 In estimating the amount of losses to be recognized under FASB Statement No. 5, institutions focus on the adequacy of the allowance for loan losses at each reporting date. The allowance for loan losses should be adequate to cover probable credit losses related to specifically identified loans as well as probable credit losses inherent in the remainder of the loan portfolio. Credit losses related to off-balance-sheet instruments should also be accrued and reported separately as liabilities if the conditions of FASB Statement No. 5 are met.+ FASB Statement No. 114 amended FASB Statement No. 5 to clarify that a creditor should evaluate the collectibility of both contractual interest and contractual principal of all receivables when assessing the need for a loss accrual. The Statement also amends FASB Statement No. 15, Accounting by Debtors and Creditors for Troubled Debt Restructurings, to require a creditor to measure all loans that are restructured in a troubled debt restructuring involving a modification of terms in accordance with FASB Statement No. 114. Provisions for loan and other credit losses should be charged to operating income sufficient to maintain the allowance for loan losses or liabilities related to off-balance-sheet credit losses at an adequate level – that is, management should address the adequacy of the allowance and the liabilities, not of the provision charged to income.

9.34 Confirmed credit losses for loans, which may be for all or part of a particular loan, should be deducted from the allowance and the related loan balance should be charged off in the period in which they are deemed uncollectible. Recoveries of loans previously charged off should be added to the allowance when received. Confirmed credit losses for off-balance-sheet financial instruments should be deducted from the liability for credit losses in the period in which they are deemed uncollectible.

9.35 FASB Statement No. 5 prohibits recognizing losses if the events causing the losses have not yet occurred. The act of lending money generally is not the event that causes asset impairment. Though some credit losses can be predicted, future losses should not be provided for at the time loans are made, because the events that cause the losses or loan impairment (for example, loss of employment, disability, or bankruptcy) have not yet occurred. Generally, a loan would be impaired at origination only if a faulty credit granting decision has been made or loan credit review procedures are inadequate or overly aggressive, in which case, the loss should be recognized at the date of loan origination.

9.36 FASB Statement No. 114 addresses the accounting by creditors for impairment of certain loans, uncollateralized as well as collateralized, except for (*a*) large groups of smaller-balance homogeneous loans that are collectively evaluated for impairment, (*b*) loans that are measured at fair value or at the lower of cost or fair value, (*c*) leases (as defined in FASB Statement No. 13, *Accounting for Leases*), and (*d*) debt securities as defined in FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*, as amended by FASB Statements No. 114 and No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, establishes the accounting for troubled debt restructurings.

[+] Note that upon the implementation of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, credit exposure for certain financial instruments will be part of fair value consideration.

9.37 FASB Statement No. 114 requires that such impaired loans 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 the collateral if the loan is collateral-dependent.[§] Paragraph 20 of FASB Statement No. 114, as amended, requires disclosure of information about loans that meet the definition of an impaired loan in paragraph 8 of the Statement. Included are various disclosures about the recorded investment in the impaired loans, the creditor's income recognition policy, restructured loans, and the activity in the allowance for loan losses.

9.38 In addition to disclosures required by FASB Statements No. 5, No. 114, and No. 118, a description of the accounting policies and methodology the institution used to estimate its allowance for loan losses and liability for off-balance sheet credit losses and related provisions for loan or other credit losses should be included in the notes to the financial statements. Such a description should identify the factors that influenced management's judgment (for example, historical losses adjusted for existing economic conditions) and may also include discussion of risk elements relevant to particular categories of financial instruments. Institutions should also disclose their policy for charging off uncollectible loans.

9.39 *Credit Unions.* A change from a method of calculating the allowance for loan losses that is not generally accepted (for example, a calculation used for regulatory purposes) to a method that is generally accepted and that results in an adjustment to the amount previously reported is considered a correction of an error and should be reported as a prior-period adjustment in accordance with paragraph 36 of APB Opinion No. 20, *Accounting Changes*. Such a change frequently arises when a credit union that has in the past undergone only supervisory committee audits initially undergoes an audit in accordance with generally accepted auditing standards.

AUDITING

Objectives

9.40 The primary objectives of audit procedures for credit losses are to obtain reasonable assurance that—

a. The allowances for loan losses and liability for other credit exposures are adequate to cover the amount of probable credit losses inherent in the loan portfolio at the balance-sheet date.
b. Credit losses and other items charged or credited to the allowance for loan losses, such as loan chargeoffs and recoveries, have been included in the financial statements at appropriate amounts and are properly disclosed.
c. Disclosures are adequate.

The independent accountant attempts to achieve those objectives by testing management's estimates of the allowance based on available and relevant information regarding loan collectibility. The independent accountant is not responsible for estimating the amount of the allowance or ascertaining the collectibility of each, or any, specific loan included in an institution's loan portfolio.

[§] Paragraph 12 of FASB Statement No. 114 permits a creditor to aggregate impaired loans that have common risk characteristics and use historical statistics, such as average recovery period and average amount recovered, along with a composite interest rate as a means of measuring those impaired loans.

Planning

9.41 In planning the audit, the independent accountant should consider the factors influencing inherent risk, which are described in chapter 5, as they relate to financial statement assertions about credit losses. Because of the significance of loans to institutions' balance sheets, and because the estimation of loan losses is based on subjective judgments, independent accountants should generally assess inherent risk related to the allowance for loan losses as high. Such assessment should influence engagement staffing, extent of supervision, overall scope and strategy, and degree of professional skepticism applied. Further, independent accountants should be familiar with the applicable regulatory guidance, including guidance on the classification of credits, concentration of credits, foreign loans, and significant related parties. SAS No. 57 provides guidance to auditors on obtaining and evaluating sufficient competent evidential matter to support significant accounting estimates in an audit of financial statements.

9.42 The audit procedures performed in connection with the allowance for loan losses typically are time-consuming and are most efficient when initiated early in the fieldwork. Because of the subjective nature of the loan review process, experienced audit personnel, preferably with prior depository institution engagement experience and, if necessary, with knowledge of industries in which the institution's loans are concentrated, should closely supervise or perform this section of the engagement. The assigned audit staff should also understand the lending environment, including credit strategy, credit risk, and the lending policies, procedures, and control environment of the institution, and should be familiar with known related parties and related-party transactions.

9.43 An important planning consideration is whether an institution's internal loan review and internal audit functions can be considered by the independent accountant and permit the independent accountant to increase audit efficiency. Discussions with internal loan review and internal audit staff can provide the independent accountant with information concerning loan customers, related party transactions, and account histories that may not be readily available elsewhere. Also, because the internal audit department is involved in evaluating accounting systems and control activities (as discussed in chapter 6), it can provide the independent accountant with important control process descriptions and results of testing that are helpful in understanding internal control. Chapter 3 discusses consideration of the internal audit function.

9.44 In determining the scope of audit procedures, the independent accountant should consider its assessment of internal control risk and general factors such as:

- Composition of the loan portfolio.
- Identified potential problem loans, including loans classified by regulatory agencies.
- Trends in loan volume by major categories, especially categories experiencing rapid growth, and in delinquencies and restructured loans.
- Previous loss and recovery experience, including timeliness of chargeoffs.
- Concentrations of loans to individuals and their related interests, industries, and geographic regions.
- Size of individual credit exposures (few, large loans versus numerous, small loans).
- Quality of internal loan review and internal audit functions, and results of their work.
- Total amount of loans and problem loans, including delinquent loans, by officer.
- Lending, chargeoff, collection, and recovery policies and procedures.
- Local, national, and international economic and environmental conditions, including for example, the financial condition of a credit union’s sponsoring organization or field of membership.

- Experience, competence, and depth of lending management and staff.
- Results of regulatory examinations.
- Related party lending.

Internal Control Over Financial Reporting and Possible Tests of Controls

9.45 SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), provides guidance on the independent accountant's consideration of an institution's internal control in an audit of financial statements performed in accordance with GAAS. It describes the components of internal control and explains how an independent accountant should consider internal control in planning and performing an audit. Paragraph 19 of SAS No. 55, as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55*, requires that, in all audits, the independent accountant obtain sufficient understanding of each of the five components (the control environment, risk assessment, control activities, information and communication, and monitoring) to plan the audit by performing procedures to understand the design of policies and procedures relevant to audit planning and whether they have been placed in operation.

9.46 Effective internal control related to estimating the allowance for loan losses should reduce the likelihood of material misstatement of the allowance for loan losses. The independent accountant should obtain an understanding of how management developed the allowance for loan losses, how the process has changed from prior periods, and an understanding of the institution's loan portfolio, lending process, loan accounting policies, market focus, trade area, and other relevant factors. Specific aspects of effective internal control related to the allowance for loan losses should include the following:

- *Management communication of the need for proper reporting of the allowance*. The control environment strongly influences the effectiveness of the system of controls and affects the independent accountant's assessment of control risk. The control environment reflects the overall attitude, awareness, and action of the board of directors and management concerning the importance of control. The independent accountant should consider (*a*) the level of integrity and ethical values, (*b*) commitment to competence, (*c*) the level of involvement and quality of leadership provided by the board of directors, audit committee, and senior management in evaluating the allowance, (*d*) management's philosophy and operating style, (*e*) the organizational structure, (*f*) assignment of authority and responsibility, and (*g*) human resource policies and practices.
- *Accumulation of relevant, sufficient, and reliable data on which to base management's estimate of the allowance*. Management reports summarizing loan activity, renewals, and delinquencies are vital to the timely identification of problem loans. The institution's procedures and controls are important for identifying when loans should be placed on nonaccrual status, reserved for, or charged off. Most institutions have written policies covering nonaccrual status, the timing of chargeoffs, and transfers of loans to the special asset or workout department. Most institutions have policies and procedures for the gathering and analysis of information from and about debtors.
- *Independent loan review*. Loan reviews should be conducted by competent institution personnel who are independent of the underwriting, supervision, and collections functions. The specific lines of reporting depend on the complexity of the institution's organizational structure, but the loan reviewers should report to a high level of management that is independent from the lending process in the institution. The loan review function should monitor and test line management's identification and evaluation of existing and potential problem loans in a timely manner. The selection of loans for review should be representative and unbiased except for a bias toward higher risk loans.

- *Loss estimation process.* A loss estimation process for individually impaired loans and groups of other loans. This includes:
  - — Assigning responsibility for identification of impaired loans
  - — Assigning responsibility for measurement of impairment
  - — Impaired loan tracking and impairment measurement information system.
  - — Historical loss tracking and loss rates measurement information system
  - — A process for documenting current economic conditions that differ from historical loss rates and justification for specific adjustments to historical loss averages
  - — A process for accumulating the component needs of the allowance and provision amounts
- *Adequate review and approval of the allowance estimates by the individuals specified in management's written policy*. This includes—
  - — Review of sources of relevant information.
  - — Review of development of assumptions and methodologies.
  - — Review of reasonableness of assumptions, methodologies, and resulting estimates.
  - — Consideration of the need to use the work of specialists (such as appraisers or construction specialists).
  - — Consideration of changes in previously established methods to arrive at the allowance.
- Comparison of prior estimates related to the allowance with subsequent results to assess the reliability of the process used to develop the allowance.

9.47 Because compliance with a well-defined lending policy is essential to an institution's asset quality, failure to follow that policy could have a substantial impact on the reliability of financial statement assertions. For example, authority limits established in management's written underwriting policies are based in large part on (*a*) the knowledge and skill of the reviewing loan officer or committee and (*b*) the credit risk the institution is willing to assume on a particular type of loan. A loan made for an amount in excess of an officer's limit, or for an unauthorized loan type, would normally involve greater amounts of credit or other risks. Accordingly, management's financial statement assertions about impairment and valuation of the loan portfolio, for example, may be affected.

9.48 The independent may consider performing the following tests to obtain evidential matter about the effectiveness of internal controls over financial reporting in the area of credit losses:

- Reviewing the company's accounting policies and procedures describing the process for determining, evaluating, and maintaining the allowance for loan losses and other credit losses in accordance with generally accepted accounting principles. Discuss these policies and procedures with appropriate personnel to determine if they understand the related financial reporting objective.
- Review evidence that the company has procedures for identifying and reporting potential problem loans (e.g., a "watch list") and following-up on such loans, as well as delinquent loan reports and procedures for follow-up on delinquencies.
- Examine evidence that credit officers perform a periodic review of potential problem loans and assign risk ratings that are promptly reflected in a classified loan or other appropriate report.
- Examine evidence that senior management and appropriate Board committee review and monitor past due, watch list, classified loans, and assigned risk ratings.

- Test the controls over the preparation of the periodic past due, watch list, and classified loans reports.
- Evaluate the basis for which each report is prepared, including which loans are included and excluded.
- Examine evidence that the delinquent loan report interfaces appropriately with the watch list or problem loan report.
- Test the reports' accuracy by tracing a sample of loans between the trial balance and the applicable report.
- Examine evidence that the company has a independent loan review function to review and evaluate credit officer's analysis of significant loans.
- Evaluate whether the results of loan confirmations support the integrity of loan trial balances, loan files, and delinquency reports.
- Review the company's reviewable record that analyzes the need for and documents each component of the allowance for credit losses. (For example, test the calculation of historical loss experience for one or more periods and one or more pools of loans, or test the calculation of discounted expected cash flow for one or more impaired loans.)
- Read minutes of meetings of the Board or loan committee for evidence of evidence of Board's periodic review and approval of the adequacy of the allowance for credit losses based on an appropriate reviewable record.

Substantive Tests

9.49 In evaluating the reasonableness of the allowance for loan losses, the independent accountant would normally concentrate on key factors and assumptions that are—

a. Significant to the estimate of the amount of the allowance, such as—
   - The effectiveness of the institution's internal control related to loans and the allowance for loan losses.
   - Current local, national, and international economic conditions and trends, particularly as they have impacted collateral values.
   - The amount of recoveries of loans previously charged off.
   - Composition of the loan portfolio and trends in volume and terms of loans, as well as trends in delinquent and nonaccrual loans that could indicate historical loss averages do not reflect current conditions.
   - Identified potential problem loans and large groups of problem loans, including delinquent and nonaccrual loans and loans classified according to regulatory guidelines.
   - Concentrations of loans to individuals or entities and their related interests, to industries, and in geographic regions.
   - Size of specific credit exposures (a few large loans versus numerous small loans).
   - Quality of the internal loan review and internal audit functions

- The affects of changes in lending policies and procedures, including those for underwriting, credit monitoring, collection, and chargeoffs that could indicate historical loss averages do not reflect current conditions.
- Results of regulatory examinations.
- Nature and extent of related-party lending.

b. Sensitive to variations. Assumptions based on historical trends, such as the amount of late or partial payments in a particular period and the amount of chargeoffs, can have a significant effect on estimates of the allowance.

c. Subjective and susceptible to misstatement and bias, such as—

- The risk classification and allowance allocation given to problem loans.
- Estimates of collateral values, and the related assumptions that drive the determination of such values, such as cash flow estimates, discount rates, and projected occupancy rates.
- Current economic or market conditions that in the future may affect a borrower's ability to meet scheduled repayments.
- Contingencies, such as a commitment for funding from a third party.

9.50 The independent accountant should normally consider the historical experience of the institution in evaluating the adequacy of the allowance, as well as the independent accountant's experience with the industry. Changes in facts, circumstances, or an institution's procedures may cause factors different from those considered in the past to become significant to the estimate of the allowance.

9.51 Further, the independent accountant should consider the total credit exposure of particular borrowers, including that related to standby letters of credit, guarantees, commitments to lend, and other off-balance-sheet exposures in relation to the institution's liability for other credit exposures.

9.52 In performing substantive procedures, the independent accountant should consider the following approaches:

a. Review and test the process used by management to develop the allowance.

b. Develop an independent expectation of the allowance to corroborate the reasonableness of the allowance.

c. Review subsequent events and transactions occurring prior to completion of fieldwork.

9.53 In some situations, the audit strategy will include aspects of all three approaches. The independent accountant assesses reasonableness by performing procedures to test the process used by management to estimate the allowance. The following are procedures the independent accountant should consider:

- Identify whether there are controls over the preparation of the estimate of the allowance for loan losses and over the related supporting data that may be useful in the evaluation of the adequacy of the allowance and test controls.
- Identify the sources of data and other factors that management used in forming the assumptions and, based on information gathered in other audit tests, consider whether such data and factors are relevant, reliable, and sufficient for determining the allowance.
- Consider whether there are additional key factors or alternative assumptions about the factors.
- Evaluate whether the assumptions are consistent with each other, the supporting data, relevant historical data, and industry data.

- Analyze historical data used in developing the assumptions to assess whether the data are comparable and consistent with data of the period under audit, and consider whether such data are sufficiently reliable for determining the allowance.
- Compare current-year chargeoffs with prior-period estimated losses to determine the historical reliability of prior-period estimates.
- Consider whether changes in the business or industry may cause other factors to become significant to the assumptions.
- Review available documentation of the assumptions used in developing the allowance and inquire about any other plans, goals, and objectives of the institution, and consider their relationship to the assumptions.
- Test the calculations used by management to translate the assumptions and key factors into the estimate of the allowance for loan losses.
- Consider using the work of a specialist regarding certain assumptions.

9.54 The independent accountant should also test management's identification of loans that contain high credit risk or other significant exposures and concentrations. Sources of information the independent accountant should consider include—

- Recent regulatory examination reports.
- Various internally generated listings, such as watch list loans, past-due loans, loans on nonaccrual and restructured status, loans to insiders (including directors and officers), and overdrafts.
- Management reports of total loan amounts by borrower.
- Reports of historical loss experience by type of loan or risk rating.
- Internal loan review reports on their review of loan files, which should identify whether they are lacking current financial data of borrowers and guarantors or current appraisals and may identify loans that are frequently rolled over.
- Loan-documentation and compliance exception reports.
- Loan committee minutes.
- Inquiries of management regarding the experience and degree of turnover of loan officers.
- Reports of the independent loan review function or internal audit.
- Written lending policies, especially any recent policy changes.
- Reports containing loans with repayment terms structured and restructured such that collectibility problems and concerns may not be evident until payments come due, such as construction loans with interest included in the loan commitment amount.

9.55 These documents and other sources may identify—

a. Borrowers experiencing problems such as operating losses, marginal working capital, inadequate cash flow, or business interruptions.
b. Loans secured by collateral that is not readily marketable or that is susceptible to deterioration in realizable value.
c. Loans to borrowers in industries experiencing economic instability.
d. Loan-documentation and compliance exceptions.

9.56 It should be noted that, to the extent that such information is found in reports prepared by management and is to be relied on in substantive tests, the accuracy and completeness of such information should be evaluated by, for example, testing loan subsidiary ledgers and tracing delinquencies to the past-due reports.

9.57 SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 336), provides guidance concerning the independent accountant's decision to use the work of a specialist. To properly evaluate the collectibility of certain loans, the independent accountant may need information outside of his or her usual experience. For example, the independent accountant might encounter valuation problems that require special knowledge of types of collateral. Factors to be considered in selecting a specialist include professional recognition of the specialist's competence in his or her field, reputation among peers, and relationship with the client.

9.58 For example, the knowledge of a specialist could be useful for loans based on oil and gas reserves. The specialist might review engineering reports on current reserves and production reports if the wells are in production. If fluctuating market conditions exist, a specialist could answer additional inquiries concerning the current status of oil and gas properties. For example, a loan secured by drilling equipment might have only marginal collateral value in a period of declining petroleum prices, even though the loan was highly secured when it was made.

9.59 Loans to developing countries are another example of instances in which the independent accountant may require the assistance of a specialist to become familiar with the economic, political, and social factors affecting the country's debt repayment. Other sources of such information include International Monetary Fund publications, international economists, and reports provided to institutions by the ICERC.

9.60 Engaging an appraiser, especially for real estate and other subjectively valued collateral, is another example of using a specialist. The independent accountant should be familiar with the basic concepts involved in the appraisal process in order to evaluate the competency and qualifications of appraisers. The AICPA Audit and Accounting Guide *Guide for the Use of Real Estate Appraisal Information* specifically addresses the understanding of the real estate appraisal process and the independent accountant's use of real estate appraisal information.

9.61 If the independent accountant finds that the appraisal or valuation information is deficient, the independent accountant should request that management secure additional information. Also, the independent accountant might consider selecting and hiring the appraiser or consultant directly.

9.62 ***Testing of Source Documents.*** The independent accountant should consider performing tests to determine that the loans are categorized in accordance with the objectives established and classified in accordance with the institution's loan review system. Detailed testing should focus on documents that are relevant to the institution's methodology.

9.63 ***Large Groups of Loans.*** For loans that are pooled for purposes of determining the allowance for loan losses, the focus of testing is not on individual loan files, and the collectibility of individual loans is generally not tested directly. Rather, the independent accountant generally reviews and tests for compliance with the institution's chargeoff and nonaccrual policy and tests the completeness and accuracy of historical data and reports, such as delinquency reports, that are relied upon in estimating the allowance for such loans.

9.64 For example, loan categories represented by large volumes of relatively small loans with similar characteristics, such as residential real estate mortgages, consumer loans, and credit-card loans, are generally evaluated on an aggregate, or pool, basis. The independent accountant is generally more concerned with the effectiveness of and adherence to procedures related to valuing such loans than with a critical appraisal of each individual loan. Unless unusual circumstances exist, the testing or procedures and the review of delinquency status reports should permit the independent accountant to draw a conclusion about the adequacy of the allowance required for those loan categories. In evaluating the adequacy of the portion of the allowance attributable to those loans, use of unadjusted historical annual chargeoff experience may not be sufficient in itself but should be considered in light of consistent application of loan policies and current and anticipated economic conditions based on facts in evidence at the balance-sheet date.

9.65 ***Individual Loan Review.*** Although the independent accountant's primary responsibility when reviewing the allowance for loan losses is evaluation of its adequacy as a whole, practical considerations may dictate that the review be directed to the separate categories of loans that constitute the institution's portfolio. Because the risk and other inherent characteristics of primary loan categories vary, the nature and extent of the separate reviews also can be expected to vary.

9.66 Conversely, an evaluation of commercial loans generally requires a more detailed review, since the amount of an individual loan is generally large and the type of borrower, purpose of the loan, and the timing of cash flows may be dissimilar. More important, a relatively small number of potential losses can significantly affect the adequacy of the allowance. In these circumstances, the independent accountant may select and review in detail a number of problem loans.

9.67 In addition to identified problem loans, the independent accountant may select other commercial loans to include in the detailed loan file review. The selection of these additional loans generally includes a stratum of large loan balances above specified limits, loans from other sources (such as related parties and industry concentrations), and some loans selected without regard to size or other specific criteria. The independent accountant generally will be concerned with the total credit exposure of the borrower, including standby letters of credit and other commitments to lend, rather than with individual loan balances. Based on the independent accountant's evaluations and tests, the number of loans reviewed might be limited when the internal loan review function is deemed adequate in identifying and classifying problem credits.

9.68 The extent of an individual loan review varies from loan to loan. For example, a loan that has been subjected to a recent management review, an effective internal review, or a recent regulatory review may be reviewed in less detail than a loan that has not had some or all of those reviews.

9.69 An institution's exempt portfolio could be material to its financial statements. The exemption of certain loans from examiner review and criticism pursuant to the March 30, 1993, regulatory policy (see paragraph 9.25) does not extend to management's financial reporting responsibilities or to the independent accountant's responsibility in financial statement audits or other engagements involving management assertions about the exempt loans. An independent accountant's assessment of management assertions about the allowance for credit losses may depend on the availability of certain documentation, including adequate collateral appraisals or current and complete financial information about borrowers or guarantors. The March 1993 policy may affect the availability of such documentation. Independent accountants are cautioned against undue reliance on management representations when no supporting evidence exists.

9.70 For each loan selected for review, the independent accountant may prepare a loan review worksheet or other memoranda documenting the procedures performed and summarizing the conclusions reached. Exhibit 7.2 is an example of a loan review form that could be used for a commercial loan. It can also be adapted to other types of loans. For loans reviewed previously, the independent accountant typically updates prior reviews for new information concerning the loan. In addition, the independent accountant usually reviews correspondence updating classified loans, workpapers prepared by the institution's internal loan review personnel, and any regulatory examiner reports (including those with information on shared national credits). Such data often provide additional information concerning the loan and how management considered the loan in determining the allowance for loan losses.

Exhibit 9.2

Sample Loan Review Form

Client ______________________________

Audit Date ______________________________

Borrower's Name ______________________________

Nature of Business ______________________________

Purpose of Loan ______________________________

I. Borrower's Notes

Description	*Effective Interest Rate*	*Direct Loan or Participation*	*Line of Credit/ Commitment Amount*	*Outstandings* *Principal*	*Outstandings* *Interest*
				________	________
Total loans outstanding at preliminary			__/__/__	________	________
Total loans outstanding at year-end			__/__/__	________	________

Accrual basis (Y/N) ____________________

Repayment Schedule: ______________________________

Indicate probable repayment schedule,if different from contractual schedule.

Approach used to estimate impairment (check one):

__ Present value of cash flows

__ Fair value of collateral

__ Market value of loan

Repayment Status: ______________________________

	Principal	*Interest*
Amount past due	________	________
Last payment:		
Date	________	________
Amount	________	________

(continued)

II. Contingencies/Guarantees (e.g., letters of credit, participations sold with recourse)

Total at preliminary	________
Total at year-end	________

III. Related Loans

Obligor	*Relationship*	*Maturity Date*	*Commitment Amount*	*Outstandings*
				________
	Total related loans			________

IV. Collateral Summary

Description	*Gross Value*	*Prior Liens*	*Value to Lender*	*Basis for and Date of Valuation (e.g.,appraisal,market value quotes)*
	______	______	______	____________________
Total	______	______	______	____________________

V. Guarantors

VI. Loan Grade

Regulatory		*Institution's In-House*	
Classification	*Amount*	*Classification*	*Amount*
Special mention			
Substandard			
Doubtful			
Loss			
Unclassified	______		______
Total	______		______

Is the loan impaired not defined in FASB Statement No. 114 (Y/N)? ______

VII. Financial Data

Auditors ____

Type of opinion ________________ Last audit date ___________________

	Interim		*Fiscal Year*	
	Current Year ___ months ended	*Prior Year ___ months ended*	*Current Year*	*Prior Year*
	/ /	/ /	/ /	/ /
Current assets				
Current liabilities	________	________	________	________
Working capital	________	________	________	________
Total assets				
Total liabilities	________	________	________	________
Net worth	________	________	________	________
Net sales	________	________	________	________
Net income	________	________	________	________
Cash flow	________	________	________	________

VIII. Loan Officer

Comments

(Provide a narrative analysis prepared by [or through inquiry of] the loan officer of collectibility including estimated repayment dates, sources of repayment, adequacy of collateral to cover outstanding principal and interest, financial data on guarantors, and rationale for any estimated allowance allocation, chargeoff, or both.)

Institution's estimated specific allowance allocation, chargeoff, or both and management's supporting rationale:

IX. Independent Accountant's Summary ________________________________

X. Conclusion (including the amount and basis for independent accountant's estimated loss exposure) ____

9.71 For many loans, the independent accountant should discuss the status and background of the loans reviewed with the responsible loan officer and the loan review officer. In addition to providing information about the loans, such discussions may provide the independent accountant with information about the loan officer's and loan review officer's attitudes and degree of awareness of the status of loans and internal controls.

9.72 In reviewing individual loans, the independent accountant should review the institution's analysis of the borrower's financial resources, liquidity and future cash flows, and other financial forecasts, particularly for unsecured loans for which repayment is dependent on the borrower's ability to generate funds from profitable operations. The independent accountant should consider measuring such financial data against the trends and norms, both historical and forecasted, for both the borrower being reviewed and the industry in which the borrower operates. It is preferable that the institution's analysis be supported by current audited financial statements, although financial statements that have been reviewed or compiled by the borrower's independent accountant or prepared internally by the borrower may be useful.

9.73 If the independent accountant deems the financial information inadequate, the independent accountant should discuss the situation with the appropriate official. The results of such discussion or the inability of the institution to obtain adequate financial information should be considered in evaluating the collectibility of the loan. If adequate financial information is not available for significant loans, the independent accountant should notify management that a scope limitation may result.

9.74 For loans secured by collateral, a careful evaluation and valuation of that collateral is often necessary. In such circumstances, the independent accountant should evaluate the security interest in the collateral to determine how the institution knows that it has been perfected by execution and recording of the appropriate legal documents. The independent accountant should also review the reasonableness of the institution's collateral valuation by referring to quoted market prices or other pertinent sources, such as a specialist's appraisals or engineering reports.

9.75 The independent accountant may test the existence of the collateral by physical observation, independent confirmation, or other appropriate procedures, especially when the institution is involved in loans secured by marketable securities or in asset-based lending, which may include loans secured by inventories, equipment, or receivables. For collateral in the form of marketable securities, the independent accountant may evaluate whether such securities are under the institution's control, either in its own vault or in a safekeeping account in the institution's name maintained with an independent, third-party custodian. In the latter case, the independent accountant may wish to evaluate the independent custodian's ability to perform under its obligation. The AICPA's *Report of the Special Task Force on Audits of Repurchase Securities Transactions* discusses additional considerations applicable to loans collateralized with marketable securities. For other types of collateral, there should be documentation that the institution has verified the existence of the collateral. In the absence of such documentation, the independent accountant should perform these or other collateral verification procedures, especially for significant loans for which collectibility is otherwise questionable. The auditor should also consider the accounting consequence under FASB Statement No. 125 of the degree of control over collateral maintained by the institution.

9.76 For loans supported by personal guarantees, the independent accountant may perform a review solely of the borrower's ability to pay. However, if the review indicates the guarantor may be a source of repayment, the independent accountant should also review the financial statements and other pertinent information about the guarantor as if the guarantor were the borrower. It is also important to consider the extent of, as well as the institution's policies and practices for, pursuing guarantees and to evaluate, perhaps in consultation with an attorney, the enforceability and scope of the guarantee.

9.77 The substance of a guarantee depends on (*a*) the ability and willingness of the guarantor to perform under the guarantee, including a determination of whether the guarantor has other guarantees outstanding that might be pursued, *(b)* the practicality of enforcing the guarantee in the applicable jurisdiction, *(c)* the scope of the guarantee (that is, whether it covers all principal and interest or has a limit), and *(d)* a demonstrated intent by the institution to enforce the guarantee. Even if the guarantee is legally enforceable, the independent accountant should attempt to determine if there are business reasons that might preclude the institution from enforcing the guarantee. Those business reasons could include the length of time required to enforce a guarantee, whether it is normal business practice to enforce guarantees on similar transactions, or whether the institution must choose between pursuing the guarantee or the underlying collateral, instead of pursuing both.

9.78 ***Participation and Purchased Loans.*** Management should have the information necessary to authorize, monitor, and review participation loans and to estimate any related allowance for loan losses. The collectibility of participation loans (whether at the lead institution or at a participating institution) is normally evaluated in light of the entire amount of the loan, not just of the share held by the institution. Accordingly, the participating institution should supplement documentation by the lead institution with its own investigation and credit analysis. The participating institution should not rely on the lead institution to monitor the credit. Certain large participation arrangements are reviewed by regulators, who issue a shared national credit report detailing their classification and rationale to the lead and all participating institutions. The independent accountant's objectives in testing loans for a participating institution is the same as for other loans. For example, the repayment status, borrowers' financial statements, and appraisals should be considered.

9.79 The independent accountant usually confirms the existence and terms of significant participations (both purchased and sold) with the debtor and lead institution. In addition, the independent accountant normally reviews the related loan file documentation. For participations, the loan files should contain the same information as other loan files.

9.80 ***Chargeoffs and Recoveries.*** The independent accountant should consider testing the propriety of chargeoffs and recoveries. Substantive detail testing in this area may be minimized if tests of controls and analytical procedures on chargeoffs and recoveries are performed.

9.81 ***Analytical Procedures.*** The independent accountant should perform overall analytical tests to supplement the detailed tests of the reasonableness of the allowance. These analytical tests may use statistics relating to the allowance as compared to related income statement accounts, net chargeoff rates, nonperforming loan levels and other loan categories, historical experience, and peer results. Various analytical techniques can be utilized to assist the independent accountant in determining the adequacy of the allowance.

9.82 ***Conclusions.*** At the conclusion of the testing, the independent accountant should consider whether management's estimate of the allowance for loan losses is reasonable in relation to the financial statements taken as a whole. Since no one estimate of the allowance can be considered accurate with certainty, the independent accountant may, based on the testing performed and understanding of the facts and circumstances, determine a range for the allowance considered reasonable. If the institution's estimate is outside that reasonable range, the independent accountant should treat the difference between the institution's estimate and the closest reasonable estimate as a likely error and aggregate it with other likely errors, which the independent accountant must consider before reporting on the financial statements taken as a whole.

9.83 Furthermore, during their examinations of depository institutions, regulators focus a great deal of attention on the allowance for loan losses. Failure to maintain an adequate allowance is considered an unsafe or unsound practice. Due to the subjectivity involved in estimating the allowance, the allowance amounts determined to be adequate by management and the regulatory examiners may differ. The FASB's Emerging

Issues Task Force (EITF) reached a consensus in Issue No. 85-44, *Differences between Loan Loss Allowances for GAAP and RAP*, that the amount of the allowance reported in an institution's financial statements may differ from the amount reported for regulatory purposes. However, the EITF warned that independent accountants should be particularly skeptical of such differences and must justify them based on the particular facts and circumstances.

CHAPTER 10

Transfers of Loans and Mortgage Banking Activities

INTRODUCTION

10.01 Mortgage banking activities consist primarily of the purchase or origination of mortgage loans for sale to secondary market investors and the subsequent servicing of those loans. Mortgage loans can be grouped together and sold outright or pooled and securitized with or without a credit enhancement such as the guarantee of a federal agency or government-sponsored enterprise (GSE). This chapter discusses mortgage banking, as well as other sales or securitizations of loans.

10.02 Access to the secondary mortgage market is an important source of liquidity for banks and savings institutions. Many institutions have deposit bases that are keyed to variable rates and, therefore, are particularly sensitive to interest-rate risk. A variable-rate deposit base cannot fund long-term, fixed-rate assets without creating significant loss exposure in rising interest-rate environments. Therefore, sales of mortgage loans and servicing rights in the secondary market and the accompanying gains and losses and creation of income streams from servicing and other fees are an important source of funds to many institutions. Access to the secondary market also provides opportunities to restructure existing long-term portfolios.

10.03 The primary participants in the secondary market for residential financing are GSEs such as Federal Home Loan Mortgage Corporation (Freddie Mac) and Federal National Mortgage Association (Fannie Mae) and federal agencies such as Government National Mortgage Association (Ginnie Mae) and the Department of Veterans' Affairs (VA). These entities participate in the secondary market as issuers, investors, or guarantors of asset-backed securities (ABSs) such as mortgage-backed securities (MBSs), real estate mortgage investment conduits (REMICs), and collateralized mortgage obligations (CMOs). (Chapter 5 describes ABS transactions and considerations for investors in ABSs.) Many private entities are also active in the secondary market as issuers and investors.

10.04 When mortgage loans are originated for sale, the process includes not only finding an investor but also preparing the loan documents to fit the investor's requirements. Mortgage loans originated for sale normally must comply with specific standards governing documentation, appraisal, mortgage insurance, loan terms, and borrower qualifications. Investors will typically review underlying documentation prior to completing their purchase. Individual loans that fail to meet the specified criteria are eliminated from the pool of loans eligible for sale. If exceptions cannot be corrected, the selling institution may have to either find alternative investors or transfer the loan to the institution's portfolio. In most cases, the originating institution may be subject to recourse by the investor for underwriting exceptions identified subsequent to the sale of the loans and any related defaults by borrowers.

10.05 The extent to which mortgage loans are originated for sale will differ for each institution. Factors such as liquidity, interest-rate exposure, asset/liability management policy, and capital considerations will influence the nature and extent of an institution's mortgage banking activities. One institution may manage its interest-rate risk position by intentionally selling all fixed-rate mortgage loans it originates, while another institution may originate a variety of both fixed- and variable-rate loan products for sale.

Asset Backed Securitizations

10.06 Securitization is often utilized by lending institutions to diversify funding sources. In some markets, securitization has reduced entry barriers and increased competition. Securitization involves the sale, generally to a trust, of a portfolio of loan receivables. Asset backed certificates are then sold by the trust to investors through a private placement or public offering. Typically the company will retain the servicing rights for the loans sold to the trust. A subordinated interest in the trust is also typically retained by the company, serving as a credit enhancement to the asset backed certificates. Such structures provide the opportunity for less credit worthy companies to obtain funding at competitive levels through the asset backed and other structural characteristics of securitization vehicles.

Loan Servicing

10.07 When mortgage or other loans are sold, the selling institution sometimes retains the right to service the loans for a servicing fee, normally expressed as a percentage of the principal balance of the outstanding loans, that is collected over the life of the loans as payments are received. A typical servicing agreement requires the servicer to carry out the servicing function, including billing and collection of borrowers' payments; remittance of payments to the investor, insurers, and taxing authorities; maintenance of custodial bank accounts; and related activities. The agreement also may involve significant risks being retained by the servicer such as allowing the investor recourse to collect certain credit losses from the servicer. Serviced loans may have been originated by the servicer institution itself or by other financial institutions. When servicing mortgages for service agents such as GNMA, FNMA, or FHLMC, institutions must meet certain minimum net-worth requirements. Inability to meet the requirements may result in termination of the service contracts.

REGULATORY MATTERS

10.08 The federal banking agencies limit the aggregate amount of servicing assets, which includes mortgage servicing assets, that may be included in regulatory capital.

10.09 On December 13, 1999, the federal banking agencies jointly issued the Interagency Guidelines on Asset Securitization which highlight the risks associated with asset securitization and emphasizes the agencies' concerns with certain retained interests generated from the securitization and sale of assets. The guidelines set forth the supervisory expectation that the value of retained interests in securitizations must be supported by objectively verifiable documentation of the assets' fair market value, utilizing reasonable, conservative valuation assumptions. Retained interests that do not meet such standards or that fail to meet the supervisory standards outlined in the guidance will be disallowed as assets of the bank for regulatory capital purposes. The guidance stresses the need for bank management to implement policies and procedures that include limits on the amount of retained interests that may be carried as a percentage of capital. Institutions that lack effective risk management programs or engage in practices deemed to present other safety and soundness concerns may be subject to more frequent supervisory review, limitations on retained interest holdings, more stringent capital requirements, or other supervisory response.

ACCOUNTING AND FINANCIAL REPORTING

Mortgage Loans and MBSs Held for Sale

10.10 FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities,* establishes the accounting for mortgage loans held for sale.

10.11 Paragraph 6 of FASB Statement No. 65, as amended by FASB Statement No. 134, *Accounting for Mortgage Loans Held for Sale by a Mortgage Banking Enterprise*, requires that after the securitization of a mortgage loan held for sale, any retained mortgage-backed securities shall be classified in accordance with the provisions of FASB Statement No. 115. However, a mortgage banking enterprise must classify as trading any retained mortgage-backed securities that it commits to sell before or during the securitization process. Paragraph 4 of FASB Statement No. 65 says that mortgage loans held for sale should be reported at the lower of cost or market value, determined as of the balance-sheet date. Paragraph 4 requires that changes in the valuation allowance should be included in the determination of net income of the period in which the change occurs. Paragraph 4 requires that the amount by which the cost of such loans exceeds their market value should be accounted for as a valuation allowance.

10.12 Paragraph 6 of FASB Statement No. 65, as amended by FASB Statement No. 134 requires that after the securitization of a mortgage loan held for sale, any retained mortgage-backed securities shall be classified in accordance with the provisions of FASB Statement No. 115. However, a mortgage banking enterprise must classify as trading any retained mortgage-backed securities that it commits to sell before or during the securitization process. Paragraph 6 of FASB Statement No. 65 requires that mortgage loans transferred from loans held for sale to long-term-investment classification should be valued at the lower of cost or market on the date of transfer.

10.13 Paragraph 9 of FASB Statement No. 65 says that either the aggregate or individual loan basis may be used in determining the lower of cost or market value for each type of mortgage loan. Paragraph 9 of FASB Statement No. 65, as amended by FASB Statement No. 115, states that the market value of committed mortgage loans and uncommitted mortgage loans should be determined separately as follows:

- *a.* Committed loans should be valued based on fair values. The contractual service fee should be valued in accordance with FASB Statement No. 65.
- *b.* Uncommitted loans should be valued based on the market in which the institution normally operates:
  - (1) Market prices and yields sought by the mortgage banking enterprise's normal market outlets
  - (2) Quoted Ginnie Mae security prices or other public market quotations for long-term mortgage loan rates
  - (3) Freddie Mac and Fannie Mae current delivery prices

10.14 Paragraph 12 of FASB Statement No. 65 requires, in part, that the carrying amount of mortgage loans to be sold to an affiliated enterprise (as defined) should be adjusted to the lower of cost or market value of the loans as of the date management decides that a sale to an affiliated enterprise will occur. Paragraph 13 of the Statement requires, in part, that, if a particular class of mortgage loans or all loans are originated exclusively for an affiliated enterprise, the originator is acting as an agent of the affiliated enterprise, and the loan transfers should be accounted for at the originator's acquisition cost.

Transfers and Servicing of Loans

10.15 Once a decision has been made to sell loans not classified as held for sale, they should be carried at the lower of cost or market value. As discussed beginning in paragraph 7.84, FASB Statement No. 125[*] provides accounting and reporting standards for transfers of financial assets, including transfers of loans.

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[*] The FASB has issued an Exposure Draft, *Accounting for Transfers of Financial Assets-an amendment of FASB Statement No. 125*, that would revise standards for transfers of financial assets by modifying criteria and guidance for determining whether the transferor has relinquished control of assets and the transfer is therefore accounted for as a sale. The FASB anticipates issuing a Final Statement during 2000. Readers should be alert to any final pronouncement. The FASB has published a Special Report entitled, *A Guide to Implementation of Statement 125 on Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities—Questions and Answers—Third Edition.*

FASB Statement No. 115 addresses accounting for securities, including pools of loans that have been securitized.

10.16 Variable-rate loans are generally sold at stated rates, with gain or loss measurement based on a premium or discount on the face value of the portfolio to be sold. Fixed-rate loans are generally sold at a discount or premium to provide a specified yield to the investor, and the corresponding gain or loss is based on the difference between the yield of the loans to be sold and the contractual yield to the investor. The yield on a pool of loans is the calculated weighted-average interest rate for that pool.

Transfers of Loans With Recourse

10.17 Institutions may transfer loans with recourse. This may be done to deliver loans into a particular investor's commitment program, to obtain a better price, or both. For example, a seller may be required to make full or partial payment to the purchaser if the debtor fails to pay when payment is due. Similarly, a seller may be required to make payments to the purchaser as the result of loan prepayments or because of adjustments resulting from defects (such as failure to perfect a security interest in collateral) of the transferred loans. In some cases (for example, student loans), underwriting exceptions identified subsequent to the transfer of loans may subject the seller to additional recourse risk if the borrower defaults on the loan. Because of the continuing risk of delinquency and foreclosure, the institution's management should carefully evaluate its potential contingent liabilities with respect to such loans. FASB Statement No. 125 provides guidance on accounting for transfers of loans with recourse. EITF Issue No. 92-2, *Measuring Loss Accruals by Transferors for Transfers of Receivables with Recourse*, states that obligations recorded by a transferor under the recourse provisions relating to the transfer of a receivable should include all probable credit losses over the life of the receivable transferred, and not only those measured and recognized under FASB Statement No. 5, *Accounting for Contingencies*, prior to the transfer. Paragraph 11c of FASB Statement No. 125 says that upon completion of a transfer that satisfies the conditions to be accounted for as a sale, the transferor shall initially measure at fair value liabilities incurred in a sale.

Servicing Rights

10.18 Servicing rights are significant assets for some institutions. They have value in addition to the servicing fee value because of the servicer's ability to invest the "float" that results from payments that are received from borrowers but are not yet passed on to the investors in the loans. Additionally, intrinsic value components of servicing rights include ancillary income, such as late-payment charges and prepayment charges. Accordingly, servicing rights, either separately or as part of a loan, are generally readily purchased and sold.

10.19 ***Recognition and Measurement of Servicing Assets and Liabilities.*** Paragraph 13 of FASB Statement No. 125 addresses recognition and measurement of servicing assets and liabilities, including mortgage servicing rights. Paragraph 13 requires that each time an institution undertakes an obligation to service financial assets it should recognize either a servicing asset or a servicing liability for that servicing contract, unless it securitizes the assets, retains all of the resulting securities, and classifies them as debt securities held-to-maturity in accordance with FASB Statement No. 115. Paragraph 13 says, if the servicing asset or liability was purchased or assumed rather than undertaken in a sale or securitization of the financial assets being serviced, it should be measured initially at its fair value, presumptively the price paid. Paragraph 13 requires that a servicing asset or liability be amortized in proportion to and over the period of estimated net servicing income (if servicing revenues exceed servicing costs) or net servicing loss (if servicing costs exceed servicing revenues). Paragraph 13 says a servicing asset or liability should be assessed for impairment or increased obligation based on its fair value.

10.20 Paragraphs 35 through 41 of FASB Statement No. 125 provide related guidance. Paragraph 37 of FASB Statement No. 125 specifies the accounting for a contract to service financial assets separately from those assets.

10.21 ***Sales of Servicing Rights***. Sales of servicing rights relating to loans previously sold should be recognized in income subject to the considerations discussed below. Sales of servicing rights relating to loans that are retained should also be recognized in income subject to the considerations below. At the date of sale, the carrying amount should be allocated between the servicing rights and loans retained using fair values in a manner consistent with paragraph 10(b) of FASB Statement No. 125.

10.22 In general, three to six months elapse between entry into a contract to sell servicing rights and actual delivery of the loan portfolio to be serviced. These delays may result from the purchaser's inability to accept immediate delivery, the seller's inability to immediately transfer the servicing records and loan files, difficulties in obtaining necessary investor approval, requirements to give advance notification to mortgagors, or other planning considerations. Issues relating to the transfer of risks and rewards between buyers and sellers of servicing rights may be complex.

10.23 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 whether certain provisions of agreements to sell mortgage servicing rights preclude the recognition of a sale at the date title passes, or whether the sale should be recognized at that date with accrual of any estimated liability. In Issue No. 95-5, the EITF reached a consensus that sales of rights to service mortgage loans should be recognized when the following conditions have been met (1) title has passed, (2) substantially all risks and rewards of ownership have irrevocably passed to the buyer and (3) any protection provisions retained by the seller are minor and can be reasonably estimated. If a sale is recognized and minor protection provisions exist, a liability should be accrued for the estimated obligation associated with those provisions. The seller retains only minor protection provisions if (a) the obligation associated with those provisions is estimated to be no more than 10 percent of the sales price and (b) risk of prepayment is retained for no longer than 120 days.

10.24 The EITF carried forward from Issue No. 89-5 the consensus that a temporary subservicing agreement in which the subservicing will be performed by the seller for a short period of time would not necessarily preclude recognizing a sale at the closing date.[1]

10.25 Criteria that should be considered when evaluating whether a transfer of mortgage servicing rights qualifies as a sale should include—

- Whether the seller has received written approval from the investor if required.[2]
- Whether the buyer is a currently approved seller/servicer and is not at risk of losing approved status.
- In the event of a sale in which the seller finances a portion of the sales price, whether an adequate nonrefundable down payment has been received (necessary to demonstrate the buyer's commitment to pay the remaining sales price) and whether the note receivable from

[1] Issue No. 95-5 also says that the consensus carried forward from Issue No. 89-5 supersedes the consensuses reached by the EITF in Issue No. 89-5.

[2] Servicing rights may be purchased by brokers or investment bankers that intend to seek buyers for the rights. Although such purchases cannot be canceled, approval of transfer of the rights is not requested by the seller until the broker enters into a transaction with the third-party purchaser. Thus, such transactions should generally be characterized as financing transactions and a sale has not occurred until an approval of transfer of rights has been requested, even though other contingencies are resolved.

the buyer provides full recourse to the buyer. Nonrecourse notes or notes with limited recourse (such as to the servicing) are not acceptable.

10.26 EITF Issue No. 85-13, *Sale of Mortgage Service Rights on Mortgages Owned by Others*, addresses whether (and how) gains should be recorded on such sales.

10.27 EITF Issues No. 87-34, *Sale of Mortgage Servicing Rights with a Subservicing Agreement*, and No. 90-21, *Balance Sheet Treatment of a Sale of Mortgage Servicing Rights with a Subservicing Agreement*, provide additional guidance.

VA No-Bids and Private Mortgage Agencies

10.28 Historically, the VA paid lenders 100 percent of the outstanding debt on defaulted loans that the VA guaranteed. In return, the lenders turned the borrowers' houses over to the VA, which would dispose of them. The VA has the option of guaranteeing the lesser of 60 percent of a loan's original balance or $27,500, leaving the property with the lender if that is less costly for the agency. Called a *no-bid option*, this practice was seldom used, especially since inflation pushed up housing prices during the late 1970s and early 1980s. However, as inflation began to slow and the costs of carrying foreclosed houses began to rise, the VA began to invoke the no-bid option. The amount of no-bid activity has increased sharply in the last few years. Particularly hard hit have been mortgage lenders in economically depressed areas, such as energy-producing and agricultural regions of the United States. Institutions may incur losses due to the uncollectibility of receivables from other government programs such as the Federal Housing Administration (FHA) or Ginnie Mae, from other investors such as Freddie Mac and Fannie Mae, or from insolvent private mortgage insurers.

10.29 With the increased risk of foreclosure losses (including unrecoverable interest advances; foreclosure costs such as attorneys' fees, inspections, and so forth; and the implicit cost to carry the asset until ultimate sale), the evaluation of loss allowances on VA and privately insured mortgage loans has become increasingly difficult. Chapter 9 provides guidance on the valuation of foreclosed real estate, and chapter 7 provides guidance on the evaluation of the collectibility of real estate loans.

Financial Statement Presentation and Disclosure

10.30 Loans held for sale should be presented separately on the face of the balance sheet and should be reported at the lower of cost or market value.* Paragraph 6 of FASB Statement No. 65, as amended by FASB Statement No. 134, *Accounting for Mortgage Loans Held for Sale by a Mortgage Banking Enterprise*, requires that after the securitization of a mortgage loan held for sale, any retained mortgage-backed securities shall be classified in accordance with the provisions of FASB Statement No. 115. However, a mortgage banking enterprise must classify as trading any retained mortgage-backed securities that it commits to sell before or during the securitization process. The aggregate amount of gains or losses on sales of loans (including adjustments to record loans held for sale at the lower of cost or market value) should be presented separately on the face of the income statement. Per paragraph 9 of FASB Statement No. 102**,** net cash flows

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* FASB Statement No. 133 amends the FASB Statement No. 65 to require that if a mortgage loan has been the hedged item in a fair value hedge, the loan's "cost" basis used in the lower-of-cost-or-market accounting shall reflect the effect of adjustments to its carrying amount made pursuant to paragraph 22(b) of FASB Statement No. 133.
FASB Statement No. 133, as amended by FASB Statement No. 137, *Accounting for Derivative Instruments and Hedging Activities - Deferral of the Effective Date of FASB Statement No. 133*, is effective for all fiscal quarters of fiscal years beginning after June 15, 2000. A summary of FASB Statement No. 133 is provided in chapter 15 of this Guide. On March 3, 2000, the FASB issued an Exposure Draft, *Accounting for Certain Derivative Instruments and Certain Hedging Activities —an Amendment of FASB Statement No. 133*. Readers should be alert to any final pronouncement. The FASB has established the Derivative Implementation Group (DIG) to assist the Board and its staff in providing implementation guidance regarding FASB Statement No. 133. Issues addressed by the DIG and the status of related guidance can be found at the FASB's Web site at www.fasb.org.

from purchases, originations, and sales of loans held for sale should be classified as operating cash flows. Net cash flows from sales of other loans should be classified as investing cash flows.

10.31 Paragraph 29 of FASB Statement No. 65 requires that the financial statements should disclose the method used in determining the lower of cost or market value of mortgage loans (that is, aggregate or individual loan basis).

10.32 As discussed in paragraph 5.104, paragraph 17 of FASB Statement No. 125 requires certain disclosures about transfers and servicing of financial assets. Paragraph 17d of the Statement requires that, if it is not practicable to estimate the fair value of certain assets obtained or liabilities incurred in transfers of financial assets during the period, the entity must disclose a description of those items and the reasons why it is not practicable to estimate their fair value.

10.33 Paragraph 17e of FASB Statement No. 125 requires that an entity disclose the following for all servicing assets and servicing liabilities:

a. The amounts of servicing assets or liabilities recognized and amortized during the period.

b. The fair value of recognized servicing assets and liabilities for which it is practicable to estimate that value and the method and significant assumptions used to estimate the fair value.

c. The risk characteristics of the underlying financial assets used to stratify recognized servicing assets for purposes of measuring impairment in accordance with paragraph 37 of the Statement.

d. The activity in any valuation allowance for impairment of recognized servicing assets including beginning and ending balances, aggregate additions charged and reductions credited to operations, and aggregate direct write-downs charged against the allowances for each period for which results of operations are presented.

AUDITING

Objectives

10.34 Audit objectives and procedures for loan origination and underwriting are discussed in chapter 6. Audit objectives and procedures for securities, including MBSs, are addressed in chapter 5. The primary audit objectives in this area are to obtain reasonable assurance that—

a. Loans held for sale exist and are the property of the institution.

b. Loans held for sale are valued at the lower of cost or market value.

c. Loans held for sale are properly classified, described, and disclosed in the financial statements.

d. Escrow advances are properly recorded and collectibility is reasonably assured.

e. Gains and losses on the transfer of loans or servicing rights are properly measured, recorded, and disclosed.

f. Retained interests, obligations, and servicing rights are properly recognized and measured initially and on an ongoing basis.

g. Proper title has passed to the holder of purchased servicing rights.

Planning

10.35 In planning the audit, the independent accountant should consider the factors influencing inherent risk, which are described in chapter 5, as they relate to financial statement assertions about loan transfers and mortgage banking activities. The independent accountant should obtain an understanding of loan transfer activities. The independent accountant should inquire about the nature and frequency of transfers, the types of loans transferred, and the nature of obligations incurred. The independent accountant should inquire about the bookkeeping and reporting systems employed both at the time of transfer and thereafter for retained interests and ongoing obligations.

10.36 The independent accountant should obtain an understanding of mortgage banking activities in which the institution is engaged. The independent accountant should inquire about how the mortgage banking activities relate to management's objectives for managing interest-rate risk and enhancing liquidity. The independent accountant should inquire about the reporting systems used by management to account for mortgage banking activities and should consider whether management has sufficient data to evaluate loan sale transactions, identify loans held for sale, and track mortgage loan commitments and applications. Such information is usually needed to manage risks arising from mortgage banking activities.

10.37 Institutions acting as servicers of loans have a fiduciary responsibility to parties under the agreement. Failure to meet these responsibilities may result in contingent liabilities that could have a material effect on an institution's financial statements. Under contracts with third parties such as Ginnie Mae, Freddie Mac, Fannie Mae, and the Department of Housing and Urban Development (HUD), an institution must meet certain minimum net worth requirements. Failure to meet the requirements could result in termination of the servicing contract. In addition, the independent accountant should consider whether an institution's servicing systems ensure proper controls over investor and escrow accounts (for example, for taxes and insurance or loan principal and interest) and evaluate the potential for contingencies liabilities associated with noncompliance with investor-servicing requirements.

10.38 Contractual agreements with Ginnie Mae, Freddie Mac, Fannie Mae, HUD, or other investors may require engagements related to aspects of the contractual agreement or to the Uniform Single Attestation Program (USAP) for Mortgage Bankers. These agreements may require confirmation work on the actual loans being serviced under specific contracts.

Internal Control Over Financial Reporting and Possible Tests of Controls

10.39 SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), provides guidance on the independent accountant's consideration of an institution's internal control in an audit of financial statements performed in accordance with GAAS. It describes the components of internal control and explains how an independent accountant should consider internal control in planning and performing an audit. Paragraph 19 of SAS No. 55, as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55*, requires that, in all audits, the independent accountant obtain sufficient understanding of each of the five components (the control environment, risk assessment, control activities, information and communication, and monitoring) to plan the audit by performing procedures to understand the design of policies and procedures relevant to audit planning and whether they have been placed in operation.

10.40 The discussions of internal control activities in chapters 8 and 9 are also relevant to loan transfers and mortgage banking activities.

10.41 ***Policies and Procedures.*** Examples of typical internal control activities relating to financial reporting of mortgage banking activities include—

- Use of a quality control function to monitor underwriting and documentation practices.
- Executive management review of open and pending commitments to buy or sell and strategies to minimize exposure to changing interest rates.

- Loans sold with servicing retained are properly identified for derecognition.
- Periodic reconciliation of cash receipts and payments applied to the servicing (custodial) system.
- Periodic reconciliations of custodial accounts (the frequency of reconciliation should be determined by the level of account activity).
- Periodic reconciliation of servicing fees received to servicing fee income recorded in the general ledger.
- Periodic evaluation of the recoverability of servicing rights and other capitalized costs.

10.42 Examples of typical internal control activities relating to financial reporting of loan transfers include:

- Approval of sales by appropriate officers or committees.
- Periodic reconciliations of detailed trial balances to the general ledger balance of loans held for sale.
- Periodic review of the outstanding loans and locked-in borrower commitments for proper valuation.
- Procedures in place to ensure that interest and fee income and gains/losses on sales are properly recorded, and information required for GAAP disclosures is available.
- Procedures in place to ensure that retained interests and servicing rights and obligations are properly accounted for initially and on an ongoing basis.

10.43 After obtaining an understanding of internal control activities related to mortgage banking activities, the independent accountant may conclude that the controls that have been placed in operation are likely to be effective and that audit efficiency can be improved by assessing control risk at below the maximum. Tests of controls that may be used to obtain evidence to support such an assessment include:

- Selecting a sample of borrower remittances and testing allocation of payment amounts to income, principal, escrow, and service fee accounts.
- Reviewing custodial account reconciliations and supporting documentation to ensure that all activity is processed and cleared currently.
- Selecting a sample of delinquent loans serviced and considering whether collection and follow-up procedures are performed on a timely basis and are in accordance with investor requirements.
- Examining loan documentation. (See chapter 8.)

10.44 The following are tests of controls that may be used by the independent accountant to ensure that internal controls over financial reporting of loan transfers are operating effectively:

- Examine applicable loan sale and servicing agreements.
- Determine that the appropriate personnel understand the accounting treatment for sales of loans and related financial reporting implications.
- Examine accounting records to determine that verfication procedures are effectively performed to ensure interest and fee income and gains/losses on sales of loans are properly recorded.

Substantive Tests

10.45 The independent accountant should determine the nature, timing, and extent of substantive tests based on an assessment of both inherent risk and control risk. Substantive tests that the auditor should consider include[3]

- Selecting a sample of borrower remittances and testing allocation of payment amounts to income, principal, escrow, and service fee accounts.

- Reviewing and testing the documentation supporting escrow and investor account reconciliations. Custodial accounts may be off-balance-sheet accounts. Accordingly, the independent accountant may need to select custodial accounts from records independent of the general ledger. In this case, the independent accountant may need to perform separate tests of the completeness and accuracy of custodial records.
- Evaluating the propriety of loan classifications to determine that all loans held for sale within the loan portfolio are properly identified. In evaluating whether loans are held for sale or in the loan portfolio, the independent accountant should consider management policy and practices (for example, previous loan sale activity, types of loans sold, transactions subsequent to year-end, and pending contracts) and whether management has the ability and intent to hold the loans for the foreseeable future or until maturity.
- Reviewing the documentation and recalculating the amounts supporting the measurement of lower of cost or market valuation for loans held for sale.
- Selecting a sample of loan sales made during the period and reviewing investor contracts to evaluate whether servicing assets and liabilities and sale-versus-financing treatment have been recognized properly.
- Recalculating a sample of loan sale transactions to test calculation of weighted-average rates and corresponding gains or losses and vouching payments received for those transactions.
- Analytically projecting service fees for comparison with service fee revenues reported in operating income for the period.
- Evaluating the adequacy of valuation allowances for servicing and escrow advances. Some investors require that contractual interest and principal be remitted to them by the servicer regardless of mortgagor performance. Advances of such amounts are frequently made in anticipation of borrower performance and must be tracked on an individual basis to limit exposure to uncollectible advances.
- For servicing rights, reviewing the assumptions used in the valuation process, considering their current reasonableness, and evaluating the effect of changes in assumptions on impairment.
- Analyzing prepayment data used by management to calculate value of servicing rights at sale date and the systems used to update prepayment data over time for actual prepayment experience, selecting a sample of loan pools sold in prior periods, and comparing the actual current loan balance with estimates.
- Evaluating the adequacy of the liability for recourse obligations. Loan sale/servicing agreements generally address recourse provisions and should be reviewed for all substantial investors to ensure that portfolios sold with recourse are included in recourse liability considerations.
- Confirming selected loan balances serviced for others and related information directly with the borrower.

CHAPTER 11

Real Estate Investments, Real Estate Owned, and Other Foreclosed Assets

INTRODUCTION

11.01 Generally, the largest component of real estate owned by institutions is assets taken in settlement of troubled loans through surrender or foreclosure. Real estate investments, real estate loans that qualify as investments in real estate, and premises that are no longer used in operations may also be included in real estate owned. Furthermore, institutions may obtain assets other than real estate through foreclosure, and those assets also are addressed in this chapter.

Foreclosed Assets

11.02 Foreclosed assets include all assets received in full or partial satisfaction of a receivable and include real and personal property; equity interests in corporations, partnerships, and joint ventures; and beneficial interests in trusts. Foreclosed assets also include loans that are treated as if the underlying collateral had been foreclosed because the institution has taken possession of the collateral, even though legal foreclosure or repossession proceedings have not taken place.[*]

Real Estate Investments

11.03 Some institutions make direct equity investments in real estate projects.

11.04 Further, in some loans accounted for as real estate investments, institutions have virtually the same risks and rewards as those of owners or joint venture participants. Such arrangements are treated as if the institution actually has an ownership interest in the property. In such arrangements the lender participates in expected residual profits, which may be in the form of an equity kicker or a higher than usual effective interest rate. At the outset and during the construction and development of the property, the borrower generally has little or no equity in the property and the institution's only source of repayment is the property. The institution generally (*a*) agrees to provide substantially all funds to acquire, develop, and construct the property, (*b*) funds the commitment or origination fees or both, and (*c*) funds interest during the development and construction of the property.

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[*] SOP 92-3, *Accounting for Foreclosed Assets*, was issued prior to Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 114, *Accounting by Creditors for Impairment of a Loan*, which amended FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*, prospectively. Paragraph 13 of FASB Statement No. 114 requires that, regardless of the measurement method, a creditor shall measure impairment based on the fair value of the collateral when the creditor determines that foreclosure is probable. Further, paragraph 34 of FASB Statement No. 15, as amended, provides that a troubled debt restructuring (TDR) that is in substance a repossession or foreclosure by the creditor, that is, the creditor receives physical possession of the debtor's assets regardless of whether formal foreclosure proceedings take place, or in which the creditor otherwise obtains one or more of the debtor's assets in place of all or part of the receivable, shall be accounted for according to the provisions of paragraphs 28 and 33 and, if appropriate, 39 of FASB Statement No. 15.

REGULATORY MATTERS

11.05 The federal banking agencies jointly issued a policy statement on June 16, 1993, that addresses treatment of sales of real estate owned for regulatory financial reporting purposes.

11.06 Office of Thrift Supervision (OTS) policy does not automatically require general allowances on REO. However, OTS policy says that an association should establish general allowances when the association is likely to experience losses on the disposition of REO in excess of any fair value estimates, or is likely to incur costs during the holding period for REO that are not reflected in the carrying value. This policy is considered RAP and not GAAP.Also, OTS regulatory capital standards require certain real estate assets to be deducted from available regulatory capital.

11.07 Voluntary direct investments in real estate are generally limited for national banks, as described in Chapter 7 of the Code of Federal Regulations. State member banks may invest in real estate only with the prior approval of the Federal Reserve Board as described in Regulation H.

ACCOUNTING AND FINANCIAL REPORTING

Foreclosed Assets

11.08 FASB Statements No. 15 and No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, and SOP 92-3 establish guidance on accounting for and reporting of foreclosed assets.[‡] At the time of foreclosure or physical possession, the asset should be reported at its fair value if it will be held and used or at its fair value less cost to sell if it will be disposed of. Paragraphs 10 and 11 of SOP 92-3 state that there is a presumption that such assets are held for sale, which may be rebutted, except for in-substance foreclosed assets, by a preponderance of evidence.

11.09 FASB Statement No. 121 requires that long-lived assets to be disposed of be reported at the lower of carrying amount or fair value less cost to sell, except for assets that are 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.*[§] (Assets within the scope of APB Opinion 30 are reported at the lower of carrying amount or net realizable value.)

11.10 FASB Statement No. 121 requires that long-lived assets to be held and used by an institution be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable.[**] FASB Statement No. 121 requires that, in performing the review for

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[‡] As explained below and in footnotes 6 and 7 herein, certain provisions of SOP 92-3 are inconsistent with provisions of FASB Statement No. 121. AcSEC is considering actions that should be taken on SOP 92-3; however, FASB Statement No. 121 takes precedence for transactions within its scope. Paragraph 13 of SOP 92-3 requires that the amount of any senior debt to which a foreclosed asset is subject should be reported as a liability at the time of foreclosure and not be deducted from the carrying amount of the asset; principal payments on such debt should be charged to the liability. That paragraph further requires that interest that accrues after foreclosure should be recognized as interest expense.

[§] Paragraph 15 of SOP 92-3 requires that, after foreclosure, assets determined to be held for the production of income (and not held for sale) should be reported and accounted for in the same way that they would be had the assets been acquired other than through foreclosure.

[**] Paragraph 16 of SOP 92-3 requires that, if an institution subsequently decides that a foreclosed asset classified as held for sale will be held for the production of income, the asset should be reclassified from the held-for-sale category. The reclassification should be made at the amount the asset's carrying amount would have been had the asset been held for the production of income since the time of foreclosure. Selling

recoverability, the institution should estimate the future cash flows expected to result from the use of the asset and its eventual disposition. The Statement requires that, if the sum of the expected future cash flows (undiscounted and without interest charges) is less than the carrying amount of the asset, including related goodwill, an impairment loss is recognized. Otherwise, an impairment loss is not recognized. The Statement requires that measurement of an impairment loss for long-lived assets that an institution expects to hold and use should be based on the fair value of the asset.

11.11 Foreclosed and repossessed assets may be classified as a separate balance-sheet amount or included in other assets in the balance sheet, with separate disclosure in the notes to the financial statements.

Real Estate Investments

11.12 AICPA SOP 78-9, *Accounting for Investments in Real Estate Ventures*, and FASB Statements No. 34, *Capitalization of Interest Cost*, No. 58, *Capitalization of Interest Cost in Financial Statements That Include Investments Accounted for by the Equity Method*, No. 66, *Accounting for Sales of Real Estate*, and No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, establish generally accepted accounting principles (GAAP) for real estate investments.[‡‡]

11.13 The AICPA's Notice to Practitioners on acquisition, development, and construction (ADC) arrangements requires that certain ADC arrangements be accounted for as investments in real estate (in conformity with FASB Statements No. 66 and No. 67) or real estate joint ventures (in conformity with the provisions of SOP 78-9 and FASB Statement No. 34, as amended by FASB Statement No. 58) rather than as loans.[§§] As discussed in the Notice to Practitioners, ADC arrangements accounted for as investments in real estate or real estate joint ventures should not be reported as loans in the balance sheet.

Sale of Real Estate Assets

11.14 FASB Statement No. 66 establishes GAAP for recognition of profit on all real estate sales transactions, including sales of foreclosed real estate assets. FASB Statement No. 66 provides criteria for determining whether a sale has occurred and, if so, the appropriate method of profit recognition. Further, FASB Statement No. 66 establishes GAAP for sale recognition for transactions that do not include gains. The six primary methods of accounting for sales transactions are full accrual, installment, percentage of completion, reduced profit, cost recovery, and deposit. Other guidance on accounting for real estate sales that may apply includes FASB Interpretation No. 43, *Real Estate Sales*, and the following matters discussed by the FASB's Emerging Issues Task Force (EITF).

- Issue No. 84-17, *Profit Recognition on Sales of Real Estate with Graduated Payment Mortgages or Insured Mortgages*
- Issue No. 86-6, *Antispeculation Clauses in Real Estate Sales Contracts*
- Issue No. 86-7, *Recognition by Homebuilders of Profit from Sales of Land and Related Construction Contracts*
- Issue No. 87-9, *Profit Recognition on Sales of Real Estate with Insured Mortgages or Surety Bonds*

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costs included in the valuation allowance should be reversed. The net effect should be reported in income from continuing operations in the period in which the decision not to sell the asset is made.

[‡‡] AcSEC has a project under way that would amend SOP 78-9. AcSEC expects to issue an exposure draft during 2000. Readers should be alert to any final pronouncement.

[§§] The Notice appears as exhibit I in AICPA Practice Bulletin 1, *Purpose and Scope of AcSEC Practice Bulletins and Procedures for Their Issuance*, and gives guidance on determining whether an ADC arrangement should be treated as an investment in real estate or as a loan. Chapter 6 on loans applies to ADC arrangements that are considered loans.

- Issue No. 87-29, *Exchange of Real Estate Involving Boot*
- Issue No. 88-12, *Transfer of Ownership Interest as Part of Down Payment under FASB Statement No. 66*
- Issue No. 88-21, *Accounting for the Sale of Property Subject to the Seller's Preexisting Lease*
- Issue No. 88-24, *Effect of Various Forms of Financing under FASB Statement No. 66*

Development Costs

11.15 Costs directly attributable to the acquisition, development, and construction of a real estate project should be capitalized in conformity with FASB Statement No. 67. Such costs include (*a*) options and other preacquisition costs, (*b*) direct project costs, (*c*) holding costs, including real estate taxes and insurance during the period in which activities of a substantive nature necessary to get the real estate ready for use are in progress, and (*d*) direct amenity costs, net of incidental operations during the holding period. A valuation allowance should be established for the excess of capitalized costs over the fair value of the foreclosed asset or the net realizable value of the real estate investment.

11.16 Whenever practical, costs including amenities should be allocated to components of a project on the basis of specific identification. If specific identification is not practical, (*a*) land costs and all other common costs incurred prior to construction should be allocated based on the relative fair value of each land parcel before construction and (*b*) construction costs should be allocated on the basis of the relative sales values of each unit. If allocation based on relative values is also impractical, costs should be allocated based on square footage or other methods as appropriate under the circumstances.

Allocation of Income and Equiity Among Parties to a Joint Venture

11.17 When a real estate investment is made through a joint venture arrangement, a formal agreement generally exists that specifies key terms, such as profit or loss allocations, cash distribution, and capital infusion provisions. The terms of these agreements may affect the institution's investment valuation and, accordingly, should be considered in the investment evaluation process. Some joint venture agreements specify different ratios for allocating income, losses, cash distributions, liquidation distributions, and the like between partners. In these circumstances, accounting by investors for their equity in the venture's earnings under such agreements requires careful consideration of substance over form and a consideration of the underlying values. If a specified allocation has no substance (for example, all depreciation is to be allocated to one partner but all cash distributions, including proceeds from the sale of real estate, are shared equally by all partners), it should be ignored. The agreement should be analyzed to determine how changes in net assets of the venture will affect cash payments to investors over the venture's life and at liquidation. Paragraph 25 of SOP 78-9 provides further guidance on the allocation of income and equity among parties to a joint venture.[∇] Specified profit and loss ratios should not be used to determine an investor's equity in venture earnings if the allocation of cash distributions and liquidating distributions are determined on some other basis.

11.18 The institution should consider whether it is appropriate to allocate to other partners losses in excess of their capital contributions or whether the institution should record losses in excess of its own investment, including loans and advances. Items that may affect the institution's decision are (*a*) the financial strength of the partners, (*b*) the type of partners (general versus limited) and the partners' legal requirement to fund losses, (*c*) the fair value of the real estate, and (*d*) the type of losses being incurred (cash or book). Paragraphs 14 through 20 of SOP 78-9 provide guidance on investor accounting for losses in such circumstances.

[∇] AcSEC has a project under way that would amend SOP 78-9. Readers should be alert to any final pronouncement.

AUDITING

Objectives

11.19 The primary objectives of audit procedures in the real estate investments, real estate owned, and other foreclosed assets area are to obtain reasonable assurance that—

a. The assets exist and are owned by the institution.
b. The assets are properly classified, described, and disclosed in the financial statements.
c. Adequate provisions have been made for impairment, if any, of the assets.
d. Depreciation expense, where applicable, and other revenues and expenses related to real estate assets are properly allocated and reported.
e. Sales of assets, including the recognition of gains and losses, have been recognized.
f. Appropriate disclosures have been made.

Planning

11.20 In planning the audit, the independent accountant should consider the factors influencing inherent risk, which are described in chapter 5, as they relate to financial statement assertions about real estate investments, real estate owned, and other foreclosed assets. In planning the audit, the independent accountant should consider the following factors that may indicate higher inherent risk in this area:

- Adverse environmental or economic conditions that may affect real estate markets and the values and liquidity of properties or other assets
- Significant losses on past sales of real estate owned or other foreclosed assets
- Complex real estate assets
- Sales, financed by the institution, of real estate owned or other foreclosed assets
- Lack of experienced real estate staff
- High concentrations of real estate or other assets in a particular geographic area
- Significant fluctuations in the amount and number of foreclosures or in-substance foreclosures
- Inexperienced internal appraisal personnel or the use of low-quality or outdated appraisals

Internal Control Over Financial Reporting and Possible Tests of Controls

11.21 SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), provides guidance on the independent accountant's consideration of an institution's internal control in an audit of financial statements performed in accordance with GAAS. It describes the components of internal control and explains how an independent accountant should consider internal control in planning and performing an audit. Paragraph 19 of SAS No. 55, as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55*, requires that, in all audits, the independent accountant obtain sufficient understanding of each of the five components (the control environment, risk assessment, control activities, information and communication, and monitoring) to plan the audit by performing procedures to understand the design of policies and procedures relevant to audit planning and whether they have been placed in operation.

11.22 Inherent risk is often high for foreclosed assets and ADC arrangements because of the high degree of subjectivity involved in determining real estate values and the classification of ADC arrangements. However, with a high level of inherent risk in the real estate area, the independent accountant would often conclude that for most of the assertions it is more effective or efficient to assess control risk at the maximum and plan a primarily substantive approach, involving a selection of major real estate assets for detailed review.

11.23 Though a primarily substantive approach is often used to test individually significant real estate owned and other foreclosed assets, to plan the audit the independent accountant must obtain a sufficient understanding of internal control over financial reporting of such assets. However, the independent accountant may deem it appropriate to obtain evidence to support a lower assessment of control risk for the purpose of determining the nature, timing, and extent of substantive procedures applied to pools of smaller-value assets (such as one- to four-family real estate, automobiles, recreational vehicles, and mobile homes). Internal controls over financial reporting of real estate investments, real estate owned, and other foreclosed assets generally include—

- Written policies and procedures, including those that address—
  - — Frequency of appraisals and selection and qualifications of appraisers.
  - — Disbursement of funds.
  - — Evaluation of management companies.
  - — Review and monitoring of marketing efforts.
  - — Nature and amount of facilitating financing.
  - — Revenue recognition.
  - — Cost to sell.
  - — Capitalization of interest.
- Proper authorizations for specific transactions.
- Periodic reviews of balances, fair values, realizable values, and policies by persons specified in management's written policy.

Substantive Tests

11.24 ***Other Real Estate Owned and Real Estate Investments***. Obtaining evidential matter about the carrying amount of foreclosed assets (fair values) and real estate investments (including loans that qualify as real estate investments) may involve a review of appraisals, feasibility studies, forecasts, sales contracts or lease commitments, and information concerning the track record of the developer. In addition, the independent accountant should be alert to involvement of related parties and should design audit procedures accordingly. To obtain sufficient persuasive evidence of progress to completion under a real estate investment or other real estate project, the independent accountant may also decide to perform an on-site inspection of certain properties.

11.25 Substantive tests of other real estate and real estate investments generally focus on the valuation assertion; however, tests of the other assertions should also be considered. For example, evidence about the completeness assertion may be obtained through the independent accountant's testing of loans. In addition, the independent accountant should consider testing the propriety of gains and losses on real estate sales and capitalized interest and other holding costs.

11.26 Estimates of the fair value of real estate assets are necessary to account for such assets. SAS No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1, AU sec. 342), provides guidance on auditing accounting estimates (such as estimates of fair values). SAS No. 57 discusses how an independent accountant obtains an understanding of how management developed estimates, concentrating on the key factors and assumptions used. It also discusses how the independent accountant evaluates the reasonableness of those estimates. Also, the AICPA non-authoritative publication, *Auditing Estimates and Other Soft Accounting Information*, provides guidance for handling problems that arise in auditing estimates.

11.27 Many fair values will be based on valuations by independent appraisers. In applying audit procedures to real estate, the independent accountant often relies on representations of independent experts, particularly appraisers and construction consultants, to assist in the assessment of real estate values. SAS No. 73, *Using* *the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 336), and the AICPA Audit and Accounting Guide *Guide for the Use of Real Estate Appraisal Information* provide guidance in this area.

11.28 Independent appraisals may be considered acceptable audit evidence. The quality of appraisals varies, however, and in some instances the independent accountant may have reason to believe certain assumptions underlying appraisals are unrealistic. The independent accountant should understand and consider the approaches and assumptions used in obtaining the appraised value. Some matters that should be considered by the independent accountant when evaluating an appraisal are—

- A rise or decline in a particular market area not reflected in an appraisal may warrant that additional procedures, or perhaps a new appraisal, be performed.
- If the date of appraisal is substantially earlier than the audit date, a rise or decline in a particular market area between the two dates may warrant a new appraisal or the performance of additional procedures.
- Appraised values should be based on current market conditions and must be discounted for costs to complete and sell, as well as for carrying costs.
- The estimated selling prices should reflect the expectations of a sale in the reasonably near future—not in an indefinite future period.

11.29 Because of time and cost considerations, an institution may use various approaches to estimate value without using the services of an independent appraiser. In evaluating internally derived valuation data, the independent accountant should understand the methods and assumptions used and the qualifications of the individual performing the evaluation and should be aware of inherent subjective determinations in estimating value that may be significant to the valuation process. The independent accountant should consider the reasonableness of the assumptions and approach used and should test the information underlying the valuation. Further, the independent accountant may decide to engage an appraiser independent of the institution to test the institution's internally derived valuation. Despite the existence of an appraisal, in certain situations the independent accountant may wish to physically observe properties for the stage of completion, for deterioration, or for estimating the extent of occupancy.

11.30 The independent accountant should also evaluate whether significant real estate transactions qualify as sales in conformity with criteria set forth in FASB Statement No. 66.

11.31 ***Other Foreclosed Assets***. The procedures discussed above may be applied to other foreclosed assets to the extent that the independent accountant deems necessary.

CHAPTER 12

Other Assets, Other Liabilities, and Other Investments

INTRODUCTION

12.01 The following assets are among those frequently grouped as "other assets" or “other investments” in institutions' balance sheets; however, any that are individually material should be presented in the balance sheet as a separate amount:

- Accrued interest receivable (see chapter 7 for a discussion on securities and chapter 8 for a discussion on loans)
- Premises and equipment
- Other real estate, such as foreclosed assets (see chapter 11 for a discussion on real estate investments, real estate owned, and other foreclosed assets)
- Servicing assets (see chapter 10 for discussion of servicing assets)
- Federal Home Loan Bank or Federal Reserve Bank stock
- National Credit Union Share Insurance Fund deposits or other share insurance deposits
- Payroll deductions receivable
- Identifiable intangible assets, such as core deposit intangibles, and purchased credit-card relationships
- Goodwill
- Customers' liabilities on acceptances
- Deferred tax assets (which are addressed in chapter 16)
- Investments in equity securities that are not readily marketable (which meet definition of a security in FASB Statement 115 but are not subject to its provisions because they are not readily marketable), such as stock in the Federal Agricultural Mortgage Corporation (Farmer Mac) or stock in banker’s banks.
- Other equity investments, including investments in joint ventures or venture capital investments, and credit union investments in Credit Union Service Organizations (CUSOs)
- Investments in nonnegotiable certificates of deposits (see Chapter 6).

12.02 Other liabilities frequently include the following:

- Accounts payable
- Accrued interest payable (see chapter 13 for discussion of Deposits)
- Accrued expenses
- Borrower’s taxes and insurance escrows

Premises and Equipment

12.03 Premises and equipment consist primarily of land, buildings, furniture, fixtures, equipment, purchased software, and leasehold improvements used in institution operations. Such assets may be acquired directly or through a special-purpose subsidiary. Institutions may also lease property and equipment to other parties.

FHLB or Federal Reserve Bank Stock

12.04 ***FHLB Stock.*** Institutions that are members of the FHLB system are required to maintain a minimum investment in FHLB stock. The minimum is calculated as a percentage of aggregate outstanding mortgages. An additional investment is required that is calculated as a percentage of total FHLB advances, letters of credit, and the collateralized portion of interest-rate swaps outstanding. FHLB stock is capital stock that is bought from and sold to the FHLB at $100 par. Both stock and cash dividends may be received on FHLB stock.

12.05 ***Federal Reserve Bank Stock.*** Members of the Federal Reserve System are required to maintain stock in the district Federal Reserve Bank in an specified ratio to its capital. The stock does not provide the owner with control or financial interest in the Federal Reserve Bank, is not transferable, and cannot be used as collateral. A member institution's ownership of Federal Reserve stock may be canceled in the event of the institution's insolvency or voluntary liquidation, conversion to non-member status through merger or acquisition, or voluntary or involuntary termination of membership in the Federal Reserve System.

Identifiable Intangibles

12.06 Identifiable intangible assets may be acquired individually, as part of a group of assets, or in a purchase business combination. They include, among others, core deposit intangibles (the value of long-term deposit relationships), and credit-card customer lists (the value of long-term credit-card relationships).

Goodwill

12.07 Goodwill arises in a business combination accounted for under the purchase method. It represents the difference between the cost of an acquired company and the sum of the fair values of the tangible and identifiable intangible assets acquired less the fair value of the liabilities assumed.

Customers' Liabilities on Acceptances

12.08 Customer's liabilities on acceptances represent a customer's outstanding debt to the institution that resulted from a banker's acceptance transaction. A banker's acceptance is a short-term negotiable time draft drawn on and accepted by an institution.

Other Miscellaneous Items

12.09 Other items that may be classified with other assets include accounts receivable, accruals for miscellaneous fees, other prepaid expenses, payroll deductions receivable, and suspense accounts. Suspense accounts usually contain amounts related to items recorded and held pending classification and transfer to the proper account and may originate from a variety of sources, such as loan remittances, branch clearing transactions, automated teller machine (ATM) transactions, and payroll transactions.

REGULATORY MATTERS

12.10 Section 107(4) of the Federal Credit Union Act (as well as many state statutes), allows credit unions to purchase, hold, and dispose of only that property which is necessary or incidental to their operations. Credit unions are limited by regulatory authorities to a maximum investment in property and equipment. This limitation also includes lease payments. Credit unions may also be prohibited from acquiring real property from certain related parties.

12.11 Banks and savings institutions are generally limited in the type and amount of intangible assets that may be included in regulatory capital. In addition to these limits, for purposes of calculating Tier 1 capital, the amount of servicing assets (SAs) and purchased credit-card relationships (PCCRs) that institutions can include in Tier 1 capital cannot exceed 90 percent of their fair market value. The federal banking agencies have adopted Securities and Exchange Commission (SEC) guidelines concerning the amortization of intangibles, which generally limit amortization to a period not to exceed 25 years which is consistent with generally accepted accounting principles (GAAP) for SEC registrants.

12.12 Both national banks and state member banks are limited as to the amount of their investments in bank premises. National bank limitations are set forth in 12 USC 371d. State member bank limitations are set forth in 12 CFR 208.22**.**

12.13 See paragraph 10.09 for information on interagency guidelines on asset securitization.

ACCOUNTING AND FINANCIAL REPORTING

Premises and Equipment

12.14 Institutions account for premises and equipment in the same way that commercial enterprises account for property and equipment (fixed assets). Institutions carry premises and equipment on the balance sheet at cost less accumulated depreciation, and adjust the carrying amount for permanent impairments of value. Capital additions and improvements to premises should be capitalized, including construction period interest capitalized in accordance with FASB Statement No. 34, *Capitalization of Interest Cost*. Net gains or net losses on dispositions should be reflected in non-interest income or non-interest expense. A description of the institution's depreciation and capitalization policies should be included in the notes to the financial statements.

12.15 Premises and equipment may include capital leases, which should be accounted for in accordance with FASB Statement No. 13, *Accounting for Leases*, and are subject to the requirements of FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, for purposes of recognizing and measuring impairment. Consolidation of subsidiaries that own premises should be done in accordance with FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries.*

12.16 FASB Statement No. 98, *Accounting for Leases: Sale-Leaseback Transactions Involving Real Estate, Sales-Type Leases of Real Estate, Definition of the Lease Term, Initial Direct Costs of Direct Financing Leases*, provides guidance on how to account for sale-leaseback transactions, and the FASB's Emerging Issues Task Force (EITF) has reached consensus on various sale-leaseback matters, such as:

- Issue No. 84-37, *Sale-Leaseback Transaction with Repurchase Option*.
- Issue No. 86-17, *Deferred Profit on Sale-Leaseback Transaction with Lessee Guarantee of Residual Value*.

12.17 SOP 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for internal Use*, provides guidance on accounting for the costs of computer software developed or obtained for internal use. Accounting for the cost of internally developed and purchased computer software to be sold, leased, or otherwise marketed is established in FASB Statement No. 86, *Accounting for the Costs of Computer Software to be Sold, Leased, or Otherwise Marketed*.

12.18 Premises and equipment are generally shown as a single caption on the balance sheet, net of accumulated depreciation and amortization, the amount of which must be disclosed either on the face of the balance sheet or in the notes to the financial statements. If the individual categories of assets are material, they should be disclosed on the face of the balance sheet or in the notes to the financial statements. The amount of assets under capitalized leases should be disclosed.

12.19 ***Operating Leases***. An operating lease is one that fails to meet any of the capital lease criteria, as specified in paragraph 7 of FASB Statement No. 13. From the lessor's perspective, the leased assets are recorded on the balance sheet and lease payments are recognized as rental income in the income statement in accordance with paragraph 19 of FASB Statement No. 13. Operating leases are also subject to the requirements of FASB Statement No. 121 for purposes of recognizing and measuring impairment. From the lessee's perspective, lease payments are recognized as rental expense in the income statement in accordance with paragraph 15 of FASB Statement No. 13.

FHLB or Federal Reserve Bank Stock

12.20 Although FHLB (or Federal Reserve Bank) stock is an equity interest in a FHLB (or Federal Reserve Bank), it does not have a readily determinable fair value for purposes of FASB Statement No. 115, because its ownership is restricted and it lacks a market. FHLB (or Federal Reserve Bank) stock can be sold back only at its par value of $100 per share and only to the FHLBs (or Federal Reserve Banks) or to another member institution. Therefore, FHLB (or Federal Reserve Bank) stock should be classified as a restricted investment security, carried at cost, and evaluated for impairment.

12.21 In addition, the equity ownership rights represented by FHLB stock are more limited than would be the case for a public company, because of the oversight role exercised by the Federal Housing Finance Board in the process of budgeting and approving dividends.

12.22 Both cash and stock dividends are received on FHLB stock and are reported as income. The stock dividends are redeemable at par value.

12.23 In evaluating the effects of legislation on the FHLBs, it may be presumed that at least a temporary decline in value could have occurred if such legislation requires an FHLB to make payments to the Resolution Funding Corporation (REFCORP) or other entities in addition to the required payments to the Financing Corporation (FICO) and if these payments cause the FHLB's total equity to fall below its aggregate capital stock amount. FHLB stock is generally viewed as a long-term investment. Accordingly, its value should be determined based on the ultimate recoverability of the par value rather than by recognizing temporary declines in value. The determination of whether the decline is other than temporary in nature is influenced by criteria such as—

- The significance of the decline in net assets of the FHLBs as compared to the capital stock amount for the FHLBs and the length of time this situation has persisted.
- Commitments by the FHLBs to make future payments to REFCORP and other entities and the level of such payments in relation to the operating performance of the FHLBs.
- The impact of legislative and regulatory changes on the savings institutions industry and, accordingly, on the customer base of the FHLBs.
- The liquidity position of the FHLBs.

12.24 The evaluation of whether a decline is temporary or whether it affects the ultimate recoverability of the FHLB stock is ultimately made by the member institution and concurred with by its independent accountants based on the facts at the time. This consideration is influenced by (*a*) the materiality of the carrying amount to the member institution and (*b*) whether an assessment of the institution's operational needs for the foreseeable future would require and allow management to dispose of the stock.

12.25 Classification of FHLB or Federal Reserve Bank stock in the balance sheet varies among financial institutions. Some institutions, with more significant investments in FHLB or Federal Reserve Bank stock, present their investment as a separate line item in the balance sheet. Others may combine the investment in FHLB or Federal Reserve Bank stock with other investments or other assets. Either manner of presentation is acceptable. However, investments in FHLB or Federal Reserve Bank stock should not be shown with securities accounted for under FASB Statement No, 115, which is another common manner of presentation.

Intangible Assets

12.26 At the time of acquisition, intangible assets should be reported at their fair value. Chapter 19 discusses the initial valuation and recognition of intangibles in connection with a business combination. APB Opinion 17 requires separate identification of intangible assets if they exist.

12.27 FASB Statement No. 72, *Accounting for Certain Acquisitions of Banking or Thrift Institutions*, provides guidance on the appropriate amortization periods and methods for amortization for identified intangible assets and unidentified intangible assets that arise when the fair value of liabilities assumed exceeds the fair value of tangible and identifiable intangible assets acquired.

12.28 Identifiable intangible assets related to borrower or depositor relationships should be amortized over the estimated lives of the relationships that exist at the time of the acquisition without regard to new depositors or borrowers that may replace them. The amortization period and method should be determined separately for each identifiable intangible. The values assigned to those assets involve assumptions about future events, such as anticipated withdrawals of deposits. Therefore, it is important that the recoverability of such assets be evaluated at each balance-sheet date. For example, if a large segment or separable group of the operating assets of an acquired institution is sold, the portion of the intangible assets attributable to the assets sold should be included in the cost of the sale.

12.29 For unidentifiable intangible assets covered by FASB Statement No. 72, the intangible should be amortized to expense over a period no longer than the estimated remaining life of the long-term interest-bearing assets acquired, which should not exceed 40 years. If the assets acquired do not include a significant amount of long-term interest-bearing assets, goodwill should be amortized over a period not exceeding the estimated average remaining life of the existing customer base acquired. Goodwill not covered under FASB Statement No. 72 is generally amortized on the straight-line method over its estimated useful life. (Paragraph 10.09 discusses limitations on amortization periods for regulatory reporting purposes.)

Customers' Liabilities on Acceptances

12.30 Provisions for uncollectible amounts for customers' acceptance liabilities should be made, if necessary. Customers' liabilities on acceptances should be reported gross, rather than net of the related bankers' acceptance liability.

Impairment

12.31 Intangible assets, including goodwill, should be evaluated for impairment in conformity with paragraph 31[♣] of APB Opinion No. 17, *Intangible Assets*, except as discussed in paragraphs 12.31 through 12.33.

12.32 FASB Statement No. 121[*] establishes the accounting for impairment of long-lived assets, certain identifiable intangibles and goodwill related to those assets to held and used and for long-lived assets and certain identifiable intangibles to be disposed of.[∇]

12.33 FASB Statement No. 121 requires that long-lived assets and certain identifiable intangibles to be held and used by an institution be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. The Statement requires that, in performing the review for recoverability, the institution should estimate the future cash flows expected to result from the use of the asset and its eventual disposition. FASB Statement No. 121 requires that, if the sum of the expected future cash flows (undiscounted and without interest charges) is less than the carrying amount of the asset, including related goodwill, an impairment loss is recognized. Otherwise, an impairment loss is not recognized. The Statement requires that measurement of an impairment loss for long-lived assets that an institution expects to hold and use should be based on the fair value of the asset.

12.34 FASB Statement No. 121 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 that are covered by 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*. Assets within the scope of APB Opinion No. 30 are reported at the lower of carrying amount or net realizable value. Paragraph 32 of APB Opinion No. 17 provides guidance on accounting for goodwill related to assets to be disposed of.

National Credit Union Share Insurance Fund Deposit

12.35 Federally insured credit unions are required to maintain on deposit with the NCUSIF an amount equal to 1 percent of their total insured shares. The amount on deposit is adjusted periodically for changes in the amount of a credit union's insured shares. For example, if the insured shares decline, a pro rata portion of the amount on deposit with the NCUSIF is refunded to the credit union. A credit union is also required to pay an annual insurance premium equal to one-twelfth of 1 percent of its insured shares, unless the payment is waived or reduced by the NCUA Board.

12.36 Amounts deposited with the NCUSIF should be accounted for and reported as assets as long as such amounts are fully refundable. The refundability of NCUSIF deposits should be evaluated periodically. When the refundability of a deposit is evaluated, the financial condition of both the credit union and of the NCUSIF should be considered. Deposits may be returned to solvent credit unions for a

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[♣] Paragraph 31 of APB Opinion No. 17 has been amended by paragraph 4(d) of FASB Statement No. 135 to make technical correction to existing authoritative literature.

[*] The FASB currently has a project on it agenda that addresses FASB Statement No. 121 implementation issues. The FASB anticipates issuing an Exposure Draft on that project in 2000. Readers should be alert to any final pronouncement.

[∇] The third sentence of paragraph 3 of FASB Statement No. 121 says:
This Statement does not apply to financial instruments, long-term customer relationships of a financial institutions (for example, core deposit intangibles and credit cardholder intangibles), mortgage and other servicing rights, deferred policy acquisitions costs, or deferred tax assets.

number of reasons, including termination of insurance coverage, conversion to insurance coverage from another source, or transfer of operations of the insurance fund from the NCUA Board. Insolvent or bankrupt credit unions are not entitled to a return of their deposits. To the extent that NCUSIF deposits are not refundable, they should be charged to expense in the period in which the deposits are made or the assets become impaired.

12.37 In years in which the equity of the NCUSIF exceeds "normal operating levels," the NCUA Board is required to make distributions to insured credit unions to reduce the equity to normal operating levels. Such distributions may be in the form of a waiver of insurance premiums, premium rebates, or cash payments. Payments received in connection with that reduction in the equity of the NCUSIF should be reported as current-period income in the period in which it is determined that a distribution will be made.

12.38 The system of savings account insurance established by the recapitalization of the NCUSIF, which provided for reserves of 1 percent of insured deposits, is based on the concept that the required deposits create a fund with an earning potential sufficient to provide for the risk of losses in the credit union system. In years in which the earnings of the fund have been adequate to provide insurance protection and cover all expenses and losses incurred by the fund, the NCUA Board has elected to waive the insurance premiums due from insured credit unions. In those years, it has been industry practice to net imputed earnings on the insurance deposits against imputed premium expense rather than present them as gross amounts on the statement of income. In years in which the insurance premiums are not waived by the NCUA Board, the premiums should be expensed in the period to which they relate. To the extent that the NCUA Board assesses premiums to cover prior operating losses of the insurance fund or to increase the fund balance to "normal operating levels," credit unions should expense those premiums when assessed.

Other Investments

12.39 *Credit Union Service Organizations. (CUSOs).* Credit unions are allowed under the NCUA regulations to own and operate outside entities, that conduct business related to the general services of the credit union. The types of businesses are restricted as to operations within the regulations. These entities may conduct business with other credit unions, credit union members, and non-members. In addition, credit unions can own these entities with other credit unions or outside third parties.
Credit unions are restricted in the amount of money that can be invested in and loaned to the CUSO. Under current regulations, credit unions can lend and/or invest up to 1% of the credit union's unimpaired capital and surplus. The CUSO can be structured as a corporation, a limited liability company, or a limited partnership as long as the credit union is not the general partner. All CUSOs must follow GAAP, have an annual opinion audit, and prepare quarterly financial statements. The recording of the investment in or loan to the CUSO must also be accounted for in accordance with GAAP.

The following are the general approved categories of CUSOs within the regulations.

- Checking and currency services
- Clerical, professional and management services
- Consumer mortgage loan origination
- Electronic transaction services
- Financial counseling services
- Fixed asset services
- Insurance brokerage services
- Leasing
- Loan support services
- Securities brokerage services
- Shared branching

- Student loan origination
- Travel agency
- Trust and trust related services
- Non-CUSO service providers

Under current IRS regulations, federally chartered credit unions do not have to pay taxes on income from flow-through entities. However, state chartered credit unions may be liable for taxes on flow through income. All CUSOs must follow all relevant IRS and state reporting and filing requirements.

In accordance with APB Opinion 18, the equity method of accounting should be used if the institution has the ability to exercise significant influence over the operating and financial policies of the investee or CUSO. Majority owned subsidiaries should be included in the consolidated financial of the parent in accordance with FASB Statement No. 94 and ARB No. 51.

Contributed Assets

12.40 Many credit unions receive substantial contributions (for example, use of facilities and utilities, telephone services, data processing, mail services, payroll processing services, pension administration services and pension plan contributions, and other materials and supplies) from their sponsoring organizations. Many credit unions also rely on volunteers to provide various services to their members; some credit unions are staffed exclusively by volunteers. In addition, credit unions occasionally receive contributions of assets of material value.

12.41 Generally, contributions received, including unconditional promises to give, should be recognized as revenue in the period received at their fair values and should be debited to the appropriate asset account, in accordance with paragraph 9 of FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made.* Contributions of services are recognized only if the services received (*a*) create or enhance nonfinancial assets or (*b*) require specialized skills, are provided by individuals possessing those skills, and would typically need to be purchased if not provided by donation. Paragraphs 10, 24 and 25 of FASB Statement No. 116 requires certain disclosures for receipts of contributed services and promises to give. Paragraph 19 states that quoted market prices, if available, are the best evidence of the fair value of monetary and nonmonetary assets, including services.

12.42 Paragraph 19 of FASB Statement No. 116 further states that if quoted market prices are not available, fair value may be estimated based on quoted market prices for similar assets, independent appraisals, or valuation techniques, such as the present value of estimated future cash flows. Contributions of services that create or enhance nonfinancial assets may be measured by referring to either the fair value of the services received or the fair value of the asset or of the asset enhancement resulting from the services. A major uncertainty about the existence of value may indicate that an item received or given should not be recognized. The future economic benefit or service potential of a tangible item usually can be obtained by exchanging it for cash or by using it to produce goods or services.

AUDITING

Objectives

12.43 ***Other Assets.*** The primary objectives of audit procedures applied to other assets are to obtain reasonable assurance that:

a. The assets exist and are owned by the institution.

b. The assets are properly classified, described, and disclosed in the financial statements.
c. Intangible assets are being amortized on a consistent basis over the estimated period of benefit.
d. Adequate provisions have been made for impairment, if any, of the assets.
e. Sales of assets, including the recognition of gains and losses, have been properly recognized.
f. Appropriate disclosures, including the existence of liens, have been made.

12.44 ***Other Liabilities***. The primary objectives of auditing other liabilities are to obtain reasonable assurance that:

- The liabilities represent authorized obligations of the institution.
- All contingencies and estimated future expenses that should be accrued during the period have been accrued, classified, and described in accordance with generally accepted accounting principles, and the related disclosures are adequate.

Planning

12.45 In planning the audit, the independent accountant should consider the factors influencing inherent risk, which are described in chapter 5, as they relate to financial statement assertions about other assets and other liabilities. . Presented below are examples of factors that may indicate higher inherent risk or control risk for this area—

- A current interest rate environment that may adversely affect the values of intangible assets that derive their value from (*a*) loan relationships or (*b*) from the timing and amount of future cash flows
- Loss of depositor relationships
- Operating losses
- Large unreconciled balances in suspense accounts
- Planned branch dispositions

Internal Control Over Financial Reporting and Possible Tests of Controls

12.46 SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), provides guidance on the independent accountant's consideration of an institution's internal control in an audit of financial statements performed in accordance with GAAS. It describes the components of internal control and explains how an independent accountant should consider internal control in planning and performing an audit. Paragraph 19 of SAS No. 55, as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55*, requires that, in all audits, the independent accountant obtain sufficient understanding of each of the five components (the control environment, risk assessment, control activities, information and communication, and monitoring) to plan the audit by performing procedures to understand the design of policies and procedures relevant to audit planning and whether they have been placed in operation.

12.47 Although a primarily substantive approach is often used to test most other assets and other liabilities, to plan the audit the independent accountant must obtain a sufficient understanding of internal control over financial reporting of other assets. Typical financial reporting controls generally include—

- Written policies and procedures that, among other things, specify depreciation and amortization methods and periods for property and equipment.
- Proper authorizations for specific transactions, such as approval for property and equipment purchases.
- Periodic reviews of balances, fair values, realizable values, and policies by persons specified in management's written policy.

Substantive Tests

12.48 ***FHLB or Federal Reserve Stock.*** If the institution is a member of the FHLB or Federal Reserve System, the independent accountant should consider (*a*) confirming stock ownership with the related FHLB or Federal Reserve Bank and (*b*) reconciling the dollar amount of the shares with the institution's general ledger. For institutions holding FHLB stock, the independent accountant should consider the status of the FHLB's redemption of its stock at par value before concluding that income recognition is appropriate for any FHLB stock dividends.

12.49 ***Premises and Equipment***. Substantive procedures used to test premises and equipment consist primarily of physical inspection, review of documents of title or other documents supporting the acquisition, tests of disposals and other adjustments, and reasonableness tests of depreciation. Similar procedures are often used to test the classification, recording, and disclosure of leased premises and equipment.

12.50 Independent accountants should be alert for signs that premises and equipment are no longer in use and consider tests to determine whether there are any undisclosed liens on premises and equipment. The independent accountant should also consider whether there are any permanent impairments of the premises and equipment. Computer hardware and software are particularly vulnerable to obsolescence and their valuation should be reviewed.

12.51 ***Identifiable Intangible Assets and Goodwill.*** Substantiating the amount of intangible assets requires careful judgment by the independent accountant. The independent accountant should determine that the amortization periods are reasonable and that the customer relationships from which the intangibles derive their value continue to exist at the balance-sheet date. SAS No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1, AU sec. 342), provides guidance on auditing accounting estimates (such as estimates of fair values). SAS No. 57 discusses how an independent accountant obtains an understanding of how management developed estimates, concentrating on the key factors and assumptions used, and evaluates the reasonableness of those estimates. In this area, such key factors and assumptions may include the ability of the assets to generate income in the future, the expected lives of loans, or expected withdrawal rates of deposits. The independent accountant should consider whether the assumptions continue to be reasonable and evaluate the effect of changes in assumptions on the recoverability of the assets.

12.52 ***Customers' Liabilities on Acceptances.*** Substantive tests that are performed on loans, such as confirmation and collectibility reviews, are generally used to test customers' liabilities on acceptances (see chapters 8 and 9).

12.53 ***Other Liabilities***. Substantive audit procedures relating to interest payable, accrued expenses, and other liability amounts that the auditor should consider performing include:

- Tracing recorded amounts to supporting documentation
- Agreeing rates used in the calculation of recorded amounts of interest payable to board of directors' authorization
- Testing individual calculations of accrued interest (dividends)
- Tracing recorded amounts to subsequent cash disbursements
- Examining evidence supporting the carrying amount of other liabilities, including such items as an actuarial evaluation used to compute accrued pension costs, payroll tax returns, and invoices received from third parties
- Confirming recorded amounts
- Performing a search for unrecorded liabilities

12.54 ***Suspense Accounts***. The independent accountant should consider reviewing the suspense account for material items remaining in the account at year-end and making reclassification entries to the appropriate account. The independent accountant should also consider reviewing for propriety entries made to clear suspense account items.

CHAPTER 13

Deposits

INTRODUCTION

13.01 Deposits are an important source of funds for banks, credit unions, and savings institutions. Finance and mortgage companies do not take insured deposits. Because a credit union's members are also its owners, credit unions often refer to deposits as "share accounts" and related interest paid as "dividends." Some credit unions permit nonmembers to deposit funds subject to certain restrictions.

13.02 Deposits are often an institution's most significant liability and interest expense on deposits an institution's most significant expense. The predominance of negotiable certificates of deposit (CDs) and other kinds of interest-bearing deposits on which drafts can be made, the deregulation of interest rates paid on insured deposits, competition from mutual funds and other financial products, nondeposit liabilities as a source of funds, and liability management all have driven the offering of a wide range of deposit products having a variety of interest rates, terms, and conditions.

13.03 Deposits are generally classified by whether they bear interest, by their ownership (for example, public, private, interbank, or foreign), and by their type (for example, demand, time, and savings; or transaction and non-transaction). A description of various deposit products follows. These descriptions may not correspond to regulatory designations under FRB Regulation D.

Demand Deposits

13.04 Demand deposits (often called *transaction accounts* or *DDAs*) are accounts that may bear interest and that the depositor is entitled to withdraw at any time without prior notice. Checking and negotiable order of withdrawal (NOW) accounts are the most common form of demand deposits. Withdrawals are typically made through check writing, automated teller machines (ATMs), point-of-sale (POS) terminals, electronic funds transfers (EFTs), or preauthorized payment transactions. Deposits are generally made through direct deposit (such as of payroll amounts) or EFTs, or at ATMs or teller windows.

13.05 Further, an institution may issue a check drawn on itself for a variety of purposes, such as expense disbursements, loan disbursements, dividend payments, withdrawal of account balances, and exchange for cash with customers. These checks are generally referred to as official checks and may consist of cashier's, treasurer's, expense, and loan disbursement checks and money orders.

Savings Deposits

13.06 Savings deposits bear interest and have no stated maturity. Savings deposits include passbook and statement savings accounts and money-market deposit accounts (MMDAs). Withdrawals and deposits are typically made at ATMs or teller windows, by EFTs, or by preauthorized payments. Furthermore, MMDAs generally permit the customer to write checks, although the number of checks that may be written is limited by law.

Time Deposits

13.07 Time deposits (which include CDs, individual retirement accounts [IRAs], and open accounts) bear interest for a fixed, stated period of time.

13.08 CDs bear a stipulated maturity and interest rate, payable either periodically or at maturity. CDs may be issued in bearer form (payable to the holder) or registered form (payable only to a specified individual or entity) and may be negotiable or nonnegotiable (always issued in registered form). Negotiable CDs, for which there is an active secondary market, are generally short-term and are most commonly sold to corporations, pension funds, and government bodies in large denominations (generally, $100,000 to $1 million). Nonnegotiable CDs, including savings certificates, are generally in smaller denominations. Depositors holding nonnegotiable CDs may recover their funds prior to the stated maturity but must pay a penalty to do so.

13.09 Retirement accounts known as IRAs, Keogh accounts (also known as HR 10 plans), or self-employed-person accounts (SEPs) are generally maintained as CDs. However, because of the tax benefits for depositors, they typically have longer terms than most CDs. Many retirement accounts provide for automatic renewal on maturity.

13.10 Open accounts are time deposits with specific maturities and fixed interest rates but, unlike savings certificates, amounts may be added to them until maturity. Common types of open accounts are vacation and Christmas club accounts.

13.11 Brokered deposits are time deposits that are third-party deposits placed by or through the assistance of a deposit broker. Deposit brokers sometimes sell interests in placed deposits to third parties. As discussed below, federal law restricts the acceptance and renewal of brokered deposits by an institution based on its capitalization.

13.12 Employers that withhold federal taxes from employees' pay are required to deposit those funds periodically with a depository institution. Institutions record such deposits, which are non-interest-bearing, as treasury tax and loan accounts (TT&L accounts) and include such accounts with their deposits. (See paragraph 15.18.)

Dormant Accounts

13.13 Institutions generally have a policy on classifying accounts as dormant. The required period of inactivity before savings accounts are classified as dormant normally exceeds that for checking accounts because savings accounts are normally less active. After a specific period of inactivity, as determined by the state in which the institution is located, the accounts may no longer be deposits of the institution and may be required to be turned over to (escheat to) the state.

Closed Accounts

13.14 When an account is closed, the signature card is generally removed from the file of active accounts and placed in a closed-account section. Generally, account records are perforated in a canceling machine and returned to the depositor.

Other Deposit Services

13.15 Institutions often offer other deposit services such as reserve or overdraft checking (which combine a checking account and a preauthorized personal loan), check guarantee services, and consolidated account statements (which combine the account information of several services into one monthly statement).

The Payments Function and Services

13.16 The payments function of a depository institution involves facilitating money payments and transferring funds. The payments function is accomplished through checks and EFTs.

13.17 ***Check Processing***. The check-clearing process, which is highly automated, involves the exchange of checks and the settlement of balances among institutions locally, regionally, and nationally. Check processing involves encoding of checks with magnetic ink character recognition (MICR) symbols to facilitate routing, the proof and transit function, and the flow of checks for collection. A correspondent system and the Federal Reserve perform such clearinghouse functions for depository institutions.

13.18 An institution receives two types of checks: (*a*) on-us checks, drawn on a depositor's account and (*b*) foreign checks, drawn on accounts of other institutions. Such checks may be received from the Federal Reserve, local clearinghouses, other depository institutions, at an ATM or teller window, through the mail, or by other means, such as a loan payment.

13.19 Many checks that an institution receives have been dollar-amount encoded by the first institution that handles the check. However, checks received through an institution's own operations must go through its proof department or its correspondent bank. A proof department has the responsibility to—

- *a.* Prove the individual transaction against its documentation, such as a deposit slip.
- *b.* Verify totals for several departments.
- *c.* Encode the dollar-amount field.
- *d.* Mechanically endorse the back of the check.
- e. Sort the items according to destination.

13.20 The flow of checks for collection depends primarily on the location of the institution on which the check is drawn. Processing an on-us check for deposit to another account in the same institution is straightforward: The institution debits the check writer's account and credits the check depositor's account. Processing a check drawn on another depository institution, however, can be complex.

13.21 Though some direct collections are made in the banking system, most institutions collect foreign checks through a clearing arrangement (clearinghouse), a correspondent bank, or the Federal Reserve.

13.22 In a clearing arrangement, a group of depository institutions in a given area that receive large numbers of deposited checks drawn on one another meets to exchange and collect payment for the checks. Checks are physically exchanged among participants, and collection is made by crediting or debiting the net amount presented by each institution against all the others.

13.23 When a correspondent institution receives a check drawn on one of its respondent institutions, the check collection process can take several different routes. If the presented check is drawn on an institution that also maintains an account with the correspondent, collection simply involves the correspondent's transfer of deposit credit from one account to another account. If the check is drawn on an institution that does not have an account relationship with the correspondent, the check is credited to the respondent institution's account and then either (*a*) sent to a second correspondent in which the first correspondent and the institution on which the check is drawn both have an account, (*b*) sent to a local clearinghouse, or (*c*) sent to a Federal Reserve bank.

13.24 The Federal Reserve collects checks by internally transferring credit balances from one account to another, in much the same way that individual institutions collect on-us checks. For presenting and paying institutions that have accounts at two different Federal Reserve banks, an extra step is involved in the collection process. Each Federal Reserve bank has an interdistrict settlement account that it maintains on the books of the Interdistrict Settlement Fund established in Washington, D.C., to handle settlements. A check presented to one Federal Reserve bank drawn on a depository institution in another Federal Reserve district will result in a transfer of interdistrict settlement account balances from one Federal Reserve bank to another.

13.25 ***Electronic Funds Transfer (EFT) Systems***. Institutions have responded to the large volume of checks and the high costs of clearing checks by increasingly using EFT systems. EFT systems are computer-based networks designed to move funds to and from accounts and to and from other institutions electronically, thus eliminating paper-based transactions. Banks and savings institutions transact an enormous volume of daily business between themselves and for customers over regional and national EFT systems. The three principal kinds of EFT systems are direct deposit systems, automated clearinghouse (ACH) systems, and ATMs.

13.26 A direct deposit system involves the direct deposit of payments into a customer's account without the use of a definitive check and is widely used for payrolls. The payment information is usually transmitted to the institution from the payer in electronic form and processed through the institution's proof system.

13.27 An ACH is used to transfer funds from one institution's account at a Federal Reserve bank to that of another; conduct transactions in the federal funds market; transfer funds for customers; transfer book entries representing certain securities; and receive, send, and control other specific EFT messages between member banks and other clearinghouses. The largest ACH is Fedwire, operated by the Federal Reserve. The Clearing House Interbank Payments System (CHIPS) is an ACH operated by the New York Clearing House Association and is the focal point for payments in the world's international dollars market. International dollar payments generally do not leave the United States but are held as deposits at money-center and regional banks or the U.S. branches of foreign banks and are transferred between accounts through CHIPS in payment for internationally traded goods and services, international financial transactions, or settlement of debt.

13.28 Institutions also provide a variety of retail EFT services, including ATMs, POS terminals, telephone bill payment, and home computer banking.

REGULATORY MATTERS

Limitations on Brokered Deposits

13.29 Restrictions on the acceptance of brokered deposits, particularly for institutions that become undercapitalized, could affect an institution's liquidity. The effect of such restrictions on liquidity may be a condition, when considered with other factors, that could indicate substantial doubt about an entity's ability to continue as a going concern (see chapter 5).

13.30 ***Banks and Savings Institutions.*** Section 29 of the Federal Deposit Insurance (FDI) Act (codified in Title 12 of the Code of Federal Regulations [12 CFR] Part 337) significantly limits the acceptance or use of brokered deposits, funds which the reporting bank obtains directly or indirectly by or through any deposit broker for deposit into one or more accounts, by depository institutions other than those that are well capitalized (as defined for purposes of prompt corrective regulatory action, as discussed in chapter 1). Adequately capitalized institutions may accept brokered deposits only if they first obtain a waiver from the Federal Deposit Insurance Corporation (FDIC). Undercapitalized institutions are prohibited from accepting brokered deposits.

13.31 Section 29 of the FDI Act also limits the interest rates that may be offered by under- or adequately capitalized institutions. Undercapitalized institutions may not solicit any deposits by offering rates significantly higher (as defined) than prevailing rates. Adequately capitalized institutions are prohibited from paying interest on brokered deposits above certain levels.

13.32 ***Credit Unions.*** Section 107(6) of the Federal Credit Union (FCU) Act (codified in Title 12 of the Code of Federal Regulations [12 CFR] Part 701.32(b)) limits the acceptance or use of nonmember and public unit deposits (as defined), including brokered deposits, to the greater of (*a*) 20 percent of the total deposits of the federal credit union or (*b*) $1.5 million.

Credit Union Confirmations

13.33 As discussed further in paragraph 13.50, supervisory committees of federal credit unions are required to perform a verification of member's accounts.

ACCOUNTING AND FINANCIAL REPORTING

13.34 The institution's liability for deposits originates and should be recognized at the time deposits are received rather than when the institution collects the funds. Checking accounts that are overdrawn should be reclassified as loans and should therefore be evaluated for collectibility as part of the evaluation of credit loss allowances.

13.35 The institution's liability for deposits originates and should be recognized at the time deposits are received rather than when the institution collects the funds. Checks that are deposited by customers and that are in the process of collection and are currently not available for withdrawal (deposit float) should be recorded as assets and liabilities. Deposits should not be recorded based solely on collections.

13.36 Generally accepted accounting principles (GAAP) require that all member deposit accounts of credit unions, including member shares, be reported as liabilities in the statement of financial condition. It must be unequivocal on the face of the statement of financial condition that deposit accounts are a liability. The statement of financial condition must either (a) present deposit accounts as the first item in the liabilities and equity section or (b) include deposit accounts within a captioned subtotal for total liabilities. An unclassified presentation whereby all liabilities and equity are shown together under one subheading and savings accounts are presented as the last item before retained earnings is not an acceptable presentation. The interest paid or accrued on these accounts, commonly referred to as "dividends," should be reported as an expense on the statement of income, and the amount of interest payable to members should be included as a liability in the statement of financial condition. This is the same position that the FASB's Emerging Issues Task Force (EITF) took in EITF Issue No. 89-3, "Balance Sheet Presentation of Savings Accounts in Financial Statements of Credit Unions".

13.37 The Credit Union Membership Access Act (CUMAA) (H.R. 1151) was passed into law in August 1998. This legislation requires all federally insured credit unions with assets of $10 million and over to follow generally accepted accounting principles (GAAP). Accordingly, all federally insured credit unions with over $10 million in assets are required to file their call report on a GAAP basis. However, the call report is not structured for GAAP presentation and disclosure and shows deposits in a separate category, not in equity or liabilities. To the NCUA, the call report deals specifically with recognition and measurement for GAAP rather than presentation and disclosure.

13.38 Auditors who have issued qualified opinions in prior years for GAAP departures and are currently being requested to opine on financial statements that continue to show deposits as equity need to properly disclose the departure and the new regulations. AICPA Professional Standards AU Section 508.38 describes the required disclosures in a qualified opinion resulting from a departure from a generally accepted accounting principle.

13.39 Disclosures about deposits should generally include the following:

- *a.* The aggregate amount of time deposit accounts (including CDs) in denominations of $100,000 or more at the balance-sheet date
- *b.* For time deposits, the aggregate amount of maturities for each of the five years following the balance sheet date (in conformity with paragraph 10b of Financial Accounting Standards Board [FASB] Statement of Financial Accounting Standards No. 47, *Disclosures of Long-Term Obligations*)
- *c.* Securities, mortgage loans, or other financial instruments pledged as collateral for deposits, except for transactions within the scope of paragraph 15(a) of FASB Statement No. 125
- *d.* The aggregate amount of any demand deposits that have been reclassified as loan balances, such as overdrafts, at the balance-sheet date
- *e.* The amount of deposits of related parties at the balance-sheet date (in conformity with FASB Statement No. 57, *Related Party Disclosures*)
- *f.* Deposits that are received on terms other than those available in the normal course of business
- *g.* The fair value of deposits (in conformity with FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*)*

13.40 For deposits payable on demand or with no defined maturities, the fair value disclosed would be the amount payable on demand at the reporting date.

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* In December 1996, the FASB issued FASB Statement No. 126, *Exemption from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities*, which makes the disclosures about fair value of financial instruments prescribed in FASB Statement No. 107 optional for entities that meet all of the following criteria specified in paragraph 2 of FASB Statement No. 126:

a. The entity is a nonpublic entity (as defined in FASB Statement No. 126).

b. The entity's total assets are less than $100 million on the date of the financial statements.

c. The entity has not held or issued any derivative financial instruments, as defined in FASB Statement No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of* Financial Instruments, other than loan commitments, during the reporting period.

Note that FASB Statement No. 133 replaces paragraph 2.c of FASB Statement No. 126 (item c. above) with the following –

The entity has no instrument that, in whole or in part, is accounted for as a derivative instrument under FASB No. 133, *Accounting for Derivative Instruments and Hedging Activities*, during the reporting period.

FASB Statement No. 133, as amended by FASB Statement No. 137, *Accounting for Derivative Instruments and Hedging Activities - Deferral of the Effective Date of FASB Statement No. 133* is effective for all fiscal quarters of fiscal years beginning after June 15, 2000. On March 3, 2000, the FASB issued an Exposure Draft, *Accounting for Certain Derivative Instruments and Certain Hedging Activities —an Amendment of FASB Statement No. 133*. Readers should be alert to any final pronouncement. The FASB has established the Derivative Implementation Group (DIG) to assist the Board and its staff in providing implementation guidance regarding FASB Statement No. 133. Issues addressed by the DIG and the status of related guidance can be found at the FASB's Web site at www.fasb.org.

AUDITING

Objectives

13.41 The primary objectives of auditing procedures for deposit liabilities are to obtain reasonable assurance that—

a. Financial statement amounts for deposit liabilities and related transactions include all deposit obligations of the institution and reflect all related transactions for the period.
b. Deposit liabilities and related income statement and balance-sheet accounts have been properly valued, classified, and disclosed in conformity with generally accepted accounting principles (GAAP).

Planning

13.42 In planning the audit of investments, the independent accountant should consider the factors influencing inherent risk, which are described in chapter 5, as they relate to financial statement assertions about deposits.

The following factors related to deposits contribute to higher inherent risk:

a. Recurring and significant difficulties in reconciling exception items
b. A practice of permitting depositors to withdraw funds from their accounts before deposited checks have been collected by the institution
c. Introduction of new deposit products
d. Use of derivative instruments to hedge deposits
e. Significant changes in the amount and activity of previously inactive or dormant accounts
f. Significant increases in the number of closed accounts, especially near the end of a reporting period
g. Numerous accounts having instructions not to mail account statements to the depositor (*no-mail* accounts)

Internal Control Over Financial Reporting and Possible Tests of Controls

13.43 SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), provides guidance on the independent accountant's consideration of an institution's internal control in an audit of financial statements performed in accordance with GAAS. It describes the components of internal control and explains how an independent accountant should consider internal control in planning and performing an audit. Paragraph 19 of SAS No. 55, as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55*, requires that, in all audits, the independent accountant obtain sufficient understanding of each of the five components (the control environment, risk assessment, control activities, information and communication, and monitoring) to plan the audit by performing procedures to understand the design of policies and procedures relevant to audit planning and whether they have been placed in operation.

13.44 Effective internal control (as it relates to financial reporting of deposits) should provide reasonable assurance that (*a*) deposits are accepted in accordance with management's established policies, (*b*) misstatements caused by error or fraud in the processing of accounting information for deposits are prevented or detected, and (*c*) deposits are monitored on an ongoing basis to determine whether recorded financial statement amounts require adjustment.

13.45 The independent accountant's assessment of control risk for deposits should include consideration of whether the institution has control activities that contribute to a strong control environment, which may include—

- Policies and procedures approved by the board of directors and that include position limits for each type of deposit (including brokered deposits) and guidelines for setting the interest rates offered on deposits.
- Segregation of duties between persons involved with the proof function, persons having access to cash, persons responsible for opening new accounts and issuing CDs or savings certificates, persons with responsibility for authorizing account adjustments, and persons with responsibility for posting information to the general ledger. (Because many of the potential duty conflicts found in the deposits area also exist for cash, it is usually efficient to coordinate any assessment of segregation of duties in those two areas.)
- Reconciliation of subsidiary ledgers for deposit principal, accrued interest, and related accounts to the general ledger on a periodic basis.
- Daily performance of a proof and transit operation with rejected or exception items segregated and individually reviewed. Examples of such items include activity in dormant accounts or customer overdrafts.
- Designation by management of persons such as officers or supervisory employees, to be responsible for reviewing and approving unposted holdover items, overdrafts, return items, and status of inactive or dormant accounts.
- Files, ledger cards, canceled checks, deposit tickets, signature cards, and unissued CDs and savings certificates safeguarded from unauthorized access (including dual control over and prenumbering of unissued certificates and official checks).
- Periodic depositor account statements mailed regularly. Returned statements are controlled, with follow-up on a timely basis.
- Supervisory personnel designated by management to be responsible for periodically reviewing activity in employee accounts for unusual transactions.
- EFTs subject to control procedures that:
  - Segregate duties between employees who handle cash, balance EFT transactions, authorize EFTs, and post EFTs to deposit accounts.
  - Require authorization for EFTs exceeding a depositor's available balance.
  - Establish and maintain current, written agreements with all depositors making EFT requests, particularly for those customers who initiate EFT requests by telephone, modem, or other means not involving signed authorization. These agreements generally should be required to set forth the scope of the institution's liability and the agreed-upon security procedures for authenticating transactions (such as callbacks or passwords).
  - Provide for review of rejected transactions and the correction and reversal of entries by a supervisor.
  - Restrict initiation of EFTs and access to computer terminals or other EFT equipment.
  - Require that documentation of EFTs is provided to the parties involved on a timely basis.
  - Disclose the name of the debit party to the receiver of funds.
  - Provide for written instructions to employees and users concerning the EFT function.
  - Provide for use and confidentiality of authorized caller and other access codes or authentication algorithms, including periodic changes in such codes or algorithms.
  - Provide for maintenance of a current list of personnel authorized to initiate EFTs.
  - Establish authorization limits for personnel.

  - Provide for holds to be placed on customer accounts by EFT personnel when instructions are received directly from the authorized customer to confirm that available funds are in the customer's account or that the EFT funds are within authorized limits before the EFT is made.
  - Provide for maintenance of card files or authorization letters on file for all customers who initiate EFTs.
- Controls and verification procedures over requests for EFTs in place at respondent depository institutions.

13.46 The independent accountant may decide to perform procedures to obtain evidential matter about the effectiveness of both the design and operation of control activities to support a lower level of assessed control risk. Examples of tests of controls might include—

- Observing or otherwise obtaining evidence about segregation of duties and supervisory review of activity in employee accounts.
- Testing reconciliations of related accounts, including disposition of reconciling items and review and approval by a person other than the preparer.
- Testing controls over origination of and access to signature cards and mailing address files.
- Testing controls over the direct mailing of statements to depositors.
- Comparing withdrawal slips with the applicable signature cards.
- Testing controls over restrictions on deposits pledged as collateral, inactive or dormant accounts, and mail receipts.

13.47 Tests of control activities related to EFTs might include—

- Testing compliance with management's established authorization and verification procedures.
- Validating sequence numbers on transfers sent and received.
- Confirming that acknowledgments are returned for all outgoing messages.
- Reviewing management's daily comparison of the total number and dollar amount of EFTs sent and received with summaries received from the Federal Reserve.
- Testing reconciliations of daily reserve or clearing account statements for disposition of reconciling differences and supervisory review and approval.
- Testing procedures for identification and verification of EFTs with respondent institutions.
- Observing control activities that address access.

Substantive Tests

13.48 Audit procedures for deposits may include testing reconciliations of related subsidiary and general ledger accounts, confirmation of account balances, and analytical procedures.

13.49 ***Subsidiary Records and Reconciliations***. Procedures should be planned that provide reasonable assurance that the subsidiary ledger information to be confirmed and tested has been recorded properly in the general ledger. The disposition of reconciling items between general and subsidiary ledgers (such as returned items, adjustment items, holdovers, overdrafts, and service charges) should be investigated to determine whether any adjustments to recorded amounts are necessary.

13.50 ***Confirmations.*** Guidance on the extent and timing of confirmation procedures is found in SAS No. 39, *Audit Sampling* (AICPA, *Professional Standards*, vol. 1, AU sec. 350), and SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312). Guidance on planning, performing, and evaluating samples is included in SAS No. 45, *Omnibus Statement on Auditing Standards 1983* (AICPA, *Professional Standards*, vol. 1, AU sec. 313, "Substantive Tests Prior to the Balance Sheet Date"). Confirmation of deposits provides evidence about existence and accuracy. Because independent accountants are generally more concerned with the completeness of recorded deposits, the independent accountant should consider performing other substantive procedures. It would be appropriate for the independent accountant to use the negative form of confirmation request only when the combined assessed level of inherent and control risk is low and the independent accountant has no reason to believe that the recipients will not consider the requests (see SAS No. 67, *The Confirmation Process* [AICPA, *Professional Standards*, vol. 1, AU sec. 330], for additional guidance). If confirmations are used, active, inactive, and dormant accounts, and accounts closed during the period, should all be included in the population subject to audit procedures.

13.51 Some depositors may have instructed the institution not to send account statements to the depositor's mailing address. For such *no-mail* accounts, the independent accountant should review a written request from the depositor requesting the no-mail status and should use alternative procedures to obtain adequate evidence about the account balance. No-mail accounts and accounts for which confirmation requests are returned undelivered should be subjected to alternative procedures (such as personal contact with the depositor). (See paragraphs 31 and 32 of SAS No. 67 for additional guidance.)

13.52 ***Credit Union Supervisory Committee Procedures.*** It should be noted that one of the explicit duties of a federally insured credit union's supervisory committee is to perform a verification of the members' accounts. In addition to procedures required under generally accepted auditing standards (GAAS), auditors may be asked to extend their procedures to assist in meeting the supervisory committee's requirements. Section 701.12(e) of the NCUA's *Rules and Regulations* require that the verification be made using any of the following methods.

- A controlled verification of 100 percent of members' share and loan accounts.
- A sampling method that provides a random selection that is expected to be representative of the population from which the sample was selected, which will allow the auditor to test sufficient accounts in both number and scope to provide assurance that the general ledger accounts are fairly stated in relation to the financial statements taken as a whole. That sampling procedure must provide each dollar in the population an equal chance of being selected.
- Independent, licensed, certified public accountants are provided the additional option of sampling members' accounts using nonstatistical sampling methods consistent with applicable generally accepted auditing standards provided the sampling method provides a selection that allows the auditor to test sufficient accounts in both number and scope to provide assurance that the general ledger accounts are fairly stated in relation to the financial statements taken as a whole. Independent, licensed, certified public accountants will be responsible for documenting their sampling procedures, and providing evidence to NCUA, if requested, that the method used is consistent with applicable generally accepted auditing standards.

13.53 ***Accrued Interest Payable, Interest Expense, and Service Charge Income***. Audit procedures should be performed on accrued interest payable, interest expense, and service charge income in connection with other procedures on deposits. Audit procedures for such amounts include reviewing and testing reconciliations of subsidiary ledgers with the general ledger, recalculating interest paid, accrued interest payable, and service charge income, and testing of interest expense and service charge income for the period.

13.54 ***Other Analytical Procedures.*** Analytical review procedures can provide substantive evidence about the completeness of deposit-related financial statement amounts and disclosures; however, such procedures in tests of deposit expense are often less precise than substantive tests such as recalculations. Because institutions generally offer a wide variety of deposit products and rates (which change frequently during a financial reporting period), it is normally difficult to develop expectations to be used in analyzing yields on deposits. Accordingly, analytical procedures in this area should generally be considered only as a supplement to other substantive procedures, except where an expected yield can be known with some precision. Further guidance is provided in SAS No. 56, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 329), and SAS No. 31, *Evidential Matter*, as amended by SAS No. 80, *Amendment to Statement on Auditing Standards No. 31*, Evidential Matter (AICPA, *Professional Standards*, vol. 1, AU sec. 326). The independent accountant should be careful not to view trends entirely from a historical perspective; current environmental and business factors as well as local, regional, and national trends should be considered to determine if the institution's trend appears reasonable. Some analytical review procedures that should be considered include—

- Comparing the percentage of deposit growth during the period with historical percentages.
- Comparing the average deposit account balances during the period with those of prior periods.
- Reviewing the relative composition of deposits from period to period.
- Comparing the amounts and percentage ratio of dormant accounts to total deposits with those of prior periods.
- Comparing deposit interest rates with those prevailing in the institution's marketing area for the same periods.

CHAPTER 14

Federal Funds and Repurchase Agreements

INTRODUCTION

14.01 This chapter addresses two types of transactions—federal funds and repurchase agreements—that can be either investing or financing transactions, depending on which side of the transaction the financial institution participates. Federal funds transactions can be an important tool for managing liquidity. Repurchase agreements also can provide a cost-effective source of funds and may provide a means for the institution to leverage its securities portfolio for liquidity and funding needs.

Federal Funds Purchased

14.02 Federal funds are funds that commercial banks deposit at Federal Reserve Banks. Banks must meet legal reserve requirements on a daily basis by maintaining a specified total amount of deposits at Federal Reserve Banks and vault cash. A bank with excess reserves on a particular day may lend the excess, at an agreed rate of interest (the federal funds rate), to another bank needing funds to meet its reserve requirements that day. The federal funds market does not increase or decrease total reserves in the Federal Reserve System, but merely redistributes them to facilitate efficient use of bank reserves and resources. However, by setting reserve requirements the Federal Reserve may increase or decrease total reserves in the system. No physical transfer of funds takes place; the Federal Reserve Bank charges the seller's reserve balance and credits the buyer's reserve balance. In addition to buying and selling funds to meet their own needs, banks with correspondent banking relationships absorb or provide funds as a service or accommodation to their correspondents. Accordingly, banks may operate on both sides of the federal funds market on the same day.

14.03 Two types of transactions involving federal funds are commonly used. In an unsecured transaction, the selling bank sells federal funds on one day and is repaid with interest at maturity (usually the next day). In a collateralized transaction, other than by a repurchase agreement, a bank purchasing federal funds places U.S. government securities in a custody account for the seller until the funds are repaid. A borrowing bank records a liability (federal funds *purchased*) and a selling bank records an asset (federal funds *sold*).

Repurchase Agreements [1]

14.04 An institution that sells securities and agrees to repurchase the identical (or substantially the same) securities at a specified date for a specified price has entered into a repurchase agreement, or repo,[2] as a seller-borrower. Alternatively, an institution may participate as a buyer-lender by agreeing to purchase and resell at a specified future date for a specified price. Most repos involve obligations of the federal government or its agencies, but other financial instruments, such as commercial paper, banker's acceptances, and negotiable certificates of deposit (CDs), are sometimes used in repos. Repos are similar to the

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[1] Paragraphs 14.23 and following address whether, for accounting purposes, certain transfers of securities are considered sales or secured borrowings.

[2] Banks and broker-dealers (and this Guide) refer to agreements by seller-borrowers to sell and repurchase securities as repurchase agreements (repos) and agreements by buyer-lenders to purchase and resell securities as reverse repurchase agreements (reverse repos). Savings institutions and credit unions have in the past used the opposite terms, calling a seller-borrower's agreement a reverse repurchase agreement and a buyer-lender's agreement a repurchase agreement.

seller-borrower's borrowing funds equal to the sales price of the related securities with the securities as collateral. The difference in the price at which the institution sells its securities and repurchases them represents interest for the use of the funds. Most repo transactions occur with other depository institutions, dealers in securities, state and local governments, and customers (retail repurchase agreements). Maturities of such agreements are flexible and generally vary from one day to 270 days.

14.05 Dollar repurchase agreements (also called *dollar rolls*) are agreements to sell and repurchase similar but not identical securities. The dollar roll market consists primarily of agreements that involve mortgage-backed securities (MBSs). Dollar rolls differ from regular repurchase agreements in that the securities sold and repurchased, which are usually of the same issuer, are represented by different certificates, are collateralized by different but similar mortgage pools (for example, single-family residential mortgages), and generally have different principal amounts. The most common types of dollar rolls are fixed-coupon and yield-maintenance agreements.

14.06 In a fixed-coupon agreement, the securities repurchased have the same stated interest rate as, and maturities similar to, the securities sold and are generally priced to result in substantially the same yield. The seller-borrower retains control over the future economic benefits of the securities sold and assumes no additional market risk.

14.07 In a yield-maintenance agreement, the securities repurchased may have a different stated interest rate from that of the securities sold and are generally priced to result in different yields as specified in the agreement.[3] The seller-borrower surrenders control over the future economic benefits of the securities sold and assumes additional market risk. Yield-maintenance agreements may contain par cap[4] provisions that could significantly alter the economics of the transactions.

14.08 The terms of the agreements often provide criteria to determine whether the securities are similar enough to make the transaction, in substance, a borrowing and lending of funds or whether the securities are so dissimilar that the transaction is a sale and purchase of securities. For agreements involving securities collateralized by dissimilar pools, those transactions are accounted for as sales and purchases of securities.

14.09 ***Rollovers and Extensions.*** Occasionally, securities involved in repos are not delivered on the settlement date of the agreement and the contract may be rolled over or extended upon mutual agreement of the buyer-lender and seller-borrower.

14.10 ***Breakage.*** Securities repurchased under repos commonly have a principal amount that differs from the principal amount of the security originally sold under the agreement. This is particularly common to dollar rolls, which involve MBSs. That difference is referred to as breakage and occurs because the principal amounts of MBSs generally differ as a result of the monthly amortization of principal balances of mortgages collateralizing the MBSs. The amount of the breakage is a factor in determining whether substantially the same security is reacquired in the repo transaction, that is, whether good delivery (one in accordance with the agreement terms) has been met on repurchase of the MBSs.

14.11 ***Business Risk.*** Business risks associated with repos include the contractual and economic complexities inherent in certain of these transactions and the corresponding risk associated with the

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[3] The price-spread relationship between securities with different contract interest rates does not move in tandem. The existence of yield and price disparities provides opportunities for the buyer-lender to deliver, within the terms of the agreement, certificates providing the greatest benefit to the buyer-lender.

[4] A par cap provision limits the repurchase price to a stipulated percentage of the face amount of the certificate. Fixed-coupon agreements do not contain par cap provisions.

degree to which the institution's management understands the terms of the agreements and the economics of the transactions. Misunderstandings may result in incorrect pricing of the agreements or an incorrect assessment of the risks that are being assumed, the return that is anticipated to be earned, or the financing costs that are being incurred. Misunderstandings of the terms may also result in improper accounting treatment of the transaction (that is, as a sale and purchase or as a secured borrowing).

14.12 ***Market Risk.*** The prices of government securities vary inversely with changes in interest rates. Price changes may be small, but they can result in significant changes in the market values of government securities due to the large dollar amounts often involved in government securities transactions. This is generally referred to as *market risk*. Price changes may affect the ability of the seller-borrower under repos to continue the financing without providing additional collateral. Changes in prices also affect the margin in a transaction and may create a need for the seller-borrower to transfer additional securities or return cash.

14.13 The excess of the market value of the securities transferred by the seller-borrower over the amount of cash transferred by the buyer-lender is called a *haircut*. A haircut represents a margin of safety required by the buyer-lender to guard against a decline in the value of the collateral as a result of rising interest rates during the term of the agreement. Whether an agreement provides for a haircut depends on competition among buyer-lenders and seller-borrowers and their relative bargaining strengths. Haircuts generally range from a fraction of 1 percent to 4 percent or 5 percent but may be higher in certain instances.

14.14 All of the following factors are considered in determining the haircut for a particular transaction:

- *a.* The term of the agreement
- *b.* The creditworthiness of the institution
- *c.* The type of securities underlying the agreement, the length of time to maturity, and the creditworthiness of the issuer of the securities
- *d.* The volatility of the market value of the underlying securities
- *e.* The differential between the interest rate specified in the agreement and the interest rate on the securities

14.15 ***Credit Risk.*** A repo or reverse repo can be considered a loan of cash by one party and a loan of securities by another. When the agreement is completed, both loans are repaid. Parties to repo and reverse repo transactions are subject to credit risk, that is, the risk that the transaction counterparty will not perform under the terms of the agreement. For example, a seller-borrower is at risk that changes in market prices and resulting economic losses may prevent the buyer-lender from returning the securities at the maturity of the agreement.

14.16 Credit risk also exists to the extent that the issuer of the underlying securities may default. However, such risk may be negligible for securities issued or guaranteed by the U.S. government or its agencies. If the issuer of the underlying securities defaults, both participants in the repo are obligated to complete the transaction. This aspect of credit risk is affected by the extent to which the institution's repo position is concentrated in any one type of underlying security or with any one counterparty.

14.17 The extent of credit risk faced by a seller-borrower also depends on the buyer-lender's business policies and practices for control and use of collateral, the extent of the haircut on securities serving as collateral, the extent to which the buyer-lender offsets transactions (that is, maintains a matched book), and the buyer-lender's extent of capitalization.

14.18 Analyzing credit risk requires an understanding of how securities dealers and other counterparties to repos manage their businesses and of the steps that can be and are taken to reduce their exposure to market risk. Securities dealers are typically highly leveraged, with securities positions that represent large multiples of their net capital and that can quickly be eroded by adverse market changes. Many securities dealers entering into repos frequently employ matched-book transactions. In a matched-book transaction, the securities dealer effects both a repo and a reverse repo with the same underlying securities for the same period of time but usually at slightly different rates. By running a matched book, a dealer can reduce its exposure to market changes, and a seller-borrower may face less credit risk by entering into agreements with a dealer that has a matched book and employs adequate procedures to control credit risk. Even if the dealer runs a matched book, the seller-borrower still faces credit risk associated with the dealer's credit risk, that is, the risk that a customer of the dealer might not be able to complete its agreement with the dealer.

14.19 ***Risk of Collateral Loss.*** When an institution transfers the securities sold under an agreement to repurchase, there is a risk that the dealer may not be able to reverse the transaction by selling the securities back at the agreed price. If the institution overcollateralizes the agreement by selling the securities at a relatively large discount from the market price, its rights to the overage may be diminished or lost entirely in the event of the dealer's bankruptcy. In that case, the institution may find that neither the securities nor the funds to replace the securities are available for the dealer to complete the transaction and, as a result, may incur an economic loss. If the institution does not have the legal right of setoff, the potential economic loss extends to the full value of the securities, including accrued interest.

14.20 If the institution has the legal right to set off the securities against the borrowed funds, the potential economic loss is limited to the excess of the market value of the securities, plus accrued interest, at the date of the sale over the amount borrowed, plus or minus any change in that market value and accrued interest. However, the accounting loss may be greater or less than the economic loss if the book value of the securities is above or below their market value. (See paragraph 12.30.)

14.21 Securities purchased under agreements to resell (reverse repos) pose risk to buyer-lenders to the extent that they do not take possession of the securities they agreed to resell. If the buyer-lender or securities dealer through whom the transaction is made does not perfect a security interest in securities purchased (by having signed an agreement and by taking possession, either directly or through a custodian acting as its agent), the potential economic loss extends to the full value of the securities and the risk assumed namely, credit risk becomes that of an unsecured lender. Institutions reduce such risk (*a*) by making sure that definitive collateral is held by the counterparty's custodian as the counterparty's agent with specific identification of the assignee, (*b*) by settling through the Federal Reserve System, where book-entry collateral is transferred directly or by a notation entry, (*c*) by evaluating the creditworthiness of the other party to the agreement, and (*d*) by overcollateralizing the borrowing.

REGULATORY MATTERS

14.22 In 1985, the FFIEC issued a policy statement that was adopted by the OCC, FRB, and FDIC. The policy established guidelines for insured depository institution repurchase agreement activities including guidelines for written repurchase agreements, policies and procedures, credit risk management, and collateral management. The OTS has not separately adopted the policy statement, but refers federal savings associations to the FFIEC policy statement. In 1998, the FFIEC modified the policy statement to reflect the enactment and inclusion of other laws and regulations applicable to repurchase agreements and to update the list of written repurchase agreement provisions with an expanded list of provisions to reflect current market practice.

ACCOUNTING AND FINANCIAL REPORTING

14.23 As discussed beginning in paragraph 5.79, Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*[♣], provides accounting and reporting standards for transfers of financial assets, including repurchase transactions. Paragraphs 66 through 68, 70, and 71 provide implementation guidance for accounting for repurchase agreements.

14.24 Paragraph 68 of FASB Statement No. 125 says:

> If the criteria in paragraph 9 [of the Statement] are met, including the third criterion, the transferor shall account for the repurchase agreement as a sale of financial assets and a forward repurchase commitment, and the transferee shall account for the agreement as a purchase of financial assets and a forward resale commitment. Other transfers that are accompanied by an agreement to repurchase the transferred assets that shall be accounted for as sales include transfers with agreements to repurchase at maturity and transfers with repurchase agreements in which the transferee has not obtained collateral sufficient to fund substantially all of the cost of purchasing replacement assets.

14.25 Paragraph 70 of the Statement notes that, under many agreements to repurchase transferred assets before their maturity the transferor maintains effective control over those assets. (Paragraphs 27 through 30 of FASB Statement No. 125 provide guidance on determining whether an agreement maintains effective control over transferred assets.) Thus, paragraph 70 says that repurchase agreements that do not meet all the criteria in paragraph 9 of FASB Statement No. 125 should be treated as secured borrowings.

14.26 Paragraph 27 of FASB Statement No. 125 says an agreement that both entitles and obligates the transferor to repurchase or redeem transferred assets from the transferee maintains the transferor's effective control over those assets, and the transfer is therefore to be accounted for as a secured borrowing, if and only if all of the following conditions are met:

- *a.* The assets to be repurchased or redeemed are the same or substantially the same as those transferred (paragraph 28 of the Statement gives related guidance [paragraph 12.27 herein]).
- *b.* The transferor is able to repurchase or redeem them on substantially the agreed terms, even in the event of default by the transferee (paragraph 29 of the Statement [paragraph 12.28 herein]).
- *c.* The agreement is to repurchase or redeem them before maturity, at a fixed or determinable price.
- *d.* The agreement is entered into concurrently with the transfer.

14.27 Paragraph 28 of FASB Statement No. 125 says that, to be substantially the same, the asset that was transferred and the asset that is to be repurchased or redeemed need to have all of the following characteristics:

- *a.* The same primary obligor (except for debt guaranteed by a sovereign government, central bank, government-sponsored enterprise or agency thereof, in which case the guarantor and the terms of the guarantee must be the same).[5]

[♣] The FASB has issued an Exposure Draft, *Accounting for Transfers of Financial Assets-an amendment of FASB Statement No. 125*, that would revise standards for transfers of financial assets by modifying criteria and guidance for determining whether the transferor has relinquished control of assets and the transfer is therefore accounted for as a sale. This proposed amendment of FASB Statement No. 125 may affect the accounting for repurchase agreements. The FASB anticipates issuing a Final Statement during 2000. Readers should be alert to any final pronouncement.

[5] The exchange of pools of single-family loans would not meet this criterion, because the mortgages making up the pool do not have the same primary obligor and would therefore not be considered substantially the same.

b. Identical form and type so as to provide the same risks and rights.[6]

c. The same maturity (or in the case of mortgage-backed pass-through and pay-through securities have similar remaining weighted-average maturities that result in approximately the same market yield).[7]

d. Identical contractual interest rates.

e. Similar assets as collateral.

f. The same aggregate unpaid principal amount or principal amounts within accepted "good delivery" standards for the type of security involved.[8]

14.28 Paragraph 29 of FASB Statement No. 125 says that, to be able to repurchase or redeem assets on substantially the agreed terms, even in the event of default by the transferee, a transferor must at all times during the contract term have obtained cash or other collateral sufficient to fund substantially all of the cost of purchasing replacement assets from others.

14.29 Paragraph 30 of FASB Statement No. 125 notes that a call option or forward contract that entitles the transferor to repurchase, prior to maturity, transferred assets not readily obtainable elsewhere maintains the transferor's effective control, because it would constrain the transferee from exchanging those assets, unless it is only a cleanup call (as defined).

14.30 ***Offsetting.*** Financial institutions may operate on both sides of the federal funds and repo markets on the same day. Accounting Principles Board Opinion No. 10, *Omnibus Opinion 1966*, 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*, defines right of setoff and specifies conditions that must be met to permit offsetting. FASB Interpretation No. 41, *Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements*, modifies FASB Interpretation No. 39 to permit offsetting in the statement of financial position of only payables and receivables that represent repos and reverse repos and that meet all of the conditions specified therein and does not apply to securities borrowing or lending transactions.

14.31 As discussed in paragraph 5.104, paragraph 17 of FASB Statement No. 125 requires certain disclosures about transfers and servicing of financial assets. Paragraph 17a, as amended, requires an entity that has entered into repurchase agreements or securities lending transactions to disclose its policy for requiring collateral or other security.

14.32 ***Fair Value Disclosures.*** FASB Statement No. 107, *Disclosures about Fair Value of Financial Assets*, as amended, requires disclosures of fair values of all financial instruments for which it is practicable to estimate fair value.[*] The carrying amounts of repos and reverse repos maturing within 90 days generally

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[6] For example, the following exchanges would not meet this criterion: Government National Mortgage Association (Ginnie Mae) I securities for Ginnie Mae II securities; loans to foreign debtors that are otherwise the same except for different U.S. foreign tax credit benefits (because such differences in the tax receipts associated with the loans result in instruments that vary "in form and type"); commercial paper for redeemable preferred stock.

[7] For example, the exchange of a *fast-pay* Ginnie Mae certificate (that is, a certificate with underlying mortgage loans that have a high prepayment record) for a *slow-pay* Ginnie Mae certificate would not meet this criterion, because differences in the expected remaining lives of the certificates result in different market yields.

[8] Participants in the MBS market have established parameters for what is considered acceptable delivery. These specific standards are defined by the Public Securities Association (PSA) and can be found in *Uniform Practices for the Clearance and Settlement of Mortgage-Backed Securities and Other Related Securities*, which is published by the PSA.

[*] In December 1996, the FASB issued FASB Statement No. 126, *Exemption from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities*, which makes the disclosures about fair value of financial instruments prescribed in FASB Statement No. 107 optional for entities that meet all of the following criteria specified in paragraph 2 of FASB Statement No. 126:

would approximate their fair values. Under FASB Statement No. 107, quoted market prices should be used to estimate fair values. If quoted market prices are not available, quoted market prices and prevailing interest rates of financial instruments with similar characteristics should be used to estimate fair value.

AUDITING

Objectives

14.33 The primary objectives of audit procedures applied to federal funds and repo transactions are to obtain reasonable assurance that

a. The reported amounts include all federal funds purchased or sold and that repos and reverse repos are properly identified, described, and disclosed; include all such agreements; and are stated at appropriate amounts.
b. Interest expense or income and the related balance sheet accounts are properly measured and reported in the proper periods.
c. Repos and dollar rolls accounted for as secured borrowings meet the criteria for secured borrowings, including the condition that the assets to be repurchased or redeemed are the same or substantially the same as those transferred.
d. Federal funds and repo transactions have been executed in accordance with management's authorizations and are obligations of the institution.
e. Assets pledged as collateral for federal funds and repo transactions are properly disclosed in the financial statements.
f. The federal funds sold and securities purchased under reverse repos exist and are either on hand or are held in safekeeping or custody for the bank.
g. The institution has legal title or similar rights of ownership for all recorded securities.
h. Recorded amounts include all such assets owned by the institution, and the financial statements include all related transactions during the period.
i. The values at which securities are reported are appropriate.
j. Realized and unrealized gains and losses on sales of securities are properly measured, recorded, and disclosed.
k. Securities involved in such agreements are properly described and classified in the financial statements and the related note disclosures are adequate.

Planning

14.34 In planning the audit, the independent accountant should consider the factors influencing inherent risk, which are described in chapter 5, as they relate to financial statement assertions. Federal funds transactions are fairly routine for most institutions, are generally not complex, and many have matured by the close of audit fieldwork; thus, less risk may be associated with this account balance at a specific institution. Normal auditing procedures for borrowed funds should be applied to such obligations. However, certain repo transactions, whether viewed from an accounting, legal, or economic perspective, are extremely complex.

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a. The entity is a nonpublic entity (as defined in FASB Statement No. 126).
b. The entity's total assets are less than $100 million on the date of the financial statements.
c. The entity has no instrument that, in whole or in part, is accounted for as a derivative instrument under FASB No. 133, *Accounting for Derivative Instruments and Hedging Activities*, during the reporting period.

FASB Statement No. 133, as amended by FASB Statement No. 137, *Accounting for Derivative Instruments and Hedging Activities - Deferral of the Effective Date of FASB Statement No. 133*, is effective for all fiscal quarters of fiscal years beginning after June 15, 2000. On March 3, 2000, the FASB issued an Exposure Draft, *Accounting for Certain Derivative Instruments and Certain Hedging Activities —an Amendment of FASB Statement No. 133*. Readers should be alert to any final pronouncement. The FASB has established the Derivative Implementation Group (DIG) to assist the Board and its staff in providing implementation guidance regarding FASB Statement No. 133. Issues addressed by the DIG and the status of related guidance can be found at the FASB's Web site at www.fasb.org.

Also, the risks involved in repo transactions vary widely, depending on the terms of the agreement, the parties involved, and the legal status of the agreement. The risks faced by an institution entering into a repo are generally reduced if the institution maintains effective controls related to the authorization, processing, and recording of these transactions. The auditing guidance in this chapter focuses on repo transactions.[9]

14.35 The independent accountant should review the current year's interim financial statements, board of directors' reports and minutes, supervisory examination reports or related reports, and pertinent financial information and accounting to obtain an understanding of the level of activity in federal funds and repos, types of transactions entered into, accounting treatment (financing versus a sale and repurchase), and compliance with the institution's established investment and asset/liability management policies.

14.36 The independent accountant should be aware that when the institution concentrates its repos with one dealer or a small group of dealers, the evaluation of credit risk and counterparty risk assumes particular importance. The independent accountant should—

a. Consider the institution's controls over evaluating the reputation and financial strength of the dealer.

b. Review the latest audited financial statements of the dealer.

c. Determine the specific entity within an affiliated group with which the institution is doing business.

d. Be alert to the implications of transactions between that entity and its affiliates.

14.37 The audit procedures applied to federal funds purchased and securities sold under agreements to repurchase are also appropriate for federal funds sold and securities purchased under agreements to resell. However, the independent accountant should also be aware that as a buyer-lender an institution might not take delivery of the securities that serve as collateral in a repo transaction. If it does take delivery, either directly or indirectly through another party acting as its agent, credit risk is less than may otherwise be the case; the independent accountant should consider confirming the occurrence and terms of the transaction, and the seller-borrower's obligation to repurchase the securities with the seller-borrower, and should consider counting securities in the institution's possession and confirming securities not in its possession with the custodian.

14.38 Whenever a buyer-lender or its agent does not take delivery of the securities, the independent accountant should consider confirming not only the occurrence and terms of the transaction and the obligation to repurchase the securities but also that they have not been delivered and are being held on the institution's behalf. The independent accountant should also recognize that, when delivery is not made, the transaction has many of the attributes of an unsecured loan. Accordingly, the independent accountant should consider assessing the reputation and financial strength of the seller-borrower and of its custodian. Based on those assessments, the independent accountant should consider the desirability of obtaining a report from the custodian's independent accountant on the custodian's internal accounting controls over securities held in safekeeping, about which Statement on Auditing Standards (SAS) No. 70, *Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324), provides guidance. The report should cover both the design of the system and compliance tests directed to specific objectives of internal accounting control over the custodial function.

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[9] In June 1985, a special task force of the Auditing Standards Board (ASB) issued a report on auditing repurchase agreements entitled *Report of the Special Task Force on Audits of Repurchase Securities Transactions*. The nonauthoritative report was the result of the task force's study of the adequacy of existing guidance on auditing transactions involving repo and reverse repo of securities. The report provides guidance with respect to accounting and reporting considerations, auditing considerations, and risk considerations.

Internal Control Over Financial Reporting and Possible Tests of Controls

14.39 SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), provides guidance on the independent accountant's consideration of an institution's internal control in an audit of financial statements performed in accordance with GAAS. It describes the components of internal control and explains how an independent accountant should consider internal control in planning and performing an audit. Paragraph 19 of SAS No. 55, as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55*, requires that, in all audits, the independent accountant obtain sufficient understanding of each of the five components (the control environment, risk assessment, control activities, information and communication, and monitoring) to plan the audit by performing procedures to understand the design of policies and procedures relevant to audit planning and whether they have been placed in operation.

14.40 The independent accountant should gain an understanding of the institution's internal control over financial reporting of federal funds and repo transactions. (Chapters 5 and 13 discuss related control issues for investments and borrowings, respectively.) Examples of controls in this area are as follows:

- The institution has formal, written policies that specify the types of securities that can be sold or repurchased under repos.
- Formal policies and procedures are in place to provide that repo transactions are executed in accordance with written contracts that describe the rights and obligations of the parties. Master agreements used by the institution should be entered into by authorized personnel and should specify the terms of the transactions and the intent of the parties.
- Only board-approved securities dealers and other institutions are allowed to enter into transactions with the institution.
- The institution has policies and procedures to provide that only authorized individuals enter into and approve such transactions and that those individuals are aware of the inherent risks and returns of such agreements. The institution's board of directors sets limits on the amount and terms of agreements with particular securities dealers and other institutions.
- The institution has policies and procedures for monitoring the reputation, financial stability, and creditworthiness of securities dealers and other institutions with which the institution may enter into an agreement as a basis for evaluating their ability to fulfill their obligation to return the collateral to the institution.
- The institution has procedures for monitoring communications with securities dealers and other institutions and for reviewing confirmations from securities dealers to detect unrecorded or inappropriately recorded transactions and to determine the reasonableness of interest rates.
- Initial transactions and rollover agreements are reviewed by a responsible official who determines whether the transactions represent sales or financing transactions.
- Written policies require frequent evaluation of the market value, including accrued interest, of the agreements and required collateral levels.
- The subsidiary ledgers containing information on securities collateralizing agreements are periodically reconciled to the general ledger.
- Policies and procedures exist to monitor the use of hedging techniques, if any, to reduce market risk.

14.41 The independent accountant may perform tests of controls to obtain evidence of the effectiveness of controls and conclude that control risk is below the maximum. Examples of tests of controls the independent accountant may perform include the following:

- Obtain and review the institution's written investment and asset/liability management policies (or other applicable policies relating to the management of federal funds and repo transactions), and consider whether such policies have been reviewed and approved by the institution's board of directors.

- Obtain the institution's approved list of counterparties to agreements, and compare the list with those dealers with whom borrowing transactions were entered into during the current year. Ascertain that counterparty limits set by the board of directors have not been exceeded.
- Review selected transactions to consider whether all significant terms were specified and documented and whether the amounts and terms were consistent with those established by the institution's formal investment and asset/liability management policies.
- Review supporting documentation for transactions, and consider whether only authorized individuals entered into or otherwise executed those transactions on behalf of the institution.
- Test whether the institution has properly followed procedures for recording the difference between the selling price and repurchase price as interest expense and whether interest expense is properly recorded on other borrowings, such as federal funds purchased.[10]
- Review the latest audited financial statements of the counterparties and other available reports, such as reports on internal control or special-purpose reports by the dealer's accountant, to determine whether the dealer has net capital in excess of statutory requirements.[11]

14.42 If there is reason to question the creditworthiness of the counterparty, the independent accountant should consider consulting with legal counsel regarding whether, in the event of the counterparty's inability to return (sell back) the collateral securities, the institution has the right to set off the loan liability against the collateral.

Substantive Tests

14.43 ***Inspection of Repo or Other Documentation of Borrowing.*** Repos and other source documents should be reviewed by the independent accountant and relevant details should be agreed to the respective recording of the liability in the subsidiary records. The independent accountant should consider testing that securities collateralizing the borrowing are adequately identified to ensure proper disclosure, and the amounts and description should be agreed to the respective subsidiary ledger.

14.44 ***Confirmation.*** The independent accountant should consider confirming the amount and all significant terms of federal funds and repos with the respective securities dealers, customers, and institutions. Details of any rollovers or extensions of repos should be agreed to brokers' advices. Confirming the repo transactions provides evidence of the occurrence of the transactions, their terms, and the treatment of the underlying securities, for example, evidence that the securities were delivered to the counterparty; confirmation does not provide evidence about the existence, location, or transferability of the securities or about the counterparty's ability to complete the transactions. It is usually impracticable to confirm the location of the securities delivered to the counterparty as collateral. The counterparty often is not able to determine the exact location of the securities delivered because they are fungible with other securities of the same issue under the dealer's control and are commingled with those securities. In addition, the counterparty may have appropriately used the securities for collateral in another repo or dollar roll in which the counterparty sold the securities to be repurchased at a later date. The seller-borrower and its independent accountant need not necessarily be concerned, however, about the location of securities transferred to the counterparty as collateral because their location does not necessarily affect the risk that the counterparty may not complete the transactions.

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[10] These procedures also could be performed to provide substantive evidence.

[11] See footnote 9 in this chapter.

14.45 The independent accountant should consider the need to assess the counterparty's ability to complete the transaction by other procedures, such as testing subsequent completion of the transaction, reviewing audited financial statements of the counterparty, considering the regulatory requirements applicable to the counterparty, and, if necessary, obtaining a special-purpose report from the counterparty's independent accountant.

14.46 ***Review of Related Party Transactions.*** The independent accountant should consider reviewing borrowing transactions involving related parties that have been accounted for as sales transactions to determine whether there are potential unrecorded financing transactions. A review of transaction activity may indicate that an event accounted for as two separate transactions a sale and subsequent purchase is in fact a repo that should be accounted for as a financing. The independent accountant should be alert for related party transactions that are improperly accounted for, possibly to avoid recognizing losses on sales.

14.47 ***Assess Collateral Risk.*** The independent accountant should assess the collateral risk through consideration of the counterparty's reputation, financial position, and market presence. The independent accountant should review the current market values, including accrued interest, of securities serving as collateral and consider whether the collateral is sufficient or excessive in relation to the requirements of the agreement. Further, the independent accountant should assess whether those securities repurchased under repos meet the substantially-the-same criteria for financing transactions or whether a gain or loss should have been recorded under a sales transaction. Also, the independent accountant should test whether collateral held should be recognized on the balance in accordance with FASB Statement No. 125.

14.48 ***Analytical Procedures.*** Chapters 7 and 15 discuss analytical procedures that may also be applied in this area.

14.49 ***Tests of Fair Value Disclosures.*** The independent accountant should test the institution's fair value disclosures by referring to the quoted market prices or prevailing interest rates of the same or similar instruments to evaluate whether the estimates are reasonable. SAS No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1, AU sec. 342), provides guidance on evaluating accounting estimates.

14.50 ***Other Procedures.*** Other audit procedures related to repos that the independent accountant may consider performing are as follows:

- Read the board of directors' minutes to determine whether financing transactions have been authorized.
- Test whether approved securities dealers are used, and whether financing arrangements comply with the institution's established policies.
- Recompute gains or losses on reverse repos that are not accounted for as financing agreements on a test basis.

14.51 The independent accountant should be aware that when the institution concentrates its repos with one counterparty or a small group of counterparties, the evaluation of credit risk assumes particular importance. The independent accountant should consider the institution's controls over evaluating the reputation and financial strength of the counterparty. The independent accountant should also consider reviewing the latest audited financial statements of the counterparty. The independent accountant should consider determining the specific entity within an affiliated group with which the institution is doing business, and should be alert to the implications of transactions between that entity and its affiliates.

CHAPTER 15

Debt

INTRODUCTION

15.01 Depository institutions use long- and short-term borrowings to provide funds that supplement deposits and to carry out their overall asset/liability management strategy. Finance and mortgage companies cannot take deposits, and therefore, rely almost exclusively on borrowings to fund loans and operations.

15.02 Debt-to-equity ratios of finance companies generally are higher than those of manufacturing companies because finance company assets consist more of liquid receivables than of inventories and fixed assets. Debt-to-equity ratios of at least four-or five-to-one are not uncommon for finance companies. However, finance companies' leverage has traditionally been much lower than leverage of depository institutions.

15.03 Debt may be classified as senior, senior subordinated, and junior subordinated. The classifications describe declining priorities, which become especially significant when solvency becomes questionable.

15.04 Company policy and credit rating goals cause companies to establish diverse target amounts for each priority category of debt. Moreover, debt agreements usually contain restrictions on the amount of debt that may be incurred in each category. For example, a common restriction in debt securities issued to the general public prohibits pledging assets to secure new or existing debt. Other common restrictions may limit dividend payments and the amount of additional senior debt that can be incurred. If an issuer has other restrictions in its current typical public issue, lenders commonly demand the same restrictions in a private placement.

15.05 The creditworthiness of an institution's debt may be assessed by a rating agency based on analysis of ratios and other factors.[1] Ratings directly affect the institution's cost of borrowing and, thus, its ability to borrow. Institutional investors, such as other financial institutions, insurance companies, trusts, mutual funds, and pension and profit sharing plans, rely heavily on credit ratings when making investment decisions. Some are prohibited by law or formal agreement from investing in debt below a specified minimum level. For example, some states prohibit licensed domestic insurance companies from investing in corporate obligations that do not meet specified fixed-charge coverage ratios. Similarly, many government agency pension funds are prohibited by law from investing in securities that do not have an investment grade rating.

Long-Term Debt

15.06 The most common long-term debt funding sources are debentures and notes. Institutions also may have long-term mortgages, obligations and commitments under capital leases, and mandatorily redeemable preferred stock, which have many of the characteristics of debt. Such obligations are similar to those of other kinds of enterprises. Funds are also borrowed through Eurodollar certificates, collateralized mortgage obligations (CMOs) and real estate mortgage investment conduits (REMICs), mortgage-backed bonds (MBBs), mortgage-revenue bonds, and Federal Home Loan Bank (FHLB) advances.

[1] For example, many debt agreements consider the debt in default if the issuer fails to pay interest. Accordingly, credit risk may be assessed (in part) through analysis of fixed-charge coverage, which is the ratio of pretax earnings (before interest expense) to interest expense.

15.07 The terms of an institution's long-term debt obligations vary widely. They may be secured or unsecured; unsecured is far more prevalent. The debt may be senior or subordinated to other debt. The debt may be convertible into shares of common stock. Convertible debentures are convertible into stock at a specified price at the option of the holder. In most cases, convertible debt securities are also callable at the option of the issuer, generally beginning a few years after issuance. Interest rates may be fixed or floating.

15.08 Credit unions may borrow from individuals (whether or not they are members of the credit union) by issuing promissory notes or *certificates of indebtedness*. Certificates of indebtedness are generally uninsured. Their issuance is governed by Section 701.38 of *NCUA Rules and Regulations.* Credit unions can have access to the NCUA maintained Central Liquidity Facility for short term borrowing by either being a member directly, or indirectly through an agent, which is usually a corporate credit union. Other notes issued by credit unions are generally payable to corporate credit unions or other financial institutions, or a Federal Reserve Bank.

15.09 Institutions and their subsidiaries sometimes finance expansion using traditional real estate mortgages.

Short-Term Debt

15.10 ***Repurchase Agreements (Repos).*** Repos are discussed in chapter 14.

15.11 ***Federal Funds Purchased.*** Federal funds purchased are discussed in chapter 14.

15.12 ***Commercial Paper.*** Commercial paper is an unsecured promissory note that provides creditworthy institutions typically, finance companies or holding companies of banks and savings institutions with short-term funds. Commercial paper is generally short-term (at most 270 days, but usually much less) and negotiable.

15.13 Institutions that rely heavily on commercial paper generally sell and redeem it continuously. They may sell more commercial paper than needed on certain days simply to maintain a market for customers who wish to invest beyond the finance company's current needs. Sales of commercial paper may also increase when large amounts of commercial paper or long-term debt mature. Proceeds in excess of current needs are often invested through repurchase agreements, Eurodollar deposits, or commercial paper issued by others.

15.14 ***Lines of Credit.*** Institutions often obtain funds through lines of credit from banks and savings institutions.

15.15 Institutions may obtain lines of credit as a source of funds or to provide creditors with assurance that commercial paper and other shorter term debt will be repaid. Further, rating agencies generally will not rate a finance company's commercial paper if it is not supported by a line of credit.

15.16 Institutions may pay commitment fees, maintain compensating balances, or do both to have lines of credit available. Interest rates on borrowings under lines of credit are usually based on a spread over the lender's prime rate based on the lender's assessment of credit risk.

15.17 ***Borrowing From Federal Reserve Discount Windows and FHLBS.*** Member depository institutions may borrow from their regional Federal Reserve Bank in the form of discounts (often called *rediscounts*) and advances, which are primarily used to cover shortages in the required reserve account and also in times of liquidity problems. Most institutions regard the discount window as a lender of last resort. A discounting transaction is technically a note to the Federal Reserve with recourse secured by a member institution's eligible loans. In an advancing transaction, a member institution executes a promissory note, which is collateralized generally by government securities to the Federal Reserve. Most discount-window transactions are in the form of advances. Interest charged in those transactions is referred to as *discount*. The rates are set biweekly by the individual reserve banks. Such loans usually have short maturities. Members of the FHLB System (FHLBS) can obtain advances of varying maturities from their district FHLBs. FHLB advances often are secured through pledges of loans or securities.

15.18 ***Treasury Tax and Loan Note Accounts.*** Employers that withhold federal taxes from employees' pay are required to deposit those funds periodically with a bank or savings institution. Institutions record such deposits, which are non-interest-bearing, as treasury tax and loan accounts (TT&L accounts) and include such accounts with their deposits. However, on the day after receipt such funds must be remitted to the Federal Reserve Bank or converted into an open-ended, interest-bearing note, commonly referred to as a *treasury tax and loan note account.*

15.19 ***Bankers' Acceptances***. A banker's acceptance, which is often used to finance shipments of goods to bank customers, is a short-term time draft that a bank (drawee) has agreed to pay at maturity by stamping "accepted" over the signature of an officer. When the bank accepts the draft, it guarantees its redemption at maturity, which makes the draft negotiable. In return for the guarantee, the party on whose behalf the bank accepts the draft (drawer) agrees to provide the bank with the necessary funds prior to maturity. The bank receives a fee for creating the acceptance. The drawer's outstanding debt to the bank is reported as an asset, and the bank's obligation is reported as a liability. Bankers' acceptances are similar to other short-term borrowed funds in that they can be effectively used for short-term liquidity needs by avoiding disbursing funds for short-term loans to bank customers.

15.20 ***MBBs***. MBBs are any borrowings (other than those from an FHLB) collateralized in whole or in part by one or more real estate loans. MBBs typically have the following characteristics:

- *a.* Fixed maturities or payments of principal and interest
- *b.* The use as collateral of mortgage loans or mortgage-backed securities (MBSs) owned by the issuer
- *c.* Stated or fixed interest rates with interest payable monthly or semiannually (there may also be call provisions)
- *d.* Principal payments made through periodic sinking-fund payments or at final maturity
- *e.* Mortgage collateral in which the purchaser does not have an ownership interest
- *f.* Collateral values usually ranging from 110 percent to 200 percent of the amount of the debt issue, so that the collateral exceeds the principal value during its entire outstanding life (overcollateralization)

15.21 The total mortgage collateral pool is generally overcollateralized to the extent necessary to provide assurance that the investor can sell the mortgage loans without loss in the secondary market should the MBB issuer default.

15.22 ***Preferred Stock and Other Obligations of Finance Subsidiaries***. Finance subsidiaries, as defined in federal banking regulations, are a means by which institutions can issue preferred stock and other securities at rates lower than those the institutions would otherwise have to pay if they issued the securities directly. Thus, finance subsidiaries afford banking institutions the opportunity to obtain less costly funds.

15.23 In a structured financing (the simplest form of a finance subsidiary), the parent institution transfers certain assets to a special-purpose finance subsidiary to collateralize or otherwise support the securities issued by the finance subsidiary. In return for the assets, the subsidiary remits the net proceeds of the offering to the parent for use in operations. Where debt is issued at the subsidiary level, the trustee for the debt perfects a security interest in the transferred collateral. If preferred stock is issued, no security interest is perfected. However, because the finance subsidiary is chartered for the limited purpose of issuing the securities and can neither incur debt nor engage in any other business, the preferred stock is, in fact, insulated from other encumbrances and is, therefore, backed by the collateral in a manner approximating a security interest. The result is to provide greater protection for preferred stockholders than any of them would have had if the parent institution had been the issuer.

15.24 The economic value of this financing technique is made possible by a variety of factors. Because of the requirements established by the rating agencies, preferred stock offerings are significantly overcollateralized by a combination of mortgage securities, short-term money-market instruments, treasuries, and other securities. This degree of collateralization, combined with the protection afforded by the structure, enables the rating agencies to issue triple-A ratings. Additionally, because qualified corporate taxpayers holding preferred stock are eligible for a deduction of a specified percentage of dividends received, the dividends paid by the issuer can be low by market standards, making the transaction a low-cost "borrowing" for the parent.

15.25 ***CMOs***. As introduced in paragraph 5.25, CMOs are multiclass, pay-through bonds collateralized by MBSs or mortgage loans and are generally structured so that all, or substantially all, of the collections of principal and interest from the underlying collateral are paid to the holders of the bonds. Typically, the bonds are issued with two or more maturity classes; the actual maturity of each bond class varies depending upon the timing of the cash receipts from the underlying collateral. CMOs are usually issued by a minimally capitalized special-purpose corporation (issuer) established by one or more sponsors (that is, the original owners of the mortgages). The MBSs collateralizing the obligations are acquired by the special-purpose corporation and then pledged to an independent trustee until the issuer's obligation under the bond indenture has been fully satisfied. The investor agrees to look solely to those trusteed assets and the issuer's initial capital (collectively referred to as *segregated assets*) for repayment of the obligations. Therefore, the sponsor and its other affiliates no longer have any financial obligations for the instrument, although one of those entities may retain the responsibility for servicing the underlying mortgage loans.

15.26 For the sponsor of the CMO, cash is immediately generated; there is no waiting for collection of the amounts when the respective mortgage payments come due. Credit enhancement of CMOs is generally achieved by using collateral that carries a third-party guarantee; otherwise, they are overcollateralized to mitigate the risk of default. The excess collateral reverts to the sponsor at the maturity of the CMOs. The sponsor of the CMO issuer may retain any residual (see chapter 5) or an unrelated third party may acquire the residual as an investment.

15.27 For both the issuer and investor, cash flows may not materialize as scheduled. For example, prepayments of the underlying mortgages at a greater-than-anticipated rate can reduce the yield to maturity expected by the investor.

15.28 ***REMICs***. REMICs are vehicles for issuing multiclass mortgage-backed obligations that require compliance with a number of technical requirements of the Internal Revenue Code (IRC). REMIC refers to the taxable entity (rather than to the security structure like a CMO and other types of mortgage-backed borrowings). Failure to comply with the requirements could result in imposition of a corporate income tax on the gross income of the REMIC. REMIC certificates of ownership are qualifying real property loans and qualified assets under the IRC.

15.29 To qualify for REMIC status as defined by the IRC, all of the assets continuously held by the REMIC must consist of qualified mortgages and permitted investments. In general, the term, *qualified mortgages* refers to mortgages that are principally collateralized by an interest in real property and are transferred to the REMIC at the time of its formation or purchased by the REMIC within three months of its formation. Qualified mortgage also refers to a regular interest in another REMIC. The term *permitted investments* includes cash flow investments, qualified reserve assets, and foreclosed property.

15.30 All of the interests in the REMIC must consist of either regular interests or residual interests. A regular interest is an interest that unconditionally entitles the holder to receive specified principal and interest payments under terms that are fixed at the time of the REMIC's formation. A residual interest is any interest in a REMIC that is not a regular interest. Only one class of residual interest may exist with respect to a REMIC. In other words, the rights of all of the holders of interests that do not qualify as regular interests must be exactly the same.

REGULATORY MATTERS

15.31 Institutions regulated by the Office of Thrift Supervision (OTS) must notify the OTS before borrowing money, unless the institution meets regulatory capital requirements and any applicable minimum capital directive. Regulations may also prohibit growth above a certain level without prior regulatory approval. Further, savings institutions must obtain written approval (prior to issuance) for subordinated debt to qualify as regulatory capital.

15.32 The Federal Reserve Act limits the availability of borrowings through the Federal Reserve discount window for certain borrowings.

15.33 Federal Reserve Board regulations allow certain cumulative preferred stock instruments to qualify as tier 1 capital for bank holding companies. Marketed under a variety of proprietary names such as MIPS and TROPS, these instruments are issued out of a wholly owned, special purpose parent company subsidiary. The proceeds are lent to the parent in the form of a very long-term, deeply subordinated note which gives rise to a minority interest upon consolidation of the subsidiary with the parent holding company. To be eligible as Tier 1 capital, such instruments must provide for a minimum five year consecutive deferral period on distributions to preferred shareholders. Additionally, the intercompany loan must be subordinated to all subordinated debt and have the longest feasible maturity. The amount of these instruments, together with other cumulative preferred stock a bank holding company may include in Tier 1 capital is limited to 25 percent of Tier 1 capital.

15.34 The OTS has issued TB 73 which states "if a thrift holding company issues trust preferred securities (TPSs) and invests the proceeds in the thrift, those funds may qualify as capital at the thrift level. Because any deferred payments on TPSs are cumulative, however, savings associations that issue TPSs may not count them towards their Tier 1 capital requirements.

ACCOUNTING AND FINANCIAL REPORTING

15.35 Significant categories of borrowings should be presented as separate line items in the liability section of the balance sheet, or as a single line item with appropriate note disclosures of components. Institutions may, alternatively, present debt based on the debt's priority (that is, senior or subordinated) if they also provide separate disclosure of significant categories of borrowings. Paragraph 15 of FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, as amended, explains how a debtor and a secured party should report (in the statement of financial position) collateral provided in any borrowing.

15.36 The notes to the financial statements should describe the principal terms of the respective agreements including, but not limited to, the title or nature of the agreement, or both; the interest rate (and whether it is fixed or floats); the payment terms and maturity date(s); collateral; conversion or redemption features; whether it is senior or subordinated; and restrictive covenants (such as dividend restrictions), if any.

15.37 Accounting for long-term obligations is the same for financial institutions as for other enterprises. If the financial institution has an unclassified balance sheet, there is no need to separate balances into current and long-term portions. Costs related to the issuance of debentures or other debt should be deferred and amortized to interest expense using the effective interest method over the life of the issue.

15.38 ***Redeemable Preferred Stock.*** For redeemable preferred stock of a subsidiary accounted for as a liability in a parent’s consolidated financial statements, dividends should be included in the determination of income as interest expense. For redeemable preferred stock of a subsidiary accounted for as a minority interest in a subsidiary in a parent’s consolidated financial statements, the dividends should be presented as minority interest in income of a subsidiary. For redeemable preferred stock of a parent treated as capital but displayed in the balance sheet as mezzanine capital, dividends should be included in the statement of changes in shareholders' equity.

15.39 ***Bankers' Acceptances.*** Paragraphs 77 through 81 of FASB Statement No. 125 discuss banker's acceptances and risk participations in them. Paragraph 80 of FASB Statement No. 125 says an accepting bank that obtains a risk participation should not derecognize the liability for the banker's acceptance because the accepting bank is still primarily liable to the holder of the banker's acceptance even though it benefits from a guarantee of reimbursement by a participating bank. Paragraph 80 requires that the accepting bank should not derecognize the receivable from the customer because it controls the benefits inherent in that receivable and it is still entitled to receive payment from the customer. Paragraph 80 says the accepting bank should, however, record the guarantee purchased, and the participating bank should record a liability for the guarantee issued.

15.40 ***MBBs.*** Transfers of mortgages accounted for under FASB Statement 125 as secured borrowings of the issuing institution (mortgage-backed bonds) should be classified as debt on the institution's balance sheet. Such mortgage-backed bonds should be classified separately from advances, other notes payable, and subordinated debt. Any discounts or premiums associated with the issuance of MBBs should be recorded in a contra liability (debit) or liability (credit) account. Bond issue costs or expenses (legal, accounting, printing, and other expenses) should be deferred and amortized to operations using the constant effective yield method over the life of the bonds.

15.41 In accordance with FASB Statement No. 47, *Disclosure of Long-Term Obligations*, institutions should disclose maturity and sinking-fund requirements for each of the five years following the last balance-sheet date. Further, if debt was considered in-substance defeased in an extinguishment occurring before January 1, 1997, a general description of the transaction and the amount of the debt that is considered extinguished at the end of the period should be disclosed as long as the debt remains outstanding.

15.42 ***Extinguishments of Liabilities.*** FASB Statement No. 125 provides accounting and reporting standards for extinguishments of liabilities. Paragraph 16 of FASB Statement No. 125 says a debtor should derecognize a liability if and only if it has been extinguished. Paragraph 16 says a liability has been extinguished if either of the following conditions is met:

a. The debtor pays the creditor and is relieved of its obligation for the liability. Paying the creditor includes delivery of cash, other financial assets, goods, or services or reacquisition by the debtor of its outstanding debt securities whether the securities are canceled or held as so-called treasury bonds.

b. The debtor is legally released from being the primary obligor under the liability, either judicially or by the creditor. Paragraph 84 of FASB Statement No. 125 provides related guidance.

15.43 Gains and losses from extinguishment of debt should be included in the determination of net income and, if material in the aggregate, classified as an extraordinary item, net of related income tax effect, in accordance with FASB Statement No. 4, *Reporting Gains and Losses from Extinguishment of Debt*.

15.44 Paragraph 17b of FASB Statement No. 125 requires that, if an entity had debt that was considered to be extinguished by in-substance defeasance under the provisions of FASB Statement No. 76 prior to the effective date of FASB Statement No. 125, the entity should provide a general description of the transaction and the amount of debt that is considered extinguished at the end of the period so long as that debt remains outstanding.

15.45 ***Foreign Currency Debt***. FASB Emerging Issues Task Force (EITF) Issue No. 86-25, *Offsetting Foreign Currency Swaps*, addresses how the effect of a change in exchange rates on a foreign currency swap contract should be displayed in the balance sheet.

15.46 ***Dual Currency Bonds***. EITF Issue No. 93-10, *Accounting for Dual Currency Bonds*, addresses accounting for the effect of a change in foreign currency rates on dual currency bonds.

15.47 ***REMICs.*** As discussed earlier, REMIC is simply a label that covers various forms of underlying securities. These securities may resemble either CMOs or pass-through certificates that represent a transfer of the underlying receivables. Institutions may enter into REMIC transactions to raise immediate cash from mortgage agreements. As discussed beginning in paragraph 5.79, FASB Statement No. 125 provides accounting and reporting standards for transfers of financial assets, including transfers associated with REMICs and CMOs. Paragraphs 14.08 and 14.09 discuss REMIC accounting for federal income tax purposes.

15.48 All transaction costs associated with an offering accounted for as a sale should be expensed when the associated collateral is eliminated from the financial statements and the resultant gain or loss is recognized.

15.49 EITF Issue No. 84-30, *Sales of Loans to Special-Purpose Entities*, addresses whether the consolidated financial statements of an institution should include the assets and liabilities of a special-purpose corporation.

Lease Financing

15.50 Accounting for leases by lessees and lessors is established by FASB Statement No. 13, *Accounting for Leases*, as amended by FASB Statement No. 98, *Accounting for Leases: Sale-Leaseback Transactions Involving Real Estate, Sales-Type Leases of Real Estate, Definition of the Lease Term, Initial Direct Costs of Direct Financing Leases*. Other interpretive pronouncements address additional circumstances.

Lending of Customers' Securities

15.51 Paragraphs 61 through 65 of FASB Statement No. 125 discuss application of the Statement to securities lending transactions. Banks and savings institutions sometimes lend customers' securities. Any contingencies related to the lending of securities should be accounted for in conformity with FASB Statement No. 5, *Accounting for Contingencies*.

Fair Value Disclosures

15.52 FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, as amended, requires disclosures of fair values of all financial instruments for which it is practicable to estimate fair value.* Paragraph 28 of FASB Statement No. 107 says that "a fair value for financial liabilities for which quoted market prices are not available can generally be estimated using the same techniques used for estimating the value of financial assets" and provides further guidance.

AUDITING

Objectives

15.53 The primary audit objectives in this area are to obtain reasonable assurance that—

a. Short- and long-term borrowings recorded as of the date of the financial statements include all such liabilities of the institution and that they have been properly valued, classified, described, and disclosed and reflect all transactions for the period.

b. Financing subsidiaries are consolidated with the parent institution as required by FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries*.

c. Interest expense and the related balance-sheet accounts (accrued interest payable, unamortized premiums or discounts, and issuance costs) are properly measured and recorded, and amortization has been properly computed.

d. Transactions representing an extinguishment of debt through an in-substance defeasance before January 1, 1997, are properly evaluated and reported, and any related gains or losses on the transactions are properly calculated and reported.

e. Collateral for borrowings is properly identified and disclosed.

f. Borrowings have been authorized in accordance with management's written policies and are obligations of the institution.

g. The effects on reported amounts and disclosures of any noncompliance with debt covenants are properly identified, described, and disclosed.

Planning

15.54 In planning the audit, the independent accountant should consider the factors influencing inherent risk, which are described in chapter 5, as they relate to financial statement assertions about other borrowings. Such factors might include regulatory considerations, the existence of restrictive covenants, and the existence

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* In December 1996, the FASB issued FASB Statement No. 126, *Exemption from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities*, which makes the disclosures about fair value of financial instruments prescribed in FASB Statement No. 107 optional for entities that meet all of the following criteria specified in paragraph 2 of FASB Statement No. 126:

a. The entity is a nonpublic entity (as defined in FASB Statement No. 126).

b. The entity's total assets are less than $100 million on the date of the financial statements.

c. The entity has not held or issued any derivative financial instruments, as defined in FASB Statement No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments*, other than loan commitments, during the reporting period.

d. The entity has no instrument that, in whole or in part, is accounted for as a derivative instrument under FASB No. 133, *Accounting for Derivative Instruments and Hedging Activities*, during the reporting period.

FASB Statement No. 133, as amended by FASB Statement No. 137, *Accounting for Derivative Instruments and Hedging Activities - Deferral of the Effective Date of FASB Statement No. 133*, is effective for all fiscal quarters of fiscal years beginning after June 15, 2000. On March 3, 2000, the FASB issued an Exposure Draft, *Accounting for Certain Derivative Instruments and Certain Hedging Activities —an Amendment of FASB Statement No. 133*. Readers should be alert to any final pronouncement. The FASB has established the Derivative Implementation Group (DIG) to assist the Board and its staff in providing implementation guidance regarding FASB Statement No. 133. Issues addressed by the DIG and the status of related guidance can be found at the FASB's Web site at www.fasb.org.

and adequacy of collateral, if applicable. The independent accountant should also review board of directors' reports, the current year's interim financial statements, and other documents that may include information about whether any significant new debt has been incurred or issued and whether any significant debt has been repaid or refinanced. The independent accountant should also inquire as to the existence of financing subsidiaries.

Internal Control Over Financial Reporting and Possible Tests of Controls

15.54 SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), provides guidance on the independent accountant's consideration of an institution's internal control in an audit of financial statements performed in accordance with GAAS. It describes the components of internal control and explains how an independent accountant should consider internal control in planning and performing an audit. Paragraph 19 of SAS No. 55, as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55*, requires that, in all audits, the independent accountant obtain sufficient understanding of each of the five components (the control environment, risk assessment, control activities, information and communication, and monitoring) to plan the audit by performing procedures to understand the design of policies and procedures relevant to audit planning and whether they have been placed in operation.

15.55 Controls relating to the financial reporting of debt include the following:

- Debt transactions are reviewed and approved by the board of directors or its designated committee and documented in the minutes.
- Debt agreements are reviewed by the appropriate accounting and legal personnel to ensure that borrowings meet GAAP criteria for classification as a liability.
- Adjustments to liability accounts are reviewed and approved by a responsible official.
- The institution is named as issuer or borrower in the respective credit or financing agreements.
- All off-balance-sheet obligations (such as operating leases and guarantees) have been identified, described, and disclosed.
- The subsidiary ledgers for long- and short-term borrowings and collateral are periodically reconciled with the general ledger.
- Reports or statements from outside trustees or transfer agents are periodically reconciled to the institution's records.
- Through periodic confirmation with the trustee or transfer agent, the institution ascertains that collateral on borrowings remains sufficient.
- Borrowings (such as CMOs and REMICs) are reviewed to ensure that they meet the GAAP criteria for treatment as financing transactions.
- If defeasance of debt has occurred, documentary evidence of defeasance of debt and related documentation of compliance with the relevant accounting requirements have been maintained.
- Periodic tests of covenant compliance are performed and reviewed by responsible personnel.

15.56 It is often more efficient and effective to assess control risk at the maximum for debt and take a primarily substantive approach. However, certain tests of controls, such as those over interest accruals and recurring cash payments, may provide audit evidence more efficiently than a purely substantive approach. The independent accountant should obtain an understanding of relevant internal controls to plan effective substantive tests.

15.57 SAS No. 70, *Service Organizations*, as amended by SAS No. 88, *Service Organizations and Reporting on Consistency* (AICPA, *Professional Standards*, vol. 1, AU sec. 324), paragraphs 6 through 21 provide guidance on the user auditor's consideration of the effect of a service organization on internal control of the user organization and availability of audit evidence. That guidance should be considered when planning and performing the audit of the financial statements of an institution that obtains services from another organization that are part of its information system (for example, processing CMO or REMIC cash flows by a trustee).

Substantive Tests

15.58 ***Review of Documentation***. The independent accountant should consider reviewing documentation such as legal agreements and notes supporting long-term debt and agree pertinent information to subsidiary ledgers. The independent accountant should consider reviewing the following information:

- *a.* Type of debt
- *b.* Interest rate and dates interest is payable
- *c.* Maturity of the debt
- *d.* Underlying collateral of the debt, if any
- *e.* Subordination of the debt
- *f.* Evidence of regulatory approval, if required
- *g.* Presence of restrictive covenants

15.59 ***Confirmation***. The independent accountant should consider confirming pertinent information with the trustee or transfer agent, including all terms, unpaid balance, accrued interest payable, principal and interest payments made during the year, collateral description, annual trust accounts activity, and the occurrence of any violations of the terms of the agreement. If collateral is not under the control of the institution and is held by a trustee or transfer agent, the independent accountant should consider confirming its existence, completeness, and valuation with the trustee or transfer agent. If collateral is deemed deficient with respect to the terms of the debt agreement or is not under the control of the institution, the independent accountant should consider the need for disclosure.

15.60 ***Tests of Valuation***. The independent accountant should consider testing borrowings that were issued at a premium or discount to determine whether amortization has been properly computed and recorded. The independent accountant should also evaluate the propriety of amortization of costs incurred in connection with a debt issuance. The independent accountant should consider assessing the sufficiency of the value of assets collateralizing any borrowings by confirmation.

15.61 ***Analytical Procedures.*** Analytical review procedures can provide substantive evidence about the completeness of debt-related financial statement amounts and disclosures; however, such procedures in tests of debt expense are often less precise than substantive tests such as recalculations. Because institutions generally issue a wide variety of debt with rates that vary with each issuance, it is normally difficult to develop expectations to be used in analyzing yields on debt. Accordingly, analytical procedures in this area should generally be considered only as a supplement to other substantive tests. Further guidance is provided in SAS No. 56, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 329), and SAS No. 31, *Evidential Matter*, as amended by SAS No. 80, *Amendment to Statement on Auditing Standards No. 31*, Evidential Matter (AICPA, *Professional Standards*, vol. 1, AU sec. 326). The independent accountant should be careful not to view trends entirely from a historical perspective; current environmental and business factors as well as local, regional, and national trends should be considered to determine if the institution's trend appears reasonable. Following are some of the analytical review procedures that should be considered.

- Compare interest expense by major category of debt as a percentage of the average amount of the respective debt outstanding during the year with stated rates on the debt instruments (yield test).
- Evaluate the reasonableness of balance-sheet accruals and other related balance-sheet accounts (accrued interest payable, deferred issuance costs, and premiums and discounts) by comparison to prior-year balances.

15.62 ***Other Procedures.*** Other audit procedures the independent accountant may consider related to debt and the extinguishment of debt are as follows:

- Review debt covenants and test whether the institution has complied with such covenants. Determine whether disclosures are appropriate.
- If the institution has assets from which the cash flows will be used to service a specific obligation of the institution, test whether the transaction(s) represents the extinguishment of debt through an in-substance defeasance transaction and whether it has been properly recorded.
- Read minutes of meetings of the board of directors to determine whether financing transactions have been authorized in accordance with the institution's written policies.
- Compare recorded interest expense and accrued interest payable to recorded debt for completeness of debt liabilities.
- Obtain a detailed supporting schedule of prior-year and current-year account balances. Agree the prior-year balance to prior-year working papers and the current-year balance to the general ledger. Review activity for reasonableness.
- For CMOs and REMICs, obtain and review compliance and verification letters prepared by the trustee's independent accountants. (Such letters are prepared on an annual basis and provide for the verification of the principal balance of the collateral and bonds, the cash flows associated with the issue, and compliance with the respective terms of the underlying agreements.)
- Examine canceled notes for borrowings that have been paid in full.
- Read lease agreements, identifying those that should be capitalized, and determine whether they were recorded using effective rates of interest.

15.63 If applicable, the independent accountant may be engaged to perform agreed-upon procedures relating to collateral for FHLB advances by reference to the security agreement signed by the institution's management that indicates compliance. The procedures depend upon the nature of the agreement (blanket lien, specific lien without delivery, or specific lien with delivery of the collateral). The respective district FHLB should provide guidance on procedures to be performed. However, the independent accountant should consider whether and how to perform all that is requested by the FHLB district bank in light of the professional standards.

15.64 Some debt agreements may require companies to have their independent auditors issue compliance reports on various restrictive covenants involving matters such as restrictions on assets, payments of interest, and dividend payments. Such reports, which normally are in the form of negative assurance, are discussed in SAS No. 62, *Special Reports*.

15.65 ***Finance Company Credit Questionnaires***. Finance companies provide creditors with financial and operating information through standard credit questionnaires developed jointly by industry and Robert Morris Associates (an association of lending officers). Some finance companies include credit questionnaires as information in addition to the finance company's basic financial statements. The independent accountant's responsibility depends on the services requested by the finance company.

15.66 Paragraph 4 of SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor Submitted Documents* (AICPA, *Professional Standards*, vol. 1, AU sec. 551), says an independent accountant who submits a document containing audited financial statements to the client or to others has a responsibility to report on all the information (such as a credit questionnaire) included in the document. However, SAS No. 29 explains that, when the independent accountant's report is included in a client-prepared document and the auditor is not engaged to report on information accompanying the basic financial statements, the independent accountant should follow SAS No. 8, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 550).

CHAPTER 16

Income Taxes

INTRODUCTION

16.01 Depository institutions generally are subject to the same tax rules that apply to other corporations, including those that are members of a consolidated group. Generally, credit unions are exempt from federal income taxes. Banks and savings institutions are permitted to elect subchapter S status under IRC Section 1362, provided certain requirements are met. Among these requirements are a 75-shareholder limitation, one class of stock restriction, prohibition on the use of the reserve method of accounting for bad debts for tax purposes and certain restrictions on the amount of passive investment income. If elected, S corporation status essentially converts the financial institution to a pass-through entity for tax purposes so that most of the corporate level tax on income is avoided.

16.02 The Internal Revenue Code (IRC) contains many provisions specific to taxable depository institutions. Finance and mortgage companies generally are subject to the same tax rules that apply to other corporations. The purpose of this chapter is to highlight certain federal tax matters and related accounting matters specific to the industry and to provide related auditing guidance.[1]

Banks and Savings Institutions

16.03 ***Definition of a Bank for Tax Purposes***. IRC Section 581 defines a bank for tax purposes and provides special rules governing bank taxation.

16.04 ***Definition of a Savings Institution for Tax Purposes***. Savings institutions are considered to be mutual savings banks (IRC Section 591), domestic building and loan associations (IRC Section 7701(a)(19)), or cooperative banks (IRC Section 7701(a)(32)). Failure of an institution to qualify as a savings institution may affect the financial accounting standards that apply (see paragraph 16.26).

16.05 ***Securities Gains and Losses***. IRC Section 582 provides banks special treatment for certain asset dispositions. Gains and losses on bonds, debentures, notes, certificates, and other evidences of indebtedness held by banks generally are treated under IRC Section 582 as ordinary (rather than capital) gains and losses. Equity securities and other investments generally are not afforded IRC Section 582 ordinary treatment. IRC Section 582 generally is not applicable to nonbank subsidiaries, including, for example, passive investment companies established for state planning purposes.

16.06 ***Tax Bad Debt Deductions***. IRC Section 585 provides that a bank or savings institution with $500 million or less in assets is allowed a tax bad debt deduction for reasonable additions to the bad debt reserve. This asset test generally is based upon the average adjusted tax basis of all assets. If the institution is a member of a controlled group (as defined), all assets of the group are taken into account. The annual addition to the reserve generally cannot exceed the greater of the amount computed using actual experience percentages or the base year fill-up method (as defined).

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[1] This chapter is not intended to provide comprehensive discussion of all possible tax matters an accountant might encounter in the preparation or audit of the financial statements of a financial institution. Further, state tax matters are beyond the scope of the introductory section of this chapter. Consulting this chapter cannot take the place of a careful reading of the related laws, regulations, rulings, and related documents, where appropriate.

16.07 A bank or savings institution with assets exceeding $500 million generally is allowed to claim a tax bad debt deduction only under the general rule of IRC Section 166, which generally permits taxpayers to deduct any debt that becomes worthless, in whole or in part, during the taxable year (the *specific charge-off* method [2]).

16.08 A bank or savings institution also may be required to recapture a portion of its bad debt reserves if it makes distributions to shareholders that exceed earnings and profits accumulated after 1951. Additionally, if a savings institution makes a distribution in redemption of stock or in partial or complete liquidation, notwithstanding the existence of earnings and profits, a portion of the reserve may have to be recaptured. Exceptions to this rule exist for certain tax-free reorganizations and certain distributions to the FDIC in redemption of an interest if such interest was originally received in exchange for assistance provided (see IRC Section 597(c)).

16.09 ***Net Operating Losses (NOLs)***. For taxable years beginning after August 5, 1997, net operating losses (NOLs) of banks and savings institutions generally are carried back two years and then forward twenty years under the provisions of IRC Section 172. For taxable years prior to 1994, banks and savings institutions also had various special provisions in the IRC that determined the appropriate carryback and carryforward periods.

Other

16.10 ***Mark to Market***. IRC Section 475 generally requires any company that is a dealer in securities to mark its securities to market. A dealer is broadly defined as any taxpayer that regularly purchases securities from, or sells securities to, customers in the ordinary course of business. The definition of securities differs from and is generally more expansive than the definition of securities in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. For purposes of IRC Section 475 nonsecuritized loans are, in some circumstances, considered securities. Further, institutions generally may not exempt any security held for investment if it is identified as such at the date of acquisition. A window (sometimes as much as 30 days) has generally been allowed for identification of certain loans.

16.11 ***Interest Expense Relating to Tax-Exempt Income***. IRC Section 291 generally provides that 20 percent of the allocable interest expense attributable to tax-exempt obligations acquired by a financial institution after 1982 and before August 8, 1986, is not deductible. For tax-exempt obligations acquired after August 7, 1986, IRC Section 265 generally requires that all of the interest expense attributable to the obligation be nondeductible. An exception exists for certain "qualified small issuer" obligations (as defined), which are subject to IRC Section 291.

Credit Union

16.12 Federal credit unions are exempt from federal and state income tax. State chartered credit unions may be subject to state income tax. Credit Union Service Organizations (CUSOs), which are subsidiaries of federal or state credit unions, may be subject to unrelated business income tax (UBIT) for federal income tax purposes.

[2] Finance companies and mortgage companies also use the specific charge-off method.

REGULATORY MATTERS

16.13 The Federal Financial Institutions Examination Council (FFIEC) requires, for regulatory reporting purposes, that income taxes be accounted for in conformity with generally accepted accounting principles (GAAP). However, income taxes receive special treatment in regulatory capital calculations as the federal banking regulatory agencies limit the amount of deferred tax assets that may be included in regulatory capital.

16.14 In 1998, the federal banking agencies adopted an Interagency Policy Statement on Income Tax Allocation in a Holding Company Structure. The policy statement, which does not materially change any of the guidance previously issued by the agencies, generally, requires that intercorporate tax settlements between an institution and its parent company be no less favorable to the institution than if it were a separate taxpayer. Taxes should not be paid to the parent before the payment would have been due to the taxing authority and if the subsidiary incurs a tax loss it should receive a refund from the parent. Adjustments for statutory tax considerations which arise in a consolidated return are permitted if they are made on an equitable basis, consistently applied to all affiliates. These rules generally require that deferred taxes of the institution may not be paid or transferred to, or forgiven by, its holding company. The agencies recommend that members of a consolidated group have a written comprehensive tax agreement to address intercorporate tax policies and procedures.

16.15 Internal Revenue Service (IRS) regulations permit an institution to obtain evidence, from its primary regulator, stating that the institution maintains and applies loan review and loss classification standards consistent with the agency's regulations regarding loan charge-offs. Each of the federal banking regulatory agencies has implementing guidance on this express determination letter process.

ACCOUNTING AND FINANCIAL REPORTING

16.16 FASB Statement No. 109, *Accounting for Income Taxes*, establishes the accounting for the effects of income taxes that result from an institution's activities during the current and preceding years. It requires an asset-and-liability approach for financial accounting and reporting for income taxes and, therefore, has a balance-sheet orientation. The objectives of accounting for income taxes in conformity with FASB Statement No. 109 are to recognize (*a*) the amount of income taxes payable or refundable for the current year and (*b*) deferred tax liabilities and assets for future tax consequences of events that have been recognized in an institution's financial statements or tax returns.

16.17 FASB Statement No. 109 applies the following basic principles in accounting for income taxes at the date of the financial statements:

- A current income tax liability or asset is recognized for the estimated taxes payable or refundable on tax returns for the current year.
- A deferred tax liability or asset is recognized for the estimated future tax effects attributable to temporary differences and carryforwards.
- The determination of the current and deferred tax liabilities and assets is based on provisions of the enacted tax law; the effects of future changes in tax laws or rates are not anticipated.
- The measurement of current and deferred tax assets is reduced, if necessary, by the amount of any tax benefits that, based on available evidence, are not expected to be realized.

Deferred Tax Assets and Liabilities

16.18 In general, FASB Statement No. 109 requires that a deferred tax liability be recognized for all taxable temporary differences (for example, book and tax bases differences that will result in future taxable amounts).

Deferred tax assets are to be recognized for deductible temporary differences (that is, book and tax bases differences of assets and liabilities that will result in future deductible amounts) and for tax NOL and credit carryovers. The determination of deferred taxes (paragraph 17(e) of FASB Statement No. 109) includes reduction of deferred tax assets by a valuation allowance (as defined) if—

> based on the weight of available evidence, it is *more likely than not* (a likelihood of more than 50 percent) that some portion or all of the deferred tax assets will not be realized.

16.19 Paragraph 26 of FASB Statement No. 109 generally requires that a change in the amount of the valuation allowance be recognized in income in the period of the change.

Temporary Differences

16.20 A temporary difference is a difference between the tax basis of an asset or liability and its reported amount in the financial statements that will result in taxable or deductible amounts in future years when the reported amount of the assets or liability is recovered or settled, respectively (see paragraph 289 of FASB Statement No. 109). Examples of temporary differences common to financial institutions follow.

- *Bad debt reserves* for institutions that deduct bad debt reserves under IRC Section 585 (which excludes the base year amount discussed at paragraph 16.23) and bad debt reserves for financial statement purposes in excess of the bad debt reserve for tax purposes. (For larger institutions that are covered under IRC Section 166, there is no bad debt reserve for tax purposes and, therefore, the entire allowance for credit losses in the financial statements is a temporary difference.)
- *Unrealized gains or losses on securities* under FASB Statement No. 115 may differ from amounts recognized under IRC Section 475.
- *Other real estate owned and other assets* may reflect post-acquisition impairment write-downs in the financial statements; those write-downs are generally not recognized for tax purposes until the asset is sold or disposed of for a bank. (For a savings institution, assets acquired before 1996 will generally be treated as a loan until sold.)
- *Accrued deferred compensation* is not deductible for tax purposes until paid.
- *Accrued loss contingencies* are generally not deductible for tax purposes until paid.
- *Depreciation of property, plant, and equipment* and amortization of intangible assets may be different for financial statement and tax purposes.
- *Accrual of retirement liabilities* is often made in the financial statements in different periods from those in which the expense is recognized for tax purposes.
- *Other basis differences* in assets and liabilities are caused by the following:
  - — *Gains and losses on sales* of loans, foreclosed assets, or property, plant, and equipment recognized in financial reporting periods different from tax periods
  - — *Amortization of imputed interest income* from transactions involving loans recognized in different periods for financial reporting and tax purposes
  - — *Accretion of discount on securities* recorded currently for financial reporting purposes, but subject to tax at maturity or sale, or accreted differently for tax purposes
  - — *Carryover tax basis of assets and liabilities* in a transaction that is accounted for under the purchase method of accounting in accordance with Accounting Principles Board (APB) Opinion No. 16, *Business Combinations*
  - — *Commitment fees* included in taxable income when collected but deferred to a period when earned for financial reporting purposes
  - — *Loan fee income* recognized on a cash basis for tax purposes while recognized as a yield adjustment for financial reporting purposes
  - — *Federal Home Loan Bank (FHLB) stock dividends* recognized as current financial reporting income but deferred for tax purposes

— The timing of the recognition of *income or loss for hedges and swaps* that differ for financial reporting and tax purposes

Financial Statement Presentation and Disclosure

16.21 Paragraphs 41 through 49 of FASB Statement No. 109 establish requirements for financial statement presentation and disclosure of income taxes.

16.22 Paragraph 44 of FASB Statement No. 109 requires that, whenever a deferred tax liability is not recognized because of certain exceptions addressed by APB Opinion No. 23, *Accounting for Income Taxes-Special Areas* (as amended by FASB Statement No. 109), the following information should be disclosed:

- A description of the types of temporary differences for which a deferred tax liability has not been recognized and the types of events that would cause those temporary differences to become taxable
- The cumulative amount of each type of temporary difference
- The amount of unrecognized deferred tax liability for temporary differences related to investments in foreign subsidiaries and foreign joint ventures that are essentially permanent in duration if determination of that liability is practicable or a statement such determination is not practicable
- The amount of the deferred tax liability for other temporary differences that is not recognized in accordance with the provisions of paragraphs 31 and 32 of FASB Statement No. 109

16.23 Bad debt reserves for tax purposes of U.S. savings institutions (and other qualified thrift lenders) that arose in tax years beginning before December 31, 1987 (that is, the base-year amount), are included in paragraph 31 of FASB Statement No. 109 as one example of temporary differences of banks or savings institutions for which a deferred tax liability is not recognized when the "indefinite reversal criteria" of APB Opinion No. 23 are met.

16.24 Paragraph 46 of FASB Statement No. 109 requires that institutions disclose the amount of income tax expense or benefit allocated to continuing operations and the amounts separately allocated to other items addressed in paragraphs 35 through 39 of the Statement. For example, the amount of income tax expense or benefit allocated to certain items whose tax effects are charged or credited directly to other comprehensive income (such as translation adjustments under FASB Statement No. 52, *Foreign Currency Translation*, or changes in the unrealized holding gains and losses of securities classified as available-for-sale under FASB Statement No. 115) should be separately allocated and disclosed.

AUDITING

Objectives

16.25 The objectives of auditing income taxes are to obtain reasonable assurance that—

a. The provision for income taxes and the reported income tax liability or receivable are properly measured, valued, classified, and described in accordance with GAAP.

b. Deferred income tax liabilities and assets accurately reflect the future tax consequences of events that have been recognized in the institution's financial statements or tax returns (temporary differences and carryovers).

Planning

16.26 In planning the audit, the independent accountant should consider the factors influencing inherent risk, which are described in chapter 5, as they relate to financial statement assertions about income taxes. The independent accountant should be aware that the tax laws specific to financial institutions, as well as to general corporate taxation, can change from year to year.

Internal Control Over Financial Reporting and Possible Tests of Controls

16.27 SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), provides guidance on the independent accountant's consideration of an institution's internal control in an audit of financial statements performed in accordance with GAAS. It describes the components of internal control and explains how an independent accountant should consider internal control in planning and performing an audit. Paragraph 19 of SAS No. 55, as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55*, requires that, in all audits, the independent accountant obtain sufficient understanding of each of the five components (the control environment, risk assessment, control activities, information and communication, and monitoring) to plan the audit by performing procedures to understand the design of policies and procedures relevant to audit planning and whether they have been placed in operation.

16.28 The independent accountant should obtain an understanding of relevant internal controls. It may be more efficient and effective to assess control risk at the maximum for income taxes and take an entirely substantive approach. Chapter 5 discusses related considerations.

Substantive Tests

16.29 Substantive audit procedures may include the following:

- Review the tax status and consolidated return requirements of subsidiaries.
- Review the status of current-year acquisitions of other companies and their preacquisition tax liabilities and exposures.
- Obtain a schedule reconciling net income per books with taxable income for federal, state, and foreign income taxes. Agree amounts to general ledger and supporting documents as appropriate. Consider the reasonableness of the current tax account balances.
- Test the rollforward of tax balance-sheet accounts. Consider vouching significant tax payments and credits.
- Review reconciliation of prior-year tax accrual to the actual filed tax return and determine the propriety of adjustments made in this regard and consider the impact on the current year's tax accrual.
- Consider the deductibility of transactions such as profit-sharing, bonus, contributions, or stock option transactions.
- Ascertain whether changes in income tax laws and rates have been properly reflected in the tax calculations and account balances.
- Review the allocation, apportionment, and sourcing of income and expense applicable to state tax jurisdictions with significant income or franchise taxes.
- Review classification and description of accounts to identify possible tax reporting differences such as reserves for anticipated losses or expenses.
- Review schedule of NOL and other tax credit carryforwards and their utilization
- Review and determine the need for and appropriateness of any valuation allowance for deferred tax assets. The auditor should recognize that institutions often may have a significant deferred tax asset resulting from the loan loss reserve. This asset should be

evaluated based upon the likelihood of realization, taking into account the timing of the bad debt deduction, and the special NOL carryovers and carryback tax rules, if applicable.

- Review tax planning strategies and assumptions utilized in the calculation of deferred income taxes under FASB Statement No. 109.
- Evaluate tax contingencies and consider the appropriate accounting treatment and disclosure requirements for these items under FASB Statement No. 5, *Accounting for Contingencies*. Review recent Revenue Agent Reports, if any, and consider current treatment of items challenged by the taxing authorities in prior years for impact on tax contingencies. (The auditor should also review Coordinated Issue Papers issued by the IRS for banks and savings institutions to determine their impact on tax contingencies.)
- Evaluate the adequacy of the financial statement disclosures.
- For separate financial statements of affiliates, review terms of all tax-sharing agreements between affiliated entities to determine proper disclosure and accounting treatment. The auditor should be cognizant of and consider whether the institution is in compliance with the regulatory accounting rules for banks and savings institutions related to intercompany tax allocation and settlement.

CHAPTER 17

Equity and Disclosures Regarding Capital Matters

INTRODUCTION

17.01 Chapters 1 and 2 discuss the regulatory capital requirements for banks and savings institutions and credit unions, respectively. Chapter 4 discusses similar capital requirements for mortgage companies. This chapter discusses the related financial statement disclosures and auditing guidance. Finance companies are not subject to regulatory capital requirements.

REGULATORY CAPITAL MATTERS FOR ALL ENTITIES

Regulatory Capital Disclosures for Branches of Foreign Institutions

17.02 The disclosure requirements related to capital adequacy and prompt corrective action do not apply to branches of foreign organizations because such branches do not have capital. Paragraph A.51 of SOP 01-6, *Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others***,** states: **"**Foreign branches, while they do not have capital requirements, are required to maintain capital-equivalent deposits and, depending on facts and circumstances, supervisory-mandated reserves. These requirements carry regulatory uncertainty of a nature similar to that posed by the regulatory capital rules in that failure to meet such mandates can result in supervisory action and, ultimately, going-concern questions. Accordingly, AcSEC believes that those foreign bank branches should disclose such requirements and the degree of compliance therewith. "

17.03 Paragraph 15(a) of SOP 01-6 states: "Branches of foreign financial institutions, while they do not have regulatory capital requirements, may be required to maintain capital-equivalent deposits and, depending on facts and circumstances, supervisory-mandated reserves. These requirements carry regulatory uncertainty of a nature similar to that posed by the regulatory capital rules in that failure to meet such mandates can result in supervisory action and ultimately going-concern questions. Accordingly, branches should disclose such requirements. Quantitative disclosure should be made, highlighting mandated deposit or reserve requirements and actual balances in those reserve or deposit accounts at the balance-sheet date(s) reported. Further, if an uncertainty exists related to a parent that creates a higher-than-normal risk as to the viability of a branch or subsidiary, then that matter should be adequately disclosed in the notes to the financial statements of the branch or subsidiary. If factors do not exist that indicate a higher than normal amount of risk or uncertainty regarding parent capital and other regulatory matters, then disclosures of capital and supervisory issues of the parent would not be required."

Regulatory Capital Disclosures for Trust Operations

17.04 Paragraph A.52 of SOP 01-6 states: **"**Trust banks are required by certain federal regulators to hold capital as a percentage of discretionary and nondiscretionary assets under management. The percentages vary for each category. The percentages are not standardized as with other capital requirements and are communicated on an entity-by-entity basis in the application to obtain a trust charter or by other supervisory processes. Depending on the type of charter, these entities may be subject to risk-based standards as well. Because these are not published requirements, these guidelines are applied on a discretionary basis by the agencies and may not be uniformly applied to all entities. . Because failure to meet capital requirements can have an adverse effect on the financial condition and results of operations of an entity, AcSEC concluded that, in cases in which these requirements are applied, a discussion of the existence of these requirements, ramifications of failure to meet them, and a measurement of the entity's position relative to imposed requirements should be disclosed.**"**

17.05 Paragraph 15(b) of SOP 01-6 states: "If an institution is subject to capital requirements based on trust assets under management, a discussion of the existence of these requirements, ramifications of failure to meet them, and a measurement of the entity's position relative to imposed requirements should be disclosed in the notes to the financial statements."

Regulatory Capital Disclosures for Business Combinations ¥

17.06 Paragraph A.53 of SOP 01-6 states: **"**In applying this requirement to entities that have completed a business combination, AcSEC recognized that special requirements were necessary. First, because the post-transaction capital of two entities combined through a purchase differs from that of the same two entities had the transaction been accounted for as a pooling, different approaches to comparative capital disclosures must be taken for pooling of interests and purchase business combinations. Second, the determination of regulatory capital position involves not only purely quantitative elements but also potentially highly subjective qualitative factors, such as relative operation risks, risks associated with nontraditional activities, and other factors, which may in turn be mitigated by the relative sophistication of management and systems. Finally, AcSEC believes it would not be representationally faithful to simply compare the combined capital and risk-weighted assets of the premerged entities, even in a pooling, to statutory capital adequacy and prompt corrective action minimums or to actual or composite adjusted minimums of the premerged entities. Such an approach might overlook mitigating factors that may have been enhanced or risks that may have been magnified and assessed differently in a combined entity rather than in separate entities and inappropriately suggest that the regulators may have reviewed and accepted such combined levels as adequate when they actually had never made such an evaluation."

17.07 Paragraphs 15(c) of SOP 01-6 states: "Following a business combination accounted for as a pooling of interests, the prior-year disclosures should—

(1) Contain quantitative disclosures limited to the combined Tier I, Tier II, and total capital, or net worth, as applicable, and related assets or risk-weighted assets, as applicable, and the ratios derived therefrom

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∞ In June 2001, the FASB issued FASB Statement No. 141, *Business Combinations*, which supersedes APB Opinion 16, *Business Combinations*. FASB Statement No. 141, which applies to all business combinations except those between not-for-profit enterprises, requires that all business combinations initiated after June 30, 2001 be accounted for using the purchase method. The provisions of FASB Statement No. 141 are applicable to business combinations accounted for by the purchase method completed after June 30, 2001.

(2) Not compare such ratios to either statutory or regulatory capital adequacy or prompt corrective action minimums, the mandated minimums of either premerged entity, or a composite of the premerged entities' mandated minimums

(3) Include a discussion of whether the entities, precombination, were required to hold capital in excess of statutory regulatory minimums in order to be considered well and/or adequately capitalized, and the reasons for those amended minimums

(4) Include a statement that there was not a determination by regulatory authorities as to the capital adequacy or prompt corrective action category of the combined entity relative to the premerger combined amounts and ratios presented

17.08 Paragraphs 15(d) of SOP 01-6 states: "Following a business combination accounted for as a purchase, because prior capital position can be less relevant as a result of capital repatriation to former owners and the effects of purchase accounting adjustments and the push-down of basis, judgment should be used as to relevant disclosures. Minimum disclosures should include the capital position of the purchaser at the prior period end and information to highlight comparability issues, such as significant capital requirements imposed or agreed to during the regulatory approval process, and the effects of purchase accounting, if any, on regulatory capital determination."

BANKS AND SAVINGS INSTITUTIONS

Introduction

17.09 Banks are organized with capital stock and shareholders. Savings institutions operate under a capital stock structure, like banks, or a cooperative form of ownership, like credit unions. Savings institutions operating under the cooperative form are referred to as "mutual institutions." Although mutual institutions may be incorporated, they issue no capital stock and have no stockholders. The equity section of a mutual institution's statement of financial condition generally consists only of retained earnings and the accumulated other comprehensive income under FASB Statement No. 130. The equity section for banks and stock savings institutions additionally include common stock and additional paid-in capital.

Equity

17.10 ***Common Stock.*** Common stock consists of stock certificates issued to investors (stockholders) as evidence of their ownership interest.

17.11 ***Preferred Stock.*** Preferred stock has certain privileges over common stock, such as a first claim on dividends. Typically, preferred stock conveys no voting rights, or only limited voting rights, to the holders. The rights of preferred stockholders are described in the articles of incorporation.

17.12 ***Additional Paid-In Capital.*** Amounts paid over the excess of par are additional paid-in capital. Absent such a stated par value, the bank or savings institution will assign a nominal par value to capital stock. Adjustments for treasury stock transactions and capital contributions may also be included in additional paid-in capital.

17.13 ***Retained Earnings.*** Retained earnings include undivided earnings and other appropriations as designated by management or regulatory authorities. Undivided earnings include the transfer of net income, declaration of dividends and transfers to additional paid-in capital.

17.14 ***Accumulated Other Comprehensive Income.*** In accordance with FASB Statement No. 130, banks and savings institutions are required to transfer the total of other comprehensive income for a period to a separate component of equity until realized. For example, other comprehensive income would include unrealized holding gains and losses on available-for-sale securities and effective portion of the accumulated change in fair value on cash flow hedges. Declines in the fair values of investments that are other than temporary and the ineffective portion of cash flow hedges should be charged directly to operations.

Holding Company Equity and Regulatory Capital

17.15 ***Mandatory Redeemable Preferred Stock.*** Mandatory redeemable preferred stock, also known as trust preferred stock, is a hybrid instrument possessing characteristics typically associated with debt obligations. Although each issue of these securities may involve minor differences in terms, under the basic structure of trust preferred securities a bank holding company, first organizes a business trust or other special purpose entity. This trust issues two classes of securities: common securities, all of which are purchased and held by the bank holding company, and trust preferred securities, which are sold to investors. The business trust's only assets are deeply subordinated debentures of the corporate issuer, which the trust purchases with the proceeds from the sale of its common and preferred securities. The bank holding company makes periodic interest payments on the subordinated debentures to the business trust, which uses these payments to pay periodic dividends on the trust preferred securities to the investors. The subordinated debentures have a stated maturity and may be redeemed under other circumstances. Most trust preferred securities are subject to a mandatory redemption upon the repayment of the debentures.

17.16 The Securities and Exchange Commission has addressed if mandatory redeemable preferred stock should be reflected in the equity section of the balance sheet in Regulation S-X, section no. 210.5-02.28. This regulation states that mandatory redeemable preferred stock is not to be included in amounts reported as stockholders' equity. Although nonpublic companies are not required to follow Regulation S-X, it would be appropriate for them to do so in most cases. However, practice varies. FASB Concepts Statement No. 6, *Elements of Financial Statements*, paragraph 62, states all classes of equity depend to some extent on enterprise profitability for distribution of enterprises assets, and no class of equity carries an unconditional right to receive future transfers of assets from the enterprise except in liquidation, and then only after liabilities have been satisfied. This characteristic of equity is generally not found in mandatory redeemable preferred stock. If the stock is redeemable at a specific date or at the option of the holder, debt classification as suggested by Regulation S-X seems most appropriate. Some financial statements present mandatory redeemable preferred stock in a category between liabilities and equity. However, facts and circumstances in nonpublic entities (e.g., certain stock issued for estate planning purposes) may justify equity classification of certain mandatory redeemable preferred stock.

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* Note that FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, amends paragraph 13 of FASB Statement No. 115, and states that "all or portion of the unrealized holding gain and loss of an available-for-sale security that is designated as being hedged in a fair value hedge shall be recognized in earnings during the period of the hedge, pursuant to paragraph 22 of Statement 133." FASB statement No. 133, as amended by FASB Statement No. 137, *Accounting for Derivative Instruments and Hedging Activities ¾ Deferral of the Effective Date of FASB Statement No. 133*, is effective for all fiscal quarters of fiscal years beginning after June 15, 2000.

17.17 On October 21, 1996, the Federal Reserve Board approved the use of certain cumulative preferred stock instruments in tier 1 capital for bank holding companies. These instruments, which are marketed under a variety of proprietary names, are issued out of a special purpose subsidiary that is wholly owned by the parent company. The amount of these instruments, together, with other cumulative preferred stock a bank holding company may included in tier 1 capital, is limited to 25 percent of tier 1 capital.

17.18 ***Bank Holding Companies Under $150 million in Assets.*** The Board of Governors of the Federal Reserve System has adopted a minimum ratio of tier 1 capital to total assets to assist in the assessment of the capital adequacy of bank holding companies regulated by the Federal Reserve. The guidelines apply on a consolidated basis to bank holding companies with consolidated assets of $150 million or more. For bank holding companies with less than $150 million in consolidated assets, the guidelines will be applied on a bank-only basis unless the parent is engaged in a nonbank activity involving significant leverage or the parent company has a significant amount of outstanding debt that is held by the general public.

Disclosures for Banks and Savings Institutions

17.19 Noncompliance with regulatory capital requirements could materially affect the economic resources of a bank or savings institution and claims to those resources. Accordingly, at a minimum, the institution should disclose the following in the footnotes to the financial statements:[1]

1. A description of regulatory capital requirements (*a*) for capital adequacy purposes and (*b*) established by the prompt corrective action provisions of Section 38 of the FDI Act
2. The actual or possible material effects of noncompliance with such requirements
3. Whether the institution is in compliance with the regulatory capital requirements, including, as of each balance-sheet date presented[2], the following with respect to quantitative measures:[3, 4]
    - *a*. The institution's required and actual ratios and amounts of Tier I leverage, Tier I risk-based, and total risk-based capital, (for savings institutions) tangible capital, and (for certain banks and bank holding companies) Tier 3 capital for market risk.
    - *b*. Factors that may significantly affect capital adequacy such as potentially volatile components of capital, qualitative factors, and regulatory mandates

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[1] Disclosures should also be presented for any state-imposed capital requirements that are more stringent than or significantly differ from federal requirements.

[2] For "adequately capitalized" or "undercapitalized" institutions, this should present the minimum amounts and ratios the institution must have to be categorized as *adequately capitalized* under the prompt corrective action framework and should include the effect of any supervisory action that has been imposed.

[3] These amounts may be presented in either narrative or tabular form.

[4] The percentages disclosed should be those applicable to the entity. Institutions with CAMELS ratings of 1 that are not anticipating or experiencing significant growth and have well-diversified risk are required to maintain a minimum leverage ratio of 3.0 percent. An additional 100 to 200 basis points are required for all but these most highly rated institutions. Also, if the institution has been advised that it must meet capital adequacy levels that exceed the statutory minimums, those higher levels should be disclosed. Such institution-specific requirements also should be the basis for management's assertion in disclosure item 3 about whether the institution is in compliance.

4. As of each balance sheet date presented, the prompt corrective action category in which the institution was classified as of its most recent notification[5]
5. As of the most recent balance sheet date, whether management believes any conditions or events since notification have changed the institution's category

17.20 If, as of the most recent balance sheet date presented, the institution is either (*a*) not in compliance with capital adequacy requirements or (*b*) considered less than adequately capitalized under the prompt corrective action provisions or (*c*) both, the possible material effects of such conditions and events on amounts and disclosures in the financial statements should be disclosed.[6] Further, noncompliance with regulatory capital requirements may, when considered with other factors, raise substantial doubt about the institution's ability to continue as a going concern for a reasonable period of time. Additional information that might be disclosed in situations where there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time may include—

- Pertinent conditions and events giving rise to the assessment of substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time.
- Possible effects of such conditions and events.
- Management's evaluation of the significance of those conditions and events and any mitigating factors.
- Possible discontinuance of operations.
- Management's plans (including relevant prospective financial information).
- Information about the recoverability or classification of recorded asset amounts or the amounts or classification of liabilities.

17.21 Other regulatory limitations may exist (such as those discussed in paragraphs 5.134 and 5.135) despite compliance with minimum regulatory capital requirements. To the extent such limitations could materially affect the economic resources of the institution and claims to those resources, they should similarly be disclosed in the footnotes to the financial statements.

Disclosure for Holding Companies

17.22 The disclosures required by paragraphs 17.19, 17.20, and 17.21 should be presented for all significant subsidiaries of a holding company. Bank holding companies should also present the disclosures required by paragraphs 17.19, 17.20, and 17.21 as they apply to the holding company, except for the prompt corrective action disclosure required by item 4 in paragraph 17.19. Savings institution holding companies are not subject to regulatory capital requirements separate from those of their subsidiaries. Bank holding companies are not subject to the prompt corrective action provisions of the FDI Act.

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[5] A bank or savings institution is (under federal regulations) deemed to be within a given capital category as of the most recent date (*a*) the institution filed a regulatory financial report, (*b*) a final regulatory examination report is delivered to the institution, or (*c*) the institution's primary regulator provides written notice of the institutions' capital category or that the institution's capital category has changed.

[6] The institution should consider also making such disclosures when one or more of the institution's actual ratios is nearing noncompliance or when capital adequacy restrictions are imposed by regulation.

Illustrative Disclosures for Banks and Savings Institutions

17.23 ***Well Capitalized.*** The example disclosures that follow are for illustrative purposes only. Following is an illustrative disclosure for an institution that is in compliance with capital adequacy requirements and considers itself *well capitalized* under the prompt corrective action framework. Comparative disclosures should be included for each balance sheet presented.

> The Bank is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory—and possibly additional discretionary—actions by regulators that, if undertaken, could have a direct material effect on the Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of the Bank's assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.
>
> Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the table below) of total and Tier I capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier I capital (as defined) to average assets (as defined).[7] Management believes, as of December 31, 200X, that the Bank meets all capital adequacy requirements to which it is subject.
>
> As of December 31, 200X, and December 31, 200W, the most recent notification from [*institution's primary regulator*] categorized the Bank as [*well capitalized*] under the regulatory framework for prompt corrective action. To be categorized as [*well capitalized*] the Bank must maintain minimum total risk-based, Tier I risk-based, Tier I leverage ratios as set forth in the table.[8] There are no conditions or events since that notification that management believes have changed the institution's category.

17.24 ***Adequately Capitalized.*** Following is an illustrative paragraph to be added to the disclosures illustrated in paragraph 17.23 when an institution considers itself *adequately capitalized*:

> Under the framework, the Bank's capital levels do not allow the Bank to accept brokered deposits without prior approval from regulators [*describe the possible effects of this restriction*].

17.25 ***Undercapitalized.*** Following are illustrative paragraphs to be added to the disclosures illustrated in paragraphs 17.23 and 17.24 when an institution considers itself *undercapitalized*. For a discussion about the independent accountant's consideration of noncompliance, see paragraph 5.134.

> The Bank may not issue dividends or make other capital distributions, and may not accept brokered or high rate deposits, as defined, due to the level of its risk-based capital. [*Describe the possible effects of these restrictions.*]

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[7] See footnote 4 in this chapter.

[8] Paragraphs 1.31 through 1.41 describe the prompt corrective action ratios. For some institutions, the calculation of required amounts and ratios under the prompt corrective action framework may differ from calculations under the capital adequacy requirements. The disclosure should provide the relevant amounts and ratios accordingly.

Under the regulatory framework for prompt corrective action, the Bank's capital status may preclude the Bank from access to borrowings from the Federal Reserve System through the discount window. [*Describe the possible effects of these restrictions*.] Also, as required by the framework, the Bank has a capital plan that has been filed with and accepted by the Federal Deposit Insurance Corporation (FDIC). The plan outlines the Bank's steps for attaining the required levels of regulatory capital. Management believes, at this time, that the Bank will meet all the provisions of the capital plan and all the regulatory capital requirements by December 31, 200Y (or earlier if stated in the capital plan). [*The disclosure should continue with discussion of management plans such as reducing the size of the institution by converting noncash assets and reducing liabilities, issuing additional equity securities at prices less than book value, or other plans for financial restructuring*.]

17.26 ***Banks.*** Following is an illustrative table for presentation in financial statements for a bank's actual capital amounts and ratios as of the balance sheet date. All disclosures required by paragraph 17.23 should be presented.

	Actual		***For Capital Adequacy Purposes:***[9]		***To Be Well Capitalized Under Prompt Corrective Action Provisions:***[10]	
	Amount	***Ratio***	***Amount***	***Ratio***	***Amount***	***Ratio***
Total Capital (to Risk Weighted Assets)	$X,XXX,XXX	X.X%	$X,XXX,XXX	8.0%	$X,XXX,XXX	10.0%
Tier I Capital (to Risk Weighted Assets)	$X,XXX,XXX	X.X%	$X,XXX,XXX	4.0%	$X,XXX,XXX	6.0%
Tier I Capital (to Average Assets)	$X,XXX,XXX	X.X%	$X,XXX,XXX	4.0%	$X,XXX,XXX	5.0%

17.27 ***Savings Institutions.*** Following is an illustrative table for presentation in financial statements for a savings institution's actual capital amounts and ratios as of the balance sheet date. All disclosures required by paragraph 17.23 should be presented.

	Actual		***For Capital Adequacy Purposes:***[11]		***To Be Well Capitalized Under Prompt Corrective Action Provisions:***[12]	
	Amount	***Ratio***	***Amount***	***Ratio***	***Amount***	***Ratio***
Total Capital (to Risk Weighted Assets)	$X,XXX,XXX	X.X%	$X,XXX,XXX	8.0%	$X,XXX,XXX	10.0%
Core Capital (to Adjusted Tangible Assets)	$X,XXX,XXX	X.X%	$X,XXX,XXX	4.0%	$X,XXX,XXX	5.0%
Tangible Capital (to Tangible Assets)	$X,XXX,XXX	X.X%	$X,XXX,XXX	1.5%	N/A	
Tier I Capital (to Risk Weighted Assets)	$X,XXX,XXX	X.X%	N/A		$X,XXX,XXX	6.0%

[9] See footnote 8 in this chapter.

[10] For adequacy capitalized or undercapitalized institutions, this column should present the minimum amounts and ratios the institution must have to be categorized as adequately capitalized under the prompt corrective action framework and should include the effect of any prompt-corrective-action capital directive.

[11] See footnote 8 in this chapter.

[12] See footnote 10 in this chapter.

17.28 ***Holding Companies.*** Following is an illustrative table for presentation in consolidated financial statements for a bank (or savings and loan association) holding company and each significant subsidiary as of the balance sheet date. Tier 3 capital market risk requirements are required to be disclosed only for certain banks and bank holding companies. All disclosures required by paragraph 17.23 should be presented except 17.23(4) disclosures related to prompt corrective action.):

	Actual		***For Capital Adequacy Purposes:***[13]		***To Be Well Capitalized Under Prompt Corrective Action Provisions:***[14]	
	Amount	***Ratio***	***Amount***	***Ratio***	***Amount***	***Ratio***
Total Capital (to Risk Weighted Assets):						
Consolidated	**$X,XXX,XXX**	**X.X%**	**$X,XXX,XXX**	**X.X%**	**N/A**	
Subsidiary Bank A	$X,XXX,XXX	X.X%	$X,XXX,XXX	X.X%	$X,XXX,XXX	X.X%
Subsidiary Bank B	$X,XXX,XXX	X.X%	$X,XXX,XXX	X.X%	$X,XXX,XXX	X.X%
Subsidiary Bank C	$X,XXX,XXX	X.X%	$X,XXX,XXX	X.X%	$X,XXX,XXX	X.X%
Tier I Capital (to Risk Weighted Assets):						
Consolidated	**$X,XXX,XXX**	**X.X%**	**$X,XXX,XXX**	**X.X%**	**N/A**	
Subsidiary Bank A	$X,XXX,XXX	X.X%	$X,XXX,XXX	X.X%	$X,XXX,XXX	X.X%
Subsidiary Bank B	$X,XXX,XXX	X.X%	$X,XXX,XXX	X.X%	$X,XXX,XXX	X.X%
Subsidiary Bank C	$X,XXX,XXX	X.X%	$X,XXX,XXX	X.X%	$X,XXX,XXX	X.X%
Tier I Capital (to Average Assets):						
Consolidated	**$X,XXX,XXX**	**X.X%**	**$X,XXX,XXX**	**X.X%**	**N/A**	
Subsidiary Bank A	$X,XXX,XXX	X.X%	$X,XXX,XXX	X.X%	$X,XXX,XXX	X.X%
Subsidiary Bank B	$X,XXX,XXX	X.X%	$X,XXX,XXX	X.X%	$X,XXX,XXX	X.X%
Subsidiary Bank C	$X,XXX,XXX	X.X%	$X,XXX,XXX	X.X%	$X,XXX,XXX	X.X%

[13] See footnote 8 in this chapter.

[14] See footnote 10 in this chapter.

CREDIT UNIONS

Introduction

17.29 Credit unions operate under a cooperative form of ownership. Members, in effect, "own" the credit union, although their interests in the credit union (that is, their shares) have the characteristics of deposits. The equity section of a credit union's statement of financial condition generally consists only of retained earnings and other comprehensive income. Retained earnings includes statutory reserves, retained earnings and other appropriations as designated by management or regulatory authorities. Although credit unions may be incorporated, no stock is issued. Retained earnings is generally shown as a single line item in the statement of financial condition. The components of retained earnings may be presented in the body of the statement of financial condition, the notes to the financial statements, or the statement of retained earnings. All appropriations and other restrictions of retained earnings should be disclosed.

Members' Equity

17.30 ***Regular Reserve (Statutory Reserve).*** The Federal Credit Union Act and certain states require that a regular (or statutory) reserve be established and maintained to provide an equity base for credit unions. The regular (or statutory) reserve account represents that required appropriation of equity. The regular (or statutory) reserve is established through a charge to undivided earnings and a credit to the reserve account. For federal credit unions, the amount required to be transferred is defined in sections 702.201 and 702.303 of the NCUA *Rules and Regulations*. The prompt corrective action rules describe the mandatory and discretionary prompt corrective actions that a credit union is subject to in cases where the credit union's capital level is below the "well capitalized" level, or the credit union fails to meet its required risk-based net worth requirement, or the credit union is subject to regulatory restrictions because of activities that are judged by the NCUA to be unsafe and unsound. In cases relating to inadequate capital with respect to the net worth requirement or the risk-based net worth requirement, a credit union is generally required to increase its net worth by the equivalent of at least 0.1% of assets each quarter until the credit union is classified as "well capitalized." The credit union must transfer that amount of earnings, or more by choice, from undivided earnings to the regular reserve until the credit union is classified as "well capitalized."

17.31 Certain states may have adopted similar regulations that apply to state-chartered credit unions. The statutes for each state should be consulted for applicable requirements.

17.32 The regular reserve should not be viewed as a substitute for or supplement to the allowance for loan losses. Loan losses and the provision for loan losses should not be charged directly to the regular reserve. The provision for loan losses and the allowance for loan losses should be accounted for in accordance with GAAP.

17.33 ***Undivided Earnings.*** Undivided earnings represent unappropriated accumulated earnings or losses of the credit union since its inception. The undivided earnings may also be increased or decreased as a result of transfers to or from appropriated accounts such as the regular reserve.

17.34 ***Appropriated Undivided Earnings.*** The board of directors of a credit union may restrict or appropriate portions of undivided earnings for specific purposes in accordance with paragraph 15 of FASB Statement No. 5. Examples include appropriations for loss contingencies and for major expenditures. The amount of such appropriations is normally transferred from undivided earnings, pending resolution of its purpose. Amounts appropriated may be returned to undivided earnings when they are no longer deemed necessary.

17.35 Federally-insured state chartered credit unions are required under terms of the insurance agreement to establish an investment valuation reserve, displayed as an equity classification, for held-to-maturity nonconforming investments. Nonconforming investments are those investments permissible under state law for a state-chartered credit union, but which are impermissible for federally chartered credit unions.

17.36 ***Accumulated Other Comprehensive Income.*** In accordance with FASB Statement No. 130, banks and savings institutions are required to transfer the total of other comprehensive income for a period to a separate component of equity until realized. For example, other comprehensive income would include unrealized holding gains and losses on available-for-sale securities and effective portion of the accumulated change in fair value on cash flow hedges. Declines in the fair values of investments that are other than temporary and the ineffective portion of cash flow hedges should be charged directly to operations.

New Credit Unions and Low-Income Designated Credit Unions

17.37 The prompt corrective action regulations for credit unions designated as "new" are different than for other natural person credit unions. To be designated as "new" a credit union must have been in existence for less than 10 years and have less than $10 million in total assets. For credit unions designated as "low-income" by the NCUA, the net worth calculation includes certain uninsured, secondary capital accounts (as defined in the regulations).

Disclosures for Natural Person Credit Unions

17.38 Paragraph 16(a) of SOP 01-6 states: "Noncompliance with regulatory capital requirements could materially affect the economic resources of a credit union and claims to those resources. Accordingly, at a minimum, the institution should disclose the following in the notes to the financial statements:[15]

1. A description of regulatory capital requirements (*a*) for capital adequacy purposes and (*b*) mandated by the prompt corrective action.
2. The actual or possible material effects of noncompliance with such requirements
3. Whether the institution is in compliance with the regulatory capital requirements, including, as of each balance-sheet date presented[16], the following with respect to quantitative measures:[17,]

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[15] Disclosures should also be presented for any state-imposed capital requirements that are more stringent than or significantly differ from federal requirements.

[16] For adequately capitalized or undercapitalized institutions, this should present the minimum amounts and ratios the institution must have to be categorized as *well capitalized* under the prompt corrective action framework and should include the effect of any prompt-corrective-action capital directive. Credit unions subject to a separate RBNW determination may employ alternative total asset ratios, which may differ from the financial statement totals. If alternative ratios are used, they should be disclosed in the notes to the financial statements.

[17] These amounts may be presented in either narrative or tabular form.

a. Whether the institutions meets the definition of a complex credit union as defined by the National Credit Union Administration

b. The institution's required and actual capital ratios and required and actual capital amounts.

c. Factors that may significantly affect capital adequacy such as potentially volatile components of capital, qualitative factors, and regulatory mandates

4. As of each balance sheet date presented, the prompt corrective action category in which the institution was classified [18]

5. If, as of the most recent balance-sheet date or issuance of the financial statements, the institution is not in compliance with capital adequacy requirements, the possible material effects of such conditions on amounts and disclosures in the financial statements

6. Whether subsequent to the balance sheet date and prior to issuance of the financial statements, management believes any events or changes have occurred to change the institution's prompt corrective action category."

17.39 If, as of the most recent balance sheet date presented, the institution is either (*a*) not in compliance with capital adequacy requirements or (*b*) considered less than well capitalized under the prompt corrective action provisions or (*c*) both, the possible material effects of such conditions and events on amounts and disclosures in the financial statements should be disclosed.[19] Paragraph 16b of SOP 01-6 states: "Noncompliance with regulatory capital requirements may, when considered with other factors, raise substantial doubt about the credit union's ability to continue as a going concern for a reasonable period of time. Additional information that might be disclosed in situations where there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time may include the following:

- Pertinent conditions and events giving rise to the assessment of substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time.
- Possible effects of such conditions and events.
- Management's evaluation of the significance of those conditions and events and any mitigating factors.
- Possible discontinuance of operations.
- Management's plans (including relevant prospective financial information).
- Information about the recoverability or classification of recorded asset amounts or the amounts or classification of liabilities."

[18] A credit union is (under federal regulations) deemed to be within a given capital category as of the most recent date of the following: (*a*) the last day of the calendar month following the end of the calendar quarter, (b) the date the credit union's net worth ratio is recalculated by or as a result of its most recent final report of examination, or (c) the date the credit union received written notice from NCUA or, if State-chartered, the appropriate State official, of reclassification on safety and soundness grounds.

[19] The institution should consider also making such disclosures when the institution's actual ratio is nearing noncompliance.

Illustrative Disclosures for Natural Person Credit Unions

17.40 ***Well Capitalized.*** The example disclosures that follow are for illustrative purposes only. Following is an illustrative disclosure for an institution that is in compliance with capital adequacy requirements and considers itself "*well capitalized*" under the prompt corrective action framework. Comparative disclosures should be included for each balance sheet presented.

> The Credit Union is subject to various regulatory capital requirements administered by the NCUA. Failure to meet minimum capital requirements can initiate certain mandatory—and possibly additional discretionary—actions by regulators that, if undertaken, could have a direct material effect on the Credit Union's financial statements. Under capital adequacy regulations and the regulatory framework for prompt corrective action, the Credit Union must meet specific capital regulations that involve quantitative measures of the Credit Union's assets, liabilities, and certain off-balance-sheet items as calculated under generally accepted accounting practices. The Credit Union's capital amounts and net worth classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.
>
> Quantitative measures established by regulation to ensure capital adequacy require the Credit Union to maintain minimum amounts and ratios (set forth in the table below) of net worth (as defined) to total assets (as defined). Credit unions are also required to calculate a Risk-Based Net Worth Requirement (RBNWR) which establishes whether or not the Credit Union will be considered "complex" under the regulatory framework. The Credit Union's RBNW ratio as of December 31, 200X was ___%. The minimum ratio to be considered complex under the regulatory framework is 6%. Management believes, as of December 31, 200X, that the Credit Union meets all capital adequacy requirements to which it is subject.
>
> As of December 31, 200X, the most recent call reporting period, the NCUA categorized the Credit Union as "*well capitalized*" under the regulatory framework for prompt corrective action. To be categorized as "*well capitalized*" the Credit Union must maintain a minimum net worth ratio of 7% of assets.[20] There are no conditions or events since that notification that management believes have changed the institution's category.

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[20] Paragraphs 2.33 through 2.50 describe the prompt corrective action net worth ratios. For some institutions, the calculation of required amounts and net worth ratios under the prompt corrective action framework may differ from calculations under the capital adequacy requirements. The disclosure should provide the relevant amounts and ratios accordingly.

The Credit Union's actual capital amounts and ratios are also presented in the table.

	Actual		***To be Adequately Capitalized Under Prompt Corrective Action Provisions***[21]		***To be Well Capitalized Under Prompt Corrective Action Provisions***	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
Net worth	$2,000,000	7.5%	$1,600,000	6.0%	$1,800,000	7.0%
Risk-Based Net Worth Requirement	$1,700,000	6.5%	N/A	N/A	N/A	N/A

Because the RBNWR, 6.5%, is less than the net worth ratio, 7.5%, the Credit Union retains its original category. Further, in performing its calculation of total assets, the Credit Union used the [*select one: average of the quarter-end balances of the four most recent quarters, monthly average over the quarter, daily average over the quarter, or quarter-end balance*] option, as permitted by regulation.

17.41 ***Adequately Capitalized.*** Following is an illustrative paragraph to be added in place of the third illustrative paragraph in paragraph 17.40 for an institution that is in compliance with capital adequacy requirements and considers itself *"adequately capitalized"* under the prompt corrective action framework:

As of December 31, 200X, and December 31, 200W, the most recent call reporting period, the NCUA categorized the Credit Union as "adequately capitalized" under the regulatory framework for prompt corrective action. To be categorized as "adequately capitalized" the Credit Union must maintain a minimum net worth ratio of 6% of assets and, if applicable, must maintain adequate net worth to meet the Credit Union's risk-based net worth requirement of X% as set forth in the table.[22] As an "adequately capitalized" credit union, the NCUA's prompt corrective action regulations require that the Credit Union to increase its net worth quarterly by an amount equivalent to at least 0.1% of its total assets for the current quarter, and must transfer that amount (or more by choice) from undivided earnings to its regular reserve account until it is "well capitalized," while continuing to meet its risk-based net worth requirement. There are no conditions or events since that filing date that management believes have changed the institution's category.

17.42 ***Undercapitalized.*** Following are illustrative paragraphs to be added to the disclosures illustrated in paragraph 17.40 when a credit union considers itself *undercapitalized* [for existing credit unions].

The Credit Union may not increase assets and must restrict member business loans due to its net worth. [*Describe the possible effects of these restrictions.*] Under the regulatory framework for prompt corrective action, the Credit Union's net worth classification requires that a net worth restoration plan (NWRP) has been filed with and accepted by the National Credit Union

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[21] For "adequacy capitalized" or "undercapitalized" institutions, this column should present the minimum amounts and ratios the institution must have to be categorized as adequately capitalized under the prompt corrective action framework and should include the effect of any mandatory or discretionary supervisory actions.

[22] For some institutions, the calculation of required amounts and net worth ratios under the prompt corrective action framework may differ from calculations under the capital adequacy requirements. The disclosure should provide the relevant amounts and ratios accordingly.

Administration (NCUA). The plan outlines the Credit Union's steps for attaining the "adequately capitalized" level of net worth. Management believes, at this time, that the Credit Union will meet implement the steps and meet all the targets of the plan and all the regulatory net worth requirements by December 31, 200X (or earlier if stated in the restoration plan). [*The disclosure should continue with discussion of any discretionary actions required by the NCUA.*]

17.43 ***New Credit Unions.*** Following are illustrative paragraphs to be added to the disclosures illustrated in paragraph 17.40 when a new credit union considers itself *moderately, marginally, minimally, or undercapitalized* [for new credit unions].

The Credit Union must restrict member business loans due to its net worth. [*Describe the possible effects of these restrictions*.] Under the regulatory framework for prompt corrective action, a revised business plan has been filed, as required, with and accepted by the National Credit Union Administration (NCUA). The plan outlines the Credit Union's steps for attaining the required levels of net worth. Management believes, at this time, that the Credit Union will implement the steps and meet all the targets of the plan and all the regulatory net worth requirements by December 31, 200Y (or earlier if stated in the revised business plan). [*The disclosure should continue with discussion of any discretionary actions required by the NCUA.*]

CORPORATE CREDIT UNIONS

Introduction

17.44 Corporate credit unions operate under a cooperative form of ownership similar to natural person credit unions. Corporate credit unions are established to serve the financial needs of natural person credit unions that join the corporate. The equity section of a corporate credit union's statement of financial condition generally consists of membership capital, paid-in capital, retained earnings and other accumulated other comprehensive income. Retained earnings include all forms of retained earnings such as regular or statutory reserves and undivided earnings. Although some corporate credit unions may be incorporated under state laws, no stock is issued.

Equity

17.45 ***Membership Capital***. Corporate credit unions are different from natural person credit unions in that they have specific membership capital accounts. Membership capital is comprised of funds contributed by the natural person credit unions, which are available to cover losses that exceed retained earnings and paid-in-capital. In the event of liquidation, membership capital is payable only after satisfaction of all other liabilities including uninsured deposits. These funds are not insured and can not be pledged. In general these funds have a minimum withdrawal notice of three years. Corporate credit unions may use either a term certificate for this account or an adjusted balance account, which is generally based on the assets of the member credit union.

17.46 ***Paid-in-capital.*** Paid in capital is defined as the accounts or other interests that are available to cover losses that exceed reserves and undivided earnings. The NCUSIF or any other insurer does not insure these funds. These funds are callable only at the discretion of the corporate and only if the corporate meets the minimum capital requirements after the funds are called. Paid in capital includes both member and non-member paid-in-capital. Paid-in-capital can not exceed reserves and undivided earnings. Corporate credit unions can also have non-member paid-in-capital if it is approved by the NCUA[#]

17.47 ***Reserves and Undivided Earnings***. Undivided earnings and reserves represent unappropriated accumulated earnings or losses of the corporate credit union since its inception. The accounting treatment of transactions in undivided earnings of a credit union is similar to that of transactions in retained earnings of corporate enterprises. The undivided earnings may also be increased or decreased as a result of transfers to or from appropriated accounts such as the regular reserve. Corporate credit unions are required to maintain a minimum capital ratio of 4%. To comply with this regulation, corporate credit unions calculate their capital ratio monthly. The capital ratio is the total corporate capital divided by the moving daily average net assets. The moving daily average net assets is calculated by the average of daily average net assets for the one month being measured and the previous 11 months. Where the capital ratio is greater or equal to 4%, the reserve transfer is optional. When the capital ratio is less than 4% but greater than or equal to 3%, the corporate must transfer .10 percent of its moving daily average net assets from undivided earnings to statutory reserves. When the ratio is below 3%, the transfer is .15 percent. These transfers must be calculated monthly and transferred at least quarterly. The NCUA can require more transfers if deemed warranted based on the circumstances.

17.48 ***Accumulated Other Comprehensive Income.*** In accordance with FASB Statement No. 130, corporate credit unions are required to transfer the total of other comprehensive income for a period to a separate component of equity until realized. For example, other comprehensive income would include unrealized holding gains and losses on available-for-sale securities and effective portion of the accumulated change in fair value on cash flow hedges. Declines in the fair values of investments that are other than temporary and the ineffective portion of cash flow hedges should be charged directly to operations.

Disclosures for Corporate Credit Unions

17.49 Under current regulation, corporate credit unions are subject to regulatory capital requirements and not prompt corrective action. In applying the disclosure requirements of SOP 01-6, those prompt corrective action disclosures are not applicable for corporate credit unions. Paragraph 16(a) of SOP 01-6 states: "Noncompliance with regulatory capital requirements could materially affect the economic resources of a credit union and claims to those resources. Accordingly, at a minimum, the institution should disclose the following in the notes to the financial statements:[23]

1. A description of regulatory capital requirements (*a*) for capital adequacy purposes and (*b*) mandated by the prompt corrective action.
2. The actual or possible material effects of noncompliance with such requirements

[#] The information contained in this section could change if the proposed section 704 is approved as currently drafted.

[23] Disclosures should also be presented for any state-imposed capital requirements that are more stringent than or significantly differ from federal requirements.

3. Whether the institution is in compliance with the regulatory capital requirements, including, as of each balance-sheet date presented[24], the following with respect to quantitative measures:[25,]
   a. Whether the institutions meets the definition of a complex credit union as defined by the National Credit Union Administration
   b. The institution's required and actual capital ratios and required and actual capital amounts.
   c. Factors that may significantly affect capital adequacy such as potentially volatile components of capital, qualitative factors, and regulatory mandates
4. As of each balance sheet date presented, the prompt corrective action category in which the institution was classified [26]
5. If, as of the most recent balance-sheet date or issuance of the financial statements, the institution is not in compliance with capital adequacy requirements, the possible material effects of such conditions on amounts and disclosures in the financial statements
6. Whether subsequent to the balance sheet date and prior to issuance of the financial statements, management believes any events or changes have occurred to change the institution's prompt corrective action category."

17.50 If, as of the most recent balance sheet date presented, the institution is either (*a*) not in compliance with capital adequacy requirements, the possible material effects of such conditions and events on amounts and disclosures in the financial statements should be disclosed.[27] Paragraph 16b of SOP 01-6 states: "Noncompliance with regulatory capital requirements may, when considered with other factors, raise substantial doubt about the credit union's ability to continue as a going concern for a reasonable period of time. Additional information that might be disclosed in situations where there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time may include the following:

- Pertinent conditions and events giving rise to the assessment of substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time.
- Possible effects of such conditions and events.
- Management's evaluation of the significance of those conditions and events and any mitigating factors.
- Possible discontinuance of operations.
- Management's plans (including relevant prospective financial information).
- Information about the recoverability or classification of recorded asset amounts or the amounts or classification of liabilities."

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[24] For adequately capitalized or undercapitalized institutions, this should present the minimum amounts and ratios the institution must have to be categorized as *well capitalized* under the prompt corrective action framework and should include the effect of any prompt-corrective-action capital directive. Credit unions subject to a separate RBNW determination may employ alternative total asset ratios, which may differ from the financial statement totals. If alternative ratios are used, they should be disclosed in the notes to the financial statements.

[25] These amounts may be presented in either narrative or tabular form.

[26] A credit union is (under federal regulations) deemed to be within a given capital category as of the most recent date of the following: (*a*) the last day of the calendar month following the end of the calendar quarter, (b) the date the credit union's net worth ratio is recalculated by or as a result of its most recent final report of examination, or (c) the date the credit union received written notice from NCUA or, if State-chartered, the appropriate State official, of reclassification on safety and soundness grounds.

[27] The institution should consider also making such disclosures when the institution's actual ratio is nearing noncompliance.

Illustrative Disclosures for Corporate Credit Unions

17.51 The example disclosures that follow are for illustrative purposes only. Comparative disclosures should be included for each balance sheet presented.

> The Corporate Credit Union is subject to various regulatory capital requirements administered by the National Credit Union Administration ("NCUA"). Failure to meet minimum capital requirements can initiate certain additional actions by regulators that, if undertaken, could have a direct material effect on the Corporate's financial statements.
>
> NCUA Regulation 704 establishes a minimum capital ratio of 4%. The regulation further sets forth the levels of reserve transfers based on a reserve ratio as defined in the regulation as follows:

Reserve Ratio	***Required Minimum Annual Reserve Transfer as a Percent of Average Daily Net Assets***
≥4%	Optional
≥3% to 4%	0.10%
<3%	0.15%

> The Corporate's capital ratios are as follows:

	200X
Actual:	
Capital	$XXX
Capital ratio	XXX%
Required:	
Capital	$XXX
Capital ratio	4.0%

> The Corporate's reserve ratio was X.X% and X.X% as of December 31, 200X. The Corporate made monthly reserve transfers in accordance with regulatory requirements.

MORTGAGE COMPANIES AND MORTGAGE BANKING ACTIVITIES

Introduction

17.52 Mortgage companies are organized with capital stock and shareholders. Mortgage banking activities primarily consist of two separate but interrelated activities: (1) the origination or acquisition of mortgage loans for the purpose of selling those loans to permanent investors in the secondary market, and (2) the subsequent long-term servicing of those loans. Mortgage loans are acquired for sale to permanent investors from a variety of sources, including in-house origination and purchases from third-party correspondents. Certain common requirements are discussed in Chapter 4. For example, to participate in the Federal Housing Administration (FHA) mortgage insurance program, a mortgage lender must obtain, U.S. Department of Housing and Urban Development (HUD) approval by meeting various requirements prescribed by HUD, including maintaining minimum net worth requirements. Net worth requirements vary depending on the program. To obtain approval to sell and service mortgage loans for Fannie Mae and/or Freddie Mac, a mortgage lender must meet various requirements including maintaining an acceptable net worth.

Disclosure for Mortgage Companies and Mortgage Banking Activities

17.53 Paragraph 17(a) of SOP 01-6 states: "Noncompliance with minimum net worth (capital) requirements imposed by secondary market investors or state-imposed regulatory mandates could materially affect the economic resources of a mortgage banking entity and claims to those resources. To the extent an entity is subject to such requirements, the entity should disclose the following in the notes to the financial statements:

(1) A description of the minimum net worth requirements related to:
   (a) secondary market investors and
   (*b*) state-imposed regulatory mandates
(2) The actual or possible material effects of noncompliance with those requirements
(3) Whether the entity is in compliance with the regulatory capital requirements, including, as of each balance-sheet date presented, the following with respect to quantitative measures:
   (a) The entity's required and actual net worth amounts
   (b) Factors that may significantly affect adequacy of net worth such as potentially volatile components of capital, qualitative factors, or regulatory mandates
(4) If, as of the most recent balance-sheet date, the entity is not in compliance with capital adequacy requirements, the possible material effects of such conditions on amounts and disclosures in the notes to the financial statements."

17.54 Paragraph 17(b) of SOP 01-6 states: "Further, noncompliance with minimum net worth requirements may, when considered with other factors, raise substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time. Additional information that might be disclosed in situations where there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time may include the following:

- Pertinent conditions and events giving rise to the assessment of substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time
- Possible effects of such conditions and events

- Management's evaluation of the significance of those conditions and events and any mitigating factors
- Possible discontinuance of operations
- Management's plans (including any relevant financial information)
- Information about the recoverability or classification of recorded asset amounts or the amounts or classifications of liabilities"

17.55 Paragraph 17(c) of SOP 01-6 states: "Servicers with net worth requirements from multiple sources should disclose, in the notes to the financial statements, the net worth requirement of the following:

(1) Significant servicing covenants with secondary market investors with commonly defined servicing requirements[28]

(2) Any other secondary market investor where violation of the requirement would have a significant adverse effect on the business

(3) The most restrictive third-party agreement if not included above"

[28] At the time of issuance of SOP 01-6, common secondary market investors include the U.S. Department of Housing and Urban Development (HUD), Federal National Mortgage Association (FNMA), Government National Mortgage Association (GNMA), and Federal Home Loan Mortgage Corporation (FHLMC).

Illustrative Disclosures for Mortgage Companies and Mortgage Banking Activities

17.56 The disclosures that follow are for illustrative purposes only, and represent a mortgage company that is in compliance with capital adequacy requirements. Comparative disclosures should be included for each balance sheet presented.

> The Company is subject to various capital requirements in connection with seller/servicer agreements that the Company has entered into with secondary market investors. Failure to maintain minimum capital requirements could result in the Company's inability to originate and service loans for the respective investor and, therefore, could have a direct material effect on the Company's financial statements. Management believes, as of December 31, 200X and 200W, that the Company met all capital requirements to which it is subject.
>
> The Company's actual capital amounts and the minimum amounts required for capital adequacy purposes, by investor, are as follows:

	Actual Capital	***Minimum Capital Requirement***
As of December 31, 200X:		
HUD	$X,XXX,XXX	$XXX,XXX
FHLMC	$X,XXX,XXX	$XX,XXX
FNMA	$X,XXX,XXX	$XX,XXX

AUDITING

Banks, Savings Institutions and Credit Unions

Objectives

17.57 In addition to testing of disclosures, as discussed below, the independent accountant should consider the implications of capital noncompliance, as discussed beginning in paragraph 5.134 and in chapter 22.

17.58 The independent accountant's objective in this area is to obtain reasonable assurance that the financial statements include proper description and disclosure of regulatory matters (as discussed in paragraphs 17.02 through 17.10) in the context of the financial statements taken as a whole. Similarly, the audit objective for regulatory capital matters relates primarily to disclosure.[29] Capital amounts determined under regulatory accounting principles (RAP) are, by definition, not recognized or measured in the institution's financial statements prepared in conformity with GAAP.

17.59 An independent accountant's report on financial statements containing the required regulatory capital disclosures does not constitute an opinion on the fair presentation of the institution's regulatory reports (in part or taken as a whole) in conformity with underlying instructions for such reports or RAP.

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[29] Notwithstanding the disclosure objective, regulatory matters may also affect preparation of the independent accountant's report, as discussed in chapter 22.

Nor does the opinion indicate that the independent accountant has confirmed with any regulatory agency that the agency has examined or otherwise evaluated or opined on the fair presentation of such reports.

Planning

17.60 In planning the audit, the independent accountant should consider the factors influencing inherent risk, which are described in chapter 5, as they relate to financial statement assertions about regulatory capital. Independent accountants should have knowledge of capital regulations sufficient to understand Call Report instructions and to assess related application and classification decisions made by management. The independent accountant should review changes in regulatory reporting instructions and related capital requirements since the preceding audit.

17.61 Paragraphs 5.141 through 5.150 discuss the independent accountant's responsibility relative to review of supervisory reports and coordination with examiners. Such review and coordination should involve consideration of matters for disclosure.

17.62 While planning and carrying out procedures in other audit areas, the independent accountant should consider the potential that RAP-GAAP differences might result from the institution's transactions. This information will help the independent accountant assess differences (*a*) between GAAP equity amounts and RAP capital amounts and (*b*) between GAAP and RAP asset amounts, including risk weightings and off-balance-sheet equivalents. The information will also be useful for performing any procedures applied to such differences (including consideration of the relative risk weightings assigned to certain amounts or transactions).

17.63 In planning the audit, the independent accountant should consider factors influencing inherent risk, which are described in chapter 5, as they relate to the adequacy of disclosure about regulatory matters. Some components of regulatory capital ratios, including related amounts, asset measures, and risk weightings, may be difficult to determine due to (*a*) the complexity and subjectivity of capital regulations and related regulatory reporting instructions or (*b*) the complexity of the institution's transactions. The number and variety of differences between GAAP and RAP amounts affecting the institution also will affect inherent risk in this area.

17.64 Management's regulatory financial reporting classification and risk weighting decisions involve a high degree of subjective analysis by management and might be challenged by examiners. Accordingly, such decisions that could have a material impact on regulatory disclosures should be carefully considered by the independent accountant.

17.65 The following are examples of factors related to regulatory matters that may indicate higher inherent risk and/or higher control risk:

- A high volume and/or high degree of complexity of off-balance-sheet transactions
- Actual or borderline noncompliance with minimum capital requirements
- A poor regulatory rating
- Past disagreements between management and regulators about classifications, risk weightings, or other interpretations of RAP or application of capital regulations in general
- Frequent corrections to filed regulatory reports
- Regulatory restrictions or other regulatory actions taken related to capital compliance (for example, any MOU or LUA issued)
- Unusual, material, or frequent related party transactions
- Capital calculations, including management's classification or risk weighting decisions, that are not well documented

Internal Control Over Financial Reporting

17.66 SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), provides guidance on the independent accountant's consideration of an institution's internal control in an audit of financial statements performed in accordance with GAAS. It describes the components of internal control and explains how an independent accountant should consider internal control in planning and performing an audit. Paragraph 19 of SAS No. 55, as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55*, requires that, in all audits, the independent accountant obtain sufficient understanding of each of the five components (the control environment, risk assessment, control activities, information and communication, and monitoring) to plan the audit by performing procedures to understand the design of policies and procedures relevant to audit planning and whether they have been placed in operation.

17.67 Effective internal control over financial reporting in this area should provide reasonable assurance that errors or fraud in financial statement disclosures about regulatory matters are prevented or detected. In part, these controls may overlap with controls the institution has established for compliance with capital requirements. Institutions' systems for gathering the necessary information and preparing regulatory financial reports vary in sophistication. Examples of factors that may contribute to effective internal control in this area follow.

- Responsibilities for capital planning, monitoring compliance with capital laws and regulations, and preparation of call reports have been assigned to competent officials in the institution.
- Regulatory financial reporting is subject to risk assessment and supervisory control procedures and is overseen by financial officers of the institution who review the details supporting classifications and risk weightings.
- Capital amounts reported to regulators are reconciled to underlying detailed schedules and subsidiary ledgers with reconciling items supported by appropriate computations and documentation and with appropriate supervisory review and oversight.
- Procedures are in place for collection and reporting by branches, divisions, and subsidiaries of amounts necessary for regulatory capital calculations.
- Management obtains competent outside advice, as warranted, on significant classification or risk weighting questions before and after major transactions are executed.
- Regulatory capital analyses, calculations, and supporting documentation are well prepared and readily accessible.
- The regulatory financial reporting process (including classifications and risk weightings) is reviewed by the internal audit function.

Substantive Tests

17.68 The extent to which the independent accountant applies tests to specific transactions or amounts will depend on the independent accountant's assessment of inherent and control risks and the materiality of the accounts. Where inherent and control risks are assessed at lower levels, the independent accountant may consider testing a reconciliation of RAP-GAAP differences before year-end, reviewing classifications made for risk weighting purposes, reviewing examination findings, and testing material RAP-GAAP differences, risk weighting classifications, and ratio calculations in preparation for any substantive tests to be applied to disclosures of year-end amounts and ratios.

17.69 For credit unions, the auditor should be satisfied that regular reserve transfers have been made in accordance with regulatory requirements. To gain such satisfaction, the auditor should be familiar with the reserve requirements of the applicable federal and state laws and regulations. Other entries, including direct charges and credits in accordance with regulatory requirements, should be tested for propriety. Other appropriations of net "retained earnings" should be traced to authorization by the board of directors. Certain changes to the regular reserve are subject to regulatory approval and the auditor should be familiar with these requirements.

17.70 Chapters 1 and 2 discuss the independent accountant's responsibility relative to review of supervisory reports and coordination with examiners. Such review and coordination should involve consideration of the adequacy of the financial statement disclosures in this area.

17.71 Substantive procedures should be designed to the extent considered necessary to assess computations of regulatory capital amounts and asset measures by obtaining reasonable assurance that the underlying data are materially complete. Such procedures might include the following.

- Obtain and test management's schedules supporting calculation of the institution's actual and required regulatory capital ratios, including regulatory capital amounts (ratio numerators) and related asset bases (ratio denominators).
- Review and evaluate management's analyses of significant nonrecurring transactions and their impact on regulatory capital.
- Inquire about, and discuss with officers having responsibility for regulatory financial reporting, the existence and nature of the institution's RAP-GAAP differences. Review copies of prior-year regulatory reports (and, as necessary, client's supporting working papers), and obtain management's analysis of classification issues concerning preparation of call reports, including risk weighting classifications assigned. In assessing the completeness of any reconciliation, consider the potential for other of the institution's transactions to produce standard RAP-GAAP differences.
- Obtain any reconciliation of amounts supporting the institution's regulatory capital ratio calculations to amounts in the institution's financial statements prepared in conformity with GAAP.[30]
    - — Test management's supporting schedules and reconciliations for completeness and mathematical accuracy.
    - — Agree GAAP amounts to general and/or subsidiary ledgers and obtain supporting schedules for non-GAAP amounts.
- Review the nature and amount of material non-GAAP amounts for propriety and consistency with prior years.
- Consider current treatment of items that resulted in past corrections or changes to regulatory financial reports.
- Consider whether significant changes in instructions for preparation of call reports have been applied to material transactions.
- Inquire about, and discuss with officers having responsibility for call reporting, any significant reclassification of transactions since the last filed regulatory report.

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[30] See OTS letter to chief executive officers dated September 11, 1992.

Mortgage Companies and Activities

Objectives

17.72 In addition to testing of disclosures, the independent accountant should consider the implications of capital noncompliance.

17.73 The independent accountant's objective in this area is to obtain reasonable assurance that the financial statements include proper description and disclosure of capital matters in the context of the financial statements taken as a whole.

Planning

17.74 Independent accountants should have knowledge of capital requirements that the entity is subject to as a result of seller/servicer agreements entered into with investors, as well as capital requirements that may be imposed as a result of other business transactions such as borrowing arrangements. In connection with these requirements, it is important that the independent accountants understand the elements that constitute capital, as defined in the various agreements.

17.75 In obtaining information concerning the entity's capital requirements, the independent accountants should also be aware of any assurance services that are required of the independent accountants. In planning the audit, the independent accountant should consider factors influencing inherent risk, which are described in chapter 5, as they relate to the adequacy of disclosure about capital matters.

17.76 The following are examples of factors related to capital matters that may indicate higher inherent risk and/or higher control risk:

- Actual or borderline noncompliance with minimum capital requirements
- Communications or restrictions from investors regarding capital compliance issues
- Capital requirements and calculations that are not well documented

Internal Control Over Financial Reporting

17.77 Effective internal control over financial reporting in this area should provide reasonable assurance that errors or fraud in financial statement disclosures about capital matters are prevented or detected. Examples of factors that may contribute to effective internal control in this area follow:

- Responsibilities for capital planning and monitoring compliance with capital requirements have been assigned to competent officials in the company.
- Capital analyses, calculations and supporting documentation are well prepared and readily accessible.

Substantive Tests

17.78 The extent to which the independent accountant applies tests to specific transactions or amounts will depend on the independent accountant's assessment of inherent and control risks and the materiality of the accounts.

17.79 Substantive procedures should be designed to the extent considered necessary to assess computations of capital amounts by obtaining reasonable assurance that the underlying data is materially complete. Such procedures might include the following:

- Obtain and read new seller/servicer agreements entered into during the period, or amendments to existing agreements, for capital requirements in effect.
- Obtain and test management's schedules supporting calculation of the entity's actual and required capital amounts
- Review and evaluate management's analyses of significant nonrecurring transactions and their impact on capital.
- Obtain any reconciliation of amounts supporting the entity's capital calculations to amounts in the entity's financial statements prepared in conformity with GAAP.
- Test management's supporting schedules and reconciliations for completeness and mathematical accuracy
- Agree GAAP amounts to general and/or subsidiary ledgers

CHAPTER 18

Futures, Forwards, Options, Swaps, and Similar Financial Instruments

INTRODUCTION

18.01 The financial instruments addressed in this chapter-futures; forward, swap, and option contracts; and other financial contracts with similar characteristics (which, collectively, are referred to in this chapter as *derivatives*)-have become important financial management tools for banks and savings institutions.[1] This chapter provides background information on basic contracts, risks, and other general considerations to provide a context for related accounting and auditing guidance.

18.02 This chapter focuses on end uses of derivatives, rather than on the broader range of activities that includes the marketing of derivatives to others. Some banks and savings institutions, primarily large commercial banks, act as market makers or dealers in derivatives that are not traded under uniform rules through an organized exchange. The primary goals of those activities are to make a market and earn income on the difference between the bid and offer prices. Although the volume of transactions often causes individual exposures to offset each other, such activities may be subject to different permutations of risks and different accounting and auditing considerations.

Risks Inherent in Derivatives

18.03 Risks inherent in derivatives such as credit risk, market risk, legal risk, and control risk are the same as risks inherent in more familiar financial instruments. However, derivatives often possess special features such as

- Little or no cash outflows or inflows required at inception.
- No principal balance or other fixed amount to be paid or received.
- Potential risks and rewards substantially greater than the amounts recognized in the statement of financial position.

Also, many derivatives' values are more volatile than those of other financial instruments potentially alternating between positive and negative values in a short period of time.

18.04 Given these features, a derivative's risks can be difficult to segregate because the interaction of such risks may be complex. This complexity is increased (*a*) when two or more basic derivatives are used in combination, (*b*) by the difficulty of valuing complex derivatives, and *(c)* by the volatile nature of markets for some derivatives. The economic interaction between an institution's position in derivatives and that institution's other on- or off-balance-sheet positions (whether assets or liabilities) is an important determinant of the total risk associated with an institution's derivatives use. Risk assessment, therefore, involves consideration of the specific instrument and its interaction with other on- and off-balance-sheet portfolios and activities. There is no list of risk characteristics that can cover all those complex interactions, but a discussion of the basic risk characteristics associated with derivatives follows.

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[1] Paragraph 5 of the Financial Accounting Standards Board's (FASB's) Statement of Financial Accounting Standards No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments*, defines a derivative financial instrument as "a futures, forward, swap, or option contract, or other financial instrument with similar characteristics." Asset-backed securities, which are addressed in chapter 5, also are often referred to as derivatives though they do not meet the definition of *derivative financial instrument* for the purposes of FASB Statement No. 119.

18.05 ***Credit Risk***. This risk relates to the economic losses an institution would suffer if the party on the other end of the contract (the counterparty) fails to meet its financial obligations under the contract. Entities often quantify this risk of loss as the derivative's replacement cost -that is, the current market value of an identical contract.[2] The requirement that participants settle changes in the value of their positions daily mitigates the credit risk of many derivatives traded under uniform rules through an organized exchange (exchange-traded derivatives). *Settlement risk* is the related exposure that a counterparty may fail to perform under a contract after the institution has delivered funds or assets according to its obligations under the contract. Institutions can reduce settlement risk through master netting agreements (see paragraph 15.25 and following). *Counterparty risk* connotes the exposure to the aggregate credit risk posed by all transactions with one counterparty.

18.06 **M*arket Risk***. This risk relates broadly to economic losses due to adverse changes in the fair value of the derivative.[3] Related risks include price risk, basis risk, liquidity risk, and valuation or model risk. *Price risk* relates to changes in the level of prices due to changes in (*a*) interest rates, (*b*) foreign exchange rates, or (*c*) other factors that relate to market volatilities of the rate, index, or price underlying the derivative. *Basis risk* relates to the differing effect market forces have on the performance or value of two or more distinct instruments used in combination (see the discussion of hedging that follows). *Liquidity risk* relates to changes in the ability to sell, dispose of, or close out the derivative, thus affecting its value. This may be due to a lack of sufficient contracts or willing counterparties. *Valuation or model risk* is the risk associated with the imperfection and subjectivity of models and the related assumptions used to value derivatives.

18.07 ***Legal Risk***. this risk relates to losses due to a legal or regulatory action that invalidates or otherwise precludes performance by the institution or its counterparty under the terms of the contract or related netting arrangements. Such risk could arise, for example, from insufficient documentation for the contract, an inability to enforce a netting arrangement in bankruptcy, adverse changes in tax laws, or statutes that prohibit entities (such as certain state and local governmental entities) from investing in certain types of financial instruments.

18.08 ***Control Risk.*** This risk relates to losses that result from the failure (or absence) of internal controls to prevent or detect problems (such as human error, fraud, or system failure) that hinder an institution from achieving its operational, financial reporting, or compliance objectives. Such failure could result, for example, in an institution failing to understand a contract's economic characteristics. Lack of adequate control also could affect whether published financial information about derivatives was prepared reliably by a failure to prevent or detect misstatements caused by error or fraud in financial reporting. Finally, the institution may be negatively affected if controls fail to prevent or detect instances of noncompliance with related contracts, laws, or regulations. Failure to understand derivatives used may lead to inadequate design of controls over their use.

Types of Derivatives

18.09 A key feature of derivatives, as defined in this chapter, is that resulting cash flows are decided by reference to--

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[2] There is a fundamental difference between the credit risk associated with on-balance-sheet financial assets (such as notes receivable or debt securities) and that associated with derivatives the amount of credit exposure in a derivative is volatile, as it will vary with changes in the derivative's market value. Generally, a derivative has credit exposure only when the derivative has positive market value. That value represents an obligation of the counterparty and, therefore, an economic benefit that can be lost if the counterparty fails to fulfill its obligation. Furthermore, the market value of a derivative may fluctuate quickly, alternating between positive and negative values.

[3] Market risk can be measured using a methodology referred to as *value at risk.* Paragraph 69(e) of FASB Statement No. 119 defines value at risk as "the expected loss from an adverse market movement with a specified probability over a period of time." The Group of Thirty report *Derivatives: Practices and Principles* discusses measurement of risk and the concept of value at risk.

a. Rates, indexes (which measure changes in specified markets), or other independently observable factors.

b. The value of underlying positions in the following:

- Financial instruments such as government securities (interest-rate contracts), equity instruments (such as common stock), or foreign currencies
- Commodities such as corn, gold bullion, or oil
- Other derivatives

18.10 Derivatives can generally be described as either *forward-based or option-based,* or there can be combinations of the two. A traditional forward contract obligates one party to buy and a counterparty to sell an underlying financial instrument, foreign currency, or commodity at a future date at an agreed-upon price. Thus, a *forward-based derivative* (examples are futures, forward, and swap contracts) is a two-sided contract in that each party potentially has a favorable or unfavorable outcome resulting from changes in the value of the underlying position or the amount of the underlying reference factor. A traditional option contract provides one party that pays a premium (the option holder) with a right, but not an obligation, to buy (call options) or sell (put options) an underlying financial instrument, foreign currency, or commodity at an agreed-upon price on or before a predetermined date. The counterparty (the option writer) is obligated to sell (buy) the underlying position if the option holder exercises the right. Thus, *an option-based derivative* (examples are option contracts, interest rate caps, and interest-rate floors) is one-sided in the sense that, in the event the right is exercised, only the holder can have a favorable outcome and the writer can have only an unfavorable outcome. If market conditions would result in an unfavorable outcome for the holder, the holder will allow the right to expire unexercised. The expiration of the option contract results in a neutral outcome for both parties (except for any premium paid to the writer by the holder). Although there are a variety of derivatives, they generally are variants or combinations of these two types of contracts.

18.11 Derivatives also are either exchange-traded or over-the-counter (OTC). Institutions and dealers trade futures, certain option, and other standardized contracts under uniform rules through an organized exchange. Most of the risk inherent in such exchange-traded derivatives relates to market risk rather than to credit risk. OTC derivatives are privately traded instruments (primarily swap, option, and forward contracts) customized to meet specific needs and for which the counterparty is not an organized exchange. As a result, although OTC derivatives are more flexible, they potentially involve higher credit and liquidity risk. The degree of risk depends on factors such as (*a*) the financial strength of the counterparty, (*b*) the sufficiency of any collateral held, and (*c*) the liquidity of the specific instrument. The advantages of OTC derivatives are that they can be customized and may be easier to use.

18.12 A description of the basic contracts and variations follows.

18.13 ***Forwards***. *Forward contracts* are contracts negotiated between two parties to purchase and sell a specific quantity of a financial instrument, foreign currency, or commodity at a price specified at origination of the contract, with delivery and settlement at a specified future date.[4] Forward contracts are not traded on exchanges and, accordingly, may be less liquid and generally involve more credit and liquidity risk than futures contracts.

18.14 *Forward-rate agreements,* which are widely used to manage interest-rate risk, are forward contracts that specify a reference interest rate and an agreed-upon interest rate (one to be paid and one to be received) on an assumed deposit of a specified maturity at a specified future date (the settlement date).[5] The term of

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[4] Forward and futures contracts can also be based on an index, such as Standard & Poor's Composite Index of 500 Stocks (the S&P 500).

[5] Examples of reference rates include the U.S. Treasury bill rate and the London Interbank Offered Rate (LIBOR), which is the rate international banks charge each other to borrow money.

the assumed deposit may begin at a subsequent date; for example, the contract period may be for six months, commencing in three months. At the settlement date, the seller of the forward-rate agreement pays the buyer if interest calculated at the reference rate is higher than that calculated at the agreed-upon rate; conversely, the buyer pays the seller if interest calculated at the agreed-upon rate is higher than that calculated at the reference rate.

18.15 ***Futures***. *Futures contracts* are forward-based contracts to make or take delivery of a specified financial instrument, foreign currency, or commodity at a specified future date or during a specified period at a specified price or yield.[6] Futures are standardized contracts traded on an organized exchange. The deliverable financial instruments underlying interest-rate futures contracts are specified investment-grade financial instruments, such as U.S. Treasury securities or mortgage-backed securities (MBSs). *Foreign-currency futures contracts* involve specified deliverable amounts of a particular foreign currency. The deliverable products under *commodities futures contracts* are specified amounts and grades of commodities, such as oil, gold bullion, or coffee.

18.16 Active markets exist for most financial and commodities futures contracts. Active markets provide a mechanism by which entities may transfer their exposures to price risk to other parties. Those parties may, in turn, be trying to manage their own financial risks or achieve gains through speculation. Recognized exchanges, such as the International Monetary Market (a division of the Chicago Mercantile Exchange) or the Chicago Board of Trade, establish conditions governing transactions in futures contracts. U.S. Treasury bond (interest-rate) futures contracts are the most widely traded financial futures contracts. To ensure an orderly market, the exchanges specify maximum daily price fluctuations for each type of contract. If the change in price from the previous day's close reaches a specified limit, no trades at a higher or lower price are allowed. Consequently, trading in the contract is stopped until buy orders and sell orders can be matched either within the daily price limits or on the next business day. Such limits may affect liquidity and thereby hinder the effectiveness of futures contracts used as hedges.

18.17 Brokers require both buyers and sellers of futures contracts to deposit assets (such as cash, government securities, or letters of credit) with a broker. Such assets represent the initial margin (which is a good-faith deposit) at the time the contract is initiated. The brokers mark open positions to market daily and either call for additional assets to be maintained on deposit when losses are experienced (a margin call) or credit customers' accounts when gains are experienced. This daily margin adjustment is called *variation margin.* Variation margin payments generally must be settled daily in cash or acceptable collateral, thus reducing credit risk. The broker returns the initial margin when the futures contract is closed out or the counterparty delivers the underlying financial instrument according to the terms of the contract.

18.18 Delivery of the commodity or financial instrument underlying futures contracts occurs infrequently, as contracts usually are closed out before maturity. This close-out process involves the participants entering a futures contract that is equal and opposite to a currently held futures contract. This provides the participant with equal and opposite positions and obligations and eliminates any net obligation during the remaining lives of the futures contracts.

18.19 ***Swaps***. *Swap contracts* are forward-based contracts in which two parties agree to swap streams of payments over a specified period. The payment streams are based on an agreed-upon (or notional) principal amount. The term *notional* is used because swap contracts generally involve no exchange of principal at either inception or maturity. Rather, the notional amount serves as a basis for calculation of the payment streams to be exchanged.

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[6] See footnote 4 in this chapter.

18.20 *Interest-rate swaps* are the most prevalent type of swap contract. One party generally agrees to make periodic payments, which are fixed at the outset of the swap contract. The counterparty agrees to make variable payments based on a market interest rate (index rate). Swap contracts allow institutions to achieve net payments similar to those that would be achieved if the institution actually changed the interest rate of designated assets or liabilities (the underlying cash position) from floating to fixed rate or vice versa.

18.21 Interest-rate swap contracts are considered a flexible means of managing interest-rate risk. Because swap contracts are customized for institutions, terms may be longer than futures contracts, which generally have delivery dates from three months to three years. Swap contract documentation usually is standardized and transactions can be concluded quickly, making it possible to rapidly take action against anticipated interest-rate movements.

18.22 Interest-rate swap contracts normally run to maturity. However, there may be circumstances that eliminate an institution's need for the swap contract before maturity. Accordingly, an institution may cancel contracts, sell its position, or enter an offsetting swap contract and realize gains or losses, depending on the value of the swap.

18.23 Swap contracts are not exchange-traded but negotiated between two parties. Therefore, they are not as liquid as futures contracts. They also lack the credit risk protection provided by regulated exchanges. The failure by a counterparty to make payments under a swap contract usually results in an economic loss to an institution only if the underlying prices (for example, interest rates or foreign exchange rates) have moved in an adverse direction; that is, in the direction that the swap contract was intended to protect against. The economic loss corresponds to the cost to replace the swap contract. That cost would be the present value of any discounted net cash inflows that the swap contract would have generated over its term.

18.24 In some swap contracts, the timing of payments varies. For example, in an interest-rate swap contract, one party might pay interest quarterly while the counterparty pays interest semiannually. An added element of credit risk exists for the quarterly payer because of the risk that the semiannual payer may default. Here, the economic loss equals the lost quarterly payment and the cost of replacing the swap contract.

18.25 Many entities enter legally enforceable master netting agreements that may reduce total credit risk. Upon default by an applicable counterparty, the agreements provide that entities may set off (for settlement purposes) all their related payable and receivable swap contract positions.

18.26 *Foreign-currency swaps* (sometimes called *cross-currency exchange agreements)* are used to fix (for example, in U.S. dollar terms) the value of foreign exchange transactions that will occur in the future. Foreign-currency swap contracts are also used to transfer a stream of cash flows denominated in a particular currency or currencies into another currency or currencies. Basic features of foreign-currency swap contracts include the following:

- The principal amount is usually exchanged at the initiation of the swap contract.
- Periodic interest payments are made based on the outstanding principal amounts at the respective interest rates agreed to at inception.
- The principal amount is usually re-exchanged at the maturity date of the swap contract.

18.27 In *fixed-rate-currency swaps*, two counterparties exchange fixed-rate interest in one currency for fixed-rate interest in another currency. Currency coupon or cross-currency interest-rate swap contracts combine the features of an interest-rate swap contract and a fixed-rate-currency swap contract. That is, the counterparties exchange fixed-rate interest in one currency for floating-rate interest in another currency.

18.28 *Basis swaps* are a variation on interest-rate swap contracts where both rates are variable but are tied to different index rates. For example, one party's rate may be indexed to three-month LIBOR while the other party's rate is indexed to six-month LIBOR.

18.29 *Equity swaps* are contracts in which the counterparties exchange a series of cash payments based on (*a*) an equity index and (*b*) a fixed or floating interest rate on a notional principal amount. Equity swap contracts typically are tied to a stock index, but sometimes they relate to a particular stock or a defined basket of stocks. One party (the equity payer) pays the counterparty (the equity receiver) an amount equal to the increase in the stock index at regular intervals specified in the contract. Conversely, the equity receiver must pay the equity payer if the stock index declines. The counterparties generally make quarterly payments. Whatever the index performance, the party designated as the equity receiver may also receive an amount representing dividends paid by the companies making up the index during the period.

18.30 The equity payer, on a floating-rate equity swap contract, typically receives LIBOR (plus or minus a notional spread) on the notional principal amount defined in the equity swap contract. This notional principal amount is based on the underlying equity index value at the contract's inception. The notional principal amount is adjusted at each payment date to reflect the settlement of the equity gain or loss. The floating rate is also reset on the periodic payment dates. A fixed-rate equity swap contract is essentially the same, except that the interest rate is fixed for the term of the contract.

18.31 *Commodity swaps* are contracts in which the counterparties agree to exchange cash flows based on the difference between an agreed-upon, fixed price and a price that varies with changes in a specified commodity index, as applied to an agreed-upon quantity of the underlying commodity.

18.32 In *mortgage swaps*, two counterparties exchange contractual payments designed to replicate the net cash flows of a portfolio of MBSs financed by short-term floating-rate funds. For example, mortgage swaps enable an institution to finance mortgage securities at a rate tied to a floating-rate index below LIBOR on a guaranteed, multiyear basis. Mortgage swaps have been described as being similar to an amortizing interest-rate swap (rather than one with a fixed notional principal amount) with a long-term forward commitment to purchase MBSs. In a typical mortgage swap transaction, an investor contracts with a third party to receive cash flows based on a generic class of MBSs over a specified period in exchange for the payment of interest at a rate typically based on LIBOR. The payments are made as if there were an underlying notional pool of mortgage securities. Payments are exchanged on a monthly basis. The cash flows received by the investor are derived not only from the fixed coupon on the generic class of securities but also, to the extent that the coupon is above or below par, from the benefit or loss implicit to the discount or premium. The notional amount of the mortgage swap is adjusted monthly, based on the amortization and prepayment experience of the generic class of MBSs.

18.33 The contract may require the investor either to take physical delivery of mortgages at a predetermined price (for example, a percentage of the par amount of mortgages remaining in the pool) when the contract expires or to settle in cash for the difference between the predetermined price of the mortgages and their current market value as determined by the dealer.

18.34 Credit risk for mortgage swaps is the possibility that the dealer will be unable to deliver the mortgages when the contract terminates. If the dealer cannot perform, and if the mortgages are selling above the original contract price at settlement, the investor suffers a loss and can also lose any margin or collateral retained by the dealer against the ultimate purchase of the mortgage securities. Similarly, the investor is also exposed to counterparty default risk on the interest-rate swap component of the transaction over the term of the contract.

18.35 At the time the mortgage swaps are initiated, the investor generally posts initial collateral with the dealer. Additional collateral is taken by the dealer or returned to the investor based on changes in the market price of the underlying mortgages. This two-way collateral policy reduces counterparty credit risk.

18.36 ***Options.*** *Option contracts* are traded on an exchange or over the counter (that is, they are negotiated between two parties). Option contracts allow, but do not require, the holder (or purchaser) to buy (call) or sell (put) a specific or standard commodity, or financial or equity instrument, at a specified price during a specified period (an American option) or at a specified date (a European option).[7] Furthermore, certain option contracts may involve cash settlements based on changes in specified indexes, such as stock indexes. Again, the principal difference between option contracts and either futures or forward contracts is that an option contract does not require the holder to exercise the option, whereas performance under a futures or forward contract is mandatory.

18.37 At the inception of an option contract, the holder typically pays a fee, which is called a *premium,* to the writer (or seller) of the option. The premium includes two values, the intrinsic value and the time value. The *intrinsic value* of a call option is the excess, if any, of the market price of the item underlying the option contract over the price specified in the option contract (the strike price or the exercise price). The intrinsic value of a put is the excess, if any, of the option contract's strike price over the market price of the item underlying the option contract. The intrinsic value of an option cannot be less than zero. The other component of the premium's value is the time value. The *time value* reflects the probability that the price of the underlying item will move above the strike price (for a call) or below the strike price (for a put) during the exercise period.

18.38 The advantage of option contracts held is that they can be used to mitigate downside price risk without totally negating upside profit potential. This is because the loss on a purchased option contract is limited to the amount paid for the option contract. Profit on written option contracts is limited to the premium received but the loss potential is unlimited because the writer is obligated to settle at the strike price if the option is exercised.

18.39 Option contracts are frequently processed through a clearinghouse that guarantees the writer's performance under the contract. This reduces credit risk, much like organized exchanges reduce credit risk for futures contracts. Thus, such option contracts are primarily subject to market risk. However, for option contracts that are not processed through the clearinghouse, the holder may have significant credit and liquidity risks.

18.40 Different option contracts can be combined to transfer risks from one entity to another. Examples of such option-based derivatives are caps, floors, collars, and swaptions.

18.41 *Interest-rate caps* are contracts in which the cap writer, in return for a premium, agrees to limit, or cap, the cap holder's risk associated with an increase in interest rates. If rates go above a specified interest-rate level (the strike price or the cap rate), the cap holder is entitled to receive cash payments equal to the excess of the market rate over the strike price multiplied by the notional principal amount. Issuers of floating-rate liabilities often purchase caps to protect against rising interest rates while retaining the ability to benefit from a decline in rates.

18.42 Because a cap is an option-based contract, the cap holder has the right but not the obligation to exercise the option. If rates move down, the cap holder has lost only the premium paid. Because caps are not

[7] Option-based derivatives do not necessarily include an explicit option that requires deliberate exercise by the holder. Instead, the holder receives the benefit automatically under the terms of the contract (for example, when the interest rate exceeds desired levels).

exchange-traded, however, they expose the cap holder to credit risk because the cap writer could fail to fulfill its obligations.

18.43 A cap writer has virtually unlimited risk resulting from increases in interest rates above the cap rate. However, the cap writer's premium may potentially provide an attractive return.

18.44 *Interest-rate floors* are similar to interest-rate caps. Interest-rate floors are contracts in which the floor writer, in return for a premium, agrees to limit the risk associated with a decline in interest rates based on a notional amount. If rates fall below an agreed rate, the floor holder will receive cash payments from the floor writer equal to the difference between the market rate and an agreed rate multiplied by the notional principal amount. Floor contracts allow floating-rate lenders to limit the risk associated with a decline in interest rates while benefiting from an increase in rates. As with interest-rate caps, the floor holder is exposed to credit risk because the floor writer could fail to fulfill its obligations.

18.45 *Interest-rate collars* combine a cap and a floor (one held and one written). Interest-rate collars enable an institution with a floating-rate contract to lock into a predetermined interest-rate range.

18.46 *Swaptions* are option contracts to enter an interest-rate swap contract at some future date or to cancel an existing swap contract in the future. As such, a swaption contract may act as a floor or a cap for an existing swap contract or be used as an option to enter, close out, or extend a swap contract in the future.

Uses of Derivatives to Alter Risk

18.47 Financial market participants have created a large variety of derivatives. Not only are there basic contracts, but there are variants tailored to add, subtract, multiply, or divide the related risk and reward characteristics and thereby satisfy specific risk objectives of the parties to the transactions. Such innovation has been driven by the users' desire to cope with (or attempt to take advantage of) market volatility in foreign exchange rates, interest rates, and other market prices; deregulation; tax law changes; and other broad economic or business factors. An institution may attempt to alter such risks (*a*) at a general level (that is, the overall risk exposures faced by the institution), (*b*) at the level of specific portfolios of assets or liabilities, or (*c*) narrowly to a specific asset, liability, or anticipated transaction. Uses of derivatives to alter risks range from uses that help mitigate or control volatile risk exposures (activities that include the idea of taking defensive action against risk through hedging) to uses that increase exposures to risk and, by that, the potential rewards (the idea of offensive action, often considered as trading or speculation). However, distinguishing between activities that dampen or increase the volatility of risk exposures can be difficult.

18.48 ***Speculation***. *Speculation* involves the objective of profiting by entering into an exposed position, that is, assuming risk in exchange for the opportunity to profit from anticipated market movements. A speculator believes that the cash market price of an underlying commodity, financial instrument, or index will change so that the derivative produces net cash inflows or can be closed out in the future at a profit.

18.49 ***Risk Management***. Some institutions use the volatility of derivatives to increase or decrease risks associated with existing or anticipated on- or off-balance sheet transactions.[8] Institutions often manage financial risks both generally (through management of the overall mix of financial assets and liabilities) and specifically (through hedges of specific risks or transactions).

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[8] Although risk management is often read to connote risk reduction, the distinction between certain risk management activities and speculative activities is not well defined.

18.50 Some entities continually analyze and manage financial assets and liabilities based on their payment streams and interest rates, the timing of their maturities, and their sensitivity to actual or potential changes in market prices or interest rates. Such activities fall under the broad definition of *asset/liability management.* Some institutions purchase derivatives to help manage and select their total exposure to interest-rate risk. Institutions also purchase derivatives to create synthetic instruments. Those synthetic instruments can be used in the institution's asset/liability management activities to synthetically alter the interest income and expense flows of certain assets or liabilities. For example, an institution can convert the cash flow pattern and market risk profile of floating-rate debt to those of fixed-rate debt by entering an interest-rate swap contract.

18.51 *Hedging* connotes a risk alteration activity to protect against the risk of adverse price or interest-rate movements on certain of an institution's assets, liabilities, or anticipated transactions.[9] A *hedge* is a defensive strategy. It is used to avoid or reduce risk by creating a relationship by which losses on certain positions (assets, liabilities, or anticipated transactions) are expected to be counterbalanced in whole or in part by gains on separate positions in another market. For example, an institution may want to attempt to fix the value of an asset, the sales price of some portion of its future production, the rate of exchange for payments to its suppliers, or the interest rates of an anticipated issuance of debt.

18.52 The use of various financial instruments to reduce certain risks results in the hedger's assuming a different set of risks. Effective control and management of risks through hedging, therefore, require a thorough understanding of the market risks associated with the financial instrument that is part of the hedging program.

18.53 *Basis risk* is an important risk encountered with most hedging contracts. As introduced above, basis is the difference between the cash market price of the instrument or other position being hedged and the price of the related hedging contract. The institution is subject to the risk that the basis will change while the hedging contract is open (that is, the price correlation will not be perfect). Changes in basis can occur continually and may be significant. Changes in basis can occur even if the position underlying the hedging contract is the same as the position being hedged. However, entities often enter a hedging contract, such as a futures contract, on a position that is different from the position being hedged. Such *cross-hedging* increases the basis risk.

18.54 As cash market prices change, the prices of related hedging contracts change, but not necessarily to the same degree. *Correlation* is the degree to which hedging contract prices reflect the price movement in the cash market. The higher the correlation between changes in the cash market price and the hedging contract's price, the higher the precision with which the hedging contract will offset the price changes of the position being hedged.

18.55 Gains or losses on the hedge position will not exactly offset the exposed cash market positions when the basis changes. The institution might enter a hedge when (*a*) it is perceived that the risk of a change in basis is lower than the risk associated with the cash market price exposure or (*b*) there is the ability to monitor the basis and to adjust the hedge position in response to basis changes.

18.56 Basis changes in response to many factors. Among them are (*a*) economic conditions, (*b*) supply and demand for the position being hedged, (*c*) liquidity of the cash market and the futures market for the instrument, (*d*) the credit rating of the cash instrument, and (*e*) the maturity of the instrument being hedged as compared with the instrument represented in the hedging contract. A discussion of how these factors affect

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[9] This discussion of hedging is broader than, and should not be confused with, the criteria in generally accepted accounting principles (GAAP) that must be met to achieve hedge accounting. (See paragraphs 15.68 and following.)

basis is beyond the scope of this chapter. However, convergence --a significant contributor to a change in the basis over time -- warrants mention.

18.57 *Convergence* is the shrinking of the basis between the hedging contract's price and the cash market price as the contract delivery date approaches. The hedging contract's price includes an element related to the time value up to the expiration of the contract. Convergence results from the delivery feature of hedging contracts that encourages the price of an expiring contract to equal the price of the deliverable cash market instrument on the day that the contract expires. As the delivery day approaches, prices generally fluctuate less and less from the cash market prices because the effect of expectations related to time is diminishing.

18.58 *The correlation factor* represents the potential effectiveness of hedging a cash market instrument with a contract where the deliverable financial instrument differs from the cash market instrument. The correlation factor generally is determined by regression analysis or another method of technical analysis of market behavior. When a high degree of positive correlation has historically existed between the hedging instrument price and the cash market price of the instrument being hedged, the risk of price variance associated with a cross-hedge is expected to be lower than the risk of not being hedged. Institutions usually employ the correlation factor to analyze cross-hedging risk at the inception of the hedge, while actual changes in the relative values of the hedge instrument and the hedged item usually are employed throughout the hedge period to measure correlation.

Variations on Basic Derivatives

18.59 Some derivatives combine two or more basic contracts and thereby the risk and reward characteristics of several different products. Written options and other variations embedded in certain derivative and nonderivative contracts can magnify interest-rate and other risks assumed by the institution as end user. Included may be variations affecting the term, notional amount, interest rate, or specified payments. These variations have the potential to produce higher cash inflows or outflows than similar instruments that do not contain the option feature. This follows the general rule that the greater the potential return, the higher the risk.

18.60 ***Embedded Written Options***. Some swap contracts involve the institution's writing of options that the counterparty issuer may exercise if certain changes occur in the index rate or under other specified circumstances. For example, the counterparty issuer may be given the option to –[10]

- Extend or shorten the term of the contract.
- Require the institution to purchase securities at a fixed price.
- Put a cap on variable payments to be received by the institution.

18.61 As with most option contracts (and allowing for the effect of the premium paid for the contract) the holder of the option (here, the counterparty) has a potentially favorable (or neutral) outcome, while the writer of the option (here, the institution) has a potentially unfavorable (or neutral) outcome if the option is exercised. For example, the counterparty will exercise an option to sell securities to the institution at a specified price only when that price exceeds the current market prices. Accordingly, the institution must analyze such contracts carefully to understand the nature of the derivative and how it will work under various interest-rate and other conditions.

[10] See footnote 7 in this chapter.

18.62 ***Other Variations***. Other variations built into derivatives may require the institution to take certain actions or may result in changes in terms if specified events or conditions occur. For example, such variations might involve –

- Increases or decreases in the notional amount based on certain changes in interest rates.
- Increases or decreases in interest rates based on a multiplier.
- Additional payments required under specified conditions.
- A settlement payment required upon the expiration of a contract.

18.63 Some swap contracts magnify changes in the specified index rate by tying floating payments to an exponent of the index rate over a specified denominator. The risks of this variation are similar to the risks posed by written options. Consider a contract that specifies the floating rate as three-month LIBOR squared and divided by 5 percent. Assume that three-month LIBOR is 5 percent at inception. Were three-month LIBOR to climb five basis points to 5.05 percent, the increase would be magnified. The floating rate would increase ten basis points to approximately 5.10 percent (5.05 percent squared and divided by 5 percent). Thus, at this level of interest rates, an increase of one basis point in the index rate for the contract would result in an increase of two basis points in the contractual rate -- in other words, one basis point on twice the stated notional amount.

18.64 Finally, the notional principal amount of certain swap contracts changes with changes in the rate to which the floating payments are indexed. These are called index amortizing swaps. For example, the notional principal amount may decrease when interest rates decline. Thus, the floating-rate payer would lose some of the benefit of declining interest rates but would not get a corresponding benefit if interest rates increase.

REGULTORY MATTERS

18.65 Chapter 7 discusses the regulatory matters affecting the permissibility of certain investments.

18.66 Banking Circular (BC) 277, issued by the Office of the Comptroller of the Currency (OCC), addresses banks' risk management of derivatives and sets forth best practices and procedures for managing risk. OCC Bulletin 94-31 answers commonly asked questions about BC 277. The Board of Governors of the Federal Reserve System (FRB) issued detailed guidance to its examiners for evaluating derivatives with respect to management oversight, measurements and monitoring procedures, and internal controls in Supervisory and Regulatory Letters (SR) 96-17, 97-18 and 98-13. The Federal Deposit Insurance Corporation (FDIC) issued guidance for its examiners in Financial Institutions Letter (FIL) 45-98. The OTS issued TB 13a, which provides guidance to management and boards of directors on management of interest rate risk, including the management of investment and derivative activities.

18.67 On December 29, 1998, the federal banking agencies issued a joint statement that banking organizations must adopt FASB Statement No. 133 for regulatory reporting purposes when they adopt it for other financial reporting purposes. This statement provides interim regulatory reporting and capital treatment guidance for institutions.

ACCOUNTING AND FINANCIAL REPORTING

18.68 In June 1998, the FASB issued Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities. FASB Statement No. 133 establishes the accounting and reporting standards for derivative instruments and for hedging activities. FASB Statement No. 133, as amended by FASB Statement No. 137,* Accounting for Derivative Instruments and Hedging Activities - Deferral of the Effective Date of FASB Statement No. 133, *is effective for all fiscal quarters of fiscal years beginning after June 15, 2000.*

FASB Statement No. 133 changes the way many futures, forwards, options, swaps, and other instruments are accounted for. This chapter will be modified to conform to the requirements of FASB Statement No. 133 in a future edition of the Guide. A brief summary of FASB Statement No. 133 is provided before the "Auditing" section of this chapter. Note that the FASB has issued an exposure draft entitled, Accounting for Certain Derivative Instruments and Certain Hedging Activities - an Amendment of FASB Statement No. 133*, that addresses a limited number of issues causing implementation difficulties for a large number of entities when applying FASB Statement No. 133. Readers should be alert to any final pronouncement. The FASB has established the Derivative Implementation Group (DIG) to assist the Board and its staff in providing implementation guidance regarding FASB Statement No. 133. Issues addressed by the DIG and the status of related guidance can be found at the FASB's Web site at www.fasb.org.*

18.69 Authoritative pronouncements that establish accounting for derivatives generally involve consideration of (*a*) designation of derivatives as hedges, (*b*) effectiveness of the hedge strategy, and (*c*) the recognition and measurement of the instrument based on items (*a*) and (*b*). Although the accounting for futures and foreign currency forward contracts is fairly well-defined, the accounting for option, swap, and other forward contracts is more diverse and is continuing to evolve. Further, guidance does not exist for many customized instruments, and authoritative accounting literature that addresses hedge accounting is limited. The FASB's Emerging Issues Task Force (EITF) has dealt with a variety of issues related to certain derivatives, but not comprehensively.

18.70 The general guidelines for accounting for such financial instruments follow:

a. Funds deposited as margin should be reported as initial deposits, generally as other assets or liabilities. The payment or receipt of premiums should be reported as assets or liabilities. The notional amount or gross amount of assets deliverable under the contracts generally should not be reported in the balance sheet.

b. The financial instruments are marked to market with the resulting unrealized gains or losses recognized in earnings currently when
- The instrument is used for speculative purposes or for market making (in which case, the instrument should be included in the institution's trading account and the realized and unrealized gains or losses recognized as part of trading revenue).
- The instrument represents a hedge of asset positions, contemplated asset positions, or short positions, all of which are, or will be, carried at market value.
- The instrument is designated as a hedge but applicable criteria for hedge accounting are not met.

c. If hedging criteria are met, the objective of accounting for the instruments is to achieve symmetrical accounting between the hedging instrument and the hedged item (gains and losses either are reported currently or are deferred for both the hedging instrument and the hedged item, but the treatment is symmetrical for both components). However, there are numerous hedge accounting issues that have not been resolved in the accounting literature. Specified criteria are not defined for all financial instruments but risk reduction, designation, and effectiveness are common criteria.

18.71 These general rules apply to all of the financial instruments discussed below. The discussion of each specific instrument highlights any accounting pronouncements related to that instrument.

Foreign Currency Futures and Forwards

18.72 ***FASB Statement No. 52***. FASB Statement No. 52, *Foreign Currency Translation*, provides guidance on accounting for forwards, futures, and swaps involving foreign currencies. Gains and losses on those foreign currency transactions are generally included in determining net income for the period in which exchange rates change unless the transaction hedges a foreign currency commitment or a net investment in a foreign entity. Contracts, transactions, or balances that meet FASB Statement No. 52's criteria as effective hedges of foreign exchange risk are accounted for as hedges without regard to their form. Specifically, paragraph 21 of FASB Statement No. 52 states, in part, that

> A foreign currency transaction shall be considered a hedge of an identifiable foreign currency commitment provided both of the following conditions are met:
>
> *a*. The foreign currency transaction is designated as, and is effective as, a hedge of a foreign currency commitment.
>
> *b*. The foreign currency commitment is firm.

18.73 ***EITF Discussions***. The EITF has discussed the following issues related to foreign currency forwards.[12]

- Issue No. 86-25, *Offsetting Foreign Currency Swaps,* addresses how the effect of a change in exchange rates on a foreign currency swap contract should be displayed in the balance sheet.
- Issue No. 87-2, *Net Present Value Method of Valuing Speculative Foreign Exchange Contracts,* addresses whether a discounting (or net present value) approach should be used in calculating the gain or loss on unsettled speculative foreign currency forward exchange contracts under FASB Statement No. 52.
- Issue No. 87-26, *Hedging of Foreign Currency Exposure with a Tandem Currency*, addresses whether a net investment in a foreign subsidiary may be hedged using a tandem currency (that is, a currency for which the exchange rate generally moves in tandem with the exchange rate for the exposed currency).
- Issue No. 88-18, *Sales of Future Revenues,* addresses certain transactions in which an institution receives cash from an investor and agrees to make certain payments to the investor based on future revenue or income denominated in a foreign currency
- Issue No. 91-1, *Hedging Intercompany Foreign Currency Risks,* addresses whether intercompany transactions present foreign exchange risk that may be hedged for accounting purposes, including whether that conclusion would be affected by the type of hedging instrument used (for example, forward exchange contracts or purchased foreign currency options).

Futures and Forwards Other Than Foreign Currency Futures and Forwards

18.74 ***FASB Statement No. 80.*** FASB Statement No. 80 establishes standards of accounting for exchange-traded futures other than contracts for foreign currencies, which are addressed by FASB Statement No. 52.[13] FASB Statement No. 80 requires that a change in the market value of an open futures contract be recognized as a gain or loss in the period of the change unless the contract qualifies as a hedge of certain exposures to price or interest-rate risk. Immediate gain or loss recognition is also required by FASB Statement No. 80 if the futures contract is intended to hedge an item that is reported at fair value.

18.75 If the hedge criteria specified in FASB Statement No. 80 are met, a change in the market value of the futures contract is either reported as an adjustment of the carrying amount of the hedged item or included in

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[12] See also Issue Nos. 90-17 and 91-4 in paragraph 15.82.

[13] Paragraph 34 of appendix C, "Background Information and Basis for Conclusions," of FASB Statement No. 80 says:

> Exclusion of forward contracts from the Statement should not be construed as either acceptance or rejection by the Board of current practice for such contracts, nor should the exclusion be interpreted as an indication that the general principles of this Statement might not be appropriate in some circumstances for certain forward contracts. At some future date, the Board may address the accounting for particular types of forward contracts, and it may address the conceptual aspects of accounting for executory contracts generally.

the measurement of a qualifying subsequent transaction. FASB Statement No. 80 requires that entities cease accounting for a contract as a hedge if high correlation of changes in the market value of the futures contract and the effects of price or interest-rate changes on the hedged item has not occurred.

18.76 Hedge accounting under FASB Statement No. 80 differs from hedge accounting under FASB Statement No. 52 in three significant ways.

a. Paragraph 21(b) of FASB Statement No. 52 precludes a foreign currency transaction from being considered a hedge unless the foreign currency commitment is firm. Paragraph 9 of FASB Statement No. 80 permits hedge accounting for certain anticipated transactions without the existence of such a firm commitment.

b. The idea of risk reduction is applied in FASB Statement No. 52 at the transaction level but in FASB Statement No. 80 at the level of the institution's overall exposure to risk.

c. FASB Statement No. 80 permits cross-hedging.[14] FASB Statement No. 52 generally requires that the hedge instrument be denominated in the same currency as the item being hedged.

18.77 ***EITF Discussions***. The EITF has discussed many issues related to forward and futures contracts, including the following.

- Issue No. 84-14, *Deferred Interest Rate Setting,* addresses accounting for deferred-interest-rate-setting arrangements.
- Issue No. 85-6, *Futures Implementation Questions,* involves discussion of issues surrounding implementation of FASB Statement No. 80 that were subsequently addressed in the June 1985 issue of the FASB publication *Highlights*.
- Issue No. 86-26, *Using Forward Commitments as a Surrogate for Deferred Rate Setting,* involves a discussion of accounting for the change in value of a forward commitment entered into simultaneously with the issuance of fixed-rate debt.
- Issue No. 86-34, *Futures Contracts Used as Hedges of Anticipated Reverse Repurchase Transactions,* addresses accounting for such contracts.

Swaps

18.78 FASB Statement No. 52 addresses accounting for foreign currency swaps. There is no comprehensive guidance on accounting for noncurrency swaps. For swaps that are entered into to change the character of an interest-bearing asset or liability held in connection with asset/liability management (for example, from a fixed to a floating interest rate), interest income or expense for that asset or liability is reported using the revised interest rate, with any fees or other payments amortized as yield adjustments. Speculative contracts should be market to market.

18.79 ***EITF Discussions***. EITF discussions of related swap issues include the following.

- Issue No. 84-7, *Termination of Interest Rate Swaps,* addresses recognition of gain or loss on the sale or the termination of an interest-rate swap.
- Issue No. 84-36, *Interest Rate Swap Transactions,* involves discussion of accounting for interest-rate swaps, including whether hedge criteria should apply and terminations. Related issues were subsequently addressed in the article "Interest Rate SwapsCYour Rate or Mine?" written by two FASB staff members, Keith Wishon and Lorin S. Chevalier, published in the September 1985 issue of the *Journal of Accountancy.*

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[14] Paragraph 4b of FASB Statement No. 80 says that:

> A futures contract for a commodity or a financial instrument different from the item intended to be hedged may qualify as a hedge provided there is a clear economic relationship between the prices of the two commodities or financial instruments, and provided high correlation is probable.

- Issue No. 87-1, *Deferral Accounting for Cash Securities That Are Used to Hedge Rate or Price Risk,* addresses accounting for hedges of interest-rate swap portfolios using cash securities.
- Issue No. 88-8, *Mortgage Swaps,* addresses various issues related to the recognition and measurement of mortgage swaps.

Options and Other Option-Based Derivatives

18.80 There is no authoritative comprehensive accounting guidance for options and other option-based derivatives. Practice is somewhat diverse and controversial, especially in light of the differences between FASB Statements No. 52 and No. 80. AICPA Issues Paper No. 86-2, *Accounting for Options,* discusses options. However, the issues paper contains viewpoints that differ in certain respects from the conclusions in FASB Statements No. 52 and No. 80. The advisory conclusions expressed in the issues paper are not authoritative, and the FASB has advised that the existing authoritative accounting pronouncements should be followed.

18.81 FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, provides guidance on accounting for options (such as purchased equity options) that meet the definition of equity security in paragraph 137 and have a readily determinable fair value, as defined in paragraph 3 of FASB Statement No. 115.

18.82 In practice, accounting for options typically follows the general rules described in paragraph 15.69. Because of the nature of options, only purchased options are typically considered eligible for hedging treatment. Option writing is usually considered speculative and is accounted for as such. Therefore, the premium received for writing an option is marked to market. For purchased options considered hedges and accounted for on an accrual basis, gains or losses should be recorded in the appropriate period to match the timing of recognition of income or expense of the hedged item. The time value component of the premium paid for such purchased options is typically amortized over the life of the option while the intrinsic piece is considered part of the basis of the hedged exposure. The balance-sheet and income statement classifications should generally be the same as the balance-sheet positions being hedged.

18.83 ***EITF Discussions.*** EITF discussions of issues related to options and other option-based derivatives include the following.

- Issue No. 90-17, *Hedging Foreign Currency Risk with Purchased Options,* addresses the appropriateness of hedge accounting for purchased foreign currency options under various circumstances.
- Issue No. 91-4, *Hedging Foreign Currency Risks with Complex Options and Similar Transactions,* addresses the use of hedge accounting and disclosures for other purchased foreign currency options, written options, options purchased and written as a unit, and similar transactions.
- Issue No. 94-7, *Accounting for Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock,* addresses whether such instruments should be classified as assets, liabilities, or equity instruments and other related issues.

Financial Statement Presentation and Disclosure

18.84 In addition to the disclosure provisions of the pronouncements discussed elsewhere herein, several authoritative pronouncements directly set forth disclosure requirements.

18.85 ***FASB Statement No. 119.*** FASB Statement No. 119 requires disclosures about amounts, nature, and terms of derivative financial instruments that are not subject to FASB Statement No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*, 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. FASB Statement No. 119 also amended FASB Statements No. 105 and No. 107, *Disclosures about Fair Value of Financial Instruments*, to require such distinction in certain disclosures required by those statements.

18.86 For entities that hold or issue derivative financial instruments for trading purposes, FASB Statement No. 119 requires 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, FASB Statement No. 119 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 institution manages or adjusts risks and that is useful for comparing the results of applying the institution's strategies to its objectives for holding or issuing the derivative financial instruments.

18.87 ***FASB Statement No. 105.*** FASB Statement No. 105 establishes requirements for all entities to disclose information principally about financial instruments with off-balance-sheet risk of accounting loss. The Statement extended disclosure practices of some entities for some financial instruments by requiring all entities to disclose the following information about financial instruments with off-balance-sheet risk of accounting loss:

- The face, contract, or notional principal amount
- The nature and terms of the instruments and a discussion of their credit and market risk, cash requirements, and related accounting policies
- The accounting loss the institution would incur if any party to the financial instrument failed completely to perform according to the terms of the contract and the collateral or other security, if any, for the amount due proved to be of no value to the institution
- The institution's policy for requiring collateral or other security on financial instruments it accepts and a description of collateral on instruments presently held

18.88 FASB Statement No. 105 also requires disclosure of information about significant concentrations of credit risk from an individual counterparty or groups of counterparties for all financial instruments.

18.89 FASB Statement No. 119 amended FASB Statement No. 105 to require 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 institution's management of those instruments.

18.90 ***FASB Statement No. 107.*** FASB Statement No. 107 extended fair value disclosure practices for some instruments by requiring all entities to disclose the fair value of financial instruments, both assets and liabilities recognized and not recognized in the statement of financial position, for which it is practicable to estimate fair value.* If estimating fair value is not practicable, FASB Statement No. 107 requires disclosure

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* In December 1996, the FASB issued FASB Statement No. 126, *Exemption from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities*, which makes the disclosures about fair value of financial instruments prescribed in FASB Statement No.

of descriptive information pertinent to estimating the value of a financial instrument. Disclosures about fair value are not required for certain financial instruments. (See paragraph 8 of FASB Statement No. 107.)

18.91 Paragraph 11 of FASB Statement No. 107 requires that fair values be estimated for financial instruments with no quoted prices. Paragraph 24 of the Statement suggests that an estimate of the fair value of a customized interest-rate swap or foreign currency contract might be based on the quoted market price of a similar financial instrument (adjusted as appropriate for the effects of the tailoring) or, alternatively, on the estimated current replacement cost of that instrument. Paragraph 25 of the Statement suggests that an estimate of the fair value of customized options (for example, put and call options on stock, foreign currency, or interest-rate contracts) may be valued using one of a variety of pricing models that are used regularly to value options.

18.92 FASB Statement No. 119 amended 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 the fair value of nonderivative financial instruments and 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.[15]

Other Pronouncements

18.93 ***FASB Statement No. 115.*** Paragraph 115 of FASB Statement No. 115 discusses the effect that Statement may have on the accounting for derivatives that are hedges of securities whose accounting is changed by FASB Statement No. 115.

18.94 ***FASB Interpretation No. 39.*** Accounting Principles Board (APB) Opinion No. 10, *Omnibus OpinionC1966*, 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*, defines *right of setoff* and specifies what conditions must be met to have that right. It also addresses the applicability of that general principle to forward, interest-rate swap, currency swap, option, and other conditional or exchange contracts and clarifies the circumstances in which it is appropriate to offset amounts recognized for those contracts in the statement of financial position. In addition, it permits offsetting of fair value amounts recognized for multiple forward, swap, option, and other conditional or exchange contracts executed with the same counterparty under a master netting arrangement. Appendix D-43 to the *EITF Abstracts* contains the FASB staff response to inquiries about the nature of support required for an assertion in financial statements that a right of setoff is enforceable at law.

18.95 ***FASB Statement No. 104.*** FASB Statement No. 104, *Statement of Cash Flows -- Net Reporting of Certain Cash Receipts and Cash Payments and Classification of Cash Flows from Hedging Transactions,* amended FASB Statement No. 95, *Statement of Cash Flows,* to permit cash flows resulting from futures contracts, forward contracts, option contracts, or swap contracts that are accounted for as hedges of identifiable transactions or events to be classified in the same category as the cash flows from the items being hedged, provided that accounting policy is disclosed.

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107 optional for entities that meet all of the following criteria specified in paragraph 2 of FASB Statement No. 126:

a. The entity is a nonpublic entity (as defined in FASB Statement No. 126).

b. The entity's total assets are less than $100 million on the date of the financial statements.

c. The entity has not held or issued any derivative financial instruments, as defined in FASB Statement No. 119, other than loan commitments, during the reporting period.

FASB Statement No. 126 is effective for fiscal years ending after December 15, 1996.

[15] The FASB has issued a related special report, *Illustrations of Financial Instruments Disclosures*.

Accounting for Derivative Instruments and Hedging Activities

18.96 FASB Statement No. 133 establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts (collectively referred to as derivatives), and for hedging activities. It requires that an entity recognize all derivatives as either assets or liabilities in the statement of financial position and measure those instruments at fair value. If certain conditions are met, a derivative may be specifically designated as (a) a hedge of the exposure to changes in the fair value of a recognized asset or liability or an unrecognized firm commitment, (b) a hedge of the exposure to variable cash flows of a recognized asset or liability, or of a forecasted transaction, or (c) a hedge of the foreign currency exposure of a net investment in a foreign operation, an unrecognized firm commitment, an available-for-sale security, or a foreign-currency-denominated forecasted transaction. The accounting for changes in the fair value of a derivative (that is, gains and losses) depends on the intended use of the derivative and the resulting designation. FASB Statement No. 133 (paragraphs 44–47) also contains extensive disclosure requirements. FASB Statement No. 133, as amended by FASB Statement No. 137, *Accounting for Derivative Instruments and Hedging Activities - Deferral of the Effective Date of FASB Statement No.* 133, is effective for all fiscal quarters of fiscal years beginning after June 15, 2000. Readers should refer to the full text of the Statement when considering accounting and reporting issues related to derivative instruments and hedging activities. Also note that the FASB has issued an exposure draft entitled, *Accounting for Certain Derivative Instruments and Certain Hedging Activities - an Amendment of FASB Statement No. 133*, that addresses a limited number of issues causing implementation difficulties for a large number of entities when applying FASB Statement No. 133. Readers should be alert to any final pronouncement. The FASB has established the Derivative Implementation Group (DIG) to assist the Board and its staff in providing implementation guidance regarding FASB Statement No. 133. Issues addressed by the DIG and the status of related guidance can be found at the FASB's Web site at www.fasb.org.

18.97 FASB Statement No. 133 supersedes the following pronouncements:

- FASB Statement No. 80, Accounting for Futures Contracts
- FASB Statement No. 105, Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk
- FASB Statement No. 119, Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments

18.98 FASB Statement No. 133 amends the following pronouncements that may be relevant to banking organizations:

- ARB No. 43, Restatement and Revision of Accounting Research Bulletins
- FASB Statement No. 52, Foreign Currency Translation
- FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises
- FASB Statement No. 65, Accounting for Certain Mortgage Banking Activities
- FASB Statement No. 95, Statement of Cash Flows, as amended by FASB Statement No. 104, Statement of Cash Flows—Net Reporting of Certain Cash Receipts and Cash Payments and Classification of Cash Flows from Hedging Transactions
- FASB Statement No. 107, Disclosures about Fair Value of Financial Instruments (In addition to other amendments, FASB Statement No. 133 adds to FASB Statement No. 107 certain disclosure requirements about concentrations of credit risk of all financial instruments, and carries forward certain amendments that FASB Statement No. 119 made to FASB Statement No. 107.)
- FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities
- FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities

- FASB Statement No. 126, Exemption from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities
- FASB Technical Bulletin No. 79-19, Investor's Accounting for Unrealized Losses on Marketable Securities Owned by an Equity Method Investee

18.99 Note that the FASB has established the Derivative Implementation Group (DIG) to assist the Board and its staff in providing implementation guidance regarding FASB Statement No. 133. Issues addressed by the DIG and the status of related guidance can be found at the FASB's Web site www.fasb.org.

AUDITING♠

Objectives

18.100 Financial statement assertions about derivatives activities are similar to assertions for other transactions completeness, existence, valuation, ownership, and disclosure. But because the notional or contractual amounts for derivatives generally are not recognized in the statement of financial position (that is, they are off-balance-sheet), the approach to achieving audit objectives may differ. Objectives of audit procedures for derivatives transactions might include those designed to test that--

a. Derivatives contracts have been executed and processed according to management's authorizations.

b. Income on derivatives, including premiums and discounts, is properly measured and recorded.

c. Derivatives accounted for as hedges meet the applicable criteria for hedge accounting.

d. Changes in the market value of derivatives have been appropriately accounted for in the circumstances (whether or not hedge accounting is used).

e. Information about derivatives in the financial statements is complete and has been properly classified, described, and disclosed.

18.101 The independent accountant, as a result of testing derivatives transactions, should evaluate the results in the context of the institution's financial statements as a whole. Statement on Auditing Standards (SAS) No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312), and SAS 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA *Professional Standards*, vol. 1, AU sec. 316), provides guidance on the evaluation of audit test results. Paragraph 14 of SAS No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1, AU sec. 342), and paragraph 36 of SAS No. 47discuss further that the independent accountant is to evaluate the reasonableness of estimates in relationship to the financial statements taken as a whole.

Planning

18.102 In planning the audit, the independent accountant should consider the factors influencing inherent risk, which are described in chapter 5, as they relate to financial statement assertions about derivatives. As discussed in this chapter, derivatives may be complex and volatile, and it is sometimes difficult to understand their features, risks, and intended uses. Further, accounting issues involving derivatives can be contentious. Also, management's intentions may affect the applicable accounting. Instruments' reported financial statement

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♠ The Auditing Standards Board expects to issue during the third quarter of 2000 a final SAS entitled *Auditing Derivatives, Hedging Activities, and Investments in Derivatives*. This new SAS will provide guidance that will change the contents of this section. This new SAS will also supersede SAS No. 81. Together with the new SAS the ASB is issuing an Audit Guide by the same title that will provide detailed implementation guidance. Readers should be alert to any final pronouncement and Guide.

amounts may involve accounting estimates that are based on subjective factors. Those matters may increase audit risk in audits of the financial statements of banks and savings institutions that use derivatives.

18.103 ***Learning About the Extent of Derivatives Use***. SAS No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311), addresses the considerations and procedures involved in planning and supervising financial statement audits, including preparation of an audit program and obtaining knowledge of the institution's business. SAS No. 22 recognizes that the nature, timing, and extent of planning vary with the size and complexity of the institution whose financial statements are being audited, as well as with the independent accountant's experience with the institution and knowledge of the institution's business.

18.104 A key question for addressing the audit of derivatives is whether (and to what extent) the institution engages in derivatives activities. One source of information to consider would be past derivatives activities. However, entrance into derivatives markets by a particular institution may be recent. Accordingly, the absence of past derivatives activities by an institution may not be a reliable indicator of whether the institution currently engages in such derivatives activities. In general, a good starting point would be to gather information about the nature and extent of an institution's derivatives through direct inquiry of management, particularly those in the treasury or finance function. It may also be helpful, when planning in this area, to review minutes of the board of directors or its audit, finance, or other committees, and reports prepared by the institution's internal audit function that address an institution's treasury or finance function. Review of activity in typical transaction accounts (for example, investments) and inspection of actual contracts may also be helpful. Interim financial statements, regulatory financial reports, and regulatory examination reports may be additional sources of information in this area.

18.105 Depending on the extent of derivatives activities, the independent accountant may decide to involve in the audit process personnel knowledgeable about derivatives. After assessing risk, the independent accountant may decide also that it is necessary to use the work of specialists.

18.106 ***Assessing Risk***. Once the independent accountant has gathered information about the nature and extent of derivatives activities, such information can be used in assessing audit risk and otherwise carrying out the engagement in accordance with generally accepted auditing standards (GAAS). Audit risk is defined in paragraph 2 of SAS No. 47, as amended by SAS No. 82, as "the risk that the independent accountant may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated." Paragraph 12 of SAS No. 47 says that the independent accountant should consider audit risk and materiality both in (*a*) planning the audit and designing auditing procedures and (*b*) evaluating whether the financial statements taken as a whole are presented fairly, in all material respects, in conformity with GAAP. Paragraph 27 of SAS No. 47, as amended, further describes audit risk as the product of three component risks:[16]

- *a.* *Inherent risk* involves the susceptibility of an assertion to a material misstatement in the absence of related internal controls.
- *b.* *Control risk* is the risk that a material misstatement will not be prevented or detected on a timely basis by internal controls.
- *c.* *Detection risk* is the risk that the independent accountant will not detect a material misstatement that exists in an assertion.

18.107 Further, factors such as the following may indicate higher than normal audit risk:

- Sudden or rapid growth in derivatives activities
- Significant use of derivatives without relevant expertise within the institution
- High volatility in interest rates, currencies, or other factors affecting the values of derivatives

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[16] Paragraphs 15.03 through 15.08 may be helpful to the independent accountant in assessing audit risk associated with derivatives.

- Inclusion of embedded options or other complex contractual terms
- Uncertainty regarding the financial stability of a counterparty
- Concentrations of credit risk with one counterparty
- Transactions involving derivatives having thin markets
- Large one-time transactions
- Little involvement by senior management or the board of directors in authorization of significant derivatives activities
- Absence of authorized limits for derivatives activities or noncompliance with such limits
- Failure to adequately segregate duties involving the execution of derivatives transactions from the accounting and internal audit functions
- Dependence on one individual for all organizational expertise on derivatives activities
- Inadequate information to effectively monitor derivatives transactions, including inadequate or untimely information about derivatives values

Of course, these factors should be considered in the context of the complexity and extent of the institution's derivatives activities and the institution's financial statements taken as a whole.

Internal Control Over Financial Reporting and Possible Tests of Controls

18.108 SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), provides guidance on the independent accountant's consideration of an institution's internal control in an audit of financial statements performed in accordance with GAAS. It describes the components of internal control and explains how an independent accountant should consider internal control in planning and performing an audit. Paragraph 19 of SAS No. 55, as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55*, requires that, in all audits, the independent accountant obtain sufficient understanding of each of the five components (the control environment, risk assessment, control activities, information and communication, and monitoring) to plan the audit by performing procedures to understand the design of policies and procedures relevant to audit planning and whether they have been placed in operation.

18.109 The level of sophistication of an institution's internal control as it relates to derivatives activities generally varies. Determinants include the extent of the institution's use of derivatives and the relative complexity of the instruments used. Effective internal control over financial reporting of derivatives transactions generally would include adequate segregation of duties, management oversight, and other policies and procedures designed to reasonably assure that[17]

- Derivative transactions are executed in accordance with the institution's written policies (as approved by the board of directors or its committees).
- Information relating to derivatives is complete and accurate when entered into the accounting system.
- Misstatements in the processing of accounting information for derivatives are prevented or detected in a timely manner.
- Derivatives activities are monitored on an ongoing basis to recognize and measure events affecting related financial statement assertions.

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[17] Inadequate or deficient controls should be considered in the context of SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit* , as amended by SAS No. 87, *Restricting the Use of an Auditor's Report*, (AICPA, *Professional Standards*, vol. 1, AU sec. 325). SAS No. 60 provides guidance on identifying and reporting conditions that relate to an institution's internal control over financial reporting observed during an audit of financial statements in accordance with GAAS.

18.110 If the nature of the institution's derivatives use is considered to involve more than normal risk, the independent accountant may decide to assess control risk at the maximum level and take a primarily substantive approach.[18]

18.111 The independent accountant may consider applying procedures such as inquiry, observation, and inspection of documents to obtain an understanding of internal control policies and procedures. Ultimately, the independent accountant must decide on the nature, timing and extent of substantive tests to be applied.

Substantive Tests

18.112 Many derivatives are negotiated contracts between the institution and its counterparty (for example, most interest-rate swaps). Because such transactions usually are not routine, a substantive audit approach may be the most effective means of achieving the planned audit objectives. Procedures performed in other financial statement areas might also provide evidence about the completeness of derivatives transactions. These procedures may include tests of subsequent cash receipts and payments, cutoff bank statements, and the search for unrecorded liabilities. Examples of other substantive procedures that may be applied specifically to derivatives transactions are illustrated below. The independent accountant is responsible for determining the extent of substantive testing considered necessary, based on the nature and significance of the related transactions and the assessment of audit risk. SAS No. 31, *Evidential Matter*, as amended by SAS No. 80, *Amendment to Statement on Auditing Standards No. 31*, Evidential Matter (AICPA, *Professional Standards*, vol. 1, AU sec. 326), provides guidance on evaluating evidential matter and relating it to assertions in an institution's financial statements.

18.113 ***Propriety of Accounting***. A primary audit objective usually addressed through substantive procedures is determining the propriety of the institution's accounting for derivatives. To do so, the independent accountant gains an understanding of management's objectives in engaging in derivatives transactions. For derivatives accounted for as hedges, the independent accountant generally tests whether the applicable hedging criteria are met. This might include tests of the institution's documentation of correlation results and determining that the institution is appropriately distinguishing between speculating and hedging. The independent accountant also may examine support for completed transactions to ascertain that they have been accounted for appropriately. For example, the independent accountant might review transactions that resulted in deferrals of losses during the period to determine whether they qualified for deferral accounting. Similarly, the independent accountant might review gains recognized during the period to determine whether they were hedging gains that should have been deferred.

18.114 ***Review of Contracts***. If the institution's derivatives are not exchange-traded or otherwise standardized, the independent accountant may consider inspecting the contracts and related transactions tickets to understand the terms of the transaction. Developing an understanding of the contract terms by reading the contract might include identifying nonstandard features, such as the existence of embedded options. Nonstandard features may significantly increase the risks and complexities of the transactions and may involve potential accounting and disclosure consequences.

18.115 ***Analytical Procedures.*** SAS No. 56, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 329), provides guidance on the use of analytical procedures in the planning and review stages of audit engagements. Analytical procedures might also be effectively used as a substantive test to obtain evidential matter about particular assertions related to derivatives transactions.

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[18] Although the independent accountant may be able to assess internal control risk as low (thereby modifying the nature, timing, or extent of substantive testing considered necessary) derivatives transactions often are not homogeneous. It may be more efficient and effective to adopt a primarily substantive approach. Such an approach may be particularly efficient where the number of contracts or transactions is few.

18.116 ***Confirmation***. SAS No. 67, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1, AU sec. 330), discusses the relationship of confirmation procedures to the assessment of audit risk, the design of confirmation requests, the performance of alternative procedures, and the evaluation of confirmation results. Guidance on the extent and timing of confirmation procedures is found in SAS No. 39, *Audit Sampling* (AICPA, *Professional Standards*, vol. 1, AU sec. 350), SAS No. 47, and SAS No. 45, *Omnibus Statement on Auditing Standards--1983* (AICPA, *Professional Standards*, vol. 1, AU sec. 313, "Substantive Tests Prior to the Balance Sheet Date").

18.117 ***Other Tests***. Other tests the independent accountant may perform include the following:

- Test the mathematical accuracy of the institution's accounting records, including the amortization of deferred gains and losses on financial instruments accounted for as hedges and of unearned fee income.
- Examine support for completed transactions to ascertain that they have been accounted for appropriately and in the proper period.
- Verify computations and rates used for realized gains and losses during the period.
- Review exposure to individual counterparties and consider the need to evaluate individual credit risk and review overall liquidity position.

18.118 ***Auditing Fair Values and Other Estimates***. SAS No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1, AU sec. 342), provides guidance on auditing accounting estimates (such as estimates of fair values). SAS No. 57 discusses how an independent accountant obtains an understanding of how management developed estimates, concentrating on the key factors and assumptions used. It also discusses how the independent accountant may review and test the process used by management to develop an estimate.

18.119 The fair value of certain derivatives, such as exchange-traded options, is generally readily available from independent pricing sources. Such sources include financial publications or brokers and dealers independent of the institution. Determining the fair value of other derivatives can be difficult, however, particularly where the transaction has been customized for an institution. Calculation of the fair value of customized interest-rate swaps, for example, may require various quantitative assumptions and complex mathematical modeling. Calculations of such fair values also are complicated by subjective value considerations that depend on the specifics of the transaction (such as the credit risk associated with a specific counterparties). Complex valuation models also involve the risk of errors in either data entry or assumptions or that the model is not appropriately designed or tested. The independent accountant might consider it necessary to involve specialists in assessing the institution's fair value estimates or related models. SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 336), provides guidance on using the work of a specialist. As described in paragraph 3, the guidance of SAS No. 73 applies when an independent accountant uses a specialist's work as evidential matter in performing substantive tests to evaluate material financial statement assertions.

CHAPTER 19

Business Combinations

INTRODUCTION

19.01 Business combinations may involve one enterprise acquiring the equity interests or net assets of another enterprise or both enterprises transferring their equity interests or net assets to a newly formed enterprise. Business combinations involving depository institutions are increasingly common today and result from voluntary decisions as well as regulatory mandates. Most business combination issues, such as distinguishing between whether a business combination should be treated as a purchase or a pooling of interests, are the same for depository institutions as for other business enterprises. This chapter addresses only significant issues that are unique to depository institutions.

REGULATORY MATTERS

19.02 The Office of Thrift Supervision (OTS) requires the independent accountants for both the purchasing and selling institutions to opine on whether the transaction has been accounted for in conformity with generally accepted accounting principles (GAAP).

19.03 In certain circumstances, an acquired bank or savings institution uses the acquiring institution's basis of accounting in preparing the acquired institution's financial statements. These circumstances are addressed for Securities and Exchange Commission (SEC) registrants in the SEC's Staff Accounting Bulletin (SAB) No. 54, *Application of "Push Down" Basis of Accounting in Financial Statements of Subsidiaries Acquired by Purchase.* In the Financial Accounting Standards Board's (FASB's) Emerging Issues Task Force (EITF) Issue No. 86-9, *IRC Section 338 and Push-Down Accounting*, the EITF reached a consensus that such push-down accounting is not required for companies that are not SEC registrants. However, the FFIEC *requires* push down accounting for Reports of Condition and Income if a direct or indirect change in control of at least 95 percent of the voting stock of the bank has occurred and the bank does not have an outstanding issue of publicly traded debt or preferred stock. Push down accounting is also required if the bank’s separate financial statements are presented on a push down basis in reports filed with the SEC. Push down accounting *may* also be used when a direct or indirect change in control of at least 80 percent, but less than 95 percent of the voting stock of the bank has occurred. In all cases, the bank’s primary supervisory authority reserves the right to determine whether or not a bank must use push down accounting for purposes of Reports of Condition and Income.

19.04 The SEC's SAB No. 82, *Certain Transfers of Nonperforming Assets: Disclosures of the Impact of Assistance from Federal Regulatory Agencies*, discusses accounting for transfers of nonperforming assets by financial institutions and disclosure of the impact of financial assistance from regulators. SAB No. 82 states the SEC staff's belief that users of financial statements must be able to assess the impact of credit and other risks on a company following a regulatory-assisted acquisition, transfer, or other reorganization on a basis comparable with that disclosed by other institutions, that is, as if the assistance did not exist. In that regard, the SEC staff believes that the amount of regulatory assistance should be separately disclosed and should be separately identified in the statistical information furnished pursuant to Industry Guide 3, *Statistical Disclosures by Bank Holding Companies*, to the extent that it affects such information. Further, the nature, extent, and impact of such assistance should be fully disclosed in management's discussion and analysis.

ACCOUNTING AND FINANCIAL REPORTING

19.05 Accounting for business combinations involving depository institutions is similar to that for other enterprises. Guidance on accounting for business combinations and related issues is contained in the following:

- *a.* Accounting Principles Board (APB) Opinion No. 16, *Business Combinations,* and *Business Combinations: Accounting Interpretations of APB Opinion No. 16*
- *b.* APB Opinion No. 17, *Intangible Assets*
- *c.* FASB Statement of Financial Accounting Standards No. 38, *Accounting for Preacquisition Contingencies of Purchased Enterprises*
- *d.* FASB Statement No. 72, *Accounting for Certain Acquisitions of Banking or Thrift Institutions*
- *e.* FASB Statement No. 109, *Accounting for Income Taxes*
- *f.* FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*
- *g.* FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*
- *h.* FASB Interpretation No. 9, *Applying APB Opinions No. 16 and 17 When a Savings and Loan Association or a Similar Institution Is Acquired in a Business Combination Accounted for by the Purchase Method*
- *i.* FASB Technical Bulletin No. 85-5, *Issues Relating to Accounting for Business Combinations*
- *j.* AICPA Practice Bulletin 6, *Amortization of Discounts on Certain Acquired Loans*
- *k.* EITF Issue No. 85-8, *Amortization of Thrift Intangibles*
- *l.* EITF Issue No. 85-42, *Amortization of Goodwill Resulting from Recording Time Savings Deposits at Fair Value*
- *m.* EITF Issue No. 86-31, *Reporting the Tax Implications of a Pooling of a Bank and a Savings and Loan Association*
- *n.* EITF Issue No. 87-15, *Effect of a Standstill Agreement on Pooling-of-Interests Accounting*
- *o.* EITF Issue No. 87-16, *Whether the 90 Percent Test for a Pooling of Interests Is Applied Separately to Each Company or on a Combined Basis*
- *p.* EITF Issue No. 87-27, *Poolings of Companies That Do Not Have a Controlling Class of Common Stock*
- *q.* EITF Issue No. 88-19, *FSLIC-Assisted Acquisitions of Thrifts*
- *r.* EITF Issue No. 88-26, *Controlling Preferred Stock in a Pooling of Interests*
- *s.* EITF Issue No. 88-27, *Effect of Unallocated Shares in an Employee Stock Ownership Plan on Accounting for Business Combinations*
- *t.* EITF Issue No. 89-19, *Accounting for a Change in Goodwill Amortization for Business Combinations Initiated Prior to the Effective Date of FASB Statement No. 72*
- *u.* EITF Issue No. 90-5, *Exchanges of Ownership Interests between Entities under Common Control*
- *v.* EITF Issue No. 93-2, *Effect of Acquisition of Employer Shares for/by an Employee Benefit Trust on Accounting for Business Combinations*
- *w.* EITF Issue No. 93-7, *Uncertainties Related to Income Taxes in a Purchase Business Combination*
- *x.* 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)*
- *y.* EITF Issue No. 95-3, *Recognition of Liabilities in Connection with a Purchase Business Combination*
- *z.* EITF Issue No. 95-14, *Recognition of Liabilities in Anticipation of a Business Combination*
- *aa.* EITF Issue No. 95-19, *Determination of the Measurement Date for the Market Price of*

Securities Issued in a Purchase Business Combination

bb. EITF Issue No. 96-8, *Accounting for a Business Combination When the Issuing Company Has Targeted Stock*

cc. EITF Issue No. 95-8, *Accounting for Contingent Consideration Paid to the Shareholders of an Acquired Enterprise in a Purchase Business Combination*

dd. EITF Issue No. 96-23, *The Effects of Financial Instruments Indexed to, and Settled in, a Company's Own Stock on Pooling-of-Interests Accounting for a Subsequent Business Combinaton*

ee. EITF Issue No. 97-8, *Accounting for Contigent Consideration Issued in a Purchase Business Combination*

ff. EITF Issue No. 97-9, *Effect of Pooling-of-Interest Accouting of Certain Contingently Exercisable Options or Other Equity Instruments*

gg. EITF Issue No. 97-15, *Accounting for Contingency Arrangements Based on Security Prices in a Purchase Business Combination*

hh. EITF Issue No. 98-1, *Valuation of Debt Assumed in a Purchase Business Combination*

ii. EITF Issue No. 98-3, *Determining Whether a Transaction Is an Exchange of Similar Productive Assets or a Business Combination*

jj. EITF Issue No. 98-11, *Accounting for Acquired Temporary Differences in Certain Purchase Transactions That Are Not Accounted for as Business Combinations*

kk. EITF Issue No. 99-6, *Impact of Acceleration Provisions in Grants Made between Initiation and Consummation of a Pooling-of-Interest Business Combination*

ll. EITF Issue No. 99-7, *Accounting for an Accelerated Share Repurchase Program*

mm. EITF Issue No. 99-12, *Accounting for Formula Arrangements under Issue No. 95-19*

nn. EITF Issue No. 99-15, *Accounting for decreases in Deferred Tax Asset Valuation Allowances Established in a Purchase Business Combination As a Result of a Change in Tax Regulations*.

oo. EITF Topic D-19, *Impact on Pooling-of-Interests Accounting of Treasury Shares Acquired to Satisfy Conversions in a Leveraged Preferred Stock ESOP*

pp. EITF Topic D-40, *Planned Sale of Securities following a Business Combination Expected to Be Accounted for as a Pooling of Interests*

qq. EITF Topic D-59, *Payment of a Termination Fee in Connection with a Subsequent Business Combination That is Accounted for Using the Pooling-of-Interests Method*

rr. EITF Topic D-81, *Accounting for the Acquisition of Consolidated Businesses*

19.06 In business combinations accounted for under the purchase method, the assets and liabilities of the acquired business are recorded on the books of the combined institution at their fair value at the time of acquisition. The cost of the acquisition is allocated to identifiable tangible and intangible assets and liabilities being acquired or assumed, with any excess cost recorded as an unidentifiable intangible (goodwill). For assets and liabilities acquired for which there is not an active market, determining fair values usually involves estimating cash flows and discounting those cash flows at prevailing market rates of interest. Demand deposits are valued at their face amount plus any accrued interest. FASB Statement No. 91 provides that purchases of loans or groups of loans should be recorded at their net cost, which includes the cost to the seller plus any fees paid less any fees received. The difference between this amount and the expected amounts to be received should be accounted for as an adjustment of yield over the life of the loan. Practice Bulletin 6* provides guidance as to the accounting and reporting by purchasers of certain loans for which it is not probable that the undiscounted future cash collections will be sufficient to recover the face amount of the loan and contractual interest. Paragraph 14 of FASB Statement No. 114 provides guidance as to the determination of the effective interest rate when loans are acquired at a discount because of a change in credit quality or rate,

* AcSEC expects to issue during 2000 a final SOP entitled *Accounting for Certain Purchased Loans*. It is anticipated that this proposed SOP will supercede AICPA Practice Bulletin 6. Readers should be alert to any final pronouncement.

or both. APB Opinion No. 17 establishes the accounting for both identifiable and unidentifiable intangible assets that a company acquires, including those acquired in business combinations. FASB Statement No. 72 amended APB Opinion No. 17 with regard to the amortization of unidentifiable intangible asset (goodwill) recognized in certain business combinations accounted for by the purchase method.

Identifiable Intangible Assets

19.07 FASB Statement No. 72 states that, in combinations accounted for by the purchase method involving the acquisition of a depository institution, intangible assets acquired that can be separately identified should be assigned a portion of the total cost of the acquired enterprise if the fair values of those assets can be reliably determined (paragraph 4). Such assets should not be included as part of unidentifiable intangible assets (goodwill). The fair value of such assets shall be based on customer relationships that exist at the date of acquisition without regard to new customers that may replace them. In determining those values, the acquiring bank should consider the capacity of existing deposit accounts and loan accounts to generate future income and to generate additional business or new business and the nature of territory served. Examples of other identifiable intangible assets common to depository institution acquisitions include purchased credit-card relationships, core deposit relationships, favorable leaseholds, and trust servicing. (Chapter 10 on other assets addresses amortization of intangible assets.)

Unidentified Intangible Assets

19.08 In a purchase business combination, the excess of the purchase price over the fair value of the net assets acquired, including identifiable intangible assets, is recorded as goodwill. Paragraph 2 of FASB Statement No. 72 says:

> Paragraphs 5 and 6 [of FASB Statement No. 72] apply to only those acquisitions in which the fair value of liabilities assumed by the acquiring enterprise exceeds the fair value of tangible and identifiable intangible assets acquired, and those provisions specify an amortization method for the portion of any unidentifiable intangible asset up to the amount of that excess. [APB Opinion No. 17 and FASB Interpretation No. 9] also provide guidance as to the amortization of any additional unidentifiable intangible asset recognized in the acquisition.

Intangible assets arising from purchase business combinations are generally included in other assets and amortized over the period for which they have value. (Chapter 12 on other assets addresses amortization of intangible assets.)

Negative Goodwill

19.09 If the fair value of net assets acquired exceeds the purchase price, the cost of noncurrent assets acquired (except long-term investments in marketable securities), such as premises and equipment and intangible assets, should be adjusted downward on a pro rata basis. Negative goodwill should be recorded only after the costs of such assets received in the acquisition have been adjusted to zero.

Branch Acquisitions

19.10 Depository institutions may acquire branch office locations. Such transactions typically involve the assumption of deposit liabilities by the acquiring institution in exchange for the receipt of a lesser amount of cash, or other assets, such as loans. The buying institution should account for such transactions based on the fair values of the assets acquired and liabilities assumed. The selling institution generally recognizes a gain or loss on such a transaction based on the proceeds from the transaction, the recorded amounts of the deposit liabilities assumed by the purchaser, and the recorded value of assets conveyed to fund the purchase.

19.11 The acquiring institution should account for specifically identifiable assets, liabilities and goodwill arising from the transaction in conformity with APB Opinion No. 16 and FASB Interpretation No. 9. FASB Statement No. 72 provides guidance on how to amortize unidentifiable intangible assets (goodwill) recorded in the purchase. (See paragraph 19.08.)

Regulator-Assisted Transactions

19.12 The FDIC sometimes provides financial assistance to banks and savings institutions to facilitate a purchase transaction. The kinds of assistance vary but may include *(a)* put-back rights, which represent the option to return certain acquired assets, *(b)* purchase options, which represent the right to acquire certain assets at specified terms, *(c)* cash or notes to the extent that liabilities assumed exceed assets acquired, *(d)* yield-maintenance assistance on specified assets, *(e)* purchase of equity securities, or *(f)* indemnification against certain loss contingencies.

19.13 The NCUSIF also provides assistance to credit unions to facilitate a purchase transaction. An acquirer of a credit union may receive cash from the NCUSIF, which typically equals the amount by which the fair value of the credit union's liabilities exceed the fair value of its assets. The assistance provided by the NCUSIF under such agreements may include (a) reimbursement (of up to 100 percent) if covered assets are ultimately collected or sold for amounts that are less than a specified amount during a specified period of time and (b) indemnification against certain loss contingencies.

19.14 FASB Statement No. 72 specifies that financial assistance granted to an enterprise by a regulatory authority in connection with a business combination shall be accounted for as part of the combination if receipt of the assistance is probable and the amount is reasonably estimable. If it is not probable or estimable, the future proceeds from such assistance should be reported as a reduction of goodwill when received. In such a case, subsequent amortization of goodwill would be adjusted proportionately.

19.15 EITF Issue No. 88-19 addresses situations in which a savings institution is acquired pursuant to an assistance agreement (agreement) between the acquirer and the Federal Savings and Loan Insurance Corporation (FSLIC). (Since the date of the consensus, the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) dissolved the FSLIC; however, the consensus still applies to regulatory-assisted acquisitions, including those involving the FDIC and NCUSIF.) Under the agreement, the acquirer may receive cash or a note receivable from the government regulator that typically equals the amount by which the fair value of the institution's liabilities exceeds the fair value of its assets or other assistance described in paragraphs 19.12 and 19.13. In addition, the acquirer may infuse into the institution additional capital that, with the government assistance, is expected to make the institution a viable entity.

19.16 For acquisitions involving taxable institutions, under the terms of the agreement, the government may be entitled to share in certain tax benefits that may be realized subsequently by the institution. A tax-sharing arrangement with the government in which the government is entitled to share in a specified percentage (up to 100 percent) of certain income tax benefits that are realized by the institution should be offset against the income tax benefits realized by the thrift, and the net tax benefit should be accounted for in accordance with GAAP for income taxes. This is based on the view that the institution is merely a conduit for the tax benefits accruing to the government.

19.17 The acquirer should account for assistance in the form of yield maintenance on covered assets until those assets are disposed of or liquidated. Assets covered by yield-maintenance assistance should be considered interest-bearing assets for purposes of applying FASB Statement No. 72, even if the covered assets are non-interest-bearing. This applies only to regulatory-assisted combinations covered by FASB Statement No. 72. A consequence of considering certain non-interest-bearing assets as interest-bearing assets is that those non-interest-bearing assets will affect the period over which goodwill is amortized in accordance with paragraph 5 of FASB Statement No. 72.

19.18 When allocating the purchase price, the acquirer must determine what interest rate should be used to determine the fair value of assets covered by yield-maintenance assistance. There is a rebuttable presumption that the stated interest rate (the guaranteed yield or level of return on covered assets) specified in the agreement should be considered a market rate for purposes of determining the fair value of the assets acquired. If the presumption is rebutted, the acquirer should select a market rate in accordance with paragraph 88 of APB Opinion No. 16.

19.19 No net change in the basis of the asset should be recognized if an asset covered by yield-maintenance assistance is converted to a different covered asset (for example, if land held for development is sold to an unrelated third party in exchange for a note receivable).

19.20 EITF Issue No. 88-19 also addresses how the acquirer should account for contingency losses and for the reimbursement of those losses by the government under the indemnification provisions of the agreement (including losses and reimbursements that occur after the expiration of the purchase-price allocation period). Losses resulting from acquisition-related contingencies that are covered by the indemnification provisions of the agreement should be recognized by the acquirer net of reimbursements received or receivable from the government under the agreement.

19.21 If part of the government assistance involves a note receivable from the government, and equity securities of the institution are sold to the government for cash or other consideration, there is a rebuttable presumption that consideration paid by the government for equity securities is not separable from a note receivable from the government for other assistance. Therefore, when part of the government assistance involves a note receivable from the government, a portion of the note receivable equal to the fair value of the equity securities sold to the government should be offset against the equity securities. Issuance of the equity securities to the government may be separately reported as an increase in equity only if it can be demonstrated that the equity security is economically separable from the note receivable from the government. Economic separability may be demonstrated only if all of the following conditions are met:

- *a.* The regulator acquires equity securities for cash at the same per-share price as other shareholders, and the securities are identical in all substantive respects (except for voting rights) to those issued to other shareholders.
- *b.* The portion of stock acquired by the regulator is less than 20 percent of the outstanding stock.
- *c.* The dividend requirements on the stock held by the regulator are the same as those on the stock held by others.
- *d.* The dividend terms of the equity securities do not match and offset the principal and interest terms of the note receivable.
- *e.* Repayment of principal and interest on the note is due independently of dividend or redemption payments.
- *f.* The interest rate stated in the note receivable from the regulator is a market rate.
- *g.* The stock cannot be put back to the institution by the regulator (however, callable stock is acceptable).

19.22 If all or a portion of the note receivable from the government is offset against the equity from the securities issued to the government, then subsequent dividend payments to the government on the equity securities should be netted against cash receipts from the government for interest payments on the note, and the net amount should be recorded as regulatory assistance, as appropriate.

19.23 Users of financial statements must be able to assess the impact of credit and other risks on a depository institution following a regulatory-assisted acquisition, transfer, or other reorganization on a basis comparable to that disclosed by other depository institutions, that is, if the assistance did not exist. To facilitate that assessment, the amount of regulatory assistance should be disclosed.

Conversion and Merger-Conversion Transactions

19.24 The conversion of a mutual or cooperative enterprise to stock ownership generally does not constitute a change in equity interests that would preclude pooling-of-interests accounting for two years. In accordance with paragraphs 21 through 24 of FASB Technical Bulletin No. 85-5, an exception to the change-in-equity-interests condition is allowed for mutual or cooperative enterprises that convert to stock ownership, because the conversion represents a change in the form of organization rather than a change in equity interests from one group of equity owners to another.

19.25 In some cases, shares of the former mutual or cooperative enterprise may be acquired by the other prospective combining enterprise in the conversion of the mutual or cooperative enterprise to stock ownership prior to effecting the combination. In that situation, those shares would be subject to the 10 percent test under the independence condition and the 90 percent test under the common-stock-for-common-stock condition in determining whether pooling-of-interests accounting should be applied to the subsequent business combination.

19.26 In certain merger-conversion transactions involving savings institutions, a mutual savings institution is converted to stock ownership, shares of the new stock savings institution are exchanged for shares of the issuing enterprise in the combination, and those shares of the issuing enterprise are offered first to depositors in the former mutual savings institution and then to the public. The pooling criteria are applied to the merger between the new stock savings institution and the issuing enterprise. Assuming all other pooling conditions are met, such a merger conversion does not violate the pooling conditions. In other merger-conversion transactions, as well as those transactions previously discussed, the issuing enterprise in the combination may purchase shares of its common stock issued in the combination that are not purchased by depositors in the former mutual savings institution rather than offer those shares to the public. The purchase by the issuing enterprise of less than ten percent of the shares issued to effect the combination (reduced for any other pooling violations) does not violate the pooling conditions in this situation, provided that the depositors of the former mutual savings institution are given the opportunity to acquire all of the shares issued to effect the combination and that the issuing enterprise purchases only those shares not purchased by the depositors. However, pooling-of-interests accounting is not appropriate if limitations or restrictions are placed on the depositors' rights to acquire the shares issued to effect the combination. In addition, pooling-of-interests accounting is not appropriate if regulators have required either enterprise to enter into the combination or if regulators provided financial assistance to facilitate the combination.

AUDITING

Objectives

19.27 The primary objectives of audit procedures for business combinations are to obtain reasonable assurance that:

- *a.* The transaction is properly accounted for using the pooling-of-interests or purchase methods.
- *b.* The values assigned to the assets and liabilities of the acquired institution in a purchase business combination represent the fair values at the date of acquisition.

c. Any identifiable intangible assets or goodwill arising from a purchase accounting transaction are identified and amortized over an appropriate period of time.

d. Any regulatory assistance received to facilitate the purchase is appropriately accounted for and disclosed.

e. For poolings, that prior financial information is properly stated.

Planning

19.28 In planning the audit, the independent accountant should consider the factors influencing inherent risk, which are described in chapter 5, as they relate to financial statement assertions about business combinations.

Internal Control Over Financial Reporting and Possible Tests of Controls

19.29 SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), provides guidance on the independent accountant's consideration of an institution's internal control in an audit of financial statements performed in accordance with GAAS. It describes the components of internal control and explains how an independent accountant should consider internal control in planning and performing an audit. Paragraph 19 of SAS No. 55, as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55*, requires that, in all audits, the independent accountant obtain sufficient understanding of each of the five components (the control environment, risk assessment, control activities, information and communication, and monitoring) to plan the audit by performing procedures to understand the design of policies and procedures relevant to audit planning and whether they have been placed in operation.

19.30 Typical controls relating to financial reporting of business combinations include the following:

- Accounting entries made to record the transaction initially and those required in subsequent years including values assigned are adequately supported and reviewed by supervisory personnel to ensure accuracy.
- Values assigned to the assets and liabilities of the acquired institution are reviewed by management.
- Subsequent to the acquisition date, assumptions used in assigning values to assets and liabilities are reviewed by management for continuing validity.

It may be more efficient and effective for the independent accountant to assess control risk at the maximum for business combinations and take an entirely substantive approach.

Substantive Tests

19.31 The nature, timing, and extent of substantive procedures should be determined based on the independent accountant's understanding of internal control surrounding business combinations and consolidations and the assessment of control risk in this area. Usually the independent accountant assesses control risk at the maximum and plans a substantive approach to the examination of business combinations in the year of acquisition and the period of subsequent combination of the operations of the entities.

19.32 For significant transactions accounted for as poolings of interests, the independent accountant should perform procedures to determine that the conditions for the pooling of interests method of accounting have been met.

19.33 The independent accountant should perform tests to obtain assurance regarding the fair values assigned to an acquired depository institution's or branch's assets and liabilities, which are generally supported by independent third-party appraisals. Statement on Auditing Standards (SAS) No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 336), provides guidance on the independent accountant's consideration in using the work of specialists such as appraisers. The independent accountant should consider the need for asking management to engage appraisers to determine the propriety of any significant assigned carrying values that are unsupported by independent appraisals. (Chapter 9 discusses the use of real estate appraisals.)

19.34 The independent accountant should evaluate whether the assumptions used in independent appraisals are reasonable, and particular attention should be focused on assumptions concerning the assessment of credit risk, loan prepayment factors, and the interest rate assigned in relation to current market conditions.

19.35 In applying procedures to a branch purchase, the independent accountant should be satisfied with the documentation supporting the fair values assigned to the deposit liabilities assumed and the assets acquired.

CHAPTER 20

Trust Services and Activities

INTRODUCTION

20.01 Among other engagements, independent accountants may be engaged to (*a*) report on trust company financial statements, particularly of common trust or mutual funds, (*b*) assist with directors' examinations of trust financial information,[1] or (*c*) report on internal control over financial reporting in the institution's trust department or (*d*) perform procedures agreed to by management or regulators or extended audit services to supplement the institution's internal audit efforts.[2]

20.02 This chapter deals primarily with how trust services and activities affect audits of the financial statements of financial institutions. However, it is important that independent accountants be fully aware of any regulatory expectations that may exist in the area of trust departments and design any engagements arising from those expectations in an appropriate manner.

20.03 Regulatory focus on the adequacy of auditing of trust operations of financial institutions has increased in recent years. The proliferation of trust charters in recent years among non-traditional bank holding companies, has led the bank and savings institution regulators to more closely assess the adequacy of secondary monitoring provided by audit functions. In cases where internal audit departments do not exist or lack the expertise required to audit the complexities of financial institutions and/or trust operations, the regulators are looking often to independent auditors to supplement the existing resources. In their respective rules on audits of fiduciary activities, the OTS (12 CFR 550.440) and OCC (12 CFR 9.9) require that management arrange for a suitable audit of trust operations through the efforts of external and/or internal auditors on an annual basis or as part of a continuous audit process.

20.04 While this is an important opportunity for independent accountants, it is one which must be carefully dealt with from a standpoint of managing expectations and attentiveness to audit and attestation standards. First, the audit requirements of the OTS and OCC are largely related to operating and compliance controls which are likely not tested in the audit of financial statements of a financial institution. Also the depth of testing of financial reporting controls will likely be greater than in a financial statement audit. Accordingly, the testing required in these areas should be the subject of separation engagements under standards for agreed upon procedures attestation engagements or consulting standards as they relate to extended audit services.

20.05 Trust services and activities consist of the fiduciary services provided to customers. A fiduciary may be a trustee or an agent. Trust activities of an institution may be an integral part of the institution's services;

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[1] See paragraph A-37 in appendix A.

[2] Usually, such an engagement is the result of the need of auditors of the financial statements of pension plans, mutual funds, and other entities to obtain evidential matter regarding internal control in the departments of a bank or savings institution controlling assets of other entities. Since an institution may administer many plans, it may not be economically feasible for each plan's independent accountant to carry out audit procedures at the trustee institution. Accordingly, one independent accountant may perform procedures in the area or department administering all plans at the institution and issue a report to the user institution on internal accounting controls related to administration of the plans. Statement on Auditing Standards (SAS) No. 70, *Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324), and the related Auditing Procedure Study, *Implementing SAS No. 70*, Service Organizations, and Statement on Standards for Attestation Engagements (SSAE) No. 2, *Reporting on an Entity's Internal Control Over Financial Reporting*, as amended by SSAE No. 6, *Reporting on an Entity's Internal Control Over Financial Reporting: An Amendment to Statement on Standards for Attestation Engagements No. 2* (AICPA, *Professional Standards*, vol. 1, AT sec. 400), provide guidance for such engagements.

however, because of strict laws governing fiduciary responsibilities, institutions conduct trust activities independently through[3]—

- *a.* A separate department or division of the institution.
- *b.* A separately chartered trust company.
- *c.* A contractual arrangement with the trust department or a trust company of another depository institution.

20.06 The organizational structures of institutions' trust departments or of trust companies vary greatly depending upon factors such as the scope of trust activities, the complexity of trust services offered, management's preference, and the historical development of the entity. Trust organizations vary from small operations with one person devoted to trust activities on a part-time basis to large organizations with a variety of specialized staff such as tax attorneys, employee benefit specialists, and investment specialists.

20.07 Trusts can be broadly categorized as personal, corporate, or employee benefit.

Personal Trusts

20.08 Personal trust accounts may be established for individuals or other entities such as foundations, college endowments, and not-for-profit organizations. A brief description of the primary kinds of personal trusts follows.

- *a.* *Testamentary trusts* are created under a will. Administrative responsibility begins when assets are transferred from the estate to the trust. Almost all testamentary trusts are irrevocable.
- *b.* *Voluntary trusts* (*inter vivos*), also referred to as *living trusts*, are established by individuals during their lifetimes. This type of trust is often established with powers of revocation or amendment. Furthermore, it has been increasingly common for the grantor of the trust to retain the power to control or participate in deciding on investments resulting in a self-directed trust.
- *c.* *Court trusts* are trusts in which the trustee is accountable to a court. Court trusts generally include decedents' estates (under which the courts appoint administrator institutions to settle the estates of persons who either died without leaving wills or who nominated the institutions as executors in their wills), guardianships, and some testamentary trusts.
- *d.* *Agency agreements* provide for the care of other parties' securities and properties. Safekeeping and custodianship agreements are two of the more common types.
- *e.* *Property management agreements* provide for the management of property, for example, real estate or securities investments, by the trustee institution. The institution, as agent, has managerial duties and responsibilities appropriate to the kind of property being managed. (Such agreements also may exist for employee benefit trusts.)

20.09 Closely held business management responsibilities may arise through the normal course of events when an institution serves as trustee of a personal trust (or employee benefit trust) that holds ownership of the enterprise, through involvement in winding down the affairs of an estate, or through a specialized property management agreement.

Corporate Trusts

20.10 A brief description of the primary kinds of corporate trust activities follows.

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[3] Most notably, Title 12 of the Code of Federal Regulations (12 CFR), Parts 9 (OCC) and 550 (OTS); state fiduciary laws often provide additional requirements.

a. As *transfer agent*, the trust department or trust company transfers registered (in contrast to bearer) securities from one owner to another and maintains the records of ownership.

b. As *registrar*, the trust department or trust company maintains for corporations control over the number of shares issued and outstanding.

c. As *joint registrar-transfer agent*, the trust department or trust company acts jointly as registrar and transfer agent for the same issue.

d. As *paying agent*, the trust department or trust company distributes interest or dividend payments or redeems bonds and bond coupons of corporations and political subdivisions within the terms of an agency agreement.

e. When an institution is a *trustee under indenture*, the trust department or trust company acts as an agent designated by a municipality, corporation, or other entity to administer specified cash receipt or payment functions. The trust department or trust company performs the duties specified in the agreement, which might include holding collateral; issuing bond instruments; maintaining required records, accounts and documentation; monitoring for default; ensuring legal compliance; and effecting the payment of principal and interest.

Employee Benefit Trusts

20.11 In recent years, the employee benefit trust has become a common arrangement to handle the investment of assets of employee benefit plans and the disbursement of plan assets for payments of benefits to participants. Usually employee benefit trusts are utilized in connection with employee benefit plans governed by the Employee Retirement Income and Security Act of 1974 (ERISA), the federal law dealing with employee benefit plans. A brief description of the primary kinds of employee benefit trusts follows.

a. *Pension or profit-sharing trusts* provide for a trustee institution to manage trust funds established for the benefit of eligible company officers or employees or for members of a union, professional organization, or association. Such trusts are established by comprehensive written plans in which the trustees' powers are limited and their duties are well defined. These trusts may exist in connection with a variety of types of benefit plans, including defined benefit plans, defined contribution plans, individual retirement accounts (IRAs), and health and welfare plans.

b. *Master trusts* are special trust devices used to bring together various employee benefit trusts of a plan sponsor for ease of administration. For instance, an employer may have similar benefit plans for different subsidiaries, divisions, or classes of employees. Rather than maintain separate employee benefit trusts for each plan, all of the plans, subject to restrictions of ERISA, may pool the trust assets in a single master trust and maintain separate subaccounts for each plan to preserve accountability. A master trust may also be structured to establish separate pools of trust assets managed by different investment advisers selected by the plan sponsor.

Collective Trust Funds

20.12 Collective trusts are arrangements in which the funds of individual trusts (that is, personal or employee benefit trusts) are pooled to achieve greater diversification of investment, stability of income, or other investment objectives. Under federal statute there are two types of collective investment trusts: (*a*) common trust funds,[4] which are maintained exclusively for the collective investment of accounts for which the institution serves as trustee, executor, administrator, conservator, and guardian, and (*b*) commingled pension trust funds, which consist solely of assets of retirement, pension, profit-sharing, stock bonus, or other trusts that are exempt from federal income taxes.

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[4] Common trust funds are exempt from federal income taxes under Section 584 of the Internal Revenue Code.

REGULATORY MATTERS

20.13 Some institutions are also involved with mutual funds. Their involvement may range from corporate trust activities, which are generally administrative in nature, to investment advisory activities, or may simply involve custodial activities. Some institutions sell funds sponsored by an independent fund group. Others may use their name on a fund sponsored by a third party.

20.14 12 CFR Part 9 sets forth rules concerning a national bank's operation of collective investment trusts. The independent accountant may be engaged to perform certain agreed-upon procedures required by the Office of the Comptroller of the Currency (OCC) relative to all other trust activities. The OTS has similar requirements. Regulatory approval is generally required before institutions enter into operations involving mutual funds.

20.15 The federal banking agencies use the Uniform Interagency Trust Rating System (UITRS) as a tool to evaluate the soundness of fiduciary activities of financial institutions on a uniform basis and to identify those institutions requiring special supervisory attention. The UITRS was revised in 1998 to place more emphasis on risk management and more closely align the ratings definitions language and tone with those of the CAMELS ratings definitions.

ACCOUNTING AND FINANCIAL REPORTING

20.16 While a trust department or trust company may have responsibility for the custody of trust assets, they are not assets of the institution and, therefore, should not be included in the institution's financial statements. However, cash accounts of individual trusts are often deposited with the institution in demand and time deposit accounts, and revenues and expenses related to fees for trust activities are recognized in the institution's income. Trust department income should be presented on the accrual basis. Financial institutions often make financial statement disclosures describing the nature of the trust activities and are required to apply the provisions of Financial Accounting Standards Board (FASB) Statement on Financial Accounting Standards No. 5, *Accounting for Contingencies*, to any contingencies that may exist related to trust activities.

AUDITING

Objectives

20.17 The primary objectives of financial statement audit procedures applied in the trust operations area are to obtain reasonable assurance that—

- *a.* The institution has properly described and disclosed in the financial statements contingent liabilities associated with trust activities.
- *b.* Fee income resulting from trust activities is recognized properly in the institution's financial statements.

Planning

20.18 In planning the audit, the independent accountant should consider the factors influencing inherent risk, which are described in chapter 5, as they relate to financial statement assertions about trust activities.

The independent accountant should consider the following factors in establishing the scope of audit procedures to be performed:

a. The organization of the trust department and the degree of separation from the commercial banking departments (for example, the role of legal counsel in trust account administration and the vulnerability to disclosure of insider information)

b. The nature of comments on trust operations indicated in supervisory agency or internal audit reports

c. The extent and nature of insurance coverage

d. The type and frequency of lawsuits, if any, brought against the institution and arising from trust operations

e. The nature, complexity, and reliability of data-processing systems

f. The nature and extent of lending of securities from trust accounts

The significance of an institution's exposure to liability (including liability related to the reporting of tax information) is a function of (*a*) the relative significance of the trust assets administered, (*b*) whether the institution has discretionary investment authority, (*c*) the complexity of transactions entered into by the trust, (*d*) the number of trusts administered, and (*e*) the effectiveness of administration of the trust. Thus, the importance of the trust department in an audit of an institution's financial statements should not be underestimated.

Internal Control Over Financial Reporting and Possible Tests of Controls in a Financial Statement Audit

20.19 SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), provides guidance on the independent accountant's consideration of an institution's internal control in an audit of financial statements performed in accordance with GAAS. It describes the components of internal control and explains how an independent accountant should consider internal control in planning and performing an audit. Paragraph 19 of SAS No. 55, as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55*, requires that, in all audits, the independent accountant obtain sufficient understanding of each of the five components (the control environment, risk assessment, control activities, information and communication, and monitoring) to plan the audit by performing procedures to understand the design of policies and procedures relevant to audit planning and whether they have been placed in operation.

20.20 Accounting systems for trust departments generally use sophisticated electronic data-processing systems. The accounting records of a trust department generally should reflect the department's asset holdings and liabilities to trust customers, the status of each trust account, and all transactions relating to each trust account. Records providing detailed information for each trust account generally should include the following:

- Principal (corpus) control account
- Principal cash account
- Income cash account
- Investment records for each asset owned, such as stocks, bonds, notes and mortgages, savings and time accounts, real property, and sundry assets
- Liability record for each principal trust liability
- Investment income

20.21 The independent accountant should generally evaluate trust departments' and trust companies' overall internal control over financial reporting, including the following controls.

- Individual account and departmental transactions (activity control) and suspense items are reconciled and recorded in a complete, accurate, and timely manner.

- Written policies, procedures, and controls exist for securities lending activities, including review of the borrower's creditworthiness, a formal lending agreement, and minimum collateral requirements.
- Periodic reconciliations of the trust funds on deposit with the institution or its custodian are performed by an employee having no check-signing authority or access to unissued checks and related records.
- Measures have been taken to safeguard trust assets by dual control.
- Vault deposits and withdrawals are reconciled with accounting records to promptly reflect the purchase and sale of trust assets.
- Reconciliation of agency accounts (for example, dividends, coupons, and bond redemptions) are performed regularly by an employee having no access to unissued checks or participation in the disbursement function.
- Periodic physical inspection of assets or confirmation of trust assets is conducted by an independent person.
- There is frequent reporting and written approval of uninvested cash balances and overdrafts.
- Procedures exist to ensure compliance with income and other tax filing and remittance requirements.
- Reviews are conducted to make sure all duties required by the governing trust instruments or agency contracts (legal compliance) are performed.

Financial Reporting Controls of the Trust

20.22 Additional controls that the independent accountant may wish to consider for engagements not limited to the audit of financial statements (for example, directors' exams, engagements under SAS No. 70, and agreed upon procedures or other extended audit services) include the following.

- Authorization and review procedures are in place to ensure that assets accepted into a trust conform with provisions of the trust and applicable laws and regulations.
- The physical and administrative security (physical control) of assets for which the trust department has responsibility is segregated from transaction authorization and recordkeeping.
- Trust assets are segregated from the institution's assets and are periodically inspected by people outside the trust department or trust company.
- Trust assets are registered in the name of the institution as fiduciary or in the name of the nominee.
- Proper approval is obtained from cofiduciaries (or investment power holders in self-directed trusts) for investment changes, disbursements, and so forth.
- Approval of the individual purchase and sale of all trust investments is performed by the trust or investment committee or its designees. It is important that for assets where the trustee has discretionary (investment powers) authority, investment restrictions imposed by the client are being adhered to. The independent accountant should also obtain an understanding of computer models that may be used to assist in making investment decisions or to determine whether the investment objectives of the funds are being met.
- Procedures exist to ensure proper classification of trust assets, both by trust title and by nature of asset, daily posting of journals containing detailed descriptions of principal and income transactions, and establishment of control accounts for various asset classifications, including principal and income cash.
- Procedures exist to safeguard unissued supplies of stocks and bonds by dual control.

- Periodic mailings are made of account statements of activity to an external party designated by the client.
- Policies and procedures exist related to identification and resolution of failed trades and the contractual settlement of trades posted to trust accounts.

Substantive Tests Related to Financial Statement Audits

20.23 ***Testing of Trust Department Revenues and Expenses***. Although a substantial amount of activity may be conducted and reported on within the trust department, items typically reflected in the institution's financial statements are income from trust or agency services and trust operation expenses. Those areas may be tested independently or may be integrated, as appropriate, with other tests of trust operations.

20.24 ***Contingent Liabilities***. The independent accountant should design audit procedures to determine whether any contingent liabilities should be recognized or disclosed in the institution's financial statements. Acceptance of certain assets, such as real estate with environmental contamination that subjects the trustee to environmental liabilities and ineligible investments in employee benefit trusts subject to ERISA, may result in substantial liabilities for both the trust and trustee. Further, the independent accountant should consider determining the extent to which an institution has engaged in off-balance-sheet activities that create commitments or contingencies, including innovative transactions involving securities and loans (such as transfers with recourse or put options), that could affect the financial statements, including disclosures in the notes. Inquiries of management relating to such activities should be formalized in the representation letter normally obtained at year-end. The independent accountant should also consider reviewing the institution's documentation to determine whether particular transactions are sales or financing arrangements.

Substantive Tests Related to the Trust

20.25 Additional substantive tests that the independent accountant may wish to consider for engagements not limited to the audit of financial statements (for example, directors' exams, engagements under SAS No. 70, and agreed upon procedures or other extended audit services) follow.

20.26 Examination of a trust department's activity includes tests of systems and procedures that are common to the management of all or most individual trusts or agency accounts and tests of the activity in selected representative individual trust accounts in each area of trust department service (for example, personal, corporate, and employee benefit).

20.27 ***Testing of Trust Activities' Common Procedures.*** The procedures followed for the numerous types of trusts and agency activities involve many common or similar functions. Tests of the department's conduct of those activities may be done on the department as a whole rather than on individual trusts. Functions that may be tested by the department include the following:

- Opening of new accounts
- Receipt and processing of the initial assets that constitute an account
- Processing of purchases, sales, and exchanges of principal assets
- Receipt and payment of cash or other assets
- Collateralization of trust assets held in deposit accounts at the institution, affiliate, or outside custodian, where required
- Execution of specified trust or agency activities
- Determination of fees and charging of fees to accounts
- Processing of trust assets in and out of the trust vault
- Closing of accounts

20.28 ***Testing of Account Activity.*** The independent accountant should consider performing sufficiently detailed tests to obtain reasonable assurance that transactions and activities within the various types of trust accounts are being conducted properly. The tests may cover asset validation, asset valuation, and account administration. For asset validation, a sample of accounts may be selected, trial balances of assets obtained, and the physical existence of assets for which the trust is responsible determined on a test basis. For account administration, a sample of trust accounts may be selected for testing of individual transactions. If appropriate, certain of those transactions may be incorporated in testing of common procedures in the trust department. The independent accountant may coordinate the selection of accounts for testing asset validation and account administration. The independent accountant should consider performing the following procedures for the selected accounts:

- *a.* Read the governing instrument and note the significant provisions.
- *b.* Review activity during the period being audited for compliance with the governing trust instrument and applicable laws and regulations.
- *c.* Review the assets held for compliance with the provisions of the governing trust instrument.
- *d.* Examine brokers' advices or other documentary evidence supporting the purchase and sale of investments.
- *e.* For real estate accepted or acquired, determine that appropriate measures are taken to identify potential environmental liability and to properly document the evaluation.
- *f.* Ascertain that real estate holdings are insured and are inspected on a periodic basis and that appraisals are performed or otherwise obtained as required by the governing trust instrument and applicable laws and regulations.
- *g.* Obtain reasonable assurance that income from trust assets has been received and credited to the account.
- *h.* Obtain reasonable assurance that required payments have been made.
- *i.* Test computation and collection of fees.
- *j.* Determine whether the account has been reviewed by the investment committee as required by the supervisory authorities or by local regulations.
- *k.* Test the amounts of uninvested cash to determine whether amounts maintained and time held are not unreasonable.
- *l.* Review any overdrafts and obtain reasonable assurance that they have a valid business purpose and are covered by appropriate borrowings to avoid violations of laws and regulations.
- *m.* Independently test market values used in valuing investments.
- *n.* Review the "soft dollar" charges allocated to funds for appropriateness.
- *o.* Determine whether required tax returns have been filed.
- *p.* Review the adequacy of trust reporting of co-trustees and beneficiaries.
- *q.* Confirm individual trust account assets, liabilities, and activity with co-trustees and beneficiaries.

Audits of Unit Investment Trusts

20.29 The AICPA Audit and Accounting Guide *Audits of Investment Companies* provides guidance on the auditing of financial statements of investment companies and unit investment trusts.

CHAPTER 21

Insurance Activities

INTRODUCTION

21.01 Insurance operations ordinarily are an integral part of consumer finance activities. The auditor of a company that engages in or has a subsidiary that engages in insurance activities should be familiar with FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*. This chapter deals primarily with insurance business generated from finance customers, though it also addresses insurance coverage provided to others who are not also finance customers.

Types of Insurance Coverage

21.02 Insurance activities of companies often involve insuring risks related to loan transactions. Following are the three general types of insurance coverage associated with those transactions:

- *a.* Credit life coverage for loan repayment in the event of the debtor's death
- *b.* Credit accident and health coverage for installment loan payments in the event of the debtor's illness or disability for an extended period
- *c.* Property and liability coverage on collateral or other property associated with the loan transaction

Credit Life

21.03 Credit life insurance is a form of term insurance that provides for loan repayment if the debtor dies before the loan is fully paid. It ordinarily is written on a single-premium basis, with the amount of the premium added to the loan balance and paid as part of the scheduled installments on the loan.

21.04 Credit life insurance includes level term insurance and decreasing term insurance. *Level term insurance* provides a fixed amount of coverage, generally the original amount of the loan. *Decreasing term insurance*, the more common type, insures the debtor's life to the extent of the unpaid balance of the loan, sometimes less any delinquent payments, at the date of death. However, decreasing term insurance usually is based on the contractual loan period. Therefore, the insurer may not pay off the entire uncollected balance on the loan if it is in delinquency status at the time of the debtor's death. The extent to which delinquent installments are covered generally depends on the insurance contract and on applicable state insurance rules and regulations.

21.05 The insurer's risk exposure on a policy at a given point in time under level term insurance differs from that under decreasing term credit life insurance. Because level term insurance provides coverage equal to the original amount of the loan, the insurer's risk exposure is constant throughout the term of the loan. In contrast, the insurer's exposure under decreasing term insurance decreases as scheduled loan repayments become due, usually in direct proportion to the regular monthly reductions of the loan balance.

Credit Accident and Health

21.06 Credit accident and health insurance requires the insurer to make the debtor's monthly loan payments during extended periods of illness or disability. Ordinarily it is written on a single-premium basis, with the premium added to the loan amount and, hence, paid as part of the periodic installments. Under an accident and health policy, the insurer's total risk exposure decreases —as in a decreasing term credit life insurance policy—as loan repayments are made. However, the size of potential claims and the related risk exposure do not decrease in direct proportion to the reduction in the unpaid loan balance, because most credit accident and health insurance claims are for short-duration disabilities that are cured in a period shorter than the remaining loan term.

Property and Liability

21.07 Ordinarily, a finance company requires that the collateral pledged as security to a loan be protected by property insurance. Such coverage may be obtained from the lender's insurance subsidiary or from an unaffiliated insurer. The amount of coverage is usually based on the value of the collateral and does not necessarily bear a relationship to the unpaid balance of the loan. Property insurance policies issued in connection with finance transactions can be written either on a single-premium basis for the loan term or for an annual or other period of less than the remaining loan term, and the policy renewed as required. Premiums charged by lenders' insurance affiliates for property insurance coverage related to finance transactions frequently are added to the loan amount and paid as part of the regular installment payments on the loan.

Writing Policies

21.08 An insurance subsidiary of a finance company may be a direct writing or a reinsurance company. A direct writing company writes the insurance policies in its name. A reinsurance company insures policies written by direct writing companies.

21.09 The insurance can be issued on either a group or an individual policy basis. For group coverage, the insurer issues the policy to the finance company, which in turn issues individual certificates to its debtor-customers. Group policies may be subject to experience-rated premium adjustments based on experience and profitability of the group being covered.

Commissions

21.10 Insurers, both insurance subsidiaries and independent companies, may pay commissions to companies. Those payments may be in the form of advance commissions computed as a percentage of premiums, retrospective or experience-rated commissions, or combinations of advance commissions and retrospective commissions.

REGULATORY MATTERS

21.11 Credit unions may offer through a credit union service organization (CUSO), the following insurance brokerage or agency services:

1. Agency for sale of insurances;
2. Provision of vehicle warranty programs; and
3. Provision of group purchasing programs.

Other activities or services that CUSOs may provide are outlined in Part 712 of the National Credit Union Administration Rules and Regulations.

ACCOUNTING

21.12 Accounting by enterprises that issue insurance contracts is dealt with in FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*; 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 Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*; Securities and Exchange Commission Regulation S-X, Article 7; and SOP 94-5, *Disclosures of Certain Matters in the Financial Statements of Insurance Enterprises*.

Premium Income

21.13 Premium income should be recognized in accordance with the methods described in FASB Statement No. 60. The statement classifies insurance contracts as being of short or long duration, depending on the period over which such contracts are expected to remain in force. The statement provides the following guidance on factors to consider in determining whether a contract is of short or long duration:

a. Short-duration contracts provide insurance protection for a fixed period of short duration and enable insurers to cancel the contracts or to adjust provisions of the contracts (such as the amount of premiums charged or coverage provided) at the end of any contract period.

b. Long-duration contracts generally are not subject to unilateral changes in their provisions, such as noncancelable or guaranteed renewable contracts, and require performance of various functions and services (including insurance protection) for extended periods.

21.14 FASB Statement No. 60 indicates that examples of short duration policies include most property and liability insurance contracts and certain term life insurance contracts, such as credit life insurance. The statement also indicates that accident and health insurance contracts may be of short duration or long duration, depending on the terms of such contracts.

21.15 Insurance policies issued in connection with consumer lending generally are considered to represent short-duration contracts. Premiums from such contracts are recognized as revenue over the period of the contract in proportion to the amount of insurance protection provided. According to FASB Statement No. 60, "That generally results in premiums being recognized as revenue evenly over the contract period (or the period of risk, if different), except for those few cases in which the amount of insurance protection declines according to a predetermined schedule."

Policy Acquisition Costs

21.16 Policy acquisition costs are defined in FASB Statement No. 60 to be costs that both vary with and are primarily related to the acquisition of insurance contracts. Policy acquisition costs should be deferred and amortized to income over the terms of the policies by the same method used to account for insurance premium income. Commissions paid to the affiliated companies and premium taxes normally are the most significant elements of acquisition costs. Deferred costs associated with payment of such commissions and other intercompany items should be eliminated in consolidation.

Investment Portfolios

21.17 Insurance subsidiaries maintain investment portfolios usually composed of the same types of securities found in the portfolios of independent insurance companies. State regulations restrict the types of investments that insurance companies may make.

21.18 FASB Statement No. 115 amends FASB Statement No. 60 to require that insurance enterprises account for all investments in debt securities and investments in equity securities that have readily determinable fair values, as defined by FASB Statement No. 115, in accordance with the provisions of Statement No. 115.

21.19 Insurance subsidiaries may be required to deposit some securities with state regulatory authorities. If so, the carrying amount of securities deposited should be disclosed.

State Laws

21.20 Insurance companies are regulated by state insurance laws, which require maintenance of accounting records and adoption of accounting practices in compliance with the laws and regulations of the state of domicile. Some pre- scribed or permitted statutory accounting practices differ from generally accepted accounting principles. Accordingly, the financial statements of insurance subsidiaries prepared for submission to regulatory authorities must be adjusted to conform to generally accepted accounting principles before they can be consolidated with the financial statements of the parent companies.

Commissions

21.21 A finance company may receive commissions from an independent insurer for policies issued to finance customers. Insurance commissions received from an independent insurer should be deferred and systematically amortized to income over the life of the related insurance contracts because the insurance and lending activities are integral parts of the same transactions. The method of commission amortization should be consistent with the method of premium income recognition for that type of policy as set forth in FASB Statement No. 60.

21.22 Income from experience-rated or retrospective commission arrangements should be accrued over the applicable insurance risk period.

21.23 Commissions paid to its parent company by an insurance subsidiary are eliminated in consolidation.

Consolidation Policy

21.24 FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries,* requires consolidation of all majority-owned subsidiaries unless control is temporary or does not rest with the majority owner. The statement requires consolidation of a majority-owned subsidiary even if it has *nonhomogeneous* operations, a large minority interest, or a foreign location. The statement also precludes use of parent-company financial statements prepared for issuance to stockholders as the financial statements of the primary reporting entity. The statement requires that summarized information about the assets, liabilities, and results of operations (or separate statements) of previously unconsolidated majority-owned subsidiaries continue to be provided after those subsidiaries are consolidated.

Financial Statement Presentation

21.25 Unearned premiums and unpaid claims on certain insurance policies issued to finance customers by a subsidiary may represent inter-company items because premiums are added to the consumer loan account, which is, in turn, classified as a receivable until paid, and most or all of the payments on claims are applied to reduce the related finance receivables. Therefore, unearned premiums and unpaid claims on certain credit life and credit accident and health insurance policies issued to finance customers should be deducted from finance receivables in the consolidated balance sheet. That will cause the receivables to be stated at net realizable value. The following illustrates that type of presentation:

Finance receivables	XXX
Less:	
Allowance for losses	(XXX)
Unearned premiums and unpaid claim liabilities related to finance receivables	(XXX)
Finance receivables, net	XXX

Alternatively, the balance sheet may present only the net finance receivables if the notes to the financial statements contain sufficient disclosure of unearned premiums and unpaid claims and the allowance for losses.

21.26 Unpaid claims for property insurance and a portion of level term life insurance, however, should not be applied in consolidation against related finance receivables because companies generally do not receive substantially all proceeds of such claims. That prohibition also applies to credit life and accident and health coverage written on policies for which the related receivables are assets of unrelated enterprises. In those circumstances, such amounts should be presented as liabilities.

21.27 FASB Statement No. 131, *Disclosures About Segments of a Business Enterprise and Related Information*, requires public companies to present in their financial statements information about reportable operating segments.

AUDITING

21.28 The AICPA industry audit guide, *Audits of Stock Life Insurance Companies* and the audit and accounting guide, *Audits of Property and Liability Insurance Companies*[∀], provide guidance on auditing concepts and procedures for insurance companies. The auditor should consider reviewing these AICPA guides for information. In addition, the auditor should consider whether accounts between the finance company and the insurance subsidiaries are reconciled regularly.

21.29 Because the premiums and commissions associated with insurance provided to finance customers ordinarily are an integral part of the related finance and loan transactions, the audit procedures used to test and evaluate finance transactions should include related insurance activities. Similarly, branch office controls over loans usually apply to insurance products. The auditor should be satisfied that the income recognition methods for insurance premiums and commission income conform to the principles discussed in this chapter.

21.30 Auditors should refer to Auditing Interpretation No. 4 of SAS No. 31, "Applying Auditing Procedures to Segment Disclosures in Financial Statements" (AICPA, Professional Standards, vol. 1, AU sec. 9326), for guidance on auditing segment disclosures.

[∀] The Accounting Standards Executive Committee (AcSEC) of the AICPA expects to issue a new Audit and Accounting Guide, *Life and Health Insurance Entities* during 2000. The proposed guide would supersede the Industry Audit Guide *Audits of Stock Life Insurance Companies*. Readers should be alert to the issuance of a final guide.

CHAPTER 22

Reporting Considerations

INTRODUCTION

22.01 The guidance in Statement on Auditing Standards (SAS) No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 508), as amended, applies to audit reports on the financial statements of financial institutions. Such reports may contain an unqualified opinion, an unqualified opinion with explanatory language, a qualified opinion, an adverse opinion, or a disclaimer of opinion. This chapter contains a brief discussion of each of those reports, with an emphasis on illustrating issues that an independent accountant may encounter in the industry. The reports are illustrative; the facts and circumstances of each particular audit will govern the appropriate form of report. Paragraphs 22.11 through 22.19 apply only to credit unions,

REPORTS

Unqualified Opinion

22.02 The independent accountant's standard report states that the financial statements present fairly, in all material respects, an entity's financial position, results of operations, and cash flows in conformity with generally accepted accounting principles (GAAP). This conclusion may be expressed only when the independent accountant has formed such an opinion on the basis of an audit performed in accordance with generally accepted auditing standards (GAAS). The following is an illustration of an independent accountant's standard report (unqualified opinion) on the financial statements of a bank or savings institution.

> <u>Independent Auditor's Report</u>
> To the Board of Directors
> ABC Institution:
>
> We have audited the accompanying balance sheets of ABC Institution as of December 31, 20X2 and 20X1, and the related statements of income, changes in stockholders' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Institution's management. Our responsibility is to express an opinion on these financial statements based on our audits.
>
> We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.
>
> In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of ABC Institution as of December 31, 20X2 and 20X1, and

the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

Explanatory Language Added to the Auditor's Standard Report

22.03 Certain circumstances, while not affecting the independent accountant's unqualified opinion, may require that the independent accountant add an explanatory paragraph (or other explanatory language) to the standard report. A number of such circumstances are listed in paragraph 11 of SAS No. 58, as amended. This section deals with one of them: the existence of substantial doubt about an institution's ability to continue as a going concern.

22.04 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), as amended, describes the independent accountant's responsibility for evaluating whether there is substantial doubt about the ability of the entity whose financial statements are being audited to continue as a going concern for a reasonable period of time. Chapter 3 describes going concern considerations as they relate to banks and savings institutions and discusses how an institution's regulatory capital position should be considered in the independent accountant's assessment of whether there is substantial doubt about the institution's ability to continue as a going concern. If the independent accountant concludes that there is substantial doubt about an institution's ability to continue as a going concern for a reasonable period of time, the report should include an explanatory paragraph (following the opinion paragraph) to express that conclusion. The independent accountant's conclusion about the entity's ability to continue as a going concern should be expressed through the use of the phrase "substantial doubt about its [the entity's] ability to continue as a "going concern" or similar wording that includes the terms "substantial doubt" and "going concern."[1] The following is an illustration of an independent accountant's report on the financial statements of a bank or savings institution that includes an explanatory paragraph because of the existence of substantial doubt about the institution's ability to continue as a going concern for a reasonable period of time.

Independent Auditor's Report
To the Board of Directors
ABC Institution:

We have audited the accompanying balance sheets of ABC Institution as of December 31, 20X2 and 20X1, and the related statements of income, changes in stockholders' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Institution's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial

[1] Footnote 5 to SAS No. 77, *Amendments to Statements on Auditing Standards No. 22,* Planning and Supervision, *No. 59,* The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern, *and No. 62,* Special Reports, says, in part:

> In a going-concern explanatory paragraph, the auditor should not use conditional language in expressing a conclusion concerning the existence of substantial doubt about the entity's ability to continue as a going concern.

statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of ABC Institution as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

The accompanying financial statements have been prepared assuming that ABC Institution will continue as a going concern. As discussed in Note XX to the financial statements, at December 31, 20X2, the Institution did not meet its minimum capital requirements established by the Office of the Comptroller of the Currency (OCC). The Institution also has suffered recurring losses from operations. The Institution has filed a capital plan with the OCC outlining its plans for attaining the required levels of regulatory capital by December 31, 20X4. To date, the Institution has not received notification from the OCC regarding acceptance or rejection of its capital plan. Failure to meet the capital requirements and interim capital targets included in the capital plan would expose the Institution to regulatory sanctions that may include restrictions on operations and growth, mandatory asset dispositions, and seizure. These matters raise substantial doubt about the ability of ABC Institution to continue as a going concern. The ability of the Institution to continue as a going concern is dependent on many factors, one of which is regulatory action, including ultimate acceptance of its capital plan. Management's plans in regard to these matters are described in Note XX. The accompanying financial statements do not include any adjustments that might result from the outcome of this uncertainty.

[*Signature*]

[*Date*]

22.05 SAS No. 59 states that the inclusion of an explanatory paragraph (following the opinion paragraph) in the independent accountant's report as described above serves adequately to inform users of the financial statements of the independent accountant's substantial doubt. Nevertheless, SAS No. 59 does not preclude the independent accountant from declining to express an opinion in cases involving uncertainties. If the independent accountant disclaims an opinion, the uncertainties and their possible effects should be disclosed in an appropriate manner and the independent accountant's report should state all of the substantive reasons for the disclaimer of opinion. The following is an illustration of an independent accountant's disclaimer of opinion because of the existence of substantial doubt about an institution's ability to continue as a going concern for a reasonable period of time.

<u>Independent Auditor's Report</u>
To the Board of Directors
ABC Institution:
We have audited the accompanying balance sheets of ABC Institution as of December 31, 20X2 and 20X1, and the related statements of income, changes in stockholders' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Institution's management. Our responsibility is to report on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our report.[2]

The accompanying financial statements have been prepared assuming that ABC Institution will continue as a going concern. As discussed in Note XX to the financial statements, at December 31, 20X2, the Institution did not meet its minimum capital requirements established by the Office of the Comptroller of the Currency (OCC). The Institution also has suffered recurring losses from operations. The Institution has filed a capital restoration plan with the OCC outlining its plans for attaining the required levels of regulatory capital by December 31, 20X4. To date, the Institution has not received notification from the OCC regarding acceptance or rejection of its capital restoration plan. Failure to meet the capital requirements and interim capital targets included in the Institution's capital plan would expose the Bank to regulatory sanctions that may include restrictions on operations and growth, mandatory asset dispositions, and seizure. These matters raise substantial doubt about the ability of ABC Institution to continue as a going concern. The ability of the Institution to continue as a going concern is dependent on many factors, one of which is regulatory action, including ultimate acceptance of its capital plan. Management's plans in regard to these matters are described in Note XX. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

Because of the significance of the uncertainty discussed above, we are unable to express, and we do not express, an opinion on the financial statements for the year ended December 31, 20X2.

In our opinion, the 20X1 financial statements referred to above present fairly, in all material respects, the financial position of XYZ Bank as of December 31, 20X1, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

Emphasis of a Matter

22.06 In some circumstances, the independent accountant may wish to emphasize a matter regarding the financial statements but, nevertheless, intends to express an unqualified opinion. For example, the independent accountant may wish to emphasize that the bank or savings institution is a subsidiary of a holding company or that it has had significant transactions with related parties, or the independent accountant may wish to emphasize an unusually important subsequent event or an accounting matter affecting the comparability of the financial statements with those of the preceding period. Such explanatory information should be presented in a separate paragraph of the independent accountant's report that may precede or follow the opinion paragraph. Phrases such as "with the foregoing explanation" should not be used in the opinion paragraph in situations of this type. The following is an illustration of an unqualified opinion with an emphasis of a matter paragraph regarding an institution's failure to meet minimum regulatory capital standards on the institution's financial statements.

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[2] If the independent accountant was disclaiming an opinion due to a scope limitation, this paragraph would be omitted.

Independent Auditor's Report
To the Board of Directors
ABC Institution:

We have audited the accompanying balance sheets of ABC Institution as of December 31, 20X2 and 20X1, and the related statements of income, changes in stockholders' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Institution's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note XX to the financial statements, at December 31, 20X2, the Institution failed to meet the risk-based capital requirement established by the Federal Deposit Insurance Corporation (FDIC). The Institution has filed, and the FDIC has accepted, a capital plan for attaining the required level of regulatory risk-based capital by December 31, 20X3.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of ABC Institution as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

Qualified Opinion

22.07 Paragraphs 20 through 63 of SAS No. 58, as amended, describe certain circumstances that may require the independent accountant to qualify his or her opinion on financial statements. A qualified opinion states that, except for the effects of the matter to which the qualification relates, the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows in conformity with GAAP. Such an opinion is expressed when—

a. There is a lack of sufficient competent evidential matter or there are restrictions on the scope of the audit that have led the independent accountant to conclude that an unqualified opinion cannot be expressed and the independent accountant has concluded not to disclaim an opinion.

b. The independent accountant believes, on the basis of the audit, that the financial statements contain a departure from GAAP, the effect of which is material, and has concluded not to express an adverse opinion.

Adverse Opinion

22.08 Paragraphs 58 through 60 of SAS No. 58 describe adverse opinions. An adverse opinion states that the financial statements do not present fairly the financial position or the results of operations or cash flows in conformity with GAAP. Such an opinion is expressed when, in the independent accountant's judgment, the financial statements taken as a whole are not presented fairly in conformity with GAAP. When the independent accountant expresses an adverse opinion, he or she should disclose in a separate explanatory paragraph(s) preceding the opinion paragraph of the report (*a*) all the substantive reasons for the adverse opinion and (*b*) the principal effects of the subject matter of the adverse opinion on financial position, results of operations, and cash flows, if practicable. If the effects are not reasonably determinable, the report should so state. When an adverse opinion is expressed, the opinion paragraph should include a direct reference to a separate paragraph that discloses the basis for the adverse opinion.

Disclaimer of Opinion

22.09 Paragraphs 61 to 63 of SAS No. 58 describe disclaimers of opinion. Paragraph 61 of SAS No. 58 says:

A disclaimer of opinion states that the auditor does not express an opinion on the financial statements. An auditor may decline to express an opinion whenever he is unable to form or has not formed an opinion as to fairness of presentation of the financial statements in conformity with generally accepted accounting principles. If the auditor disclaims an opinion, the auditor's report should give all of the substantive reasons for the disclaimer.

22.10 Paragraph 62 of SAS No. 58 says: A disclaimer is appropriate when the auditor has not performed an audit sufficient in scope to enable him to form an opinion on the financial statement. A disclaimer of opinion should not be expressed because the auditor believes, on the basis of his audit, that there are material departures from generally accepted accounting principles (see paragraphs 35 through 57). When disclaiming an opinion because of a scope limitation, the auditor should state in a separate paragraph or paragraphs all of the substantive reasons for the disclaimer. He should state that the scope of his audit was not sufficient to warrant the expression of an opinion. The audit should not identify the procedures that were performed nor include the paragraph describing the characteristics of an audit (that is, the scope paragraph of the auditor's standard report); to do so may tend to overshadow the disclaimer. In addition, he should also disclose any other reservations he has regarding fair presentation in conformity with generally accepted accounting principles.

Financial Statements Prepared in Conformity With an Other Comprehensive Basis of Accounting (OCBOA)

22.11 Title II of the Credit Union Membership Access Act of 1998 (CUMAA), requires all federally insured credit unions with assets of $10 million or more to follow generally accepted accounting principles. Credit unions with assets under $10 million may use a basis of accounting other than generally accepted accounting principles. SAS No. 62 recognizes bases of accounting that reporting entities use to comply with the requirements or financial reporting provisions of governmental regulatory agencies to whose jurisdiction they are subject as comprehensive bases of accounting other than generally accepted accounting principles, and provides guidance on reporting on OCBOA financial statements.

22.12 The following is an example of an auditor's report on financial statements prepared in conformity with a comprehensive basis of accounting prescribed by the National Credit Union Administration. Only credit unions with assets under $10 million may use a basis of accounting other than GAAP.

<u>Independent Auditor's Report</u>

Board of Directors
XYZ Credit Union

We have audited the accompanying statements of financial condition—regulatory basis of XYZ Credit Union as of December 31, 20X2 and 20X1, and the related statements of income—regulatory basis, members' equity—regulatory basis, and cash flows—regulatory basis for the years then ended. These financial statements are the responsibility of the credit union's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described in note X, these financial statements were prepared in conformity with the accounting principles prescribed or permitted by the National Credit Union Administration, which is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of XYZ Credit Union as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended, on the basis of accounting described in note X.

This report is intended solely for the information and use of the board of directors and management of XYZ Credit Union and the National Credit Union Administration, and is not intended to be and should not be used by anyone other than these specified parties.

[*Signature*]

[Date]

Members' Shares Reported as Equity

22.13 As discussed in paragraph 13.35, generally accepted accounting principles require that members' shares be reported as liabilities in the statement of financial condition. If members' shares are reported as such, or in any other manner in which it is not unequivocal that members' shares are liabilities, and the shares are material to the financial statements, the auditor should express a qualified opinion or, in certain cases, an adverse opinion on the financial statements unless the financial statements are prepared using a comprehensive basis of accounting other than GAAP (see paragraphs 22.11 and 22.12). An illustration of a report modified in those circumstances follows.

Qualified Opinion

[*Same first and second paragraphs as the standard report*]

The credit union has reported members' shares as equity in the accompanying statements of financial condition that, in our opinion, should be reported as liabilities in order to conform with generally accepted accounting principles. If these shares were properly reported, liabilities would increase and equity would decrease by $_______ and $_______ as of December 31, 20X2 and 20X1, respectively.

In our opinion, except for the effects of reporting members' shares as equity as discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of XYZ Credit Union as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

Communication of Internal Control Related Matters

22.14 The independent auditor may become aware of reportable conditions in internal control during the performance of the audit. SAS No. 60 requires that such reportable conditions be reported to the audit committee or its equivalent. In a credit union, these matters are normally communicated to the supervisory committee.

22.15 Paragraphs 9 through 19 of SAS No. 60, as amended by SAS No. 87, Restricting the Use of an Auditor's Report, describes the auditor's report on internal control based solely on a study and evaluation made as part of an audit. Paragraphs 7 and 8 of SAS No. 60 address reporting on matters noted in performing agreed upon procedures.

Reports on Supervisory Committee Audits

22.16 The form and content of reports that are currently prepared by independent auditors in connection with supervisory committee audits reflect a diversity of practice. As a result, supervisory committee members may not understand the fundamental differences between an engagement for the application of agreed-upon procedures to specified elements, accounts, or items of a financial statement in connection with a supervisory committee audit and an audit of a credit union's financial statements in accordance with GAAS. This is of particular concern when the limitations of the supervisory committee audit relate to areas of higher risk in the credit union industry. Further, supervisory committee members may incorrectly assume that the application of agreed-upon procedures included obtaining an understanding of the credit union's internal control similar to that obtained in an audit of the credit union's financial statements in accordance with GAAS.

22.17 Independent auditors' reports on audits of financial statements should comply with the reporting provisions contained in applicable SASs. SAS No. 58 gives guidance on reports on audited financial statements, and paragraph 42 of that SAS states that a disclaimer of opinion is appropriate when the auditor has not performed an audit sufficient in scope to enable him or her to form an opinion on the financial statements.

22.18 Independent auditors' reports on the performance of agreed-upon procedures in connection with a supervisory committee audit should be prepared in accordance with SAS No. 75[♦♦], which states that such reports should contain the following elements:,

- A title that includes the word *independent*
- Reference to the specified elements, accounts, or items of a financial statement of an identified entity and the character of the engagement
- Identification of specified parties
- The basis of accounting of the specified elements, accounts, or items of a financial statement unless clearly evident
- A statement that the procedures performed were those agreed to by the specified parties identified in the report
- Reference to standards established by the American Institute of Certified Public Accountants
- A statement that the sufficiency of the procedures is solely the responsibility of the specified parties and a disclaimer of responsibility for the sufficiency of those procedures
- A list of the procedures performed (or reference thereto) and related findings
- Where applicable, a description of any agreed-upon materiality limits
- A statement that the accountant was not engaged to, and did not, perform an audit of the specified elements, accounts, or items; and a statement that if the accountant had performed additional procedures, other matters might have come to his attention that would have been reported.
- A disclaimer of opinion on the effectiveness of internal control over financial reporting or any part thereof when the accountant has performed procedures on part of an entity's internal control over financial reporting
- A separate paragraph at the end of the report stating that the report is intended solely for the information and use of the specified parties and is not intended to be and should not be used by anyone other than the specified parties.
- Where applicable, reservations or restrictions concerning procedures or findings (as discussed in paragraphs 35,37,40, and 41 of SAS No. 75)
- Where applicable, a description of the nature of the assistance provided by a specialist. SAS No. 75 also states that the accountant should not provide negative assurance about whether the specified elements, accounts, or items of a financial statement are fairly stated in relation to established or stated criteria.[*]

22.19 As mentioned earlier, some regulatory agencies require that supervisory committee audit reports include financial statements or other data. In such instances, the supervisory committee usually includes the auditor's report on the application of agreed-upon procedures and the unaudited financial statements or data in its report to the regulatory agency.

22.20 An independent accountant may be requested to perform specific procedures in conjunction with a compilation or review of financial statements. The procedures employed in compilation and review engagements, and reports thereon, should comply with the provisions of SSARS 1, which states that any

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♦♦ The ASB has issued an Exposure Draft that would supersede SAS No. 75 and make SSAE No. 4 applicable to all agreed-upon procedures engagements. Readers should be alert to any final pronouncement.

* When the accountant consents to the inclusion of his or her report on the results of applying agreed-upon procedures in a document or written communication containing the entity's financial statements, the accountant should look to SAS No. 26, *Association with Financial Statements*, or to Statement on Standards for Accounting and Review Services (SSARS)1, *Compilation and Review of Financial Statements*, as appropriate, for guidance on his or her responsibility pertaining to the financial statements.

procedures that the accountant might have performed before or during the review engagement, including those performed in connection with a compilation of the financial statements, should not be described in his or her report. That provision, however, would not preclude the independent accountant from issuing a separate, special-purpose report on the nature and extent of procedures performed in accordance with SAS No. 75.

22.21 The following is an example of a report on the application of agreed-upon procedures performed in connection with a supervisory committee audit.

> Supervisory Committee
> XYZ Credit Union
>
> We have performed the procedures enumerated in the attached supplement, which were agreed to by [*list specified parties♠♠, ordinarily the Supervisory Committee of XYZ Credit Union*], solely to assist you in connection with your supervisory audit of XYZ Credit Union conducted pursuant to section 701.12 of the National Credit Union Administration regulations. The procedures performed by us and enumerated in the attached supplement are in accordance with the minimum procedures described in Appendix A of the National Credit Union Administration's Supervisory Committee Guide for Federal Credit Unions. Because the committee is responsible to ensure that a complete set of procedures is performed and because Appendix A procedures are designed for smaller, less complex credit unions, we performed other procedures at the committee's request. This engagement to apply agreed-upon procedures was performed in accordance with standards established by the American Institute of Certified Public Accountants. The sufficiency of the procedures is solely the responsibility of the specified parties. Consequently, we make no representation regarding the sufficiency of the procedures described in the supplement either for the purpose for which this report has been requested or for any other purpose.
>
> We were not engaged to, and did not, perform an audit, the objective of which would be the expression of an opinion on the specified elements, accounts, or items. Accordingly, we do not express such an opinion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you.
>
> This report is intended solely for the information and use of [*the specified parties*] and is not intended to be and should not be used by anyone other than these specified parties.
>
> ______________________________
> [*Signature of Independent Auditor*]
>
> [*City, State*]
>
> [*Date*]

♠♠ The NCUA should not be named as a specified party.

Supplement to Illustrative Report [#]

Loans

We obtained trial balances or subsidiary ledgers of the notes or both from the service center and reconciled the totals to the general ledger in the following amounts:

Account	*Amount Outstanding at June 30, 20X0*
Business loans	$
Consumer loans	
Real estate loans	
Participations purchased	_________
	$
	=======

Certain [*specify number*] loans, including lines of credit that had not been fully funded, were selected for confirmation directly with borrowers. The results of our confirmation efforts are summarized in Schedule A. Borrowers with lines of credit of $_______ or more as of June 30, 20X0, who did not respond to confirmation requests by July 31, 20X0, are listed in Schedule B.

We obtained and read selected loan agreements on hand, as well as readily marketable securities, and other collateral recorded as held in respect of certain selected secured loans were inspected.

We obtained the Credit Union's listing of business loans, real estate loans, and participations purchased five days or more past due as of June 30, 20X0, and compared it with a similar listing as of July 31, 20X0. The following loans were listed in both reports:

[*List loans.*]

Similarly, we obtained the Credit Union's listing of consumer loans ten days or more past due as of June 30, 20X0, and compared it to a like listing as of July 31, 20X0. The following loans were listed in both reports:

Name	*Due Date*	*Amount Outstanding at June 30, 20X0*	*Amount Outstanding at July 31, 20X0*
____________	____________	____________	____________

Loan participations "sold" and serviced by the credit union were confirmed with the purchasers, without exception.

We obtained the Credit Union's listing of overdrafts as of June 30, 20X0, and compared it to a similar listing as of July 31, 20X0. The following overdrafts were listed in both reports:

[#] *Note:* This supplement is for illustrative purposes only and, therefore, is not considered to be an all-inclusive list of accounts that may be examined and procedures that may be performed. The illustrative procedures listed may or may not be relevant to a particular engagement. The independent auditor should describe those accounts examined and procedures relevant to the specific engagement. The accounts and procedures described in the report should generally conform to those described in the engagement letter. Procedures for other accounts should be specified in detail, and differences and subsequent disposition should be reported.

Also, the accounts examined and procedures performed as described in this supplement consist of the minimum procedures described in Appendix A to the NCUA's Supervisory Committee Guide for Federal Credit Unions and optional procedures. Refer to Appendix A of the NCUA Guide for a description of the minimum procedures to be performed.

Name	*Date of Overdraft*	*Amount at June 30, 20X0*	*Amount at July 31, 20X0*
____________	____________	____________	____________

The interest rates and repayment terms of five judgmentally selected loans granted to directors, officers, and other related parties during May 20X0 were compared to the interest rate and repayment terms of similar loans granted to outsiders during the same month. No instances of the granting of favorable interest rates or repayment terms to directors, officers, and other related parties were found.

The maturity date and amount of loan commitments in excess of $50,000 were confirmed as of May 20X0 by the customers for whose benefit they were issued, without exception. We judgmentally selected five loan commitments and tested the computation of deferred fee income with satisfactory results.

Requests for confirmation of loan balances could not be mailed to the following borrowers due to lack of sufficient addresses:

Name	*Account Number*	*Balance as of June 30, 20X0*
____________	____________	____________

Lack of Evaluation of Collectibility and Adequacy of Collateral

As noted in our engagement letter and report, we did not evaluate the collectibility of loans or the adequacy of collateral thereon.

Lack of Evaluation of the Allowance for Loan Losses

As noted in our engagement letter and report, we did not evaluate the reasonableness of the allowance for loan losses determined by management.

Confirmation Statistics

[Confirmation Date]

	Loans	*Share Draft Accounts*	*Savings Accounts*	*Certificates of Deposit*
Dollar amounts				
Total				
Circularized				
Percent circularized to total				
Replies received to total circularized				
Selected but not circularized				
Not delivered by post office				
Number of accounts				
Total				
Circularized				
Percent circularized to total				

Replies received
Percent replies received to
total circularized
Selected but not circularized
Not delivered by post office

Confirmation Requests Not Mailed

	Name and Address	*Reason for Not Mailing*	*Balance as of [Audit Date]*
Loans			
Share draft accounts			
Savings accounts			
Certificates of deposit			

Note: An indication of how the samples were selected (that is, on a random, statistical, or judgmental basis), as well as an indication of the type of confirmation (that is, positive or negative requests), should be included. If the loans are categorized by type in the report, similar categories would normally be used in this schedule.

CHAPTER 23

Illustrative Financial Statements

INTRODUCTION

23.01 This chapter contains separate illustrative financial statements prepared in conformity with generally accepted accounting principles (GAAP) for (1) banks and savings institutions, (2) credit unions, (3) finance companies, and (4) mortgage companies.

23.02 The financial statements are for illustrative purposes only; are not intended to be comprehensive and are not intended to establish preference among alternative principles acceptable under GAAP. Decisions about the application of the GAAP discussed in the accounting and financial reporting sections of this Guide should not be made by reference to the illustrative financial statements but by a careful reading of the specified authoritative literature. The illustrative financial statements reflect many of the minimum disclosure requirements for the respective entity presented but do not include all of the amounts or transactions discussed in other chapters of the Guide or that might be found in practice. For example, the illustrative notes indicate the subject matter generally required to be disclosed, but they should be expanded, reduced, or otherwise modified to suit individual circumstances based on a careful reading of the specified authoritative literature.

23.03 The illustrative financial statements are in conformity with accounting standards issued up to and including Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 137, *Accounting for Derivative Instruments and Hedging Activities —Deferral of the Effective Date of FASB Statement No. 133,* except for FASB Statement No. 133. FASB Statement No. 133, as amended by FASB Statement No. 137, is effective for all fiscal quarters of fiscal years beginning after June 15, 2000. The requirements of that Statement will be reflected in the next year's edition of this Guide. Preparers and auditors of financial statements should refer to subsequent FASB Statements and other GAAP for additional requirements. Generally accepted auditing standards (Interpretation No. 3 of AU section 410, "Adherence to Generally Accepted Accounting Principles" [AICPA, *Professional Standards*, vol. 1, AU sec. 9410]) specifically address the need for the auditor to consider the adequacy of the disclosure of impending changes in accounting principles if (*a*) the financial statements have been prepared based on accounting principles that will not be acceptable in the future and (*b*) the financial statements will be restated in the future as a result of the change. In Staff Accounting Bulletin No. 74, the SEC staff indicated that recently issued accounting standards may constitute material matters and, therefore, disclosure in the financial statements should also be considered in situations where the change to the new accounting standard will be accounted for in financial statements of future periods, either prospectively or with a cumulative catch-up adjustment. Preparers and auditors of financial statements should assess the appropriateness of such disclosures pertaining to accounting standards that have been issued but do not require adoption until some future date.

23.04 Although the illustrative financial statements may include certain transactions that are not unique to the entity presented, such as disclosures about segments, employee benefit plans, and earnings per share, the illustrative financial statements are not intended to reflect all transactions that such entity may encounter. Preparers and auditors should consult authoritative pronouncements for guidance on presenting such other information.

23.05 Preparers of financial statements of entities regulated by the federal banking agencies and the National Credit Union Administration should be familiar with rules and regulations that relate to the form and content of general-purpose financial statements, rather than regulatory financial reports, filed with regulators. Such requirements involve additional information prepared in conformity with GAAP (rather than regulatory accounting practices) but that is not necessary for financial statements to be in conformity with GAAP. (Paragraphs 5.135 through 5.139 discuss the difference between regulatory financial reporting and financial statements prepared in conformity with GAAP.)

23.06 The entities illustrated herein generally present unclassified balance sheets.

23.07 The illustrative financial statements for banks and savings institutions and for finance companies encompass certain presentation issues unique to the respective financial statements, as follows.

Banks and Savings Institutions

23.08 The illustrative financial statements for banks and savings institutions assume that the entity is a registrant of the Securities and Exchange Commission (SEC). Accordingly, the illustrative financial statements reflect the application of Articles 3, 3A, 4 and 9 (to the extent that such articles are applicable to these illustrative financial statements) of Regulation S-X of the SEC. For SEC registrants, such articles have an authority similar to other officially established accounting principles. See footnote 1 to the Preface to the Guide. Preparers and auditors should consult all pertinent SEC rules and releases for guidance on presenting all information that may be required in individual situations. Disclosures required by the aforementioned Articles have been shaded for ease of identification. Certain items that are shaded may also satisfy GAAP requirements (primarily GAAP requirements that permit such information to be presented either on the face of the financial statements or in the footnotes). Therefore readers should not assume that all shaded presentations satisfy only SEC requirements. Also, certain presentations in the financial statements are not shaded, but are not necessarily GAAP requirements either (for example, certain immaterial items).

23.09 Financial statements of nonpublic entities (as defined by GAAP and including mutual institutions) may substantially differ from those presented herein. Principal differences relate to the inclusion herein of—

- A stockholders' equity section in the statement of financial condition of a stock institution
- A statement of changes in stockholders' equity which replaces the statement of changes in retained earnings as presented by a mutual institution
- Earnings-per-share data
- Segment information
- Expanded disclosures about pensions, income taxes and stock-based-compensation
- Parent-company-only financial statements
- Supplemental quarterly operations data

Finance Companies

23.10 The illustrative financial statements for finance companies represent one form of currently acceptable practice. Other financial statement formats may be equally acceptable.

23.11 The banking industry has adopted an income statement format that emphasizes the presentation of net interest income. Because of the similarity between many banking activities and finance company activities, such a presentation is of increasing relevance for the finance industry.

23.12 Alternatively, certain factors may limit the usefulness of the net interest income presentation. An income statement that does not emphasize net interest income may be more appropriate for companies that engage primarily or solely in factoring operations or that otherwise derive a substantial portion of their income from commissions for services rather than from interest earned on loans.

23.13 Therefore, the illustrative financial statements in this appendix include two alternative income statement formats, the first of which emphasizes a net interest income presentation.

23.14 Additionally, the scope of what is to be included in net interest income requires consideration. For example, as not illustrated herein, a finance company may include credit insurance premiums, and insurance claims expense on affiliated credit insurance business, in the display of net interest income to recognize the integral nature of lending and credit insurance activities. In addition, all or a portion of investment income may be included in the display of net interest income.

23.15 The illustrative financial statements reflect the application of Articles 3, 3A, and 4 (to the extent that such articles are applicable to these illustrative financial statements) of Regulation S-X of the Securities and Exchange Commission (SEC) that, for SEC registrants, have an authority similar to other officially established accounting principles. See footnote 1 to the Preface to the Guide. Preparers and auditors should consult all pertinent SEC rules and releases for guidance on presenting all information that may be required in individual situations. Financial statements of nonpublic entities (as defined by GAAP) may substantially differ from those presented herein. Principal differences relate to the inclusion herein of—

- Earnings-per-share data
- Segment information
- Expanded disclosures about pensions, income taxes and stock-based-compensation
- Parent-company-only financial statements
- Supplemental quarterly operations data

Generally Accepted Accounting Principles (GAAP)		Regulatory Accounting Practices (RAP)	
Description	*References*	*Description*	*References**

I. RECOGNITION AND MEASUREMENT

Non-accrual Loan Status

Interest Income on loans that are not impaired should be accrued and credited to interest income as it is earned. However, if it is probable that the creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement, the loan is impaired. How and when creditors should recognize, measure, or display interest income on impaired loans is not addressed.	Paragraph 6(g) of FASB Statement No. 118 (FASB, *Current Text*, vol. I, sec. I08.115); paragraph 6.47 of AICPA Audit and Accounting Guide, *Banks and Savings Institutions*.	The agencies believe that this guidance falls within the range of acceptable practice under GAAP. The agencies have adopted guidelines that Banks shall not accrue interest on any asset (1) which is maintained on a cash basis because of deterioration in the financial condition of the borrower, (2) for which payment in full of principal or interest is not expected, or (3) upon which principal or interest has been in default for a period of 90 days or more unless the asset is both well secured and in the process of collection.	Nonaccrual Status section of Glossary of Form 031 Instructions, Schedule RC of the FFIEC's Consolidated Reports of Condition and Income for Insured Banks with Domestic and Foreign Offices (Reporting Form FFIEC 031).

*This column does not include references to requirements that conform with GAAP. Only those requirements that depart from GAAP are referenced.

Generally Accepted Accounting Principles (GAAP)		Regulatory Accounting Practices (RAP)	
Description	*References*	*Description*	*References**

Valuation of Loans for Nonincurred Credit Losses

Institutions evaluate certain loans for impairment individually. If a loan is determined to be impaired, the amount of credit loss is calculated as any excess of the recorded loan amount over either (*a*) the present value of expected cash flows, discounted at the loan's effective interest rate, except as a practical expedient, a creditor may measure impairment based on a loan's observable market price, or the fair value of the fair value of the loan collateral if the loan is collateral dependent. The carrying value of the loan is reduced to the estimated present or fair value.	Paragraphs 8 and 13 of FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*, as amended by FASB Statement No. 118, *Accounting by Creditors for Impairment of a Loan's Income Recognition and Disclosures* (FASB, *Current Text*, vol. I, sec. I08.111).	The agencies believe that this guidance falls within the range of acceptable practice under GAAP. The agencies examiners often have required that institutions record credit losses (based on regulatory classification (50% for doubtful, 15% for substandard). These recorded losses often go beyond the level necessary to reduce the carrying amount of the loan to its present or fair value, even if the loan is not determined to be impaired under GAAP. Examiners attribute additional amounts to institution-specific, rather than loan-specific, factors (such as examiner assessments of the reliability of the institution's cash flow estimates and its loan review function and historical loss experience). These judgements are used as analytical tools to justify 'on-top' adjustments, rather than to amend and improve the component assumptions (such as cash flow estimates) used by the institution in estimating the loan's present or fair value.	Loan Impairment section of Glossary of Form 031 Instructions.
		Further, the FDIC requires that when available information confirms that specific loans and leases (including any recorded accrued interest, net deferred loan fees or costs, and unamortized premium or discount), or portions thereof, are uncollectible, these amounts should be promptly charged off against the allowance for loan and lease losses, regardless of whether an allowance was established to recognize impairment under FASB Statement No. 114.	FDIC Transmittal No. 95-051.

Generally Accepted Accounting Principles (GAAP)		Regulatory Accounting Practices (RAP)	
Description	*References*	*Description*	*References**

Valuation of Impaired, Collateral-Dependent Loans

Description	*References*	*Description*	*References**
Collateral-dependent loans may be valued based on one of the following: (1) the present value of expected future cash flows, discounted at the loan's effective interest rate (2) the loan's observable market price (3) the fair value of the collateral. No specific guidance exists on the timing of charge-offs.	Paragraph 13 of FASB Statement No. 114. (FASB, *Current Text*, vol. I, sec. I08.111)	The agencies believe that this guidance falls within the range of acceptable practice under GAAP. The agencies require that collateral-dependent loans be valued only based on the fair value of the collateral. The FDIC, OCC, and FRB require that the excess of the loan's carrying value over the collateral's fair value less cost to sell be charged off. The OTS permits institutions to record a specific reserve as alternative to a charge-off.	Loan Impairment section of Glossary of Form 031 Instructions; section 261 of the OTS's *Thrift Activities Regulatory Handbook*.

Foreclosed Assets

Description	*References*	*Description*	*References**
A foreclosed asset to be disposed of generally must be measured at the lower of its carrying amount or fair value (less cost to sell).	Paragraph 15 of FASB Statement No. 121 (FASB, *Current Text*, vol. I, sec. I08.134).	Despite guidance to the contrary, in practice, OTS examiners have required that institutions record additional credit losses on foreclosed assets beyond those necessary to reduce the carrying amount to fair value (less cost to sell). The OTS has further established a benchmark of 5% for such losses. The justification for such additional losses is to provide for perceived inaccuracies in the valuation process.	None.

Allowance for Loan and Lease Losses

Description	*References*	*Description*	*References**
Statement 5 provides the basic guidance for recognition of impairment losses for all receivables (except those receivables specifically addressed by other	Paragraph 8 of FASB Statement No. 5. (FASB, *Current Text*, vol. I, sec. C59.105); Paragraphs 8 and 13 of FASB Statement No. 114. (FASB, *Current Text,* vol. I, sec. 108.106, and	The agencies believe that this guidance falls within the range of acceptable practice under GAAP. The Interagency Policy guidance specifies that an adequate allowance for loan and lease losses	Allowance for Loan and Lease Losses section of Glossary of Form 031 Instructions and the *Interagency Policy Statement on the Allowance for Loan and Lease Losses*, dated December 21, 1993.

Generally Accepted Accounting Principles (GAAP)		Regulatory Accounting Practices (RAP)	
Description	*References*	*Description*	*References**
accounting literature, such as debt securities). Statement 114 proves more specific guidance on measurement and disclosure for a subset of the population of loans. That subset consists of loans that are identified for evaluation and that are individually deemed to be impaired because it is probable that the creditor will be unable to collect all the contractual interest and principal payments as scheduled in the loan agreement.	sec. 108.111.	(ALLL) should be no less than the sum of the following items given facts and circumstances as of the evaluation date (after deduction of all portions of the portfolio classified loss): (1) For loans and leases classified substandard or doubtful, whether analyzed and provided for individually or as part of pools, all estimated credit loses over the remaining effective lives of these loans. (2) For components of the loan and lease portfolio that are not classified, all estimated credit losses over the upcoming 12 months. (3) Amounts for estimated losses from transfer risk on international loans. Furthermore, when determining the appropriate level for the ALLL, management's analysis should be conservative so that the overall ALL appropriately reflects a margin for the imprecision inherent in most estimates of expected credit losses.	

Credit Losses on International Loans

Valuation allowances (for example, an allowance for credit losses on loans) are related to the assets they value (the loan or group of loans). Additions and deductions from a valuation allowance should not be made for impairments or credit losses of unrelated assets.	None	Allocated transfer risk reserves (ATRRs) are intended to recognize and measure impairment and credit losses of international assets, which are recognized and measured separately from loans. However, institutions are allowed to recognize and measure in the allowance, credit losses on loan impairments or credit losses on international assets unrelated to those loans.	12 CFR Subparts 28.52(c)(2) and (4).

Generally Accepted Accounting Principles (GAAP)		Regulatory Accounting Practices (RAP)	
Description	*References*	*Description*	*References**

Sales with Minor Leasebacks

Sale-leaseback transactions involve the sale of property by the owner and a lease of the property back to the seller. In a sale with a minor leaseback, the seller-lessee relinquishes the right to substantially all of the remaining use of the property sold, retaining only a minor portion of such use. If the amount of the rentals is unreasonable under market conditions at the inception of the lease, an appropriate amount must be deferred or accrued (by adjusting the profit or loss on the sale) and amortized in proportion to the amortization of the leased asset (if a capital lease) or in proportion to the related gross rental charged to expense over the lease term (if an operating lease) to adjust the rentals to a reasonable amount (profit allocation).	Paragraph 33 of FASB Statement No. 13, *Accounting for Leases*, as amended by paragraph 3 of FASB Statement No. 28, *Accounting for Leases: Sale-Leaseback Transactions Involving Real Estate, Sales-Type Leases of Real Estate, Definition of the Lease Term, Initial Direct Costs of Direct Financing Leases* (FASB, *Current Text*, vol. I, sec. L10.128-129).	The FDIC requires that the profit allocation in a sale with a minor leaseback must be based on an assumed minimum-lease-term of ten years (regardless of the actual minimum lease term). The FDIC allows the actual lease term to be used only if the institution's management has evidence sufficient to confirm that the lease is actually short-term. The FDIC also requires that if the institution finances the transaction (as seller-lessee), the profit recognition must be based on the longer of the note term or the lease term, unless management has evidence sufficient to show that the lease term is actually shorter than that of the note. The other agencies follow GAAP.	Section 3.4 of the FDIC Division of Supervision's *Manual of Examination Policies*.

Income Taxes of Subsidiaries Within a Consolidated Group

In practice, income taxes generally are allocated to members within a consolidated group in accordance with a tax sharing agreement.	None.	The agencies believe that this guidance falls within the range of acceptable practice under GAAP. Each banking subsidiary must be treated as if it were a separate legal entity. An institution is not permitted to receive or make payments to its holding company to the extent the amount differs from the amount owed or due on a separate entity basis.	Taxes (Income) of a Bank Subsidiary of a Holding Company section of Glossary of Form 031 Instructions; Topic 9 (Income Taxes) of the OCC's *Bank Accounting Advisory Series* (June 1994).

Generally Accepted Accounting Principles (GAAP)		Regulatory Accounting Practices (RAP)	
Description	*References*	*Description*	*References**
		If payments are made in excess of that required on a separate entity basis, the institution must record the excess as dividend payments. If payments are less than that required on a separate entity basis, the institution must record the difference as capital contributions.	
		The OTS also requires that a thrift subsidiary be treated no less favorably than if it were on a stand along basis.	

Acquirer's Accounting Pushed Down to Acquiree's Financial Statements

Generally Accepted Accounting Principles (GAAP)		Regulatory Accounting Practices (RAP)	
Description	*References*	*Description*	*References**
Push-down accounting is not required for institutions that do not register with the Securities and Exchange Commission. For SEC registrants, if ownership of an institution changes by 95% or more, the acquired institution must use the acquiring institution's basis of accounting in preparing the acquired institution's financial statements (push-down accounting). A change in control means that a person, company or control group obtains ownership in a transaction or planned series of transactions.	SEC SAB No. 54, *Application of Push Down Basis of Accounting in Financial Statements of Subsidiaries Acquired by Purchase*; EITF Issue No. 86-9, *IRC Section 338 on Push-Down Accounting*.	The agencies believe that this guidance falls within the range of acceptable practice under GAAP. OTS literature requires push-down accounting when there is at least a 90% change in control of all entities, whether or not they are public companies. However, for public companies and in certain other circumstances, the OTS's practice is to require push-down accounting when there is a change in ownership of 95% or more. The OTS does not limit its definition of a change of control to a single buyer or control group taking ownership, but includes a change of ownership to a large group of individual buyers acting independently.	Appendix A of the OTS's Service Corporation Handbook
		The other agencies require push-down accounting for all entities, public or private, when there is at least a change in ownership of 95% or more.	Business Combinations section of Glossary of Form 031 Instructions

Generally Accepted Accounting Principles (GAAP)		Regulatory Accounting Practices (RAP)	
Description	*References*	*Description*	*References**

Related Party Transactions

Transfers of nonmonetary assets to a stockholder (such as dividends-in-kind) must be recorded at fair value; however, that accounting does not apply to transfers of nonmonetary assets solely between companies or persons under common control. Rather, such transfers are accounted for at historical cost in a manner similar to that in pooling of interests accounting.	Paragraphs 4 and 18 of APB Opinion No. 29, *Accounting for Nonmonetary Transactions* (FASB, *Current Text*, vol. I, sec. N35.105); Interpretation 39 in FASB *Accounting Interpretations of APB Opinion No. 16*. [Note: Other specific transactions are addressed in EITF Issues No. 87-17, *Spinoffs or Other Distributions of Loans Receivable to Shareholders*, and No. 96-14, *Accounting for Reorganizations Involving a Non-Pro Rata Split-off of Certain Nonmonetary Assets to Owners*.]	The agencies believe that this guidance falls within the range of acceptable practice under GAAP. The FDIC maintains that transfers of assets other than cash (for example, securities of another company or real estate) to a stockholder or related party must be recorded at their fair value at the declaration date of the dividend, as if the transfer were completed at arm's length. However, this accounting is governed by the facts and circumstances of the transaction and there are often exceptions to this policy. The OTS and the OCC follow GAAP.	Dividends section of Glossary of Form 031 Instructions
Institutions must disclose the aggregate amount of loans to directors, officers, employees, and stockholders, as well as to entities with which directors, officers, employees, and stockholders are affiliated.	General guidance on related party disclosures is established in FASB Statement No. 57, *Related Party Disclosures* (FASB, *Current Text*, vol. I, sec. R36.101); paragraph 6.79 of AICPA Audit and Accounting Guide, *Banks and Savings Institutions*.	Institutions must disclose extensions of credit to executive officers, directors, principal shareholders, and their related interests.	Schedule RC-M and related instructions to Form 031 Instructions.

Generally Accepted Accounting Principles (GAAP)		Regulatory Accounting Practices (RAP)	
Description	*References*	*Description*	*References**

II. DISPLAY

Accounting Changes

New GAAP pronouncements specify how institutions must report accounting changes needed to conform to the new requirements. Some new pronouncements require or allow retroactive application.	APB Opinion No. 20, *Accounting Changes*. (FASB, *Current Text*, vol. I, sec. A06.401)	Call Report and TFR covers a single discrete period, which prohibits the restatement of prior year's Call Report. As a result, the agencies require that the effect (on undivided profits) of required retroactive application of a new pronouncement be excluded from net income and reported as a direct adjustment to equity capital.	Accounting Changes section of Glossary of Form 031 Instructions.

Gain/Loss on Certain Sales

SEC registrants are required to include in *noninterest expense* the net cost of foreclosed real estate, including gains, losses, and rental income. In practice, classification by nonregistrants of gains and losses on sales of loans, real estate owned, fixed assets (including branch office assets), and other assets varies.	Article 9.04.14(d) of SEC Regulation S-X.	The agencies require that institutions always include rental income in noninterest income. Banks to consistently report net gains (losses) on the sale of certain assets as either other noninterest income or as other noninterest expense.	Line 5(f)(2) and 7(c) on Schedule RI and related instructions of Form 031 instructions.

APPENDIX D

Information Sources

Further information on matters addressed in this Guide is available through various publications and services listed in the table that follows. 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 the user 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 telephone 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 for data lines.~~

Organization	General Information	Fax Services	World Wide Web	Recorded Announcements
American Bankers Association	1120 Connecticut Avenue, N.W. Washington, DC 20036 (202) 663-5000		www.aba.com	
America's Community Bankers	900 19th Street N.W., Suite 400 Washington, DC 20006 (202) 857-3100		www.acbankers.org	

Organization	General Information	Fax Services	World Wide Web	Recorded Announcements
American Institute of Certified Public Accountants	*Order Department* Harborside Financial Center 201 Plaza Three Jersey City, NJ 07311-3881 (888) 777-7077	*24 Hour Fax Hotline* (201) 938-3787	www.aicpa.org	
Conference of State Bank Supervisors	1015 18th Street N.W., Suite 1100 Washington, DC 20036 (202) 296-2840		www.csbs.org	
Credit Union National Association	805 15th Street N.W., Suite 300 Washington, DC 20005 (202) 682-4200		www.cuna.org	
Federal Deposit Insurance Corporation	*Corporate Communication* 550 17th Street, NW Washington, DC 20429-0001 (202) 898-6996	*Facsimile Bulletin Board System* (804) 642-0003/2036	www.fdic.gov	*Action Update* (202) 898-7210
Federal Reserve System	*Publications Services* 20th and C Streets, NW Washington, DC 20429-0001 (202) 452-3245	*U.S. Department of Commerce STAT-USA/FAX.* Some information is available to guest users. Other information requires a subscription fee. (202) 482-0005	www.frb.gov	*Federal Reserve Board Highlights* (202) 452-3206
Federal Home Loan Mortgage Corporation (Freddie Mac)	*Customer Service* 8200 Jones Branch Drive McLean, VA 22102-3107 (800) FREDDIE		www.fhlmc.org	

Organization	General Information	Fax Services	World Wide Web	Recorded Announcements
Financial Accounting Standards Board	*Order Department* P.O. Box 5116 Norwalk, CT 06856-5116 (203) 847-0700, ext. 10		www.fasb.org	*Action Alert Telephone Line* (203) 847-0700 (ext. 444)
Financial Managers Society	230 West Monroe Street Suite 2205 Chicago, IL 60606 (312) 578-1300		www.fmsinc.org	
Financial Services Roundtable	805 15th Street, N.W. Suite 600 Washington, DC 20005 (202) 289-4322		www.bankersround.org	
Independent Community Bankers of America	One Thomas Circle, NW Suite 400 Washington, DC 20005 (202) 659-8111		www.icba.org	
Independence Standards Board	1211 Avenue of the Americas New York, NY 10036-8775 (212) 596-6133	(212) 596-6137	www.cpaindependence.org	
Mortgage Bankers Association of America	~~*Publications Department*~~ ~~1125 15th Street, NW Washington, DC 20005-2766~~ ~~(800) 793-MBAA~~ 1919 Pennsylvania Ave., NW Washington, DC 20006 (202) 557-2700	*MBA Fax on Demand* This service is available only to MBA members. For more information, call (800) 909-6222.	www.mbaa.org	
National Association of Federal Credit Unions	3138 North 10th Street Arlington, VA 22201 (703) 552-4770		*www.nafcunet.org*	

Organization	General Information	Fax Services	World Wide Web	Recorded Announcements
National Association of Insurance Commissioners	444 North Capital Street, NW Suite 701 Washington, DC 20001-1512 (202) 624-7790		*www.naic.org*	
National Association of Real Estate Investment Trusts	1875 Eye Street, NW Washington, DC 20006 (202) 739-9400		*www.nareit.com*	
National Automated Clearing House Association	13665 Dulles Technology Drive Suite 300 Herndon, VA 20171 (703) 561-1100		*www.nacha.org*	
National Credit Union Administration	*Office of Public and Congressional Affairs* 1775 Duke Street Alexandria, VA 22314		*NCUA Bulletin Board* All information is available to guest users. (703) 518-6480 *NCUA World Wide Web home page* www.ncua.gov	*Newsline* (800) 755-1030 (703) 518-6339 (Washington, DC area)
Securities Industry Association	120 Broadway, 35th Floor New York, NY 10271-0080 (212) 608-1500		www.sia.com	
U.S. Department of the Treasury—Office of the Comptroller of the Currency	*Publications Control* P.O. Box 70004 Chicago, IL 60673-0004 (202) 874-4960	*OCC Information Line* (202) 479-0141	www.ustreas.gov	
U.S. Department of the Treasury—Office of Thrift Supervision	*OTS Dissemination Branch* 1700 G Street, NW Washington, DC 20552-0001 (202) 906-5900		www.ots.treas.gov	

Organization	General Information	Fax Services	World Wide Web	Recorded Announcements
U.S. Department of Education	*Federal Student Aid Information Center* (800) 433-3243		www.ed.gov	
U.S. General Accounting Office	*Superintendent of Documents* U.S. Government Printing Office Washington, DC 20401-0001 (202) 512-1800 (202) 512-2250 (f)	*Information Line* (202) 512-2250	www.gpo.gov	
U.S. Government Printing Office	*Superintendent of Documents* U.S. Government Printing Office P.O. Box 371954 Pittsburgh, PA 15250 (202) 512-1800		www.access.gpo.gov	
U.S. Securities and Exchange Commission	*Publications Unit* 450 Fifth Street, NW Washington, DC 20549-0001 (202) 942-4046 *SEC Public Reference Room* (202) 942-8078	*Information Line* (202) 942-8090 (ext. 3) (202) 942-8092 (tty)	www.sec.gov	*Information Line* (202) 942-8090 (202) 942-8092 (tty)