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AICPA

Audit and Accounting Guide

AUDITS of FINANCE COMPANIES

(Including Independent and Captive Financing Activities of Other Companies)

With Conforming Changes as of May 1, 1994

AICPA

Audit
and
Accounting
Guide

AUDITS of FINANCE COMPANIES

(Including Independent and Captive Financing Activities of Other Companies)

With Conforming Changes as of May 1, 1994

This edition of the audit and accounting guide *Audits of Finance Companies (Including Independent and Captive Financing Activities of Other Companies)*, which was originally issued in 1988, has been modified by the AICPA staff to include certain changes necessary due to the issuance of authoritative pronouncements since the guide was originally issued. The changes made are identified in a schedule in Appendix D of the guide. The changes do *not* include all those that might be considered necessary if the guide were subjected to a comprehensive review and revision.

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NOTICE TO READERS

This audit and accounting guide presents recommendations of the AICPA Finance Companies Guide Special Committee on the application of generally accepted auditing standards to audits of financial statements of finance companies. This guide also presents the committee's recommendations on and descriptions of financial accounting and reporting principles and practices for finance companies. The AICPA Accounting Standards Executive Committee and members of the AICPA Auditing Standards Board have found this guide to be consistent with existing standards and principles covered by Rules 202 and 203 of the AICPA Code of Professional Conduct. AICPA members should be prepared to justify departures from this guide.

Finance Companies Guide Special Committee (1988)

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Preface

Applicability

This guide has been prepared to assist the independent auditor in auditing and reporting on financial statements of finance companies. The guide also applies to independent and captive financing activities of other companies. It does not apply to banks, savings and loan associations, credit unions, or insurance companies; however, the guide does apply to finance company subsidiaries of such entities.

Banks, savings and loan associations, credit unions, and insurance companies are covered by other guides, and there might be differences in the way they account for similar transactions. The AICPA is considering a project to harmonize the accounting principles for the financial industry.

This guide is based on the assumption that the readers are generally expert in accounting and auditing. Accordingly, the discussion of audit procedures concentrates primarily on aspects unique to finance companies and financing activities. The nature, timing, and extent of such auditing procedures are a matter of professional judgment and depend on the size, organizational structure, internal control structure, and other factors in a particular engagement.

Changes in Accounting Practices

This guide recommends the following changes in accounting practices that the committee believes are desirable and warranted:

- Recognition of interest income on finance receivables using the interest method;
- Use of the accrual with suspension basis for recording interest income; and
- Inclusion of interest as a holding cost in determining the carrying amount of repossessed collateral expected to be held for more than a brief period.

In addition, the revised guide includes an expanded discussion of the insurance activities of finance companies.

The 1973 AICPA Industry Audit Guide, *Audits of Finance Companies*, provided for revenue recognition methods other than those listed above, including the Rule of 78s, the combination method, and the cash method. In accordance with FASB Statement No. 91 and conclusions reached by the Accounting Standards Division in preparing this guide, use of those alternative methods is no longer considered to be acceptable.

Transition and Effective Dates

This guide supersedes the 1973 AICPA Industry Audit Guide, *Audits of Finance Companies.*

Generally accepted accounting principles (GAAP) applicable to business entities in general apply to finance companies. Accordingly, the financial accounting standards established by pronouncements of the Financial Accounting Standards Board (FASB) and its predecessor bodies of the American Institute of Certified Public Accountants apply to finance companies.

FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated With Originating or Acquiring Loans and Initial Direct Costs of*

Leases, requires finance companies to make certain changes in their accounting for fees and expenses. The committee believes the changes recommended in this guide concerning recognition of interest income (revenue) and inclusion of interest as a holding cost in determining the carrying amount of repossessed collateral should be made at the same time and in the same manner as changes are made to comply with FASB Statement No. 91.

FASB Statement No. 91, paragraph 28, states

> This Statement shall be applied prospectively to lending and leasing transactions entered into and commitments granted in fiscal years beginning after December 15, 1987 and interim periods within those fiscal years. Retroactive application, by restating all prior years presented, is encouraged but not required. Earlier application is encouraged in fiscal years for which financial statements have not previously been issued. In the year that this Statement is first applied, the financial statements shall disclose the nature of accounting changes adopted to conform to the provisions of this Statement and their effect on income before extraordinary items, net income, and related per share amounts for the current year and for each restated year presented. If adopted prospectively, disclosure of the accounting change and the prior accounting policies shall be continued in financial statements of subsequent years in which outstanding loans accounted for under the prior policy are material.

Other provisions of this guide shall be effective for audits of financial statements for periods ending on or after June 30, 1988.

Finance Companies Guide Special Committee

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Glossary

Chapter 1

Activities of Finance Companies

1.01 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. Consumer and commercial financing both encompass a wide variety of activities, many of which are discussed in this chapter.

1.02 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.

Consumer Finance Activities

1.03 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.

Direct Consumer Loans

1.04 Direct consumer loans usually are repayable in installments and may be collateralized by household goods and other chattels or may be unsecured. The creditworthiness of the individual borrower is generally the lender's primary consideration in making direct consumer loans; however, as the size of the loan increases, other factors, such as the existence and value of collateral or the presence of a comaker, may become increasingly important.

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

1.06 Mortgage loans generally have larger principal amounts and lower average interest rates than other direct consumer loans. Lenders usually consider borrowers who are homeowners to be good credit risks because the loans are collateralized by the borrowers' homes and, even if the borrowers default, residential real estate tends to hold resale value to a greater degree than other forms of collateral. Loss experience on mortgage loans generally has been less than on other forms of consumer loans.

1.07 Mortgage lending, however, involves other risks. If the real estate market weakens, perhaps because of severe unemployment in a given geographical area, substantial losses may be incurred. Mortgage loans tend to have longer repayment periods than other types of direct consumer loans; this factor by itself may increase a lender's risk. Because first mortgage loans have priority, a second mortgage lender generally must buy out prior lenders or take title subject to the rights of such lenders. Second mortgage lenders may, therefore, need to make significant cash payments to protect collateral.

Retail Sales Contracts

1.08 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.

1.09 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.

1.10 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.

1.11 Terms for payment of dealer reserves and holdbacks vary. Dealer reserves may be reduced for losses and rebates on related loans. The remaining balances generally are paid periodically when amounts exceed agreed minimum percentages of related outstanding receivables. Minimum percentages are based on factors such as loss experience for contracts previously bought from such dealers, experience with lending to purchasers of similar types of merchandise, and credit quality of the purchasers. Alternatively, dealer reserves and holdbacks may be paid only after customers' loans are paid off in full.

Insurance Services

1.12 Many companies engaged in consumer finance activities also offer insurance coverage to their customers. Such coverage may include life insurance to help assure that remaining loan balances are repaid if borrowers die before loans are repaid; accident and health insurance to help 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.

Commercial Finance Activities

1.13 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. This guide refers to all such activities as **commercial finance activities**.

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

Factoring

1.15 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.

1.16 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.

1.17 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.

1.18 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.

1.19 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.

Revolving Loans

1.20 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.

1.21 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.

Receivables Portfolio Purchase Agreements

1.22 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.

1.23 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.

Installment Loans

1.24 Finance companies may make commercial installment loans collateralized by capital assets. The amounts of such installment loans usually are based on percentages of the collateral market values and vary depending on policies of the finance company lender, financial condition of the borrower, and liquidity of the pledged collateral. Finance companies also may make mortgage loans to commercial borrowers. Some installment loans are made under conditional sales contracts, in which title to the collateral is held in the name of the lender until loans are repaid.

Floor Plan Loans

1.25 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.

Leases

1.26 Leasing is a common way to finance the acquisition of equipment. 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. FASB Statement No. 13, *Accounting for Leases,* and its related interpretations and amendments provide authoritative guidance on accounting for leases.

1.27 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.

1.28 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.

1.29 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.

1.30 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.

1.31 Finance companies also may serve as *lease brokers*—that is, as intermediaries between lessors and lessees for a fee. The June 20, 1980, AICPA issues paper, *Accounting by Lease Brokers,* and FASB Technical Bulletin 86-2, *Accounting for an Interest in the Residual Value of a Leased Asset Acquired by a Third Party or Retained by a Lessor That Sells the Related Minimum Rental Payments,* provide additional information on lease broker arrangements. Copies of the issues paper are available from the AICPA.

Participations

1.32 Commercial finance companies sometimes enter into participation agreements with other lenders to maintain acceptable levels of risk or to provide the borrowers with lower costs or additional services. The agreements generally provide for losses to be shared mainly in proportion to the cash invested by each party.

Debt Financing of Finance Companies

1.33 The basic activity of finance companies is borrowing money at wholesale and lending it at retail. Finance companies usually are leveraged with outstanding borrowings equal to several times equity. Finance companies may have senior debt, senior subordinated debt, and junior subordinated debt. The existence of restrictive covenants in debt agreements is common.

1.34 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

1.35 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.

Direct Consumer Lending

1.36 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

1.37 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

1.38 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

1.39 The Uniform Commercial Code (UCC), fully adopted by all states, except Louisiana, at the date of issuing this guide, 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.

1.40 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.

1.41 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.

1.42 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.

1.43 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.

Chapter 2

Finance Receivables, Finance Income, and Operating Procedures

2.01 Finance receivables normally are the most significant portion of a finance company's total assets. This chapter describes many aspects of accounting for and auditing finance receivables and related accounts.

Accounting for Finance Receivables

2.02 Finance receivables include both interest-bearing (simple interest) and precompute (discount) loans. State regulatory laws often prescribe the types of loans that can be made; otherwise, the type of loan is a matter of operating and customer choice. The face amount of an interest-bearing loan equals the amount of cash loaned; unearned interest is not determined. In a discount loan, however, the amount of cash loaned to the borrower is less than the face amount of the loan. The difference represents unearned interest income to be earned by the lender over the life of the loan. The borrower generally is entitled to pay less than the remaining unpaid face amount if the balance due on a discount loan is paid off faster than contractually scheduled. That difference, commonly called a *rebate,* represents a cancellation of a portion of the precomputed interest charge.

2.03 Sales-type leases and direct financing leases are substantially similar to other forms of installment loans. However, accounting for lease transactions may differ from accounting for other financing transactions. FASB Statement No. 13, *Accounting for Leases,* and its related amendments and interpretations prescribe accounting for leases and their financial statement presentation.

Accounting for the Allowance for Loan Losses

2.04 A finance company should maintain a reasonable allowance for credit losses applicable to all categories of receivables through periodic charges to operating expenses. The amount of the provision can be considered reasonable when the allowance for credit losses, including the current provision, is adequate to cover estimated losses in the receivables portfolio.

2.05 The allowance for loan losses reduces the carrying amount of loans receivable to the amount that is estimated to be collectible. FASB Statement No. 5, *Accounting for Contingencies,* and FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss,* provide the accounting guidance for recognition of estimated losses from the uncollectibility of receivables. FASB Statement No. 5 requires that an allowance for credit losses be established through a charge to the provision for loan losses in the period when it is probable that an asset *has been* impaired and the amount can be reasonably estimated. FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan,* addresses the accounting by creditors for impairment of certain loans. It is applicable to all creditors and to all loans, uncollateralized as well as collateralized, except large groups of smaller-balance homogeneous loans that are collectively evaluated for impairment, loans that are measured at fair value or at the lower of cost or fair value, leases, and debt securities as defined in FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities.* It applies to all loans that are restructured in a troubled debt restructuring involving a modification of terms. FASB Statement No. 114 requires that impaired loans that are within its scope be measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or, as a practical expedient, at the loan's observable market price or the fair value of the collateral if the loan is collateral dependent. FASB Statement No. 114 amends 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. FASB Statement No. 114 applies to all financial statements for fiscal years beginning after December 15, 1994.

2.06 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. Management's analysis of historical loan loss experience may identify specific factors that indicate that loans have become impaired. Those factors, when evaluated collectively for loan portfolios over a period of time, often provide reasonably reliable indications of when such loss events have occurred.

2.07 Many consumer finance companies determine the allowance for credit losses using the portfolio approach because performing a receivable-by-receivable analysis would be impractical. In the portfolio approach, mathematical models that incorporate techniques such as linear regression analysis sometimes are used to estimate losses in the portfolio. Simpler methods also are used, such as estimating the reserve based on the historical percentage of loans made or outstanding that are written off.

2.08 Other finance companies periodically evaluate specific outstanding loans to identify those loans for which events have occurred that are likely to impair collectibility or collateral values, or both. This approach is more commonly used for large loans and diverse portfolios.

2.09 Regardless of the method used to estimate the allowance for credit losses, present conditions such as the amount of delinquent receivables and the number of days they are past due; local, national, and international economic trends; credit policies and procedures; and the mix of receivables should be taken into account in evaluating the adequacy of the allowance.

Accounting for Interest Income

2.10 The distinction between interest-bearing and discount-basis loans has no economic or accounting significance. Paragraph 15 of APB Opinion No. 21, *Interest on Receivables and Payables,* requires, among other things, that discounts on receivables and payables be amortized as interest income or expense. The concepts and principles discussed in this chapter therefore apply to both types of loans.

2.11 Interest income should be measured and recognized in a manner that reflects the economic substance of the underlying transactions. Interest income derived from a loan accrues continuously at a constant rate over the periods that a finance company's resources are held by others. The following constitute the major factors that determine interest income:

a. The amount of money provided to others

b. The periods over which the money is provided

c. The effective interest rate

2.12 Captive finance companies that offer favorable financing to increase sales of related companies may present particular problems. 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.

Measurement

2.13 The interest (actuarial) method should be used to account for interest income in accordance with FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated With Originating or Acquiring Loans and Initial Direct Costs of Leases.* Under that method, interest on fixed-rate installment loans is measured and accrued over the lives of the loans to produce constant rates of interest (yields) when applied to the outstanding loan balances at any time in the lives of the loans. Application of the method produces loans carried at amounts equal to future receipts discounted at interest rates implicit in original loan agreements, excluding differences resulting from credit losses. Other computational methods may not be used unless they clearly produce results that reasonably approximate the interest (actuarial) method.

Recognition

2.14 A finance company's revenues from loans should be accrued over time in accordance with the terms of the contracts using the interest (actuarial) method. Even if collections are not timely, the amounts at which assets are recorded in the form of receivables generally should continue to increase. If collection is not probable, however, continuing to accrue income would not reflect economic substance. Accruals or amortization of discount and, in accordance with FASB Statement No. 91, paragraph 17, amortization of deferred net fees or costs should therefore be suspended if collectibility of interest or principal is not probable. The following are examples of events that could cause such uncertainty on consumer loans:

a. The borrower is in default under the terms of the loan agreement, and interest or principal payments are past due (often a stipulated number of days past due as established in company policies).

b. The ability of the borrower to repay is in doubt because of events such as loss of employment or bankruptcy.

c. The loan terms have been renegotiated.

2.15 Identifying commercial loans on which interest should be suspended is, at least mechanically, more difficult because, unlike consumer loans, commercial loans usually lack homogeneous characteristics. In addition to the factors described above, considerations may include whether—

a. Significant unsecured balances are due from debtors suffering continued operating losses.

b. The financial condition of the debtor is weak.

c. The outlook for the debtor's industry is unfavorable.

d. The ratio of collateral values to loans has decreased because of changes in market conditions.

e. A portion of the unpaid principal or accrued interest has been written off.

When recognition of interest has been suspended, interest income that has accrued on such loans should not be reversed even though receipt of those amounts may not be forthcoming. The potential uncollectibility of such amounts should be taken into consideration in the computation of the allowance for losses.

2.16 Accrual of interest generally should not be resumed until future collectibility of the loan and accrued interest becomes probable. Determining future collectibility is a matter of judgment that depends on considerations such as—

- Whether the customer has resumed making regular payments for a certain number of installments.
- Whether the reason for the customer's delinquency has been eliminated (such as reemployment of a consumer borrower or an improved economic outlook for a commercial borrower) or was an isolated circumstance unlikely to recur.
- Whether an increase in the ratio of collateral values to loan amounts has occurred.
- Whether there are any other substantive indications of the customer's regaining an ability to repay the loan.

Nonrefundable Fees

2.17 Finance companies may charge various types of fees to customers in connection with lending transactions, including the following:

a. *Origination fees*—amounts charged for originating loans. The amounts may be intended to cover the cost of underwriting, loan application processing, and reviewing legal titles to properties involved in the loans. Origination fees commonly are called points.

b. *Commitment fees*—consideration potential borrowers pay to potential lenders for promises to lend money in the future.

c. *Delinquency fees*—amounts debtors pay because of late payments on loans. Such fees generally are small and are intended to cover additional interest on precompute loans, to compensate the lender for additional collection costs associated with delinquencies, or both.

d. *Prepayment penalties*—amounts borrowers pay to lenders, in addition to remaining outstanding principal, if borrowers pay off loans prior to contractual maturities.

2.18 FASB Statement No. 91 prescribes accounting for nonrefundable fees and costs associated with lending, committing to lend, or purchasing a loan or group of loans and their financial statement presentation. FASB Statement No. 91 specifies that—

- Loan origination fees shall be recognized over the life of the related loan as an adjustment to yield.
- Certain direct loan origination costs shall be recognized over the life of the related loan as a reduction of the loan's yield.
- All loan commitment fees shall be deferred except for certain retrospectively determined fees; commitment fees meeting specified criteria shall be recognized over the loan commitment period; all other commitment fees shall be recognized as an adjustment of yield over

the related loan's life or, if the commitment expires unexercised, recognized in income upon expiration of the commitment.

- Loan fees, certain direct loan origination costs, and purchase premiums and discounts on loans shall be recognized as an adjustment of yield generally by the interest method based on the contractual terms of the loan. Prepayments, however, may be anticipated in certain circumstances.

2.19 Delinquency fees conceptually should be recognized in income when chargeable, assuming collectibility is reasonably estimable. In practice, delinquency fees generally are recognized in income when collected, because that approach simplifies efforts to account for such relatively minor receipts.

2.20 Prepayment penalties should not be recognized in income until loans are prepaid.

Rebates

2.21 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 income on discount loans should not be affected by the possibility that rebates may be calculated on a method different from the interest method. 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.

Accounting for Factoring Commissions

2.22 Finance companies consider the extent of services to be provided under factoring arrangements by reviewing prospective clients' business operations. The amount a finance company charges as a factoring commission is based on such considerations as sales volume, number of invoices issued monthly, collection activities, and patterns of returns and chargebacks. If the finance company buys a client's receivables, the client is charged a commission, usually based on a percentage of receivables purchased, which is derived from the extent of services expected to be provided and the degree of credit risk assumed.

2.23 Finance companies should recognize factoring commissions over the periods in which services are rendered. Those periods begin when finance companies approve customers' credit and end when the customers' accounts are settled. In practice, finance companies generally recognize factoring commissions when receivables are bought, not over the longer period of providing services, because the differences between the effects of such allocations and the effects of immediate recognition generally would be immaterial. If the differences between the effects of such allocations and the effects of immediate recognition are material, then factoring commissions are recognized over the longer period of providing services.

Accounting for Advances and Overadvances to Factoring Clients

2.24 Under advance factoring arrangements, finance companies generally do not treat advances to clients as receivables for financial statement purposes. Instead, advances are applied against amounts owed to clients from the purchase of clients' customer receivables. Such treatment is sound and is based on finance companies' expectations of repayment through collection of customer receivables rather than of direct repayment from clients.

2.25 Finance companies generally limit advances to percentages of the unpaid amounts of factored receivables. If clients require advances in excess of the maximum permitted under the factoring arrangements, finance companies may renegotiate the percentage limitation on advances or require clients to grant security interests in inventory or other assets. Overadvances, which are amounts in excess of outstanding receivables bought, create additional credit risk exposure for lenders. Such overadvances should be recorded as loans receivable and segregated from customer receivables bought under factoring arrangements.

Accounting for Repossessed Assets Acquired in Liquidation of Receivables

2.26 When finance companies foreclose on loans deemed uncollectible, they may repossess goods or other properties that collateralize loans. After repossession, collateral usually is sold as quickly as possible to minimize losses. Repossessed assets acquired in loan liquidations may be significant because they absorb or reduce credit losses from defaulted loans.

2.27 Certain types of collateral may be readily salable in wholesale or other markets. Repossessions of such collateral are common. Repossessions of other types of collateral, such as household goods, usually entail losses because the market values of such collateral are so low that costs of repossession exceed expected sale proceeds. The primary purpose of such collateral often is to prompt borrowers to repay loans out of concern that the collateral could be repossessed.

2.28 Repossessions on commercial loans can result in substantial losses because of the bargain prices usually associated with reselling inventories and property, plant, and equipment. Auctioneers or other specialists may be needed to help sell the specialized types of properties that usually collateralize commercial loans.

Recourse Arrangements on Sales of Retail Contracts

2.29 Whether the finance company or the dealers are responsible for repossession losses originating from retail contracts depends on how the agreements provide for recourse between the parties. Terms of recourse arrangements, which vary considerably, include the following:

a. *Full recourse.* The dealer is required to pay off the uncollected receivable balance to the finance company at the date of repossession. Such balances ordinarily are net of unearned insurance premiums and finance income, and dealers are responsible for selling the repossessed property.

b. *Partial or limited recourse.* The dealer is liable for repossession losses up to an agreed amount (for example, the balance in his dealer's reserve account). The dealer's liability also may be partially or fully limited after passage of a defined period.

c. *Nonrecourse.* Loss is borne entirely by the finance company.

2.30 Repurchase agreements, which may incorporate recourse provisions as described above, also may exist between the finance company and dealers. Although such agreements vary, they generally provide that the dealer will buy back the collateral from the finance company at a predetermined price in the event of customer default and repossession by the finance company. The dealer may settle a repurchase obligation in cash or, if permitted by the finance company, by substituting other retail contracts.

Lower of Unpaid Balance and Fair Value

2.31 Borrowers' accounts should be credited for the unpaid loan balances or fair values of repossessed properties, whichever are lower. Borrowers' accounts also are credited for proceeds from cancellation of insurance, rebates of unearned finance income, and, if applicable, amounts transferred from dealer reserves in accordance with provisions of retail sales financing agreements. The remaining balances in the borrowers' accounts, commonly called *deficiency balances,* are adjustments of previous loss estimates and should be charged to the allowance for losses. In those instances in which proceeds from the sale of repossessed properties exceed the unpaid loan balance and are not required to be refunded, that excess should be recognized as a gain.

2.32 Repossessed assets * should be carried at cost and classified on the balance sheet as other assets. Cost should be determined at the time of repossession or foreclosure based on the lower of (*a*) unpaid loan balance and (*b*) fair value of repossessed assets.

2.33 If repossessed assets are held or likely to be held for more than a brief period of time prior to sale, cost (as defined in paragraph 2.32 above) should periodically be evaluated for recoverability, and a separate, additional valuation allowance for loss should be provided based on "net realizable value" determined as follows:

a. Estimated future sales price plus proceeds from use during the expected holding period, reduced by

b. Estimated costs of disposition, and reduced by

c. Estimated holding costs, such as taxes and maintenance, including the cost of funds tied up in holding such assets. The cost of funds should be based on the enterprise's combined cost of debt and equity.

2.34 Costs of capital improvements incurred in readying repossessed assets for sale that increase their values should be added to the carrying amount of the repossessed property. However, no amount should be capitalized that would increase the carrying amount above net realizable value. Differences between the carrying amounts of repossessed assets and amounts at which they subsequently are sold should not be charged or credited to the allowance for losses but should be recognized as gains or losses.

2.35 Although the accounting for repossessed assets should be based on fair values in accordance with FASB Statement No. 15 and SOP 92-3, it may be impractical to estimate the fair values of some repossessed consumer goods. As a practical solution to that problem, finance companies that expect to hold such repossessed goods for only short periods before reselling them sometimes carry those goods at the unpaid loan balances.

* SOP 92-3, *Accounting for Foreclosed Assets,* provides guidance on determining the balance sheet treatment of foreclosed assets after foreclosure. The SOP, which is included as Appendix C of this guide, should be applied to foreclosed assets in financial statements for periods ending on or after December 15, 1992.

Accounting for Dealer Reserves and Holdbacks

2.36 Finance companies account for dealer reserves and holdbacks as liabilities. Dealer reserve accounts are credited for the contractually agreed dealer's share of the finance charges. Dealer reserve accounts may be charged for portions of finance income not earned as a result of customers paying off contracts before maturity. Charges also result from losses on full or partial recourse contracts and from payments to dealers in excess of minimum requirements.

Accounting for Sales of Receivables

2.37 A finance company may sell a portfolio of receivables to another finance company or financial institution for various reasons. For example, the buyer may be willing to pay an attractive premium for a portfolio of receivables to expand its operations, or the seller may be seeking to end operations in an area deemed unprofitable.

2.38 If those receivables contain recourse provisions, FASB Statement No. 77, *Reporting by Transferors for Transfers of Receivables With Recourse,* controls whether such transactions should be accounted for as sales of receivables or as loans collateralized by receivables. The standard generally requires recognizing such a transfer as a sale if the transferor surrenders control of future economic benefits embodied in the receivables, the transferor's obligation under the recourse provisions can be reasonably estimated, and the transferee cannot require the transferor to repurchase the receivables except pursuant to the recourse provisions.

Financial Statement Presentation and Disclosure

2.39 Discount loans and interest-bearing loans should be presented similarly on the balance sheet, because the economic substance of the transactions is essentially the same. To accomplish that, discount loans should be presented net of unearned interest. Although disclosure of interest that is accrued but not collected on interest-bearing loans may be meaningful, disclosure of the unearned interest generally is not meaningful. If unearned interest on discount loans is disclosed, such disclosures should be in the notes and not in the number columns of the balance sheet.

2.40 The unamortized balance of loan origination, commitment, and other fees and costs and purchase premiums and discounts that is being recognized as an adjustment to yield should be classified on the balance sheet as part of the loan balance to which it relates. Amounts of loan origination, commitment, and other fees and costs recognized as an adjustment to yield should be reported as part of interest income. Amortization of other fees, such as commitment fees that are being amortized on a straight-line basis over the commitment period or included in income when the commitment expires, should be included with service fee income.

2.41 The allowance for credit losses should be deducted from receivables in the balance sheet. The provision for credit losses should be presented separately as an expense item in the income statement. An analysis of the changes in the allowance for credit losses should be included in the notes to the financial statements. See FASB Statement No. 114 for disclosure requirements that are applicable to financial statements for fiscal years beginning after December 15, 1994.

2.42 The composition of finance receivables should be disclosed either in the balance sheet or in the notes to the financial statements in a manner that best sets forth the kinds of risks and liquidity involved. The amount of accrued interest should be included in the finance receivables but need not be disclosed separately. The amount of nonearning assets represented by consumer and commercial loans for which accruals have been suspended (see paragraphs 2.14 to 2.16 of this guide) should be disclosed separately.

2.43 FASB Statement No. 13, *Accounting for Leases,* and related amendments and interpretations provide guidance on accounting and financial reporting for leases.

2.44 The expanded possible range in size and term of receivables within each receivable type has created a need for disclosure of information about terms and maturities. Though disclosure of contractual maturities may meet that need, such data will not always be relevant. For example, actual repayment experience often is faster than contractually required for consumer loans. If circumstances indicate that data on contractual maturities are not relevant, disclosure of data on prior collection experience also should be considered.

2.45 Financial statements should disclose interest and finance charges earned separately from other kinds of income, such as insurance premiums. In addition, the summary of significant accounting policies should explain the method of income recognition used. Policies for suspending and resuming accruals of income on delinquent loans and policies for charging off uncollectible loans should clearly disclose the basis for making such decisions. If the charge-off policy is based on a specific delinquency period, that period should be disclosed. Vague statements such as "consumer loans are charged off when considered to be uncollectible" are not meaningful and fail to disclose the substance of such policies.

2.46 FASB Statement No. 57, *Related Party Disclosures,* prescribes certain disclosures of material related party transactions. Such transactions may include loans to officers, directors, and employees.

2.47 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.

Audit Objectives for Receivables and Income

2.48 An audit of finance receivables and finance income should be designed to provide reasonable assurance that—

a. Loans and receivables are valid obligations owed to the entity at the date of the financial statements.

b. The allowance for related losses is adequate to provide for estimated losses in the loan portfolio at the date of the financial statements.

c. Accrued interest revenues for the period on both interest-bearing and precompute loans have been properly recorded.

d. Provisions for credit losses have been properly recorded.

e. Adequate disclosures, including proper disclosure of any pledged or assigned receivables, are included in the financial statements.

f. Deferred loan origination costs are properly stated and amortization is properly computed.

Audit Planning

2.49 The audit procedures performed in connection with the allowance for credit 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 finance company auditing experience and, if necessary, with knowledge of industries in which the finance company's loans are concentrated, should closely supervise or perform this section of the audit. 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 finance company, and should be familiar with known related parties and related party transactions.

2.50 The overriding factor in the credit extension process is the amount of credit risk associated with the lending process, which is addressed early in the auditor's review of the finance company's business and control environment. For individual loans, credit risk pertains to the borrower's ability and willingness to pay and is assessed before credit is granted or renewed and periodically throughout the loan term.

2.51 Additional risks, however, are involved in the overall credit process, and the finance company 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:

a. *Collateral risk.* The finance company may be exposed to loss on collateralized loans if its security interest is not perfected or the collateral is not otherwise under its control, or if the value of the collateral declines.

b. *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 an industry experiencing economic problems, for example, would constitute a concentration risk.

c. *Fraud risk.* Loans may expose the finance company to loss by not being either bona fide or arm's-length transactions.

d. *Insider risk.* Loans to executive officers, directors, and principal shareholders of the finance company and related interests of such insiders may expose the finance company to loss if these loans are made to related individuals, companies, or both, with little credit history, or to newly organized or highly leveraged enterprises with insufficient collateral and inadequate financial information.

e. *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 finance company to loss.

f. *Management risk.* Management's competence, judgment, and integrity in originating, disbursing, supervising, collecting, and reviewing loans could substantially affect the collectibility of loans.

g. *Operations risk.* Funds might be disbursed without proper loan authorization, collateral documentation, or loan documentation. Failure to evaluate and monitor potentially uncollectible loans also constitutes an operations risk.

2.52 Audit risk and materiality are considered together in determining the nature, timing, and extent of auditing procedures and in evaluating the results of those procedures. SAS No. 47, *Audit Risk and Materiality in Conducting an Audit,* provides guidance on audit risk and materiality as they relate to planning and performing an audit.

2.53 Audit risk and materiality are considered initially at the financial statement level in order to limit the risk of undetected material misstatement of the financial statements taken as a whole to a low level. However, the auditor should also consider audit risk at the account level (that is, allowance for credit losses) to assist in determining the scope of auditing procedures for the particular account balance or class of transaction. Because the loan portfolio is usually the finance company's largest asset, and the allowance for credit losses is, to a significant extent, based on subjective judgments, the allowance is usually a high-risk audit area.

2.54 Effective loan review and internal audit departments can provide valuable assistance to the auditor and improve audit efficiency. Discussions with loan review and internal audit staff can provide the auditor with information concerning loan customers, related party transactions, and account histories that may not be readily available elsewhere. In addition, because it is sometimes directly involved in implementing control systems, the internal audit department can provide the auditor with important system descriptions.

2.55 Sometimes the loan review and internal audit departments' testing procedures are of such quality that the auditor may conclude that it would be efficient to consider the work of the loan review and internal audit staffs in determining the nature, timing and extent of audit procedures. SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements,* provides the auditor with guidance on considering the work of internal auditors and on using internal auditors to provide direct assistance to the auditor in an audit performed in accordance with generally accepted auditing standards.

2.56 In establishing the scope of the work to be performed, the auditor normally considers the following factors:

a. Composition of the loan portfolio

b. Identified potential problem loans

c. Trends in loan volume by major categories, especially categories experiencing rapid growth, and in delinquencies, nonaccrual, and restructured loans

d. Previous loss and recovery experience, including timeliness of charge-offs

e. Concentrations of loans to individuals and their related interests, industries, and geographic regions

f. Size of individual credit exposures (few, large loans versus numerous, small loans)

g. Extent of use of work performed by internal loan review and internal audit functions

h. Total amount of loans and problem loans, including delinquent and nonaccrual loans, by branch

i. Lending, charge-off, collection, and recovery policies and procedures

j. Local, national, and international economic and environmental conditions *k.* Experience, competence, and depth of lending management and staff

l. Results of regulatory examinations

m. Related party lending

Internal Control Structure

2.57 An overview of the various internal control structure policies and procedures pertaining to finance receivables and related accounts is included in the next section of this chapter. Although not all internal control structure policies and procedures identified are found in every finance company, the following section lists considerations that may provide guidance in obtaining an understanding of the internal control structure and assessing control risk.

Receivables and Income

2.58 Internal control structure policies and procedures pertaining to loans are determined partly by the type of loan and the related risks involved. In obtaining an understanding of the internal control structure policies and procedures and to assess control risk pertaining to loan transactions, matters the auditor might consider include whether—

- Duties are segregated.
- Loans are made only in accordance with established policies.
- Credit reports are obtained for loans.
- Loans are properly approved by officers or branch managers and, if required, reviewed by a loan committee.
- Loan approval, disbursement, and collection (access to assets) are checked, performed by, or adequately tested by other employees.
- Management has established dollar limits and minimum credit standards on loans.
- Advances against significant chattels are made only after physical inspection of the property and determination that the borrower has proper title to the property.
- Loans or advances on accounts receivable are made only against verified claims for merchandise actually shipped.
- Management reviews or internal audit procedures are sufficient to detect problems early.
- Receivables balances are confirmed as part of management review or internal audit procedures.
- Physical protection of notes, collateral, and supporting documents is adequate.
- Employees who do not process or record loan transactions prepare and reconcile ledger trial balances with subsidiary and other control accounts on a timely basis.
- Paid notes are canceled and returned with collateral agreements, if any, to the borrowers.
- Collateral is reviewed and physically inspected periodically.
- UCC filings are updated periodically.
- Personal or corporate guarantees are updated periodically.
- Corporate borrowers' or guarantors' financial statements are received and reviewed periodically.

- Documents supporting new loans are inspected for proper form, completeness, and accuracy by someone other than the lending officer or branch manager.
- Loan balances are periodically compared with current collateral values.
- Status reports are prepared indicating the condition of collateralized receivables, turnover of inventory collateral, and other information, and such reports are reviewed by management.
- Loans are reviewed in a timely fashion for collectibility; the adequacy of the allowance for credit losses is evaluated and documented; and write-offs are recorded as soon as loans are reasonably expected to become uncollectible.
- Aging schedules are accurately and periodically prepared, and are used to help collection efforts and to assess collectibility.
- Control is maintained over charged-off loans.
- Reasonable collection efforts continue after the date of charge-off.
- Adequate procedures assure that income is accurately computed by the interest (actuarial) method.
- Loans are reviewed regularly to determine whether income accruals should be suspended or reinstated in accordance with company policies.
- Remedial action programs are in place for all substandard loans and are being carried out in a timely manner.
- Changes in state laws and regulations are monitored to make sure that lending activities continue to be in compliance.
- Payment extensions, deferments, or other modifications to repayment terms are made only in accordance with established policies and are reviewed by management.
- Rebates of precomputed interest and insurance premiums made in connection with renewals and early payoffs are computed in accordance with state regulations.
- Extension fees, service fees, and late charges are computed in accordance with state regulations.

Loan and Related Files

2.59 Loan files for most types of finance receivables are often significant sources of information for the auditor. The documents in loan files vary according to the types of loans. The timely receipt and review of those documents provide a basis for granting credit, reviewing extensions, and maintaining an awareness of loan status.

2.60 The principal support for most consumer loans is the signed note and security instrument. In addition to that support, consumer loan files may contain loan applications, credit agency or scoring sheets used to evaluate the creditworthiness of borrowers, histories of collection activities, and evidence of existing insurance coverage. Consumer loan files also should contain indications of compliance with the consumer credit disclosure requirements of the Truth in Lending Act. That statute, which provides for mandatory disclosure of effective interest rates being charged to the consumer, applies to all lending institutions.

2.61 Documents in mortgage loan files may depend in part on local statutory requirements and company policy. In addition to various documents found in consumer loan files, the basic documents generally include but are not necessarily limited to the notes, loan applications, appraisal reports, deeds of trust, mortgages, title insurance or opinions, insurance policies, settlement statements, and Department of Veterans Affairs guarantees or Federal Housing Administration insurance, if applicable.

2.62 A typical commercial loan file generally includes financial statements of both the borrower and guarantors (individual or corporate), copies of supplemental agreements between the finance company and the borrower, and other related correspondence. Other materials in commercial loan files may include copies of UCC filings, documentation of loan approvals summarizing the reasons for granting credit, documentation of ongoing reviews of the borrowers' credit standings, information on loan collateral, and histories of collection activities. Commercial loan terms tend to be tailored for the individual borrower, unlike consumer loans, which generally have standardized terms.

Repossessed Assets Acquired in Liquidation of Receivables

2.63 Policies and procedures related to repossessed assets acquired in liquidations may vary considerably among companies and by the nature of the collateral. In obtaining an understanding of internal control structure policies and procedures related to repossessed assets, the auditor should consider whether—

a. Separate subledger accounts are maintained for assets acquired in liquidations even though amounts of such assets held at a particular time may be immaterial.

b. Repossessions are authorized and disposed of in accordance with company policies.

c. Repossessions are promptly reported and recorded.

d. Operating procedures provide for reasonable valuation of repossessed assets acquired in liquidations.

e. Net realizable values of unsold repossessed assets are reviewed periodically to determine if carrying amounts should be written down.

f. Controls are established over reconditioning and other costs of repossessions and proceeds from sales of repossessed properties.

g. Controls assure that accounting entries are accurate for recourse arrangements with dealers that provide for sharing of repossession risks and responsibilities.

Dealer Reserves

2.64 In obtaining an understanding of internal control structure policies and procedures related to dealers' reserves, the auditor should consider whether—

a. Dealer-reserve arrangements are established only in accordance with company policies.

b. Documentation is sufficient to provide enforceability of the contract terms.

c. Accounting procedures are adequate to ensure that improper charges are not made to dealer-reserve accounts for rebates, delinquent accounts, charge-offs, and other items.

d. Charges to dealer-reserve accounts are adequately reviewed and approved by management.

e. Debit balances are followed up for collection.

f. Dealer-reserve statements are sent to dealers if required by terms of the dealer agreements.

Branch Offices

2.65 Finance companies that lend to consumers often operate branch offices to make and service loans because of the importance of convenience, close personal contact with customers, and competitive considerations. Branch offices usually have limited numbers of personnel, so complete segregation of duties may not be feasible. To compensate, many finance companies rely on central computerized controls and on management personnel to regularly review branch office operations. On visits to branch offices, management may—

- Review the extent of collection efforts and control over delinquent accounts.
- Review a sample of loans made since the last visit for proper approval and for quality and adequacy of documentation.
- Review a sample of loans for terms and financing charges.
- Count cash and confirm selected receivables.
- Observe branch employees to appraise their performance.
- Prepare a report to review with the branch manager that serves as a checklist for follow-up work and provides documentation of the visit.

2.66 Some of these procedures may be performed by the internal audit staff. Existence and effectiveness of internal audit procedures may provide additional controls beyond those supplied by management reviews. In addition, each level of management may be continuously monitored by the next-higher level of management to determine whether operating policies and procedures for review of branch operations are complied with. The auditor may conclude, therefore, that the audit of branch offices may be limited to focus primarily on the work of internal auditors or management reviews.

2.67 With the increased reliance on EDP systems, many branch office procedures have become streamlined, permitting less detailed records to be maintained. Below, the section "Branch Audits" in paragraphs 2.134 through 2.136 further discusses the effects on the audit of a finance company's reliance on EDP systems as well as its internal audit or management review procedures.

Auditing Receivables and the Allowance for Losses

2.68 The auditor uses information from tests of finance receivables and the allowance for losses to assess the collectibility of receivables as well as to determine whether the allowance for losses reasonably covers expected losses.

The Allowance for Losses

2.69 The allowance for loan losses represents an amount that, in management's judgment, approximates the current amount of loans that will not be collected. The auditor is responsible for evaluating whether management has recorded a reasonable estimate of the amount of assets that have been impaired.

2.70 Receivables from consumer loans usually are evaluated in total rather than on the basis of individual loans because they consist of large volumes of relatively small balances. In such situations, it is more difficult to judge collectibility of specific loans than to evaluate collectibility of portfolios taken as a whole. Therefore, auditing procedures for consumer lending generally emphasize review, documentation, and reliance on data processing systems; internal control structure policies and procedures and management controls; and accounting policies. Ratio analyses, historical statistics, current aging conditions, and other general trends are particularly important in evaluating collectibility. A change in composition of receivables may affect the allowance for losses, because greater risks are associated with certain types of loans than with others.

2.71 Many commercial loans are tailor-made and relatively large. The size and uniqueness of commercial receivables necessitates a greater focus on specific loans and problems than is required for more homogeneous direct cash loans and retail sales contracts. Thus, auditing procedures in connection with commercial lending tend to place less emphasis on statistical data and historical trends and focus more on current collateral values, industry concentration, and financial conditions of individual borrowers. Particular attention should be given to loans in economically distressed industries. The auditor should discuss questionable loans with management. Commercial loan files should be reviewed on a test basis for information such as borrowers' audited financial statements and loan histories. Reviewing internal audit workpapers or field audit reports also may be useful.

2.72 In evaluating the allowance for credit losses, the auditor should consider accrued interest on loans and unamortized deferred net fees or costs. Also, the auditor should be aware of the basis of any changes made in the credit evaluation and granting processes, changes in credit scoring processes or credit ratings of corporate borrowers, changes in loan administration procedures, including ways of curing delinquencies (such as accepting partial payments or rewriting contractual terms on delinquent loans), and changes in timing or other policies followed to decide when to charge off uncollectible loans.

2.73 A significant factor affecting the adequacy of the allowance for losses on commercial loans and receivables is the value of the underlying collateral. Depending on the nature of the collateral, the finance company may elect to obtain independent appraisals of current collateral. Adequacy of collateral in the event of a loan default requires special attention if the collateral is not readily marketable or is susceptible to decline in realizable values. The auditor should evaluate the effect, if any, of recourse arrangements on receivables and the adequacy of the allowance for losses. (See paragraphs 2.121 to 2.131 of this guide for a further discussion of collateralized loans.)

Loan Origination Costs

2.74 The auditor should gain an understanding of the finance company's procedures for computing deferred loan origination costs including the recognition of those costs in the income statement. In reviewing and testing the finance company's deferred loan origination costs and their amortization, the auditor's objectives are to gain reasonable assurance that (*a*) costs relate only to completed loans and are limited to the costs described in paragraphs 5 and 6 of FASB Statement No. 91; and (*b*) amortized costs are recognized as an adjustment of yield and included in determining interest income.

Credit Approval Policies

2.75 Understanding credit approval policies is an important facet of an audit of a finance company. If the auditor is concerned about the adequacy of the finance company's credit policies based on a review of those policies, or if tests of controls indicate that controls over credit policies may be ineffective, the auditor may need to expand the scope of substantive tests to evaluate credit risks that the finance company has assumed.

2.76 The auditor should be alert for changes in credit requirements during the period, particularly to less conservative requirements, and evaluate the effect of those changes on the quality of the portfolio. Additionally, the auditor may evaluate whether the company reviews its credit approval policies in light of changes in the economic environment that might affect creditors' ability to repay loans.

2.77 Credit approval policies and procedures differ significantly for consumer and commercial lending activities.

Consumer Credit Approval

2.78 Finance companies generally follow standard procedures to assess creditworthiness of prospective borrowers before approving consumer loans. Such procedures usually include investigation of a prospective borrower's employment history, salary, credit history, and completion of a credit scoring sheet on which an overall evaluation is made of the borrower's creditworthiness. Specific procedures may vary by type of loan (for example, real estate versus unsecured loans) and by type of customer (for example, new customers versus present customers).

2.79 If after obtaining an understanding of the internal control structure the auditor decides to assess control risk below the maximum level, the auditor should perform tests of controls to evaluate the effectiveness of the relevant controls. Such tests of controls should be performed on a sample of new loans made since the date of the most recent audited financial statements.

Commercial Credit Approval

2.80 Collateral for commercial loans generally is required to equal at least an amount sufficient to secure repayment in the event of a forced liquidation, thus requiring a thorough review of collateral value. However, repayment of a commercial loan generally depends on the borrower's ability to generate cash principally through operations. Therefore, a finance company usually performs a thorough review to assess the quality of management and the financial position of a prospective commercial borrower, as well as the overall prospects for the borrower's business to generate sufficient cash to liquidate the loan.

2.81 In approving commercial loans, a finance company usually analyzes the prospective borrower's financial statements and may consider factors such as the prospective borrower's financial position and operating results as compared with those of other businesses in the same industry. Various statistics, such as inventory and receivables turnover, often are developed to facilitate the analysis. The finance company also may study receivables aging schedules to help determine the quality of accounts receivable. Furthermore, the finance company may consider the potential effects of prevailing economic conditions on the borrower. The finance company also may obtain projections of future cash needs from borrowers, particularly when considering the need for overadvances in factoring or revolving credit arrangements.

2.82 Credit reports, such as those prepared by rating agencies, may be considered, and references may be obtained from the borrower's bank as well as from other sources. The borrower's corporate structure should be studied to determine the existence and the extent of possible related party transactions. Additional procedures may be necessary to estimate the value of inventory and fixed assets pledged as collateral. Finance companies often send field representatives on visits to borrowers' places of business to physically inspect inventories and premises, review agings of receivables and accounting records, evaluate internal accounting and management controls, and obtain direct impressions of the quality of operations and management.

2.83 If after obtaining an understanding of controls pertaining to credit approval policies for commercial loans, the auditor decides to assess control risk below the maximum level, the auditor should perform tests of controls. In performing tests of controls, the auditor should consider testing supporting documentation to determine whether all procedures have been satisfactorily completed. Loan approvals generally are documented in the loan files and sometimes in minutes of the meetings of loan committees and the board of directors. If the finance company sends field representatives to prospective borrowers' places of business to review their business operations, the auditor may wish to review their written reports or to accompany those persons on one or more visits to assess the quality of their reviews. Loan approvals deemed questionable by the auditor should be discussed with management to better evaluate their judgment and to ascertain that undue risk of default does not exist.

Factoring

2.84 Finance companies review potential clients' operations to determine whether to factor receivables. Many procedures used for those reviews are similar to procedures used to approve other types of commercial loans. A loan officer usually is designated to oversee the review; final approval by a loan committee may be required.

2.85 If the finance company decides to buy the client's receivables, the review is used for several other purposes. The commission to be charged for bookkeeping and collection services is calculated from information provided by review of sales volume, the number of invoices processed monthly, the amount of returns and chargebacks, and collection activities. The review also is used to set limitations on the maximum amount in receivables that the finance company is willing to buy and, if needed, the amounts of seasonal over-advances to be permitted. Such limitations ordinarily are reviewed periodically for changes in a client's needs or circumstances.

2.86 If a client's business fails, the finance company usually has problems collecting the remaining customer accounts because of inability to settle unresolved disputes between customers and the client that otherwise would have resulted in chargebacks to the client. Therefore, the auditor should consider the reasonableness of initial and subsequent reviews of the client's operations and financial condition in determining whether the finance company faces undue risk of default on the client's customer accounts.

2.87 In addition to reviewing a client's financial position, a finance company reviews the client's customers' credit for approval before goods are shipped. Finance companies usually establish for each customer a line of credit that is reviewed periodically (for example, every ninety days) to determine whether it should be raised or lowered based on changes in payment patterns, sales, credit ratings, and other circumstances. Periodic reviews are generally documented in customer files. Furthermore, a customer may buy goods or services from several of the finance company's clients. If so, the finance company typically prorates the credit limit of such a customer among the clients with which the customer does business. Therefore, to help control credit approvals, a finance company's accounting system usually provides aggregate information on total receivables due from a customer—even though the receivables may be due to a number of clients rather than to a single one.

2.88 A client usually submits orders to the finance company by telephone, teletype, or mail. Orders below a certain amount may be approved automatically. Orders for established customer accounts that have not exceeded their lines of credit also may be automatically approved. Some finance companies use a computerized credit-checking system to initially review orders for approval or rejection or to signal that additional investigation is required, or both.

2.89 The auditor should consider the reasonableness of customer credit-approval policies, including those pertaining to periodic or continuous review of customer credit standings, and also whether to perform tests of controls over such policies. Approved and rejected customer orders usually are recorded on client approval sheets. The auditor may select a sample of client invoices recorded by the finance company and trace them to the approval sheets to determine whether invoices booked represent approved orders. The auditor also may select from the approval sheets a sample of both approved and rejected customer orders for confirmation with clients. If the client responds that the finance company approved an order listed as rejected, the auditor should question the effectiveness of customer credit controls and consider whether the client has a potential legal claim against the finance company for that customer order.

2.90 Controls over customer credit limits also may be examined by selecting customers who buy goods or services from several clients of a factor. Amounts owed should be added to determine that each customer's credit limit has not been exceeded. If customers' cumulative credit limits have been exceeded, the auditor should consider the effectiveness of the related controls in designing substantive tests to determine whether the finance company has assumed additional credit risk.

Collections

2.91 In auditing collections, the auditor is concerned with the extent of collection efforts on accounts written off and procedures for controlling collections on accounts previously written off. If a finance company has many branch offices, it may be appropriate to investigate and test collection efforts at selected branch offices. Accounts written off may be confirmed on a test basis to determine whether collections, if any, have been properly recorded.

2.92 Changes in the intensity of collection efforts are likely to affect the adequacy of the allowance for losses. Decreases in amounts budgeted for salaries and other collection costs may indicate that collection efforts have been reduced and that delinquencies and bad debts might increase. Collection efforts also may be adversely affected by increased turnover of employees assigned to such efforts, indicating the use of less qualified persons, or by concentrating employee effort on making new loans, with a consequent lessening in efforts to collect existing receivables.

Aging Schedules

2.93 Finance companies prepare aging schedules to review collectibility of loans. A finance company uses aging information to help assess collectibility of accounts and to determine where to concentrate collection efforts. Collectibility of receivables that are more than a stipulated number of days delinquent should be questioned. Some companies automatically write off such delinquent receivables. Management may decide to write off certain delinquent accounts because the costs of collecting them outweigh potential benefits. If liberal extension policies or practices exist, extended accounts should be given special attention even though they are not delinquent.

2.94 Accounts receivable from retail sales contracts typically are aged by the *contractual method,* which is based on the status of payments under the original terms of the contracts. Such agings generally are modified for deferments and extensions of original contractual terms. Direct consumer loans historically have been aged by many lenders using the *recency-of-payments method.* Under this method, loans are aged based on the month in which the most recent collections were received, regardless of contractual payment terms for amounts of payments or loan periods.

2.95 The recency-of-payments method of aging was developed years ago, when direct consumer loans were for relatively modest amounts due over relatively short periods. In those circumstances, lenders were interested in regular collections of principal and accrued charges and less concerned with contractual terms of the loans. That emphasis is reflected in the recency method. More recently, direct consumer loans, particularly second mortgage loans, have been for larger amounts and longer periods. Therefore, lenders increasingly have emphasized collections of principal and charges in accordance with contractual terms. That emphasis is apparent in the Robert Morris Associates Direct Cash Lending Questionnaire, which has prescribed the contractual method for large direct cash loans.

2.96 The contractual method is considered more conservative than the recency-of-payments method; however, some finance companies weaken the basis of the contractual method by modifying their calculations. For example, such companies may consider accounts contractually current when two timely payments have been made on an account previously considered delinquent. Therefore, regardless of which aging method is used, understanding whether and how clients may reclassify delinquent loans to current status is important.

2.97 The auditor can compare results of current agings with results of past agings to identify unusual variances. The auditor should become familiar with aging policies and may refer to Robert Morris Associates questionnaires, which usually describe aging policies. The auditor should be aware that recent payments, which may have altered the classification of particular accounts, may not indicate the ultimate collectibility of those accounts. The auditor also should consider the effect of partial payments on the aging.

2.98 The aging of receivables also is affected by extension and renewal policies. Loan renewals involving little or no advances of additional cash to customers deserve special attention. Some managements believe renewals, sometimes called salvage renewals, should be granted only with additional cosigners or collateral, unless customers can demonstrate increased ability or willingness to repay such loans. Other managements believe renewals should never be granted. Although different circumstances may exist, a customer usually demonstrates increased willingness to repay a delinquent account by making regular monthly payments at reduced amounts after paying off a significant portion of the initial loan balance. Renewals without evidence of increased ability or willingness to repay may diminish reliability of aging schedules.

Charge-off Policies

2.99 Charge-off policies vary among finance companies and types of loans. Some policies automatically require that accounts be written off when they are overdue a stipulated number of days. Other policies may delay charge-offs until all practical efforts to collect have been exhausted or the customer has entered bankruptcy. Still other policies may be based on review of the status of individual loans.

2.100 The auditor should be aware of changes in charge-off policies when evaluating the adequacy of the allowance for losses and considering the reasonableness of those charge-off policies. The auditor may consider whether charge-offs are reviewed and approved by officials who do not also approve loans, whether charge-offs for deficiencies on repossessed properties are adequately reviewed and approved, and whether losses charged to dealer reserve accounts are consistent with dealer agreements. The auditor also should be alert to the effects of changes in charge-offs as well as in credit-granting policies.

2.101 If charge-off policies require automatic loan write-offs when overdue a stipulated number of days, the auditor should consider the appropriateness of the number of days specified and whether controls make sure that such procedures are followed. The auditor also should consider how partial payments on loans are treated under the policies. If procedures requiring automatic write-offs are not used, the auditor should consider whether write-offs are occurring in a timely and consistent manner.

Other Credits to Receivables

2.102 Credits to finance receivables for reasons other than cash receipts or charge-offs to the allowance for losses should be tested to determine if the reasons for the credits are appropriate. For example, was an error corrected, and, if so, was the credit properly authorized?

Chargebacks

2.103 Under factoring arrangements, typical noncash credits to receivables represent chargebacks to client accounts. Chargebacks may result from disputes over, for example, freight charges, defective merchandise, deliveries, prices, and canceled orders. Inability to collect an account because of a customer's insolvency, however, generally represents a credit loss and ordinarily should not result in a chargeback, because the finance company assumes the risk of customer default when receivables are factored. If after obtaining an understanding of the internal control structure the auditor decides to assess control risk below the maximum level, the auditor should obtain evidential matter to support the assessed level of control risk.

Anticipations

2.104 Under factoring arrangements, most finance companies accept customer payments of less than the amount of the related receivables if the customers pay before due dates. The differences or discounts, often called *anticipations,* may be allowed because a finance company obtains earlier use of the cash. Amounts of anticipations allowed usually fluctuate monthly, and interest is usually charged to the client based on some relationship to prime rates.

2.105 The auditor should consider reviewing the finance company's policies on anticipations and, if allowed, the reasonableness of the amounts deducted.

Confirmation Procedures

2.106 Finance companies may confirm receivables balances as part of their internal audit procedures. The extent and nature of those procedures vary. Some finance companies use written confirmations; others confirm information by telephone. If after obtaining an understanding of the internal control structure the auditor decides to assess control risk below the maximum level, the auditor should obtain evidential matter to support the assessed level of control risk. The auditor should establish a reasonable scope to confirm a representative number of loans. The auditor may wish to stratify loans selected for confirmation not only by recorded amounts but by categories, such as loans collateralized by real estate and unsecured loans.

2.107 Confirmation procedures may reveal certain conditions, such as payments made to the wrong account; disputes over prices, quantities, or shipping terms; payments made by customers directly to factoring clients; unrecorded merchandise returns; fictitious receivables; consignments; or prebilling.

2.108 Positive confirmations are preferable when individual account balances are relatively large or when there is reason to believe a substantial number of accounts are in dispute, inaccurate, or irregular. Negative confirmations 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. If negative rather than positive confirmations are used, however, the auditor should consider performing other substantive procedures to obtain the same degree of satisfaction.

2.109 In addition to the original amount of the loan and the current loan balance, the auditor should consider confirming other information, such as the last payment date and the amount and description of collateral.

2.110 The auditor should apply alternative procedures for all unanswered positive confirmations. To apply alternative procedures, the auditor should consider reviewing subsequent cash receipts, confirming information by telephone, and examining additional loan documentation.

No-Mail Accounts

2.111 Some consumer loan customers may request that direct correspondence not be sent to them. They are typically *no-mail accounts* and should be insignificant in relation to the total loan portfolio. If such loans are selected for confirmation, alternative procedures normally should be applied.

Confirming Purchased Customer Receivables

2.112 If a finance company buys receivables under a nonnotification arrangement (that is, the borrower does not inform its customers that their accounts have been sold or assigned to a finance company), special consideration needs to be given to confirming such receivables because customers are not aware that their accounts have been sold. Confirmations should, therefore, be prepared in a manner that preserves the confidentiality of the sales transactions between the finance company and its clients.

Ratios

2.113 Ratios are useful for analyzing trends affecting collectibility. Because of their diverse characteristics, receivables should be segregated by type (for example, retail contracts, direct consumer loans, and commercial finance receivables) before computing ratios. The comparability of receivables to those of prior periods also should be evaluated. For example, factors such as tightening of credit standards and changes in extension policies can affect the quality of the receivables and render statistical comparisons invalid.

2.114 The following two ratios commonly are used to determine loss experience trends:

a. Net credit losses to receivables liquidated (beginning balance plus volume during period, excluding old balances renewed, less ending balance)

b. Net credit losses to average monthly outstanding receivables for the period (annualized if less than one year)

2.115 The first ratio is useful in estimating the amount a finance company will write off for each dollar collected on loans. The second ratio has been used primarily for smaller loans with relatively short-term maturities. If trends show increasing rather than decreasing ratios, the allowance for losses may need to be increased.

2.116 Ratio analysis has certain weaknesses. For example, the ratio of net credit losses to average monthly outstanding receivables measures losses for only one year. Because most loans extend beyond one year, the ratio does not include all losses that would be expected, based on currently available information, to result from liquidation of all outstanding loans. Growth situations also hamper ratio analysis, particularly if the ratio of net credit losses to average monthly outstanding receivables is used. The increasing portion of new business used in the calculation may cause comparisons with previous results to be meaningless because, in some situations, the rate of increase in credit losses lags behind the rate of increase in receivables until growth levels off. For that reason, the ratio of net credit losses to receivables liquidated provides better measure in growth situations.

2.117 Other common ratios include the following:

a. Ratios of allowances for credit losses to outstanding receivables, expressed as percentages

b. Ratios of delinquencies to outstanding receivables, expressed as percentages

c. Ratios of recoveries to charge-offs, expressed as percentages

d. Ratios of provision for losses to volume, expressed as percentages

2.118 Computers and sophisticated mathematical models can be used to improve ratio analysis and to identify trends that otherwise might be obscure. For example, computers can apply regression analysis techniques to loans stratified by such criteria as the year made, type of loan, location of borrower's residence or place of business, and borrower's credit rating. Thus, volumes of detailed data may be readily summarized and analyzed to provide more sophisticated information than is practical without computers.

2.119 Though no one group of statistics is conclusive, trends may indicate significant changes that warrant attention. Industry or other published statistics on delinquencies and allowances for losses may be helpful but should be used with regard for the facts and circumstances affecting individual companies. If using ratios, the auditor should consider all relevant circumstances, such as changes in credit approval and in collection policies as well as general economic conditions.

Loans to Related Parties

2.120 Loans to officers, directors, and employees (and loans to organizations with which such individuals are affiliated) should be reviewed. FASB Statement No. 57, *Related Party Disclosures,* prescribes certain disclosures of material related party transactions. SAS No. 45, *Omnibus Statement on Auditing Standards—1983,* "Related Parties," provides auditing guidance for such matters.

Collateralized Loans

2.121 Consumer loans may be collateralized by consumer goods or by real property. Commercial loans may be collateralized by accounts receivable, inventories, or property and equipment. Loans also may be guaranteed by cosigners and guarantors.

2.122 Depending on the type of collateral, the auditor should consider testing physical existence and proper assignment to the finance company. Examination of loan documentation generally includes testing the adequacy of both the current value of collateral in relation to the outstanding loan balance and, if needed, insurance coverage on such collateral. For guaranteed loans, the auditor reviews financial statements and other evidence of the financial conditions of cosigners and guarantors. The auditor should be alert to possible concentrations of loans in one borrower, in a group of related borrowers, or in a particular industry. The auditor also should consider general economic conditions that might affect the value of underlying collateral as well as of overall collectibility and quality of the loan portfolio.

Consumer Goods

2.123 Many direct consumer loans and most retail sales contracts are collateralized by consumer goods. Resale values of most consumer goods, such as major appliances and furniture, may be significantly less than related loan balances. As a result, many lenders prefer not to repossess such collateral. Consideration of those collateral values is, therefore, less important than for other consumer goods, such as automobiles, which may be readily salable and of more significance when compared to related loan balances.

Receivables

2.124 Trade accounts receivable and installment notes sold or pledged as collateral generally are sold or assigned to a commercial finance company on a nonnotification basis. The industry trend in recent years has been to maintain total dollar control of such receivables (bulk basis) rather than detailed receivable records (ledger card or specific assignment basis). The finance company and its auditor usually have access to the seller's or borrower's accounting records if collateral records are maintained in bulk. The seller or borrower may receive all collections on the receivables but is required to turn over such collections in their original form, usually through use of a bank account designated by the finance company.

2.125 In addition to the effectiveness of credit approval policies, collection activities, internal confirmation procedures, and visits by field representatives to the client's or borrower's place of business, the auditor should consider other accounting and management controls over receivables bought or pledged as collateral. For example, the auditor's evaluation may be affected by the amount of collateral receivables maintained on a bulk basis, the frequency with which borrowers submit aged trial balances to the finance company, and the extent of management reviews of those schedules.

2.126 Based on the results of the evaluation of the finance company's procedures for examining and monitoring assets sold or collateral pledged, the auditor should consider the need to examine evidence of or otherwise be satisfied as to nonnotification receivables pledged as collateral. The examination may consist, in part, of a review of the borrower's records. Accounts receivable agings may be compared against the borrower's customer accounts subsidiary ledger, with additional review of items such as unusual invoice terms, past due accounts, and invoices paid out of order. Familiarity with trade or industry discounts, the right of return, warranties, and other terms of sale offered by the borrower facilitates analysis of collateral values of receivables. A review of trade creditors could indicate whether a right of offset exists against the receivables because the borrower buys from and sells to the same enterprise. The auditor also should consider studying the borrower's corporate structure to help identify possible receivables due from affiliated companies.

Inventories

2.127 Inventories pledged as collateral may result from a wholesale loan, for which specific items of inventory are pledged, or from an inventory loan, for which the entire inventory is pledged but individual items are not identified. Inventories also may be pledged as additional collateral for a loan initially collateralized by receivables when the loan exceeds the prime collateral value assigned to the receivables. Inventory collateral values may be more difficult to evaluate than receivable collateral because inventory is more subject to economic risks such as deterioration and obsolescence. Therefore, the percentage of loan advances made against inventory collateral generally is less than that made against receivable collateral.

2.128 Based on his or her understanding of internal control structure policies and procedures pertaining to inventory pledged as collateral, the auditor should consider (*a*) reviewing reports by finance company personnel who inspect such inventories on field visits or, if considered desirable, (*b*) inspecting inventory in custody of the borrower on a test basis. Perpetual inventory records, if maintained by the borrower, may be tested against periodic physical counts made by the finance company's internal auditors. Many finance companies do not maintain collateral records of the borrower's inventory because pertinent, accurate, and updated inventory information is not readily available, particularly for revolving loans.

2.129 Inventories pledged as collateral that are stored in public warehouses and supported by warehouse receipts may be confirmed by direct communication with the warehouses. Owners of public warehouses are primarily liable for damages resulting from nonexistence of goods listed in receipts and from failure of the goods to conform to the descriptions on warehouse receipts. Sometimes a borrower establishes a field warehousing arrangement in which a warehouse company segregates and controls the collateralized inventory in a portion of the borrower's own warehouse. A field warehousing arrangement may provide some control over inventories pledged as collateral, but the control is generally less than that in a public warehouse. Nevertheless, a field warehousing arrangement in the borrower's warehouse may be more practical than using a public warehouse because of costs and difficulties of transporting inventory between warehouses and borrowers' premises.

Property and Equipment

2.130 Loans to companies that have major items of property, plant, and equipment are generally collateralized by such assets. Also, property, plant, and equipment may be pledged as additional collateral for a receivable or inventory loan or as collateral for a separate loan made to a company that borrows against receivables and inventory.

2.131 Recent appraisals by specialists of liquidating values of property, plant, and equipment may be helpful in evaluating security provided by the collateral. The auditor may review those appraisals and collateral records. The auditor should be satisfied with the professional qualifications and reputation of a specialist whose work is to be used. If the auditor chooses to use the valuation of a specialist who is a related party, the auditor should consider the need to perform additional procedures on some or all of the specialist's assumptions, methods, or findings to determine their reasonableness. For further guidance, the auditor should refer to SAS No. 11, *Using the Work of a Specialist.**

EDP Considerations

2.132 Most finance companies use some form of computerized records. Audit considerations for computerized systems are comparable to those for manual systems, though specific audit procedures should be tailored to the type of system used. For example, manual systems rely on mathematical formulas or rate charts to calculate finance income; in computerized systems, software programming incorporates the formulas. Some significant concerns for auditing EDP systems include whether the duties of employees involved with the system are adequately segregated, source documents are available, and audit trails are sufficient to follow up on individual items. The auditor should refer to SAS No. 48, *The Effects of Computer Processing on the Audit of Financial Statements,* for further guidance.

2.133 Some finance companies subscribe to computer systems operated by outside businesses. Independent auditors or the user's internal auditors usually review internal control structure policies and procedures pertaining to those computer systems and issue reports that the user's auditor can consider. The auditor should refer to SAS No. 70, *Reports on the Processing of Transactions by Service Organizations,* which provides guidance on the factors an independent auditor should consider when auditing the financial statements of an entity that uses a service organization to process certain transactions.

Branch Audits

2.134 SAS No. 47, *Audit Risk and Materiality in Conducting the Audit,* provides general guidance on considerations of audit risk and materiality in planning the audit and designing audit procedures. Such considerations are important for the auditor's determination of the need for and extent of branch office audits. This determination depends in part on the effectiveness of home office controls over branch operations and the locations at which supporting documentation is maintained. Another consideration is whether there is an updated operating manual that prescribes all phases of branch operations, including accounting procedures. Such manuals may provide significant information for the auditor to obtain an understanding of internal control structure policies and procedures pertaining to branch operations.

2.135 The use of centralized systems has reduced the need for the auditor to visit branches to inspect subsidiary records and supporting documentation for loans. Even without such a centralized system, duplicate records may be maintained at the home office of a finance company. Consequently, the

* The AICPA's Auditing Standards Board has voted to issue a Statement on Auditing Standards that will supersede SAS No. 11. The new SAS is expected to be issued in July 1994 and to be effective for audits of financial statements for periods ending on or after December 15, 1994.

auditor may decide to limit branch audits and focus on determining the effectiveness of controls over branch office operations such as management reviews and internal audit procedures. If the home office maintains duplicate receivables ledgers, much or all of the substantive testing involving confirmation procedures and evaluation of collectibility often can be performed without visiting the branch offices.

2.136 If branch visits are warranted, the auditor ordinarily makes surprise audits of selected branches if cash is to be counted or collateral inspected. The audit of branch records normally may include tests of the internal control structure policies and procedures, comparisons of data submitted to the home office by branch personnel to branch records, and, if loan data are maintained only in the branch office, the audit procedures for loans described throughout this chapter. If floor plan loans are made, the auditor should consider examining related collateral on a test basis. The auditor may test postings of collections to customer accounts, as well as procedures for extensions, renewals, and rebates on all types of loans, to determine the reliability of the accounting records. Other audit procedures the auditor should consider performing when auditing a branch are as follows:

- Check accounts receivable ledgers for clerical accuracy, compare totals to appropriate branch controls, and trace totals to general ledger balances at the home office.
- Select a representative number of accounts for confirmation and test aged trial balances for clerical accuracy and compliance with the company's aging policy.
- If accounts receivable ledgers are maintained in the home office and accounts are confirmed using home office records, compare balances of selected accounts in home office records with records maintained at the branch.
- Compare supporting documentation for a selected number of loans with loan cards and other accounting records. Documentation might include signed notes, security agreements, loan applications, financing statements, insurance policies, and notices of lien filings.
- Test new and renewal loans for proper recording of items such as discount, dealer reserve, and insurance premiums. Rebates, extension fees, and late charges should be tested similarly.
- Test cash payment records for miscellaneous expenses.
- Review procedures used to account for and control repossessed collateral. If the branch is responsible for selling repossessed collateral, test sales of collateral by tracing proceeds to cash reports, bank deposits, and other pertinent documentation. Compare proceeds to estimates of value at the time loans were made and at the time collateral was repossessed. Examine evidence of ownership.
- If the branch is located in a state that requires interest to be computed each time a payment is received, test computations of application of interest and principal.
- Follow up on unusual bank reconciling items from the home office.
- Review the recent State Consumer Finance Division Examiner's Report or its equivalent for significant exceptions.
- Review the adequacy and documentation of the branch manager's or area supervisor's reviews of loans made, collection efforts, and cash counts.

- Review controls over cash collections, deposits, and disbursements.
- Review for duplicate loans to one borrower.
- Review no-mail and confidential loans for compliance with corporate policy.
- Review for compliance with the manager's lending limits.
- Review for compliance with policy relating to waiver of interest and late fees.

Some of the above procedures may be inappropriate or may need modification if the finance company uses an EDP system.

Leases

2.137 Audits of leases in some ways resemble audits of other finance receivables. For example, auditors should review the collectibility of minimum lease payments, including guaranteed residual values, and consider whether allowances for losses on leases are adequate. If repossessions have occurred, the auditor should consider current values of collateral not yet disposed of in evaluating the adequacy of the allowance for losses. The auditor also may confirm lease terms and the existence of leased properties directly with lessees and may test authorization for purchase of assets to lease files. Revenue recognition calculations can be tested for accuracy and compliance with FASB Statement No. 13, *Accounting for Leases,* and related amendments and interpretations. In addition, classifications as finance or operating leases may be reviewed.

2.138 The auditor should evaluate unguaranteed residual values included in gross investments recorded at the inception of leases. Residual values are the estimated fair values of leased properties at the end of their lease terms that generally are not guaranteed to lessors by lessees or third parties. The clients' methods and internal controls used to estimate residual values should be evaluated. The possibility of changes in residual values should be considered, for example, by comparing values of standard products or equipment to market prices and by consulting resale dealers and trade publications. Residual values of specialized equipment may be difficult to evaluate. Special emphasis is warranted for high-technology equipment, which often declines quickly in value because newer, more advanced, or less expensive models become available as a result of technological developments. Though purchase options included in lease terms may provide additional evidence of residual values, they should be viewed with caution because they generally would not indicate subsequent declines in values.

2.139 If reviews of residual values indicate that permanent declines have occurred, estimated residual values should be adjusted and losses should be recognized when estimates change.

2.140 The terms of lease agreements usually are reviewed and compared with the long-term lenders' contracts. The projected net cash flow analysis that is used to account for leveraged lease transactions should include income tax effects of the transactions. Tax effect calculations may be tested. Auditors should review and evaluate the validity of assumptions for projecting tax effects. Such reviews may include timing of receipt of tax benefits or payments of charges. Rates used to quantify the tax effects of transactions also should be reviewed. Reductions in leveraged lease investments caused by changes in original assumptions should be recognized in the period of change.

Income

2.141 The auditor should test the interest income recognition method and interest income accrual suspensions for compliance with generally accepted accounting principles (see paragraphs 2.14 to 2.16).

2.142 Finance income account balances usually are tested together with finance receivables. Tests of details, analytical procedures, or both may be relied on. Tests of details might include recalculation of finance income and nonrefundable fees for selected loans, such as those selected for confirmation, or tests of computer programs used to make such calculations. Analytical procedures might include comparisons of monthly recorded income amounts with those recorded in months of past years, prior months of the current year, and budgeted amounts, as well as with industry information by type of receivables. Monthly ratios of finance income to finance receivables might be compared with prior years' months and budgeted amounts.

2.143 Finance income earned on discount receivables also can be tested using the unearned finance income account as follows:

Unearned Finance Income	*Test Method*
Beginning balance	Tested in prior year
+ credits (total precomputed interest of new loans)	Recompute total unearned interest for a sample of new loans (possibly using loans selected for tests of cash payments)
− debits (finance income earned)	Balance amount
= Ending balance	Recompute balance of unearned finance income for a sample of loans outstanding (possibly using loans selected for confirmation)

This formula should be modified as necessary for such items as prepayments and loan renewals.

Statutory Regulations

2.144 Regulatory compliance is an important consideration for a finance company. State laws often restrict three major elements that determine interest income: the amount of the loan, the term of the loan, and the interest rate. State laws also may prescribe certain rebate calculations. Other regulatory restrictions may pertain to origination, delinquency, or extension fees. Compliance with the various state laws should be reviewed. Formulas used to calculate finance income should be tested to verify that results conform to applicable laws and regulations as well as to generally accepted accounting principles.

2.145 The Truth in Lending Act and regulations issued by state supervisory authorities generally affect lending transactions. The auditor may learn of possible violations of such regulations during the audit. If such is the case, the auditor should then refer for guidance to SAS No. 54, *Illegal Acts by Clients.*

Repossessed Assets Acquired in Liquidations of Receivables

2.146 The objectives of auditing repossessed assets acquired in liquidations are to test for the existence and evidence of ownership of those assets and to evaluate reasonableness of estimated net realizable values. Internal control structure policies and procedures over timing and methods of recording repossessed assets should be considered to determine the necessary extent of substantive tests of account balances.

2.147 Inspecting repossessed properties may be an appropriate test for existence. The auditor may compare carrying values of repossessions to subsequent sales, published wholesale price lists, or independent appraisals of the same or similar properties to determine reasonableness. If feasible, the auditor may group repossessions by product type and compare unit carrying amounts against the company's recent history of average losses or gains on sales of similar repossessions. Evidence of ownership may be established by reviewing legal or other pertinent documents. The auditor also may consider the ability of dealers to perform under recourse or repurchase agreements.

Dealer Reserves and Holdbacks

2.148 Before planning detailed audit tests, the auditor should become familiar with company policies and procedures on dealer reserve holdback arrangements and consider performing tests of related internal control structure policies and procedures. For example, the auditor should consider the extent of review and approval of changes to dealer reserve accounts. Though it is uncommon for dealers to know amounts of the dealer reserve accounts, such knowledge, obtained perhaps from regular statements issued by the finance company, may lessen the risk of disputes, and it may be feasible for the auditor to confirm the related liabilities to dealers. If not, the auditor may review activities in dealer reserve accounts for propriety and consider the overall adequacy of reserve balances in relation to the volume of loans bought, dealer credit status, and credit status of the dealer's customers.

2.149 Other auditing considerations may include reviewing compliance with significant provisions of dealer agreements, reconciling totals of individual dealer balances with applicable control accounts, and testing detailed transactions to the accounts and supporting documentation. Particular attention should be given to accounts with debit balances. The rationale for not writing off these amounts generally is that future purchases of retail contracts from dealers will eliminate the debit balances. The auditor should question that justification because, if past purchases of retail contracts from a dealer have resulted in debit balances in the dealer reserve accounts, future purchases may be unlikely to produce different results. The auditor should consider whether debit balances are losses that should be charged off.

Chapter 3

Capitalization of Finance Companies

3.01 Finance companies borrow funds to lend to others. 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 banks and savings and loan associations.

3.02 Finance company debt may be classified as senior, senior subordinated, and junior subordinated. The classifications describe declining priorities, which become especially significant when solvency becomes questionable. When two or more types of debt with diverse priorities are issued simultaneously, the lower priority debt ordinarily carries a higher interest rate.

3.03 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.

3.04 Generally, bank borrowings on lines of credit and commercial paper sold in the open market are sources of debt that mature in less than one year. Larger finance companies usually rely heavily on commercial paper markets but smaller finance companies may not have access to such markets and therefore may rely on bank borrowings as a source of funds.

3.05 Debt with maturity terms greater than one year is a major source of funds for most finance companies and is intended to reduce volatility of the cost and source of money. In large finance companies, such debt frequently constitutes more than half of the liabilities of finance companies. Smaller finance companies, with limited access to public debt markets, have a much greater reliance on short-term bank debt.

3.06 The related debt instruments traditionally have been acquired by insurance companies; however, banks, pension funds, and the general public have increasingly purchased those instruments. Interest rates generally are a function of the credit rating of the issuer and the prevailing money market conditions.

Bank Lines of Credit

3.07 Finance companies may pay commitment fees, maintain compensating balances, or do both to have bank lines of credit available. When a finance company borrows under a line of credit, it is charged interest at a rate usually based on a specified percentage related to the bank prime rate. Banks generally base the percentage on an analysis of the quality of the finance company's receivables and operations.

3.08 Bank borrowings are a type of senior debt commonly issued in the form of ninety-day notes, of which renewal may be negotiated before maturity. Banks generally require finance companies to pay off notes under lines of credit for a specified period, such as one month, each year. Finance companies are sometimes allowed to meet such requirements by borrowing under a second line of credit to pay off the first. They may, therefore, continuously borrow from banks, though individual bank notes are due in relatively short periods. Alternatively, they may be required to simultaneously settle all bank lines of credit for thirty days or more.

3.09 Some bank credit lines are obtained with little expectation that the finance companies will borrow under them. Such credit arrangements provide back-up sources of funds to assure a finance company's creditors that bank debt and commercial paper due in one year or less will be repaid. Though the duration of those unused credit arrangements may exceed twelve months, some contain clauses that allow the banks to withdraw commitments based on subjective evaluations of the finance company's operations.

3.10 Rating agencies strongly emphasize liquidity when they rate commercial paper. All issuers of commercial paper are expected to have bank lines of credit to back up such notes. The rating agencies view that support as security to provide temporary liquidity, and they generally do not rate a company's commercial paper without such coverage.

3.11 Bank lines of credit also are maintained to protect finance companies from unforeseen withdrawals of other credit sources. Some finance companies test the availability of bank lines periodically by borrowing under each line, particularly if those agreements are not formalized.

Commercial Paper

3.12 Commercial paper, another form of senior debt, matures in a few days to as long as 270 days from issuance. Commercial paper generally constitutes the major portion of debt due in less than one year of larger finance companies because interest rates on commercial paper are usually lower than those available from banks.

3.13 Companies with significant amounts of commercial paper outstanding generally issue and redeem commercial paper continuously. More commercial paper than needed may be sold on certain days to maintain an orderly market when regular customers have money to invest beyond the finance company's current needs. Maturity of a large amount of commercial paper or a long-term debt issue in the near future also may make it necessary for a company to sell larger-than-normal amounts of commercial paper.

3.14 Excess proceeds from sales of commercial paper usually are reinvested at comparable rates of return. Proceeds may be invested for very short periods, usually overnight, by entering into repurchase agreements with investment brokers, or by buying interest-bearing Eurodollar time bank deposits and commercial paper of other issuers.

Credit Ratings

3.15 Rating agencies generally consider fixed-charge coverage and other ratios, such as leverage, to be significant in evaluating the creditworthiness of a finance company's debt obligations. Rating agencies assign a credit rating to a company's debt obligations and commercial paper based on their detailed ratio analyses and evaluation of other factors. The ratings directly affect the lender's cost of borrowing and, therefore, its ability to borrow money.

3.16 Many institutional investors, such as insurance companies, banks, trusts, mutual funds, and pension and profit sharing plans, rely heavily on credit ratings in making their investment decisions. Many of those investors are prohibited by law or by formal agreement from investing in corporate obligations rated 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. In addition, many government agency pension funds are prohibited by law from investing in securities that do not have an investment grade rating. Those pension funds are significant buyers of finance company commercial paper and term debt securities.

Credit Questionnaires

3.17 A finance company furnishes its creditors with financial and operating information through standard questionnaires developed by a joint committee of representatives from industry and Robert Morris Associates. The credit questionnaires are revised periodically for changes in operations of finance companies and in the needs of lenders.

3.18 There are five credit questionnaires for finance companies: Sales Finance Company Questionnaire; Direct Cash Lending Questionnaire; Commercial Financing Questionnaire; Credit Questionnaire for Captive Finance Companies; and Mortgage Banking Questionnaire. The first two generally apply to independent companies that finance retail sales and make direct cash loans to consumers. The Commercial Financing Questionnaire applies to independent finance companies that provide financing services for business enterprises, including lease financing. The fourth questionnaire applies to captive finance companies formed to finance the sales of products by affiliated companies.

3.19 Some finance companies engage in several types of financing and lending activity and are required to furnish information on several types of questionnaires. For example, a finance company that both finances automobile retail sales contracts and lends directly to consumers generally would furnish information for the pertinent sections of the Sales Finance Company Questionnaire and the Direct Cash Lending Questionnaire. The various questionnaires are not all-inclusive; each reporting company must adapt the questionnaire to fit its own circumstances. The Credit Questionnaire for Captive Finance Companies reflects the wide diversity among individual companies. It consists of a series of questions designed to elicit the basic information needed for credit analysis, with the form of presentation left to the individual companies. The other questionnaires are much more specific.

3.20 Each credit questionnaire covers a specific reporting period, such as six months or a year. All have certain basic questions in common. Each requires information on the types of finance and lending activities of the company, details of business volume during and receivables at the end of the reporting period, aging of receivables, summary of credit loss experience for the period, description of certain basic operating and accounting policies, and information on the terms and liquidity of finance receivables.

3.21 Other required information pertains to the particular lending activities covered by the individual questionnaire. The Sales Finance Company Questionnaire requires analysis of the volume and type of retail sales financing receivables, such as those for automobiles, appliances, and home improvement, and indication of any significant concentration in one or more dealers. The Direct Cash Lending Questionnaire requires a schedule of collection results on direct consumer loans outstanding and an analysis of loan volume by type of borrower. The Commercial Financing Questionnaire requires specific information on larger commercial loans in each receivable classification and on a significant concentration of loans to any one debtor or group of affiliated debtors.

Accounting

3.22 The discount or premium on debt should be amortized to interest expense over the life of the related debt using the interest method as specified in APB Opinion No. 21, *Interest on Receivables and Payables,* for debt requiring imputation of interest.

3.23 Overnight investments resulting from sales of commercial paper in excess of daily needs should be recorded as assets in the balance sheet, but borrowing costs are better presented in the income statement by combining interest received on such investments against interest expense than by presenting such amounts separately. Although combined amounts normally are insignificant, such interest income should be disclosed in a note to the financial statements, if significant.

Financial Statement Presentation

3.24 The major components of debt should be disclosed on the face of the balance sheet or in the notes. FASB Statement No. 47, *Disclosure of Long-Term Obligations,* requires disclosure of the aggregate amount of maturities and sinking fund requirements for all long-term borrowings and redeemable preferred stock for each of the five years following the balance sheet date. Paragraph 19 of APB Opinion No. 15, *Earnings Per Share,* provides examples of other information to be disclosed, such as liquidation preferences, participation rights, and interest rates. In addition to the various types of subordinations, bank borrowings and commercial paper should be disclosed separately, as should components of debt that mature in more than one year. Such components may be grouped into significant categories for disclosure. The existence of bank lines of credit and their relevant terms and amounts also should be disclosed.

3.25 Finance companies traditionally have not described their assets as current and noncurrent in balance sheets, but typically have described their debt as short-term or long-term. To eliminate this inconsistency, finance companies should classify debt as *subordinated and senior* rather than as short-term and long-term.

Auditing

3.26 An audit of a finance company's debt and interest expense should be designed to provide reasonable assurance that—

a. The company has complied with restrictive covenants of loan agreements.

b. Amounts of debt are properly authorized and properly stated, classified, and described in the financial statements (for example, as senior, senior subordinated, and junior subordinated).

c. Related interest expense, including amortization of discount or premium, is properly recorded.

d. Adequate disclosures of restrictive covenants of loan agreements and other loan-related terms are included in the notes to the financial statements.

3.27 The auditor should discuss the various forms of debt with management. Terms of the debt instruments may be reviewed to understand the nature of each agreement, including any restrictive provisions. Once terms of the debt agreements are understood, the auditor can test compliance with their provisions and consider what disclosures are needed if the provisions are violated. Positive confirmations may provide evidence concerning principal and accrued interest at a given date. Confirmations may be used not only to confirm the amounts of the liabilities but also to reveal changes in the various covenants of the agreements pertaining to such matters as guarantees, payment terms, interest rates, and restrictions on assets. Confirmations of bank lines of credit also may be used to identify (*a*) conditions under which lines are available or may be withdrawn and (*b*) whether compensating balances are required.

Compliance Reports

3.28 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.*

Credit Questionnaires

3.29 Robert Morris Associates questionnaires may be included as information supplementary to the basic financial statements of the finance company. Some information required in the questionnaires will have been derived from accounting records tested by the independent auditor as part of the auditing procedures followed in the audit of the finance company's financial statements. For example, information relating to reserves for losses, delinquent accounts, repossessions, deferred finance income, and borrowings will have been derived from financial records tested by the independent auditor. However, the auditor is not required to audit information included in the questionnaires unless the finance company requests such services.

3.30 If the auditor submits to the finance company or to others a document that contains one or more questionnaires in addition to the company's basic financial statements and the auditor's standard report, the auditor should follow the reporting guidelines in SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents,* which requires that the auditor's report state that the audit was made for the purpose of forming an opinion on the basic financial statements taken as a whole. The report should identify the accompanying questionnaire and further state that it is presented for additional analysis and is not part of the basic financial statements. The auditor should express or disclaim an opinion on the information included in the questionnaire, depending on whether the information has been subjected to auditing procedures applied in auditing the basic financial statements. The auditor may express an opinion on a portion of the accompanying information and disclaim an opinion on the remainder. The report on the information included in the questionnaire may be added to the auditor's standard report on the basic financial statements or may appear separately in the auditor-submitted document.

3.31 If the finance company publishes documents containing credit questionnaires in addition to audited financial statements and the auditor's report, the auditor should refer to SAS No. 8, *Other Information in Documents Containing Audited Financial Statements,* for guidance.

Chapter 4

Participations

4.01 In a participation agreement, a finance company shares a loan with another financial institution by selling a portion of the loan or buying an interest in a loan originated by another financial institution. A seller of a participation sometimes retains a small portion of the buyer's share of interest on loans to cover overhead incurred in servicing the loans.

4.02 Terms of participation agreements ordinarily provide for sharing of credit risks in proportion to cash invested by each participant. Such participations commonly are called *pari passu*. However, some agreements, known as *first out*, provide for a disproportionate sharing of the risk in relation to the cash invested. For example, an agreement may require one participant to suffer the first loss up to a specified amount or otherwise provide priority to one of the participants in liquidation of the loan. Such agreements may be, in substance, financing arrangements collateralized by specific loans.

4.03 A participation may result from a company's reluctance to carry an unusually large receivable from a single customer or to carry a receivable from a borrower who is deemed an unusual credit risk. To transfer some of the liquidity and rate risk, lenders may sell a portion of such loans to other lenders. In addition, participations may benefit borrowers by providing lower effective interest rates based on averages of the participating parties' interest rates.

Accounting

4.04 Participations bought and sold usually are accounted for individually—that is, loan by loan. Control accounts also may be maintained for each participating financial institution. The key accounting question is whether to account for transfers of portions of loans as sales of receivables or as collateralized borrowings.

Pari Passu

4.05 A pari passu participation should be treated as a sale of the related receivable because it provides for pro rata sharing of risk. The participation should be shown on the balance sheet net of the portions sold or at net amounts bought. The amount of such a participation generally is combined with other finance receivables on the balance sheet and need not be disclosed unless it is material in relation to total receivables.

First Out

4.06 A first-out agreement provides recourse to certain participants and may raise a question of whether the transaction is a financing arrangement rather than a sharing of the risks and rewards of a particular loan. FASB Statement No. 77, *Reporting by Transferors for Transfers of Receivables With Recourse,* explicitly applies to participation agreements that provide for recourse. The standard generally requires recognizing such a participation as a sale if (*a*) the transferor surrenders control of the future economic benefits embodied in the receivables, (*b*) the transferor's obligation under the recourse provisions can be reasonably estimated, and (*c*) the transferee cannot require the transferor to repurchase the receivables except pursuant to the recourse provisions. If any of those conditions is not met, the transferor should report the amount of proceeds from the participation as a liability and continue to present the gross amount of the related receivable. Significant amounts of loans that collateralize first-out participations should be disclosed in the notes to the financial statements. FASB Statement No. *77* also requires certain disclosures for transfers of receivables with recourse reported as sales.

Auditing

4.07 The auditor should consider reviewing compliance with the significant provisions of participation agreements, reviewing subsidiary listings of participations bought from or sold to other institutions, and testing transactions to supporting documentation. The auditor generally cannot confirm directly with the debtors if the finance company bought its participating shares under nonnotification arrangements. Instead, the auditor may correspond directly with the auditor of the other participating company. For example, the auditor may ask whether the participating share was included in the sample tested by the other auditor and, if not, may request the other auditor to confirm the loan or to obtain permission from the other participating finance company to confirm the loan directly.

Chapter 5

Insurance Activities of Finance Companies

5.01 Insurance operations ordinarily are an integral part of consumer finance activities. The auditor of a finance 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

5.02 Insurance activities of finance 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

5.03 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.

5.04 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.

5.05 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

5.06 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

5.07 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

5.08 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 reinsures policies written by direct writing companies.

5.09 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

5.10 Insurers, both insurance subsidiaries of finance companies and independent companies, may pay commissions to finance 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.

Accounting

5.11 Accounting by enterprises that issue insurance contracts is dealt with in FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises,* and in 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,* and FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts.*

Premium Income

5.12 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.

5.13 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.

5.14 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."

5.15 The following summarize the revenue recognition principles for the various types of insurance policies:

a. *Credit life insurance.* Straight-line recognition of premium income should be used for level term credit life insurance because the risk exposure is constant throughout the term of the policy. The interest method should be used for decreasing term credit life insurance because the risk exposure declines in proportion to the scheduled reduction of the unpaid loan balance.

b. *Credit accident and health insurance.* The risk exposure on credit accident and health insurance decreases throughout the term of the policy because the amount of insurance in force at a given time generally equals the unpaid loan balance. However, the risk exposure as measured by anticipated claims is less than the total in unpaid installments, because most illnesses and disabilities are for periods less than the remaining loan terms. Accordingly, premiums on credit accident and health insurance customarily are recognized in income in reasonable relationship to anticipated claims. This generally results in recognizing such premium income in amounts that fall between calculations under the straight-line method and a method based on the amount of insurance in force. To illustrate, assume that a credit accident and health insurer's claim experience indicates that revenue recognition in reasonable relationship to anticipated claims approximates the mean of the straight-line and insurance in-force methods. For a loan due in six equal monthly installments of $700 and a related credit accident and health insurance premium of $42, the following amounts are applicable:

			Earned Premium for Month		
Month	*Total Unpaid Loan Installments at Beginning of Month*	*Factor for Insurance In-Force Method*	*Insurance In-Force Method*	*Straight-line Method*	*Mean of In-Force and Straight-line Methods*
1	$ 4,200	42/147	$12.00	$ 7.00	$ 9.50
2	3,500	35/147	10.00	7.00	8.50
3	2,800	28/147	8.00	7.00	7.50
4	2,100	21/147	6.00	7.00	6.50
5	1,400	14/147	4.00	7.00	5.50
6	700	7/147	2.00	7.00	4.50
Total	$14,700		$42.00	$42.00	$42.00

c. *Property and liability insurance.* Property insurance premiums should be recognized on a straight-line basis because the risk exposure generally is constant over the term of the policy. However, the premiums should be recognized on a decreasing basis in proportion to the coverage if the amount of coverage declines on a predetermined schedule.

Policy Acquisition Costs

5.16 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 finance companies and premium taxes normally are the most significant elements of acquisition costs for captive insurance companies. Deferred costs associated with payment of such commissions and other intercompany items should be eliminated in consolidation.

Investment Portfolios

5.17 Insurance subsidiaries of finance companies 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.

5.18 FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities,* 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.

5.19 Insurance subsidiaries are required to deposit some securities, usually not a significant amount, with state regulatory authorities. However, if significant, the amount deposited should be disclosed.

State Laws

5.20 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 prescribed 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

5.21 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.

5.22 Income from experience-rated or retrospective commission arrangements should be accrued over the applicable insurance risk period. Insurers generally can provide statistical data that can be used to estimate experience-rated or retrospective commissions if the finance company does not have adequate internal data.

5.23 Commissions paid to a finance company by an insurance subsidiary are eliminated in consolidation.

Consolidation Policy

5.24 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

5.25 Presentation of revenues, unearned premiums, and unpaid claims related to activities of an insurance subsidiary varies. In consolidated financial statements, some finance companies combine revenues from insurance provided both to finance customers and other customers with revenues from finance activities to present a total revenue amount; others do not. Some companies present certain unearned premiums and unpaid claims on insurance related to finance customers as liabilities in their consolidated balance sheets; others deduct such amounts from total finance receivables.

5.26 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.

5.27 Unpaid claims for property insurance and a portion of level term life insurance, however, generally may not be applied in consolidation against related finance receivables because finance 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.

5.28 Revenues from insurance provided to finance customers may be presented as part of revenues from the finance business. This presentation may be preferable because it better portrays the relative significance of captive insurance activities to the earnings of the enterprise. The following illustrates a form of that presentation:

Revenues from finance business:	
Interest and finance charges earned on finance receivables	XXX
Insurance premiums and commissions	XXX
Investment and other income	XXX
Total revenues	XXX

Alternatively, if the income statement emphasizes presentation of net interest income, another approach may be to present revenues from captive insurance activities separately below net interest income.

5.29 FASB Statement No. 14, *Financial Reporting for Segments of a Business Enterprise,* requires public enterprises to present in their financial statements industry-segment information on revenues, profitability, identifiable assets, and other matters. For such reporting purposes, insurance business relating to finance customers should be included in the finance business segment.

Auditing

5.30 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.

5.31 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.

Chapter 6

Acquisitions of Finance Companies and Operations

6.01 APB Opinion No. 16, *Business Combinations,* requires that the purchase price of a company be allocated among all assets, including identifiable intangible assets, based on their fair values. The remaining unassigned portion of the purchase price is then accounted for as goodwill. Bulk purchases of receivables portfolios of an existing finance company also result in similar allocations among tangible and intangible assets. Following are some considerations that may affect such allocations, or the purchase price of a finance company or receivables portfolio:

- A finance company may seek to expand its operations to geographical areas where it presently does not do business. To avoid the start-up costs of establishing new branch offices, the finance company may be willing to pay a premium to buy another finance company that operates in such areas. Furthermore, the finance company may be especially willing to pay a premium if licenses are difficult to obtain or if regulatory or competitive conditions otherwise complicate entry into those areas.
- A finance company may buy another finance company or a receivables portfolio to obtain an established base of loans and customers. The acquiring company may pay a premium, particularly for a portfolio of direct consumer loans and retail sales contracts, in the expectation that the purchased accounts will provide new loans and customers.
- The acquiring company may have no finance operations and thus may seek to buy an existing finance company to obtain valuable loan licenses, management expertise, and customer lists. Therefore, the buyer may be willing to pay a premium for an initial entry into the business.
- A finance company may be willing to pay a premium to another finance company with an attractive debt structure. For example, the acquired company may have issued long-term debt in prior years at interest rates that are favorable when compared with rates prevailing at the purchase date.
- The seller may enter into an agreement not to compete in a specified geographical area or for a specified period. The acquiring company may pay a premium for such an agreement not to compete.

6.02 To compute the net premium paid for the finance receivables, loans may be examined or graded and assigned to one of several rating categories to determine their estimated fair value. Considerations in determining fair values may be current market rates of interest and statutory limits on rates as well as quality of the accounts.

6.03 APB Opinion No. 17, *Intangible Assets,* as amended by FASB Statement No. 72, *Accounting for Certain Acquisitions of Banking or Thrift Institutions,* addresses accounting for intangible assets, including goodwill, acquired in business combinations. The opinion requires that useful lives of identifiable intangible assets be estimated separately so that appropriate periods of amortization may be determined. The opinion states that amortization periods for intangible assets acquired after its issuance should not exceed forty years under any circumstances.

6.04 FASB Statement No. 72 applies to the acquisition of a commercial bank, a savings and loan association, a mutual savings bank, a credit union, other depository institutions having assets and liabilities of the same types as those institutions, and branches of such enterprises. Provisions of FASB Statement No. 72 apply to acquisitions of finance companies but are not likely to have wide application in practice. Under that standard, when the fair value of liabilities assumed exceeds the fair value of tangible and identified intangible assets acquired, that excess constitutes an unidentifiable intangible asset that should be amortized to expense using the interest method over a period no greater than the estimated remaining life of the long-term interest-bearing assets acquired.

6.05 Net premiums paid for finance receivables generally are amortized over the estimated life of the existing receivables portfolio. The estimated life may include expected renewals, and generally is a relatively short period, such as five to seven years. However, the existence of valuable loan licenses or agreements not to compete may indicate that longer amortization periods are warranted. Nevertheless, conservatism should be a mitigating factor in determining those amortization periods for such net premiums and for goodwill because changes in state laws and regulations or in the competitive environment may render valueless such loan licenses or agreements not to compete. Amounts paid that are identified as relating to long-term debt with attractive interest rates should be amortized, using the interest method, over the lives of the related debt. Such amounts would reduce the carrying amount of debt and would not be shown as an asset.

6.06 APB Opinion No. 17 requires goodwill to be amortized using the straight-line method unless another rational and systematic method is demonstrated to be more appropriate. If a finance company was purchased for territorial expansion of operations or for some purpose other than an initial entry into the finance business, consideration should be given to whether amounts designated as goodwill would be more appropriately accounted for as yield adjustments to the acquired receivables. In general, a review of specific facts and circumstances, such as economic conditions and competition, should be considered.

6.07 Amounts of intangible assets may be presented in the balance sheet in one or more categories, depending on the materiality of the accounts. Intangible assets usually are presented as the last asset item or items in the balance sheet.

6.08 Auditing procedures for acquisitions of finance companies are generally similar to auditing procedures for acquisitions of other enterprises.

Appendix A

Illustrative Financial Statements

The following set of financial statements illustrates one form of currently acceptable practice and, as indicated, does not include all disclosures required under generally accepted accounting principles. The notes to the financial statements are representative of the basic type of disclosure for finance companies. Additional disclosures, such as information concerning related-party transactions, subsequent events, pension plans, postretirement benefits other than pensions, postemployment benefits, lease commitments, accounting changes, off-balance-sheet risks, concentrations of credit risk, the fair value of financial instruments, and other matters not unique to finance companies may be required by generally accepted accounting principles. Other forms of financial statements are acceptable. More or less detail should appear either in the financial statement or in the notes, depending on the circumstances.

The banking industry has adopted an income statement format that emphasizes presentation of net interest income. Because of the similarity between many banking activities and finance company activities, the Finance Companies Guide Special Committee believes that such a presentation is of increasing relevance for the finance industry. Therefore, the illustrative financial statements in this appendix include two alternative income statement formats, the first of which emphasizes a net interest income presentation.

Nevertheless, 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. Additionally, the scope of what is to be included in net interest income needs to be considered. For example, as not done in the illustrative financial statements, 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.

FASB Statement No. 95, *Statement of Cash Flows*, requires a statement of cash flows as part of a full set of financial statements for all business enterprises in place of a statement of changes in financial position.

The statement requires that a statement of cash flows classify cash receipts and payments according to whether they stem from operating, investing, or financing activities and provides definitions of each category.

The statement requires that information about investing and financing activities not resulting in cash receipts or payments in the period be provided separately.

The statement encourages enterprises to report cash flows from operating activities directly by showing major classes of operating cash receipts and payments (the direct method). Enterprises that choose not to show operating cash receipts and payments are required to report the same amount of net cash flow from operating activities indirectly by adjusting net income to reconcile it to net cash flow from operating activities (the indirect reconciliation method) by removing the effects of (*a*) all deferrals of past operating cash receipts and payments and all accruals of expected future operating cash receipts and payments, and (*b*) all items that are included in net income that do not affect operating cash receipts and payments. If the direct method is used, a reconciliation of net income and net cash flow from operating activities is required to be provided in a separate schedule.

Both the direct and the indirect methods are illustrated in this appendix.

Exhibit 1

XYZ Finance Corporation and Consolidated Subsidiaries

Balance Sheets
Years Ended December 31, 19X5 and 19X4
(in thousands except share and per share amounts)

	19X5	*19X4*
Assets		
Finance receivables, net	$333,649	$272,166
Investments in securities *	32,760	30,838
Cash	6,015	4,907
Property and equipment	4,689	3,830
Other	11,628	9,577
Total assets	$388,741	$321,318
Liabilities		
Senior debt	$163,064	$113,723
Senior subordinated debt	84,204	74,572
Junior subordinated debt	31,400	30,500
Accounts payable and accrued liabilities	15,727	13,866
Credit balances of factoring clients	4,120	3,112
Deferred income taxes **	3,972	3,469
Total liabilities	$302,487	$239,242
Shareholders' Equity		
Common stock, $1 par value; 4,269,000 shares authorized and outstanding	$ 4,269	$ 4,269
Additional paid-in capital	18,945	18,945
Net unrealized depreciation of marketable equity securities	(626)	(278)
Retained earnings	63,666	59,140
Total shareholders' equity	$ 86,254	$ 82,076
Total liabilities and shareholders' equity	$388,741	$321,318

The accompanying notes are an integral part of these financial statements.

* These financial statements have not been revised to reflect FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities.* See FASB Statement No. 115 for dislcosure requirements that are applicable to financial statements for fiscal years beginning after December 15, 1993.

** See FASB Statement No. 109, *Accounting for Income Taxes,* for disclosure requirements that are applicable for fiscal years beginning after December 15, 1992.

Exhibit 2

XYZ Finance Corporation and Consolidated Subsidiaries

Statements of Income and Retained Earnings: Format 1
Years Ended December 31, 19X5 and 19X4
(in thousands except per share amounts)

	19X5	*19X4*
Interest income		
Interest and fee income	$ 55,510	$ 47,302
Interest expense	(18,825)	(16,283)
Interest income before provision for credit losses	36,685	31,019
Provision for credit losses *	(4,284)	(3,623)
Net interest income	32,401	27,396
Insurance premiums and other income	13,040	11,650
Other expenses		
Salaries and fringe benefits	(10,546)	(8,987)
Other operating expenses	(13,227)	(11,565)
Policyholders' benefits	(6,644)	(5,600)
Income before income taxes	15,024	12,894
Income taxes	(7,211)	(6,189)
Net income	7,813	6,705
Retained earnings, beginning of year	59,140	55,551
Dividends	(3,287)	(3,116)
Retained earnings, end of year	$ 63,666	$ 59,140
Earnings per share	$ 1.83	$ 1.57
Dividends per share	$ 0.77	$ 0.73

The accompanying notes are an integral part of these financial statements.

* See FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan,* for disclosure requirements that are applicable to financial statements for fiscal years beginning after December 15, 1994.

Exhibit 3

XYZ Finance Corporation and Consolidated Subsidiaries

Statements of Income and Retained Earnings: Format 2
Years Ended December 31, 19X5 and 19X4
(in thousands except per share amounts)

	19X5	*19X4*
Revenues		
Interest and fee income	$ 55,510	$ 47,302
Insurance premiums and other income	13,040	11,650
Total revenues	68,550	58,952
Expenses		
Interest expense	18,825	16,283
Policyholders' benefits	6,644	5,600
Provision for credit losses *	4,284	3,623
Salaries and fringe benefits	10,546	8,987
Other operating expenses	13,227	11,565
Total expenses	53,526	46,058
Income before income taxes	15,024	12,894
Income taxes	7,211	6,189
Net income	7,813	6,705
Retained earnings, beginning of year	59,140	55,551
Dividends	(3,287)	(3,116)
Retained earnings, end of year	$ 63,666	$ 59,140
Earnings per share	$ 1.83	$ 1.57
Dividends per share	$ 0.77	$ 0.73

The accompanying notes are an integral part of these financial statements.

* See FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan,* for disclosure requirements that are applicable to financial statements for fiscal years beginning after December 15, 1994.

Exhibit 4a

XYZ Finance Corporation and Consolidated Subsidiaries

Statements of Cash Flows: Direct Method
Years Ended December 31, 19X5 and 19X4
(in thousands)

	19X5	*19X4*
Cash flows from operating activities:		
Interest and fees received	$ 54,698	$ 46,589
Interest paid	(18,275)	(15,897)
Cash payments for operating expenses	(21,912)	(18,686)
Income taxes paid	(5,242)	(4,565)
Insurance premiums received	12,790	11,498
Other	(2,611)	(1,937)
Net cash provided by operating activities	19,448	17,002
Cash flows from investing activities:		
Loans originated or purchased *	(190,304)	(136,571)
Loans repaid or sold *	118,705	83,750
Net investment in commercial paper	(346)	(555)
Securities purchased **	(19,243)	(17,512)
Securities sold or matured **	17,471	16,639
Capital expenditures	(1,409)	(1,656)
Proceeds from sale of property and equipment	200	643
Net cash used in investing activities	(74,926)	(55,262)
Cash flows from financing activities:		
Net borrowings of commercial paper	16,939	10,215
Proceeds from issuance of other debt	71,000	50,000
Repayment of other debt	(28,066)	(18,215)
Proceeds from issuance of common stock	0	955
Dividends paid	(3,287)	(3,116)
Net cash provided by financing activities	56,586	39,839
Net increase in cash and cash equivalents	1,108	1,579
Cash and cash equivalents, beginning of year	4,907	3,328
Cash and cash equivalents, end of year	$ 6,015	$ 4,907

* If the amounts are significant, this caption may be separated into two line items.

** These financial statements have not been revised to reflect FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities.* See FASB Statement No. 115 for disclosure requirements that are applicable to financial statements for fiscal years beginning after December 15, 1993.

Reconciliation of net income to net cash provided by operating activities:

	19X5	19X4
Net income	$ 7,813	$ 6,705
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for credit losses on finance receivables	4,284	3,623
Policyholders' benefits	6,644	5,600
Depreciation	350	303
Deferred income taxes	503	473
Accounts payable and accrued liabilities	1,861	1,530
Accrued interest receivable	(812)	(713)
Gain on sale of securities	(152)	(183)
Other	(1,043)	(336)
Net cash provided by operating activities	$ 19,448	$ 17,002

The accompanying notes are an integral part of these financial statements.

Exhibit 4b

XYZ Finance Corporation and Consolidated Subsidiaries

Statements of Cash Flows: Indirect Method
Years Ended December 31, 19X5 and 19X4
(in thousands)

	19X5	*19X4*
Cash flows from operating activities:		
Net income	$ 7,813	$ 6,705
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for credit losses on finance receivables	4,284	3,623
Policyholders' benefits	6,644	5,600
Depreciation	350	303
Deferred income taxes	503	473
Accounts payable and accrued liabilities	1,861	1,530
Accrued interest receivable	(812)	(713)
Gain on sale of securities	(152)	(183)
Other	(1,043)	(336)
Net cash provided by operating activities	19,448	17,002
Cash flows from investing activities:		
Loans originated or purchased *	(190,304)	(136,571)
Loans repaid or sold *	118,705	83,750
Net investment in commercial paper	(346)	(555)
Securities purchased **	(19,243)	(17,512)
Securities sold or matured *, **	17,471	16,639
Capital expenditures	(1,409)	(1,656)
Proceeds from sale of property and equipment	200	643
Net cash used in investing activities	(74,926)	(55,262)
Cash flows from financing activities:		
Net borrowings of commercial paper	16,939	10,215
Proceeds from issuance of other debt	71,000	50,000
Repayment of other debt	(28,066)	(18,215)
Proceeds from issuance of common stock	0	955
Dividends paid	(3,287)	(3,116)
Net cash provided by financing activities	56,586	39,839
Net increase in cash and cash equivalents	1,108	1,579
Cash and cash equivalents, beginning of year	4,907	3,328
Cash and cash equivalents, end of year	$ 6,015	$ 4,907

Supplemental disclosures of cash flow information:

	19X5	*19X4*
Cash paid during the year for:		
Interest	$ 18,275	$ 15,897
Income taxes	$ 5,242	$ 4,565

The accompanying notes are an integral part of these financial statements.

* If the amounts are significant, this caption may be separated into two line items.

** These financial statements have not been revised to reflect FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities.* See FASB Statement No. 115 for disclosure requirements that are applicable to financial statements for fiscal years beginning after December 15, 1993.

Exhibit 5

XYZ Finance Corporation and Consolidated Subsidiaries

Notes to Financial Statements

A—Summary of Significant Accounting Policies

Basis of Consolidation

The consolidated financial statements include the accounts of XYZ Finance Corporation (the Company) and its subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

Income Recognition

Interest income from finance receivables is recognized using the interest (actuarial) method. Accrual of interest income on finance receivables is suspended when a loan is contractually delinquent for ninety days or more. The accrual is resumed when the loan becomes contractually current, and past-due interest income is recognized at that time. In addition, a detailed review of commercial loans will cause earlier suspension if collection is doubtful. Premiums and commissions for credit life insurance are recognized as revenue using the interest method. Premiums and commissions for credit accident and health insurance are recognized over the terms of the contracts based on the mean of the straight-line and interest methods.

Credit Losses

Provisions for credit losses are charged to income in amounts sufficient to maintain the allowance at a level considered adequate to cover the losses of principal and interest in the existing portfolio. The Company's charge-off policy is based on a loan-by-loan review for all receivables except consumer loans and factored receivables, which are charged off when they are 180 days and 90 days contractually past due, respectively. [See FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan,* for disclosure requirements that are applicable to financial statements for fiscal years beginning after December 15, 1994.]

Loan Origination Fees and Costs

Fees received and direct costs incurred for the origination of loans are deferred and amortized to interest income over the contractual lives of the loans using the interest method. Unamortized amounts are recognized in income at the time that loans are sold or paid in full.

Investments

Investments in marketable equity securities are carried at lower of aggregate market value and cost. Investments in bonds and notes are carried at amortized cost. The amount by which the aggregate cost of investments in marketable equity securities exceeds aggregate market value is reported as a deduction from equity. Net realized gains or losses resulting from sales of investments or from declines in market values of investments that are other than temporary are included in income. [See FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities,* for disclosure requirements that are applicable to financial statements for fiscal years beginning after December 15, 1993.]

B—Finance Receivables and Allowance for Credit Losses

Finance receivables as of December 31 consisted of the following (in thousands of dollars):

	19X5	*19X4*
Consumer		
Real estate secured	$131,961	$104,078
Other	119,135	97,857
Accrued interest	3,175	2,550
	254,271	204,485
Commercial		
Accounts receivable loans	32,002	27,440
Factored accounts		
Receivables	21,404	18,594
Inventory loans to clients	2,965	2,876
Overadvances to clients	2,947	2,260
Floor plan loans	5,441	5,763
Other	29,962	23,620
Accrued interest	1,200	1,013
	95,921	81,566
Total finance receivables	350,192	286,051
Allowance for credit losses	(9,506)	(7,839)
Unearned credit insurance premiums and reserves for policyholder benefits	(7,037)	(6,046)
Finance receivables, net	$333,649	$272,166

On December 31, 19X5, the accrual of interest income was suspended on $4,086,000 and $2,107,000 of consumer and commercial loans, respectively.

[See FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan,* for disclosure requirements that are applicable to financial statements for fiscal years beginning after December 15, 1994.]

On December 31, 19X5, contractual maturities of finance receivables were as follows (in thousands of dollars):

	19X6	*19X7*	*19X8*	*19X9*	*19Y0*	*Thereafter*	*Total*
Consumer							
Real estate secured	$ 20,963	$10,785	$10,474	$ 8,480	$ 8,917	$72,342	$131,961
Other	51,325	29,374	20,164	9,507	2,423	6,342	119,135
Commercial							
Accounts receivable loans	32,002						32,002
Factored accounts	27,316						27,316
Floor plan loans	4,686	755					5,441
Other	6,140	8,243	5,192	4,934	5,453		29,962
Accrued interest	4,375						4,375
Total finance receivables	$146,807	$49,157	$35,830	$22,921	$16,793	$78,684	$350,192

It is the Company's experience that a substantial portion of the consumer loan portfolio generally is renewed or repaid before contractual maturity dates. The above tabulation, therefore, is not to be regarded as a forecast of future cash collections. During the years ended December 31, 19X5 and 19X4, cash collections of principal amounts of consumer loans totaled $57,670,000 and $40,719,000, respectively, and the ratios of these cash collections to average principal balances were 25 percent and 29 percent, respectively.

Changes in the allowance for credit losses were as follows (in thousands of dollars):

	Consumer		*Commercial*				
	Real Estate Secured	*Other*	*Accounts Receivable Loans*	*Factored Accounts*	*Floor Plan Loans*	*Other*	*Total*
Balance as of December 31, 19X3	$ 762	$3,885	$628	$556	$112	$620	$6,563
Provision for credit losses	597	1,564	627	534	129	172	3,623
Loans charged off	(376)	(1,357)	(749)	(639)	(154)	(156)	(3,431)
Recoveries	58	490	225	192	46	73	1,084
Balance as of December 31, 19X4	1,041	4,582	731	643	133	709	7,839
Provision for credit losses	651	2,090	664	583	121	175	4,284
Loans charged off	(448)	(1,601)	(808)	(710)	(147)	(178)	(3,892)
Recoveries	76	601	243	213	44	98	1,275
Balance as of December 31, 19X5	$1,320	$5,672	$830	$729	$151	$804	$9,506

C—Investments in Securities

Investments in securities as of December 31 were as follows (in thousands of dollars):

	19X5			*19X4*		
	Cost	*Market*	*Carrying Amount*	*Cost*	*Market*	*Carrying Amount*
Marketable equity securities						
Common stocks	$ 10,454	$ 9,523	$ 9,523	$ 9,429	$ 8,382	$ 8,382
Preferred stocks	5,897	6,202	6,202	5,551	6,320	6,320
Total marketable equity securities	16,351	15,725	15,725	14,980	14,702	14,702
Other						
Government bonds	6,552	6,128	6,552	6,267	5,832	6,267
Corporate bonds	4,586	4,271	4,586	4,318	4,017	4,318
Commercial paper	5,897	5,897	5,897	5,551	5,551	5,551
Total other	17,035	16,296	17,035	16,136	15,400	16,136
Total investments in securities	$ 33,386	$ 32,021	$ 32,760	$ 31,116	$ 30,102	$ 30,838

All but $6,710,000 and $3,801,000 of the above investments were held by insurance subsidiaries as of December 31, 19X5 and 19X4, respectively. As of December 31, 19X5, the marketable equity securities portfolio had gross unrealized gains of $428,000 and gross unrealized losses of $1,054,000. The gross unrealized losses have not been reduced for their tax effects. Sales of marketable equity securities resulted in net realized gains of $152,000 and $183,000 in 19X5 and 19X4, respectively.

[See FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities,* for disclosure requirements that are applicable to financial statements for fiscal years beginning after December 15, 1993.]

D—Debt

Debt as of December 31 consisted of the following (in thousands of dollars):

	19X5	19X4
Senior debt		
Commercial paper	$ 62,600	$ 45,661
4% to 7% notes due 19X6—19X9	73,866	47,570
7 1/2% notes due 19Y0—19Y4	12,090	9,314
8% notes due 19X9	9,671	7,452
Variable interest rate notes due 19X8	4,837	3,726
Total senior debt	163,064	113,723
Senior subordinated debt		
6% notes due 19X9	40,000	40,000
7% notes due 19Y0	34,572	34,572
8 1/2% notes due 19Y3—19Y7	9,632	—
Total senior subordinated notes	84,204	74,572
Junior subordinated notes		
8% notes due 19X9	25,000	25,000
10 1/2% notes due 19Y0—19Y6	6,400	5,500
Total junior subordinated notes	31,400	30,500
Total subordinated debt	115,604	105,072
Total debt	$278,668	$218,795

The Company maintains various bank credit agreements, primarily to support commercial paper borrowings. As of December 31, 19X5, these agreements included $50,000,000 of formal credit lines and $158,460,000 of revolving credit agreements. Credit lines are reviewed annually, and the revolving credit agreements consist of $50,160,000 and $108,300,000 expiring June 30, 19X7, and September 30, 19X9, respectively. As of December 31, 19X5, none of the credit lines of revolving credit agreements were in use. To support the availability of credit agreements, the Company pays commitment fees or maintains compensating balances, or both. Borrowings under these lines generally are available at the prime rate. Compensating balance and annual commitment fee requirements as of December 31, 19X5 totaled $742,000 and $987,000, respectively.

Data on commercial paper were as follows (in thousands of dollars):

	19X5	19X4
Weighted average interest rate at year end	9.2%	8.7%
Maximum amount outstanding at any month end	$62,600	$48,735
Average borrowings	54,131	43,867
Weighted average interest rate during the year	9.0%	8.5%

Maturities as of December 31, 19X5, were as follows (in thousands of dollars):

	19X6	*19X7*	*19X8*	*19X9*	*19Y0*	*There-after*	*Total*
Senior debt	$81,100	$18,500	$22,337	$29,037	$2,400	$9,690	$163,064
Senior subordinated debt				40,000	34,572	9,632	84,204
Junior subordinated debt				25,000	1,000	5,400	31,400
Total debt	$81,100	$18,500	$22,337	$94,037	$37,972	$24,722	$278,668

The loan agreements under which certain of the senior and subordinated debts were issued contain restrictions on the payment of dividends, the purchase of common stock, and the requirements for maintenance of certain financial ratios and other financial conditions. Under the most restrictive of the dividend payment provisions, approximately $21,056,000 of consolidated retained earnings were free of such restrictions as of December 31, 19X5. Requirements for maintenance of certain financial ratios and other financial conditions have the effect of requiring maintenance of consolidated stockholders' equity at certain minimum amounts; as of December 31, 19X5, consolidated equity exceeded this minimum amount by approximately $38,600,000.*

* Note: See appropriate FASB and AICPA pronouncements for additional guidance in presenting other information required by generally accepted accounting principles such as disclosures about insurance activities, segment data, lease commitments, employee benefit plans, income taxes, debt securities held as assets, financial instruments with off-balance sheet risk, financial instruments with concentrations of credit risk, postemployment benefits other than pensions, and the fair value of financial instruments.

Appendix B

Statement of Position 90-11

Disclosure of Certain Information by Financial Institutions About Debt Securities Held as Assets

November 30, 1990

Amendment to
AICPA Audit and Accounting Guides
Audits of Banks,
Audits of Finance Companies (Including Independent and Captive Financing Activities of Other Companies),
Audits of Property and Liability Insurance Companies, **and**
Audits of Stock Life Insurance Companies

Issued by the
Accounting Standards Executive Committee

American Institute of
Certified Public Accountants

AICPA

NOTICE TO READERS

Statements of Position of the Accounting Standards Division present the conclusions of at least a majority of the Accounting Standards Executive Committee, which is the senior technical body of the AICPA authorized to speak for the Institute in the areas of financial accounting reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles *in the Independent Auditor's Report,* identifies AICPA Statement of Position as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances. However, an entity need not change an accounting treatment followed as of March 15, 1992 to the accounting treatment specified in this Statement of Position.

Disclosure of Certain Information by Financial Institutions About Debt Securities Held as Assets

Scope

1. This statement of position provides guidance for disclosure by financial institutions of certain information about debt securities held as assets. It applies to financial institutions whose policy is to carry such securities either at historical cost or at the lower of cost or market value. Such financial institutions include banks, savings and loan associations, savings banks, credit unions, finance companies, and insurance companies. Entities other than financial institutions that include financial institution subsidiaries in their consolidated financial statements should provide the disclosures required by this statement for debt securities held as assets by such subsidiaries.

2. As used in this statement, *debt securities* include—

- Bills, notes, and bonds issued by—
  - *a.* The federal, state, and local governments in the United States and agencies and authorities of those governments.
  - *b.* Foreign governments and agencies of those foreign governments.
- Bonds and commercial paper issued by business enterprises and not-for-profit organizations, including collateralized bond obligations and interest-only and principal-only strips of such bonds and commercial paper.
- Mortgage-backed and other securitized debt instruments, including collateralized mortgage obligations[1] and principal-only and interest-only strips of such instruments.

Debt securities also include preferred stock that, by its terms, either must be redeemed by the issuing enterprise or is redeemable at the option of the investor because, for the purposes of this statement, such preferred stock has the essential characteristics of debt. Other unsecuritized commercial and personal loans; notes and bonds of foreign governments classified as loans; and unsecuritized leases, credit card receivables, real estate loans, construction loans, and automobile loans are not included in the scope of this statement.

3. This statement amends the following AICPA industry audit and accounting guides:

- *Audits of Banks*
- *Audits of Finance Companies (Including Independent and Captive Financing Activities of Other Companies)*
- *Audits of Property and Liability Insurance Companies*
- *Audits of Stock Life Insurance Companies*

Background

4. On May 25, 1990, the Accounting Standards Executive Committee (AcSEC) issued an exposure draft of a proposed statement of position, *Report-*

[1] For purposes of this statement, collateralized mortgage obligations also include instruments issued in equity form that are required to be accounted for as nonequity instruments under the consensus on Emerging Issues Task Force Issue 89-4.

ing by Financial Institutions of Debt Securities Held as Assets. That exposure draft was issued in response to concerns that the guidance on reporting debt securities held as assets in the AICPA audit and accounting guides for the various financial industries is uniform for particular industries but is inconsistent from industry to industry. Further, changes in the economic environment, deregulation of interest rates, the increased sophistication of interest rate and other risk management techniques, and the availability of new financial instruments used to reduce or hedge interest rate risk have resulted in increased purchases and sales of debt securities classified as investments, which have contributed to diversity in the application of that guidance.

5. Regulators of financial institutions have expressed concern about certain activities concerning securities classified as investments. Such activities are described in the April 14, 1988, Banking Circular, *Selection of Securities Dealers and Unsuitable Investment Practices,* which is reproduced in Appendix B.

6. The exposure draft recommended guidance on reporting debt securities held as investment assets that attempted to make more workable the assessment of the ability and intent to hold such securities that is required under current literature. However, comment letters on the exposure draft raised significant questions about the subjectivity of the guidance, and AcSEC concluded that the proposal needed to be studied further.

7. The exposure draft proposed disclosures about debt securities held as assets, and many commentators recommended expanded disclosures as an interim solution. This statement is intended to be such an interim solution.

Conclusions

8. Financial institutions should include in the notes to their financial statements an explanation of their accounting policies for debt securities held, including the basis for classification into balance sheet captions, such as investment or trading.

9. Financial institutions should also disclose in the notes to their financial statements the following information concerning debt securities carried at either historical cost or the lower of cost or market value[2]:

- For each balance sheet presented, the amortized cost [3], estimated market values, gross unrealized gains, and gross unrealized losses for each pertinent category. Examples of such categories are the following:
  - Debt securities issued by the U.S. Treasury and other U.S. government corporations and agencies
  - Debt securities issued by states of the U.S. and political subdivisions of the states
  - Debt securities issued by foreign governments and not classified as loans
  - Corporate securities

[2] If a financial institution carries some debt securities at amortized cost and others at the lower of cost or market value and it reports them in separate balance sheet captions, these disclosures should be presented for each caption.

[3] Amortized cost is the face amount of the debt 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 debt security. Total amortized cost presented in this disclosure should be reconciled to the amounts presented in the balance sheet, if different.

— Mortgage-backed securities

— Other debt securities

- For the most recent balance sheet, the amortized cost and estimated market values of debt securities due—
  a. In one year or less
  b. After one year through five years
  c. After five years through ten years
  d. After ten years[4]
- For each period for which results of operations are presented, the proceeds from sales[5] of such debt securities and gross realized gains and gross realized losses on such sales

Effective Date and Transition

10. This statement is effective for financial statements for fiscal years ending after December 15, 1990. This statement need not be applied to financial statements for fiscal years ending before its effective date that, for comparative purposes, are being provided with financial statements for fiscal years ending after its effective date.

[4] Securities not due at a single maturity date, such as mortgage-backed securities, may be included in a separate category. If such securities are not included in a separate category, the method used for inclusion in the maturity table should be disclosed.

[5] As debt securities approach maturity, their market prices tend to approach their maturity amounts less interest and a factor for credit risk, and market risk diminishes as a factor in their pricing. For purposes of this statement, securities that are sold at maturity or near enough to maturity that market risk is substantially eliminated as a pricing factor may be excluded from this disclosure.

APPENDIX A

Illustrative Financial Statement Disclosure

Investment Securities

The amortized cost and estimated market values of investments in debt securities are as follows: [a]

	Amortized Cost [b]	*Gross Unrealized Gains*	*Gross Unrealized Losses*	*Estimated Market Value*
U.S. Treasury securities and obligations of U.S. government corporations and agencies	$XXXXX	$XXX	$(XXX)	$ XXXXX
Obligations of states and political subdivisions	XXXXX	XXX	(XXX)	XXXXX
Debt securities issued by foreign governments	XXXXX	XXX	(XXX)	XXXXX
Corporate securities	XXXXX	XXX	(XXX)	XXXXX
Mortgage-backed securities	XXXXX	XXX	(XXX)	XXXXX
Other debt securities	XXXXX	XXX	(XXX)	XXXXX
Totals	$XXXXX	$XXX	$(XXX)	$ XXXXX

The amortized cost and estimated market value of debt securities at December 31, 19XX, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

[a] This information should be provided for each balance sheet presented that is dated after December 15, 1990.

[b] See footnote 3.

	Amortized Cost	*Estimated Market Value*
Due in one year or less	$ XXX	$ XXX
Due after one year through five years	XXX	XXX
Due after five years through ten years	XXX	XXX
Due after ten years	XXX	XXX
	XXXX	XXXX
Mortgage-backed securities	XXX	XXX
	$XXXXX	$XXXXX

Proceeds from sales of investments in debt securities during 19XX were $______. Gross gains of $______ and gross losses of $______ were realized on those sales.[c]

[c] This information should be provided for each period for which results of operations are presented for periods ending after December 15, 1990.

APPENDIX B

BANKING CIRCULAR—SELECTION OF SECURITIES DEALERS AND UNSUITABLE INVESTMENT PRACTICES *

PURPOSE

This issuance is to provide you with recommended procedures to be employed by all national banks when selecting securities dealers and to advise you of certain securities activities that the depository institution regulators view as unsuitable in an investment portfolio. The Federal Financial Institution Examination Council (FFIEC) recently endorsed the same policy statement. Adoption of the FFIEC policy is intended to achieve uniform and effective supervision by depository institution investment portfolio managers. The following is the text of the policy statement.

BACKGROUND

The depository institution regulators have become aware of speculative activity which has taken place in a number of depository institutions' investment portfolios. Certain of these institutions have failed because of the speculative activities, and other institutions have been weakened significantly as their earnings and capital have been impaired and the liquidity of their securities has been eroded by the depreciation in their market value.

Speculative activity often occurs when a depository institution's investment portfolio manager follows the advice of securities dealers who, in order to generate commission income, encourage speculative practices that are unsuitable for the investment portfolio.

RECOMMENDATIONS CONCERNING THE SELECTION OF A SECURITIES DEALER

It is common for the investment portfolio managers of many depository institutions to rely on the expertise and advice of a securities sales representative for: recommendations of proposed investments; investment strategies; and the timing and pricing of securities transactions. Accordingly, it is important for the management of depository institutions to know the securities firms and the personnel with whom they deal. An investment portfolio manager should not engage in securities transactions with any securities dealer that is unwilling to provide complete and timely disclosure of its financial condition. Management must review the dealer's financial statements and make a judgment about the ability of the dealer to honor its commitments. An inquiry into the general reputation of the dealer also is necessary.

The board of directors and/or an appropriate board committee should review and approve a list of securities firms with whom the depository's management is authorized to do business. The following securities dealer selection standards are recommended, but are not all inclusive. The dealer selection process should include:

- a consideration of the ability of the securities dealer and its subsidiaries or affiliates to fulfill commitments as evidenced by capital strength and operating results disclosed in current financial data, annual reports, credit reports, etc.;

* This banking circular was distributed by the comptroller of the currency on April 14, 1988, to chief executive officers of all national banks, deputy comptrollers, and all examining personnel.

- an inquiry into the dealer's general reputation for financial stability and fair and honest dealings with customers, including an inquiry of past or current financial institution customers of the securities dealer;
- an inquiry of appropriate State or Federal securities regulators and securities industry self-regulatory organizations, such as the National Association of Securities Dealers, concerning any formal enforcement actions against the dealer or its affiliates or associated personnel;
- an inquiry, as appropriate, into the background of the sales representative to determine his or her experience and expertise;
- a determination whether the depository institution has appropriate procedures to establish possession or control of securities purchased. Purchased securities and repurchase agreement collateral should only be kept in safekeeping with selling dealers when (1) the board is completely satisfied as to the creditworthiness of the securities dealer and (2) the aggregate value of securities held in safekeeping in this manner is within credit limitations that have been approved by the board of directors, or a committee of the board, for unsecured transactions (see FFIEC Policy Statement adopted October 1985). Federal credit unions, when entering into a repurchase agreement with a broker/dealer, are not permitted to maintain the collateral with the broker/dealer, reference part 703 of the National Credit Union Administration rules and regulations.

As part of the process of managing a depository institution's relationships with securities dealers the board of directors may wish to consider including in the financial institution's code of ethics or code of conduct a prohibition by those employees, who are directly involved in purchasing and selling securities for the depository institution, from engaging in personal securities transactions with the same securities firm that the depository institution uses for its transactions without specific board approval and periodic review. The board also may wish to adopt a policy applicable to directors, officers or employees concerning the receipt of gifts, gratuities or travel expenses from approved dealer firms and their personnel (also see in this connection the Bank Bribery Law, 18 USC 215 and interpretive releases).

OBJECTIONABLE INVESTMENT PRACTICES

Depository institution directors are responsible for prudent administration of investments in securities. An investment portfolio traditionally has been maintained by a depository institution to provide earnings, liquidity and a means of diversifying risks. When investment transactions are entered into in anticipation of taking gains on short-term price movements, the transactions are no longer characteristic of investment activities and should be conducted in a securities trading account. Securities trading of the types described in section I of the attached appendix will be viewed as unsuitable activities when they are conducted in a depository institution's investment account. Securities trading should take place only in a closely supervised trading account and be undertaken only by institutions that have strong capital and current earnings positions. Acquisitions of the various forms of zero coupon, stripped obligations and asset-backed securities residuals discussed in section II of the attached appendix will receive increased regulatory attention and, depending upon the circumstances, may be considered unsuitable for a depository institution.

State chartered financial institutions are cautioned that certain of the investment practices listed in the appendix may violate state law. If any such practices are contemplated, the appropriate state supervisor should be consulted regarding permissibility under state law.

Appendix to FFIEC Supervisory Policy Statement on the Selection of Securities Dealers and Unsuitable Investment Practices

I. TRADING IN THE INVESTMENT PORTFOLIO

Trading in the investment portfolio is characterized by a high volume of purchase and sale activity, which when considered in light of a short holding period for securities, clearly demonstrates management's intent to profit from short-term price movements. In this situation, a failure to follow accounting and reporting standards applicable to trading accounts may result in a misstatement of the depository institution's income and a filing of false regulatory reports and other published financial data. It is an unsafe and unsound practice to record and report holdings of securities that result from trading transactions using accounting standards which are intended for investment portfolio transactions; therefore, the discipline associated with accounting standards applicable to trading accounts is necessary. Securities held in trading accounts should be marked to market, or the lower of cost or market, periodically with unrealized gains or losses recognized in current income. Prices used in periodic revaluations should be obtained from sources that are independent of the securities dealer doing business with the depository.

The following practices are considered to be unsuitable when they occur in a depository institution's investment portfolio.

A. "Gains Trading". "Gains trading" is a securities trading activity conducted in an investment portfolio, often termed "active portfolio management." "Gains trading" is characterized by the purchase of a security as an investment and the subsequent sale of that same security at a profit within several days or weeks. Those securities initially purchased with the intent to resell are retained as investment portfolio assets if they cannot be sold at a profit. These "losers" are retained in the investment portfolio because investment portfolio holdings are accounted for at cost, and losses are not recognized unless the security is sold. "Gains trading" often results in a portfolio of securities with extended maturities, lower credit quality, high market depreciation and limited practical liquidity.

In many cases, "gains trading" has involved the trading of "when-issued" securities and "pair-offs" or "corporate settlements" because the extended settlement period associated with these practices allows speculators the opportunity for substantial price changes to occur before payment for the securities is due.

B. "When-Issued" Securities Trading. "When-issued" securities trading is the buying and selling of securities in the interim between the announcement of an offering and the issuance and payment date of these securities. A purchaser of a "when-issued" security acquires all the risks and rewards of owning a security and may sell the "when-issued" security at a profit before taking delivery and paying for it. Frequent purchases and sales of securities during the "when-issued" period generally are indications of trading activity and should not be conducted in a bank's investment portfolio.

C. "Pair-Offs". A "pair-off" is a security purchase transaction which is closed out or sold at, or prior to, settlement date. As an example, an investment portfolio manager will commit to purchase a security; then, prior to the predetermined settlement date, the portfolio manager will "pair-off" the purchase with a sale of the same security prior to, or on, the original settlement date. Profits or losses on the transaction are settled by one party to the transaction remitting to the counter party the difference between the purchase and sale price. Like "when-issued" trading, "pair-offs" permit speculation on securities price movements without paying for the securities.

D. Corporate Settlement on U.S. Government and Federal Agency Securities Purchases. Regular-way settlement for transactions in U.S. Government and Federal agency securities is one business day after the trade date. Regular-way settlement for corporate securities is five business days after the trade date. The use of a corporate settlement method (5 business days) for U.S. Government securities purchases appears to be offered by dealers in order to facilitate speculation on the part of the purchaser.

E. Repositioning Repurchase Agreements. Dealers who encourage speculation through the use of "pair-off," "when-issued" and "corporate settlement" transactions often provide the financing at settlement of purchased securities which cannot be sold at a profit. The buyer purchasing the security pays the dealer a small "margin" that is equivalent roughly to the actual loss in the security. The dealer then agrees to fund the purchase by buying the security back from the purchaser under a resale agreement. Apart from imprudently funding a longer-term, fixed-rate asset with short-term, variable-rate source funds, the purchaser acquires all the risks of ownership of a large amount of depreciated securities for a very small margin payment. Purchasing securities in these circumstances is inherently speculative and is a wholly unsuitable investment practice for depository institutions.

F. Short Sales. A short sale is the sale of a security that is not owned. The purpose of a short sale generally is to speculate on the fall in the price of the security. Short sales are speculative transactions that should be conducted in a trading account, and when conducted in the investment portfolio, they are considered to be unsuitable.

Short sales are not permissible activities for Federal credit unions.

II. STRIPPED MORTGAGE-BACKED SECURITIES, RESIDUALS, AND ZERO COUPON BONDS

There are advantages and disadvantages in owning these products. A depository institution must consider the liquidity, marketability, pledgeability, and price volatility of each of these products prior to investing in them. It may be unsuitable for a depository institution to commit significant amounts of funds to long-term stripped mortgage-backed securities, residuals and zero coupon bonds which fluctuate greatly in price.

A. Stripped Mortgage-Backed Securities (SMBS) consist of two classes of securities with each class receiving a different portion of the monthly interest and principal cash flows from the underlying mortgage-backed securities. In its purest form, an SMBS is converted into an interest-only (IO) strip, where the investor receives 100% of the interest cash flows, and a principal-only (PO) strip, where the investor receives 100% of the principal cash flows.

All IOs and POs have highly volatile price characteristics based, in part, on the prepayment of the underlying mortgages and consequently on the maturity of the stripped security. Generally, POs will increase in value when interest rates decline while IOs increase in value when interest rates rise. Accordingly, the purchase of an IO strip may serve, theoretically, to offset the interest rate risk associated with mortgages and similar instruments held by a depository institution. Similarly, a PO may be useful as an offset to the effect of interest rate movements on the value of mortgage servicing. However, when purchasing an IO or PO the investor is speculating on the movements of future interest rates and how these movements will affect the prepayment of the underlying collateral. Furthermore, those SMBS that do not have the guarantee of a government agency or a government-sponsored agency as to the payment of principal and interest have an added element of credit risk.

As a general rule, SMBS cannot be considered as suitable investments for the vast majority of depository institutions. SMBS, however, may be appropriate holdings for depository institutions that have highly sophisticated and well-managed securities portfolios, mortgage portfolios or mortgage banking functions. In such depository institutions, however, the acquisition of SMBS should be undertaken only in conformance with carefully developed and documented plans prescribing specific positioning limits and control arrangements for enforcing these limits. These plans should be approved by the institution's board of directors and vigorously enforced.

In those depository institutions that prepare their published financial statements in accordance with Generally Accepted Accounting Principles, SMBS holdings must be accounted for in accordance with Financial Accounting Standards Board Statement #91 (FAS #91) which requires that the carrying amount be adjusted when actual prepayment experience differs from prepayment estimates. Other institutions may account for their SMBS holdings under FAS #91 or alternatively at market value or the lower of cost or market value.

Several states have adopted, or are considering, regulations that prohibit state chartered banks from purchasing IO strips. Accordingly, state chartered institutions should consult with their state regulator concerning the permissibility of purchasing SMBS.

B. Asset-Backed Securities (ABS) Residuals. Residuals are the excess cashflows from an ABS transaction after the payments due to the bondholders and the trust administrative expenses have been satisfied. This cashflow is extremely sensitive to prepayments, and thus has a high degree of interest rate risk.

Generally, the value of residual interests in ABS rises when interest rates rise. Theoretically a residual can be used as a risk management tool to offset declines in the value of fixed-rate mortgage or ABS portfolios. However, it should be understood by all residual interest purchasers that the "yield" on these instruments is inversely related to their effectiveness as a risk management vehicle. In other words, the highest yielding ABS residuals have limited risk management value usually due to a complicated ABS structure and/or unusual collateral characteristics that make modeling and understanding the economic cashflows very difficult.

Alternatively, those residuals priced for modest yields generally have positive risk management characteristics.

In conclusion, it is important to understand that a residual cashflow is highly dependent upon the prepayments received. Caution should be exercised when purchasing a residual interest, especially higher "yielding" interests, because the risk associated over the life of the ABS may warrant an even higher return in order to adequately compensate the investor for the interest rate risk assumed. Purchases of these equity interests should be supported by in-house evaluations of possible rate of return ranges in combination with varying prepayment assumptions.

Residual interests in ABS are not permissible acquisitions for Federal credit unions. Holdings of ABS residuals by other institutions should be accounted for in the manner discussed under stripped mortgage-backed securities and should be reported as "Other Assets" on regulatory reports.

C. Other Zero Coupon or Stripped Products. The interest and/or principal portions of U.S. Government obligations are sometimes sold to depository institutions in the form of stripped coupons, stripped bonds (principal), STRIPS, or propriety products, such as CATs or TIGRs. Also, Original Issue Discount Bonds (OIDs) have been issued by a number of municipal entities. Longer maturities of these instruments can exhibit extreme price volatility and, accordingly, disproportionately large long-maturity holdings (in relation to the total portfolio) of zero coupon securities appear to be unsuitable for investment holdings for depository institutions.

Appendix C

Statement of Position 92–3

Accounting for Foreclosed Assets

April 28, 1992

Issued by the
Accounting Standards Division

American Institute of
Certified Public Accountants

AICPA

NOTICE TO READERS

Statements of Position of the Accounting Standards Division present the conclusions of at least a majority of the Accounting Standards Executive Committee, which is the senior technical body of the AICPA authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles *in the Independent Auditor's Report,* identifies AICPA Statements of Position as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

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SUMMARY

This statement of position (SOP) provides guidance on measuring foreclosed assets and in-substance foreclosed assets after foreclosure. It applies to all reporting entities, except those that account for assets at fair value or market value. It applies to all assets obtained through foreclosure or repossession, except for inventories, marketable equity securities, and real estate previously owned by the lender and accounted for under FASB Statement of Financial Accounting Standards No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects.*

Under the SOP, there is a rebuttable presumption that foreclosed assets are held for sale. The SOP recommends that foreclosed assets held for sale be carried at the lower of (*a*) fair value minus estimated costs to sell or (*b*) cost. Foreclosed assets held for the production of income should be treated the same way they would be had the assets been acquired in a manner other than through foreclosure.

The SOP should be applied to foreclosed assets in annual financial statements for periods ending on or after December 15, 1992.

Accounting for Foreclosed Assets

Scope

1. This statement of position (SOP) provides guidance on determining the balance sheet treatment of foreclosed assets[1] after foreclosure. (Paragraphs A-6 and A-7 of the Appendix discuss the exclusion from this SOP of conclusions on the accounting treatment of results of operations related to foreclosed assets held for sale.) It applies to all reporting entities except those that account for assets at market value or fair value, such as broker-dealers, futures commission merchants, and investment companies. It applies to all assets obtained through foreclosure or repossession except for *(a)* inventories that are covered by chapter 4 of Accounting Research Bulletin No. 43, *Restatement and Revision of Accounting Research Bulletins; (b)* marketable equity securities that are covered by Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards (Statement) No. 12, *Accounting for Certain Marketable Securities;* and *(c)* foreclosed real estate previously owned by the lender and accounted for under FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects.* Except for the requirements in paragraphs 12 and 17, the conclusions of this SOP do not apply to in-substance foreclosed assets (see paragraph A-10 of the Appendix).

Background

2. Paragraph 29 of FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings,* issued in 1977, requires the following: "After a troubled debt restructuring, a creditor shall account for assets received in satisfaction of a receivable the same as if the assets had been acquired for cash." That requirement has been interpreted in diverse ways.

3. The American Institute of Certified Public Accountants' (AICPA's) Industry Audit Guide *Audits of Stock Life Insurance Companies* requires that foreclosed real estate be carried at the lower of cost (less accumulated depreciation) or market value, net of any encumbrances. Paragraphs 17 and 21 of SOP 75-2, *Accounting Practices of Real Estate Investment Trusts* (as amended by SOP 78-2), require that estimated losses on individual loans and properties be based on net realizable value. The guidance in the AICPA Audit and Accounting Guide *Audits of Savings Institutions* and in the Industry Audit Guide *Audits of Finance Companies* are consistent with SOPs 75-2 and 78-2. The AICPA Industry Audit Guide *Audits of Banks* states that subsequent to foreclosure, a loss on foreclosed real estate should be recognized if cost cannot be recovered through sale or use, but it does not indicate how the loss is to be measured. The AICPA Audit and Accounting Guide *Audits of Property and Liability Insurance Companies* does not address accounting for foreclosed assets.

4. In practice, accounting by creditors for foreclosed assets, particularly real estate assets, is diverse. After foreclosure, some enterprises continue to write down the carrying amount of foreclosed assets for subsequent, further declines in fair value; others do not. After foreclosure, some enterprises discount projected cash flows related to foreclosed assets in estimating net realizable value of those assets; others do not.

[1] As used in this SOP, the term *foreclosed assets* includes all assets received in satisfaction of a receivable in a troubled debt restructuring, as the term is used in FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings.* It includes real property and personal property; equity interests in corporations, partnerships, and joint ventures; and beneficial interests in trusts.

5. Sections 4(b)(1) and 4(b)(2)(A) of the Home Owners' Loan Act of 1933 as amended by the Financial Institutions Reform, Recovery and Enforcement Act of 1989 generally provide that the director of the Office of Thrift Supervision prescribe uniform accounting and disclosure standards for savings associations, to be used in determining associations' compliance with applicable regulations, and incorporate generally accepted accounting principles into those standards to the same degree that such principles are used to determine compliance with regulations prescribed by federal banking agencies. Section 1215 of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 also provides the following:

> Before the end of the 1-year period beginning on the date of the enactment of this Act [August 9, 1989], each appropriate Federal banking agency (as defined in section 3(q) of the Federal Deposit Insurance Act) shall establish uniform accounting standards to be used for determining the capital ratios of all federally insured depository institutions and for other regulatory purposes. Each such agency shall report annually to the Chairman and ranking minority member of the Committee on Banking, Housing, and Urban Affairs of the Senate and the Chairman and ranking minority member of the Committee on Banking, Finance and Urban Affairs of the House of Representatives any differences between the capital standards used by such agency and capital standards used by any other such agency. Each such report shall contain an explanation of the reasons for any discrepancy in such capital standards, and shall be published in the Federal Register.

6. The chairman of the Federal Home Loan Bank Board (now the Office of Thrift Supervision) asked the AICPA in 1987 to address the inconsistency between banks and savings and loan associations in accounting for loans and real estate assets. The AICPA's Accounting Standards Executive Committee (AcSEC) attempted to eliminate that inconsistency in 1988 and 1989 but decided to refer the matter to the FASB at that time. On April 4, 1989, soon after AcSEC's decision to refer the matter to the FASB, the chairman of the Federal Home Loan Bank Board wrote to the chairman of the Securities and Exchange Commission (SEC) asking that the SEC or its staff remove the inconsistency for public reporting entities. The SEC has not done so.

7. Further, the chairman of the Federal Deposit Insurance Corporation, in a letter to the FASB dated November 8, 1989, asked the FASB to assist in developing "uniform accounting standards among depository institutions." In that letter, the chairman stated that "the accounting treatment in practice for certain transactions among participants in the financial services industry seems to be more a reflection of the type of charter than the substance of the transaction." Furthermore, the chairman "urge[d] the FASB to reconcile the different accounting practices outlined in [AICPA] guides for thrifts, banks, and finance companies." In early 1990, AcSEC decided that it could deal with the inconsistencies and diversity in accounting for foreclosed assets, and this SOP is a result of that decision.

8. AcSEC believes that all enterprises, not just financial institutions, should account for foreclosed assets held for sale the same way, except that enterprises that account for assets at market value or fair value should not change their accounting. AcSEC's primary objectives in issuing this statement of position are to reduce the inconsistencies and diversity in accounting for foreclosed assets and to improve the understandability, comparability, and relevance of amounts reported as foreclosed assets in balance sheets. Another objective is to make all of the AICPA Audit and Accounting Guides and SOPs consistent on this matter. Achieving those objectives will also address the needs of Congress and the thrift and banking regulators.

9. This SOP affects the following AICPA statements of position and industry audit and accounting guides:

a. SOP 75-2, *Accounting Practices of Real Estate Investment Trusts,* paragraphs 15-23, 25, 27, 28, 29*a*, 29*b*, and 29*c*
b. SOP 78-2, *Accounting Practices of Real Estate Investment Trusts,* paragraph 6
c. *Audits of Banks*
d. *Audits of Savings Institutions*
e. *Audits of Finance Companies*
f. *Audits of Property and Liability Insurance Companies*
g. *Audits of Stock Life Insurance Companies*
h. *Guide for the Use of Real Estate Appraisal Information*

Conclusions

Held-for-Sale Presumption

10. Most enterprises do not intend to hold foreclosed assets for the production of income but intend to sell them; in fact, some laws and regulations applicable to financial institutions require the sale of foreclosed assets. Therefore, under this SOP, it is presumed that foreclosed assets are held for sale and not for the production of income. That presumption may be rebutted, except for in-substance foreclosed assets, by a preponderance of the evidence. If the held-for-sale presumption is not rebutted, the asset should be classified in the balance sheet as held for sale.

11. The presumption of sale can be rebutted if (*a*) management intends to hold a foreclosed asset for the production of income, (*b*) that intent is not inconsistent with the enterprise's ability to do so or with laws or regulations, including the manner in which the laws or regulations are administered by federal or state regulatory agencies, and (*c*) that intent is supported by a preponderance of the evidence.

Foreclosed Assets Held for Sale

12. After foreclosure, foreclosed assets held for sale should be carried at the lower of (*a*) fair value[2] minus estimated costs to sell or (*b*) cost.[3] Such determination should be made on an individual asset basis. If the fair value of

[2] *Fair value,* as used in this SOP, is defined in paragraph 13 of FASB Statement No. 15 as follows:

> The fair value of the assets transferred is the amount that the . . . [creditor] could reasonably expect to receive for them in a current sale between a willing buyer and a willing seller, that is, other than in a forced or liquidation sale. Fair value of assets shall be measured by their market value if an active market for them exists. If no active market exists for the assets transferred but exists for similar assets, the selling prices in that market may be helpful in estimating the fair value of the assets transferred. If no market price is available, a forecast of expected cash flows may aid in estimating the fair value of assets transferred, provided the *expected cash flows* discounted at a rate commensurate with the risk involved.[6]
>
> [6] Some factors that may be relevant in estimating the fair value of various kinds of assets are described in paragraphs 88 and 89 of *APB* [Accounting Principles Board] *Opinion No. 16* ["Business Combinations"], paragraphs 12-14 of *APB Opinion No. 21,* "Interest on Receivables and Payables," and paragraph 25 of *APB Opinion No. 29,* "Accounting for Nonmonetary Transactions."

[3] The *cost* of such assets at the time of foreclosure is the fair value of the asset foreclosed or repossessed. Any specific valuation allowance related to the loan should not be carried forward. This SOP provides no guidance for determining cost subsequent to foreclosure (see paragraphs A-6 and A-7 of the Appendix).

the asset minus the estimated costs to sell the asset is less than the cost of the asset, the deficiency should be recognized as a valuation allowance. If the fair value of the asset minus the estimated costs to sell the asset subsequently increases and the fair value of the asset minus the estimated costs to sell the asset is more than its carrying amount, the valuation allowance should be reduced, but not below zero. Increases or decreases in the valuation allowance should be charged or credited to income.[4]

13. The amount of any senior debt (principal and accrued interest) to which the 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; payments on such debt should be charged to the liability. Interest that accrues after foreclosure should be recognized as interest expense.

14. FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects,* was extracted by the FASB from SOP 78-3, *Accounting for Costs to Sell and Rent, and Initial Rental Operations of Real Estate Projects;* SOP 80-3, *Accounting for Real Estate Acquisition, Development, and Construction Costs,* and the AICPA Industry Audit Guide *Accounting for Retail Land Sales.* These documents did not, in the opinion of AcSEC, apply to foreclosed real estate held for sale. AcSEC therefore believes that the fair-value test in this SOP, not the net-realizable-value test in FASB Statement No. 67, should be applied to foreclosed real estate held for sale, except when the foreclosed real estate was previously owned by the lender and accounted for under FASB Statement No. 67, in which case such foreclosed assets should be accounted for under FASB Statement No. 67.

Foreclosed Assets Held for the Production of Income

15. 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.

Change in Classification

16. If it is subsequently decided 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 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.

Effective Date and Transition

17. This SOP should be applied to foreclosed assets in annual financial statements for periods ending on or after December 15, 1992, with earlier application permitted. On initial application of this SOP, all enterprises should adjust the carrying amount of foreclosed assets held for sale to the lower of *(a)* the fair value of the asset minus the estimated costs to sell the asset or *(b)* the cost of the asset as of the date of the initial adoption of this SOP. For many enterprises, adoption of this SOP will result in a change in accounting principle. The nature of the change should be disclosed in the financial statements of

[4] Because the allowance is considered a valuation adjustment, insurance enterprises should report changes in the valuation allowance as realized gains and losses in income, not as unrealized gains and losses in equity.

the period in which the change is made. Any adjustment arising from the initial application of this SOP should be included in income from continuing operations in the period in which the change is made. No restatement of previously issued financial statements or cumulative-effect adjustment as of the beginning of the year this SOP is first applied is permitted.

APPENDIX

Discussion of Major Comments on the Exposure Draft

A-1. This Appendix summarizes considerations that were deemed significant by members of AcSEC in reaching the conclusions in this SOP.

A-2. In the exposure draft, AcSEC concluded that there is a rebuttable presumption that foreclosed assets are held for sale and that foreclosed assets held for sale should be carried at the lower of cost or fair value minus the estimated costs to sell. Few respondents objected to those conclusions.

Held-for-Sale Presumption

A-3. Some respondents requested more explanation of the circumstances under which the held-for-sale presumption could be rebutted. After considering the concerns expressed by respondents about the rebuttable presumption, AcSEC decided not to give detailed, specific guidance, thereby allowing for the exercise of judgment in determining whether the presumption is rebutted by the facts in particular circumstances.

A-4. AcSEC recognizes that some enterprises may hold foreclosed assets for several years before sale and may even operate the assets, but concludes that a holding period in excess of one year does not, in and of itself, rebut the held-for-sale presumption. Further, AcSEC notes that if the form of the foreclosed asset is a majority interest in an enterprise, FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries,* requires the subsidiary to be consolidated unless control is likely to be temporary.

Fair Value

A-5. Some respondents requested guidance on the determination of fair value. AcSEC recognizes that estimating fair value requires judgment. AcSEC concluded, however, that it would be inappropriate and is unnecessary to develop a new definition of fair value in this SOP, and that the definition of fair value in FASB Statement No. 15 should be used in this SOP. Moreover, AcSEC believes that the following discussion about fair value from Statement No. 15, particularly paragraph 82, will be helpful in implementing this SOP.

Concept of Fair Value

79. Some respondents to the Exposure Draft continued to argue that all troubled debt restructurings should be accounted for as modifications of the terms of debt and that none should be accounted for as transfers of assets (paragraphs 66 and 67). Others accepted the need to account for some troubled debt restructurings as asset transfers but held that obtaining assets through foreclosure or repossession under terms included in lending agreements should be distinguished from obtaining assets in exchange for cash or in other "asset swaps." They contended that *(a)* only the form of the asset is changed by foreclosure or repossession, *(b)* the substance of a secured loan is that the lender may choose either to postpone receipt of cash or take the asset to optimize cash receipts and recovery of its investment, and *(c)* foreclosure or repossession is not the completion of a lending transaction but merely a step in the transaction that begins with lending cash and ends with collecting cash.

80. The Board rejected those arguments for the reasons given in paragraphs 71-77, emphasizing that an event in which *(a)* an asset is transferred between debtor and creditor, *(b)* the creditor relinquishes all or part of its claim against the debtor, and *(c)* the debtor is absolved of all or part of its obligation to the creditor is the kind of event that is the basis of accounting under the existing transaction-based accounting framework. To fail to recognize an event that fits the usual description of a transaction and to recognize only the lending and collection of cash as transactions would significantly change the existing accounting framework.

81. Use of the fair value of an asset transferred to measure the debtor's gain on restructuring and gain or loss on the asset's disposal or the creditor's cost of acquisition is not adopting some kind of "current value accounting." On the contrary, that use of fair value is common practice within the existing accounting framework. Paragraph 13 of this Statement explains briefly the meaning of *fair value* and refers to *APB Opinions No. 16, No. 21,* and *No. 29,* which use *fair value* in the same way and provide guidance about determining fair values within the existing accounting framework. The term *fair value* is used in essentially the same way as *market value* was used in the Discussion Memorandum to denote a possible attribute to be measured at the time a debt is restructured. *Fair value* is defined in paragraph 181 of *APB Statement No. 4* as "the approximation of exchange price in transfers in which money or money claims are not involved." Although a "money claim" is necessarily involved in transferring assets to settle a payable in a troubled debt restructuring, the troubled circumstances in which the transfer occurs make it obvious that the amount of the "money claim" does not establish an exchange price. Determining fair value of the assets transferred in a troubled debt restructuring is usually necessary to approximate an exchange price for the same reasons that determining fair value is necessary to account for transfers of assets in nonmonetary transactions (*APB Opinion No. 29*).

82. That point is emphasized in this Appendix because some respondents to the Exposure Draft apparently misunderstood the concept of fair value (paragraph 11 of the Exposure Draft and paragraph 13 of this Statement) and the discounting of expected cash flows specified in those paragraphs. *Paragraph 13 permits discounting of expected cash flows from an asset transferred or received in a troubled debt restructuring to be used to estimate fair value only if no market prices are available either for the asset or for similar assets. The sole purpose of discounting cash flows in that paragraph is to estimate a current market price as if the asset were being sold by the debtor to the creditor for cash. That estimated market price provides the equivalent of a sale price on which the debtor can base measurement of a gain on restructuring and a gain or loss on disposal of the asset and the equivalent of a purchase price on which the creditor can measure the acquisition cost of the asset. To approximate a market price, the estimate of fair value should use cash flows and discounting in the same way the marketplace does to set prices—in essence, the marketplace discounts expected future cash flows*

from a particular asset "at a rate commensurate with the risk involved" in holding the asset. An individual assessment of expected cash flows and risk may differ from what the marketplace's assessment would be, but the procedure is the same. [Emphasis added by AcSEC.]

83. In contrast to the purpose of paragraph 13, *AICPA Statement of Position No. 75-2*[31] is concerned with different measures—net realizable value to a creditor of a receivable secured by real property and net realizable value of repossessed or foreclosed property. Its method of accounting for assets obtained by foreclosure or repossession thus differs from the method specified in this Statement. It proposes discounting expected cash flows at a rate based on the creditor's "cost of money" to measure the "holding cost" of the asset until its realizable value is collected in cash. The concept of fair value in paragraph 13 does not involve questions of whether interest is a "holding cost" or "period cost" because it is concerned with estimating market price, not net realizable value, however defined. Accounting for transfers of assets in troubled debt restructurings and for the assets after transfer is, of course, governed by this Statement.

[31] See paragraphs 59 and 60 of this Statement.

Results of Operations Related to Foreclosed Assets Held for Sale

A-6. In the exposure draft, AcSEC proposed that there should be no results of operations—revenues and expenses—from foreclosed assets while they are held for sale; net cash receipts related to forelosed assets during the holding period would have been credited to the carrying amount of the asset, and net cash payments, except for capital additions and improvements, would have been charged to income as a loss on holding the foreclosed assets. Further, in the exposure draft, AcSEC concluded that no depreciation, depletion, or amortization expense should be recorded. Many respondents objected to the exclusion of the results of operating a foreclosed asset from income; many also objected to crediting net cash receipts to the carrying amount of the asset and charging net cash payments to income. They raised questions about the conservatism of such treatment, about whether the treatment was conceptually sound, and about whether it would be practical to implement. Some comment letters also raised questions about whether it is appropriate not to depreciate foreclosed assets held for sale. After considering the comments, AcSEC decided not to adopt the method proposed in the exposure draft.

A-7. AcSEC considered various other ways to account for operations during the period foreclosed assets are held for sale, such as—

- Reporting the net of revenues and expenses in income, including charges or credits related to changes in the valuation allowance and depreciation expense on depreciable assets, for each reporting period as a gain or loss on holding the asset.
- Reporting the net of revenues and expenses in income, including charges or credits related to changes in the valuation allowance and depreciation expense on depreciable assets held or expected to be held for more than a specified length of time (for example, one year).
- Reporting the net of revenues and expenses in income, including charges or credits related to changes in the valuation allowance, and recognizing no depreciation expense.
- Crediting or debiting the net of revenues and expenses to the asset, and recognizing no depreciation expense. Changes in the valuation allowance would be included in income.

AcSEC believes that it should consider those options further and that its ultimate decision on the treatment of operations during the period foreclosed assets are held for sale should be exposed for public comment; AcSEC intends to undertake such a project. However, because AcSEC believes that its conclusion that foreclosed assets held for sale should be carried at the lower of fair value minus estimated costs to sell or cost would not change regardless of its conclusions on operations of foreclosed assets, AcSEC decided that it should issue the guidance in this SOP now, rather than delay issuing the guidance until the results of operations issues are resolved.

Foreclosed Assets Held for the Production of Income

A-8. In the exposure draft, AcSEC proposed to require that foreclosed assets held for the production of income be carried at an amount not greater than the assets' net realizable value. AcSEC decided to eliminate that statement.

Change in Classification

A-9. AcSEC also decided that, on reclassification of a foreclosed asset from the held-for-sale category, the asset should be measured and recorded as if asset had been held for the production of income since foreclosure. That decision is consistent with the consensus of the Emerging Issues Task Force in Issue 2 of Issue 90-6, where the reversal of a decision to sell an asset acquired in a business combination gives rise to an accounting as if the asset had never been held for sale.

In-Substance Foreclosed Assets

A-10. Many respondents asked for specific guidance on in-substance foreclosed assets, and they asked whether the SOP would apply to such assets. AcSEC concluded that, except for paragraphs 12 and 17, the guidance in this SOP need not be applied to in-substance foreclosures for the following reasons:

a. The accounting for in-substance foreclosed assets was not explicitly addressed in the exposure draft.

b. AcSEC would have found it difficult to resolve issues concerning senior debt related to in-substance foreclosed assets.

However, AcSEC notes that paragraph 34 of FASB Statement No. 15; paragraph 6 of AICPA Practice Bulletin 7, *Criteria for Determining Whether Collateral for a Loan Has Been In-Substance Foreclosed;* and SEC Financial Reporting Release 28, *Accounting for Loan Losses by Registrants Engaged in Lending Activities,* include accounting guidance related to in-substance foreclosed assets indicating that in-substance foreclosed assets should be accounted for in the same way as assets that have actually been foreclosed or repossessed. Further, AcSEC concluded that for purposes of applying this SOP, the held-for-sale presumption could not be rebutted for in-substance foreclosed assets. Accordingly, after in-substance foreclosure, an in-substance foreclosed asset, like a foreclosed asset held for sale, would be reported in the balance sheet at the lower of (*a*) fair value minus estimated costs to sell or (*b*) cost.

Carrying Amount of Assets at Foreclosure

A-11. Some respondents expressed concerns and opinions about the carrying amount of the foreclosed assets to be recognized at foreclosure. The exposure draft indicated that the attribute to be recognized at foreclosure should be the fair value of the collateral, implying that, if at the time of foreclosure the fair value of the collateral is greater than the recorded investment in the related loan, a credit to income would result. Some respondents suggested that no such credits should be permitted and that the carrying amount of the asset recognized at foreclosure should be the lower of the fair value of the collateral or the recorded investment in the loan. Notwithstanding those concerns, AcSEC notes that paragraph 28 of FASB Statement No. 15 requires that foreclosed assets be accounted for at their fair value at the time of foreclosure.

A-12. Some respondents also said that the definition of *fair value,* which is the definition in paragraph 13 of FASB Statement No. 15, implicitly contains a reduction for selling costs. For purposes of applying this SOP, AcSEC believes that the definition of fair value in paragraph 13 of FASB Statement No. 15 should be viewed as the cash sales/purchase price in a principal-to-principal transaction wherein no agents, dealers, brokers, or commission merchants are involved. If either principal decides to involve and pay outsiders to assist that principal, or to being principals together, any amount paid by that principal is independent of the fair value of the asset and does not affect that fair value. Accordingly, immediately after foreclosure, a valuation allowance related to foreclosed assets held for sale should be recognized for estimated costs to sell through a charge to income.

Offsetting of Debt

A-13. Contrary to what was proposed by AcSEC in the exposure draft, some respondents suggested that nonrecourse senior debt not assumed by the holder of the foreclosed asset be offset against the carrying amount of the asset. To protect its interest in the asset, the holder of the asset will have to settle the debt or have a subsequent transferee take the asset subject to the debt. If debt is offset, leverage is not portrayed, and the degree of possible gain is obscured. Moreover, offsetting nonrecourse senior debt against a foreclosed asset would be inconsistent with the manner in which such debt is portrayed when assets are purchased for cash and there is related nonrecourse debt. Therefore, AcSEC reaffirms that senior debt should not be offset against the asset.

Transition

A-14. Comments were specifically requested on the transition proposed in the exposure draft. Most respondents agreed that determining the cumulative effect of the change in accounting principle would either be impossible or possible only at significant cost for enterprises that do not have available the fair value of foreclosed assets at earlier balance sheet dates, and that a restatement of previously issued financial statements or a cumulative effect adjustment should not be required. Further, AcSEC concluded that, because one of the principal objectives of this SOP is to have consistent accounting of foreclosed assets, those two alternatives should not be permitted.

Appendix D

Schedule of Changes Made to Audits of Finance Companies (Including Independent and Captive Financing Activities of Other Companies)

Reference	Change	Date
General	The term "examination" has been changed to "audit" to conform to the terminology used in SAS No. 58.	October, 1990
Preface	The term "internal accounting control" has been changed to "internal control structure" to conform to the terminology used in SAS No. 55.	October, 1990
Preface	Auditing Procedures section deleted.	March, 1992
Paragraph 2.05	Revised to reflect the issuance of FASB Statement Nos. 114 and 115.	June, 1994
Paragraph 2.32	Note reference added to reflect the issuance of SOP 92-3.	May, 1992
Paragraph 2.35	Reference to SOP 92-3 added.	May, 1992
Paragraph 2.41	Reference to FASB Statement No. 114 added.	June, 1994
Paragraph 2.47	Summary of FASB Statement No. 105 added.	October, 1990
Paragraph 2.55	Conformed to the terminology used in SAS No. 65.	March, 1992
Paragraphs 2.57, 2.58, 2.63, 2.64, 2.70, 2.75, 2.79, 2.83, 2.89, 2.103, 2.104, 2.128, 2.133, 2.134, and 2.136	Conformed to the terminology used in SAS No. 55.	October, 1990
Paragraph 2.61	Reference to Veterans Administration changed to Department of Veterans Affairs.	March, 1992
Paragraph 2.108	Conformed to the terminology used in SAS No. 67.	March, 1992
Paragraph 2.131	Note reference to the supersession of SAS No. 11 added.	June, 1994
Paragraph 2.133	Reference to SAS No. 44 changed to SAS No. 70; Footnote reference to SAS No. 70 deleted.	May, 1993
Paragraph 2.145	Reference to SAS No. 17 changed to SAS No. 54.	October, 1990

Reference	Change	Date
Paragraph 2.146	Conformed to the terminology used in SAS No. 55.	March, 1992
Paragraph 2.148	Conformed to the terminology used in SAS No. 55.	October, 1990
Paragraph 3.28	Reference to SAS No. 14 changed to SAS No. 62.	October, 1990
Paragraph 5.11	Reference to FASB Statement No. 113 added.	June, 1994
Paragraph 5.18	Revised to reflect the issuance of FASB Statement No. 115.	June, 1994
Paragraph 5.30	Reference to Audit and Accounting Guide, *Audits of Fire and Casualty Insurance Companies,* changed to Audit and Accounting Guide, *Audits of Property and Liability Insurance Companies.*	October, 1990
Appendix A	Note updated to include guidance covered by SOP 90-11 and FASB Statement Nos. 105, 106, and 107.	March, 1992
Appendix A	Introduction modified.	May, 1993
Appendix A (Exhibit 1)	Footnote reference to FASB Statement No. 109 added.	May, 1993
Appendix A	References to FASB Statement Nos. 114 and 115 added.	June, 1994
Appendix B	SOP 90-11 added.	March, 1991
Appendix B	References to Audit and Accounting Guide *Savings and Loan Associations* deleted.	August, 1991
Appendix B	Notice to Readers revised to reflect SAS No. 69.	April, 1992
Appendix B	References to Audit and Accounting Guide *Audits of Credit Unions* deleted.	February, 1993
Appendix C	SOP 92-3 added.	May, 1992
Appendix C	References to Audit and Accounting Guide *Audits of Credit Unions* deleted.	February, 1993

Glossary

accounts receivable loan. A loan collateralized by the accounts receivable of the borrower.

accrual with suspension. A method of recognizing interest income based on the contractual terms of the loan (accrual basis). The accrual of interest is suspended when certain conditions occur that cast doubt on the collectibility of the unpaid loan.

acquisition costs. Costs related to making or acquiring loans or insurance contracts.

actuarial method. See **interest method.**

add-on loan. See **discount loan.**

adequate protection. A secured creditor's legal right under the U.S. Bankruptcy Code to have its collateral position not become impaired, impeded, or downgraded without sufficient protection against loss.

advance factoring. A factoring arrangement that allows a client to draw cash advances against the receivables sold to a factor before they are due or collected. Advance factoring also is called **discount factoring.**

advance payment. A payment on account made prior to the contractual due date.

anticipation. An extra allowance taken by customers on bills paid before the maturity date. The amount is based on the current interest rate.

asset-based financial services. Financial services related to secured commercial and industrial lending activities. Asset-based financial services include leasing and factoring activities.

asset-based lending. Lending collateralized by the borrower's assets.

availability. The amount that can be loaned as a percentage of collateral. The percentage is determined individually by formula, for example, 70 to 80 percent of accounts receivable and 30 to 60 percent of inventory.

average due date. The average maturity date for purchased receivables in a given month under a factoring agreement.

borrowing base of the finance company. An amount, usually defined in a note agreement or indenture, in computing the maximum amount permitted to be borrowed as a particular class of debt. It generally is determined by subtracting deferred charges and intangible assets from stockholders' equity. Subordinated debt usually is included in the borrowing base of debt senior to the subordinated debt. Also called **capital base.**

bulk purchase. The purchase of a group of loans receivable as a single transaction. Also called **receivables portfolio purchase.**

call option loan. A loan with a provision that permits the lender to require immediate repayment, at specified points in time.

capital base. See **borrowing base of the finance company.**

captive finance activities. Financing provided by a manufacturer or dealer through an affiliated finance company, generally with the intention of encouraging potential customers to purchase products of the controlling manufacturer or dealer.

carrying charge. Amount that the purchaser of consumer goods agrees to pay to the retail dealer or finance company (if the loan is obtained directly from the finance company) for the privilege of paying the principal balance in installments.

chargeback. Under a factoring agreement, the charging of an unpaid invoice or portion thereof against the client's account for amounts due to a merchandising dispute, credit, offset, deduction, or other reason for nonpayment other than the customer's inability to pay.

charges. All amounts charged, contracted for, or to be received in repayment of an obligation, excluding principal but including interest and compensation for expenses incurred by the lender; the difference between net funds advanced and total amounts to be repaid.

charges-only account. An account on which collections are applied entirely to finance, deferment, or default charges, with no portion serving to reduce the principal balance of the loan.

chattel. Personal property such as automobiles, furniture, and appliances.

chattel mortgage. An instrument under which the borrower (mortgagor) gives a lender (mortgagee) a lien on chattel property as security for payment of an obligation. The borrower continues to use the property. When the obligation is fully paid off, the lien is removed.

client. In a factoring arrangement, the business enterprise from which the factor buys trade accounts receivable.

collateral. Property pledged as security for loans. For consumer loans, collateral typically includes automobiles, furniture, and appliances. For commercial loans, collateral typically includes accounts receivable, inventory, plant and equipment, and marketable securities.

collateral management. Routine monitoring, by a finance company, of assets that a commercial borrower has pledged as security. Such procedures generally allow the lender to provide more financing than would otherwise be available.

collateral trust. A trust arrangement under which a finance company deposits its collateral with a trustee as security for borrowings. Notes issued for borrowings under such arrangements generally are called **collateral trust notes.**

collection days. The time required for a finance company to have payments received from customers collected and credited to the finance company's bank account.

comaker loan. Loans made by more than one debtor, generally unsecured. The second debtor is required because of the insufficient or unknown credit standing of the first debtor.

commission. A service fee paid to a finance company for arranging a transaction involving the sale or purchase of assets or services.

commitment fee. Consideration paid by a potential borrower to a potential lender for a promise to lend money in the future.

compensating balances. Deposit balances, frequently not interest-bearing, maintained in banks as compensation for advancing lines of credit and loans under the lines of credit, generally at some percent of the amount of the line of credit. Such amounts are shown in balance sheets as restricted funds when there is a formal, contractual agreement restricting use of such funds.

conditional sales contract. Legal instrument used in credit sales of personal property providing that the title remains with the seller until the purchase price is paid in full but that purchasers retain possession as long as there is no default.

confidential account. See **no-mail account.**

consumer. Any individual who purchases goods or merchandise for personal or family use.

consumer revolving credit and credit cards. Contracts with consumers to finance personal lines of credit that are continuously available to the consumer either for the purchase of goods or for direct advance of cash.

contracts sold under repurchase agreement. The seller, generally an equipment manufacturer, retailer, or dealer, agrees to pay within a designated period the unpaid balance of defaulted loans by repurchasing repossessed collateral from the finance company after reasonable collection effort, repossession, and delivery of the collateral to the seller.

contracts sold with recourse. Receivable contracts sold with the seller (generally an equipment manufacturer, retailer, or dealer) guaranteeing payment. If loans are not paid in accordance with terms, the finance company may force the seller to redeem the defaulted loans.

contractual method. A method of determining delinquent accounts based on contractual terms of the original loan agreement.

contractual rate. The rate of interest stated explicitly in a loan contract.

coupon book. A book of coded payment forms to be used by borrowers in remitting payments.

creditback. A credit to a factored client's account, typically to reverse prior chargebacks for payments subsequently received from customers or for credits issued by the client.

credit bureau. An organization that accumulates and makes credit information available to its members.

credit loss. The loss associated with a loan that is uncollectible.

customer. In a factoring arrangement, the individual or business enterprise that is the account debtor on the trade account receivable bought by the factor.

dealer. Retail merchant who generally purchases automobiles, furniture, appliances, or other consumer goods at wholesale and sells to customers at retail.

dealer holdbacks. Amounts withheld by finance companies from dealers on retail contracts with greater-than-normal credit risk until a certain number of payments on the contracts have been received or until contract balances have been reduced to specified amounts.

dealer reserves. Finance company liabilities for dealers' shares of finance charges on retail contracts purchased from dealers.

deficiency balances. Amounts remaining in borrowers' accounts after they have been charged with contractual amounts and credited for proceeds of sale of repossessed collateral, life insurance, and so forth.

deficiency judgment. Legal claim against a debtor for the balance of debt remaining after repossession and sale of the collateral, plus allowable expenses.

delinquency (default) fees. Amounts debtors pay because of being late with scheduled payments on loans.

demand loan. A loan that has no fixed maturity date but is payable on demand by the lender.

direct consumer loan. A two-party transaction in which the finance company lends funds directly to the borrower; such a loan may or may not be collateralized.

discount. Amount deducted from the face value in advance as a charge for the loan or a deduction for interest at the time of the loan or any charge for credit that is precomputed and included in the face of the instrument.

discount factoring. See **advance factoring.**

discount loan. A loan that is written with the interest or finance charges included in the face amount of the note. Discount loans are also called **precompute** or **add-on loans.**

effective interest rate. The implicit rate of interest based on the amount advanced and the amount and timing of the specified repayments over the period of the contract.

eligible accounts. Receivables that meet the criteria specified in a lending, factoring, or portfolio purchase agreement to entitle the borrower or client to a cash advance or payment.

equity participant. In a leveraged lease, an individual investor or group of investors who hold trust certificates evidencing their beneficial interest as owners under an owner trust.

evergreen loan. A loan that is repaid neither periodically nor according to a fixed amortization schedule, but might remain constant in relation to assets that qualify as collateral.

factor. A company that engages primarily in factoring.

factoring. Purchase, usually without recourse, of individual accounts receivable arising in the client's ordinary course of business. Under a factoring agreement, the finance company also provides credit checking, collection, and recordkeeping services.

financing statement. A notice filed in the location or locations required by state law necessary to perfect a security interest in collateral.

first out. A participation agreement that provides for a participant to have priority over all others in liquidation of a loan.

fixed-charge coverage. The number of times a company's interest cost is covered by earnings before taxes, measured by the ratio of earnings before taxes plus interest cost divided by interest cost. Credit rating agencies generally consider fixed-charge coverage in addition to other factors in evaluating the creditworthiness of a finance company's debt obligations.

floating rates. A rate of interest that, by the terms of the loan, fluctuates up or down depending on other widely followed market rates of interest, such as the prime rate, Treasury bill rate, or Federal Reserve discount rate.

floor plan checking. Physical inspection of dealer's inventories that are collateral for advances to the dealer to be repaid from the proceeds from sale of specific items. Sometimes referred to as floor plan auditing.

floor planning. Financing of dealers' inventories, particularly automobiles and other consumer goods, sometimes referred to as **wholesaling.** The dealers are obliged to repay the supplier or manufacturer from proceeds of sale of specific items, or after an elapsed period even though inventory is not sold.

foreclosure. A legal sale of mortgaged property to obtain satisfaction of the mortgage out of proceeds of sale.

garnishment. The attachment of salaries through court action to collect on a defaulted obligation.

interest-bearing loan. A loan that is written at the principal amount advanced to the borrower and bearing interest computed monthly on the unpaid balance.

interest method. A method of computing income under which interest income on a fixed-rate obligation is accrued over the life of the loan based on a constant rate (percent) of interest applied to the outstanding loan balance. As a result, the amount of income recognized at a given time is directly proportional to the outstanding loan balance. Also called the **actuarial method.**

inventory loan. A loan collateralized by inventory of the borrower.

lease. An agreement conveying the right to use property, plant, or equipment in exchange for cash payments over a stated time.

legal rebate obligation. The adjustment of precomputed interest required by state statutes on discount loans paid off before the end of their contractual terms.

letter of credit. A document issued by a financial institution, guaranteeing the seller payment of a specified amount on presentation before the expiration date of documents confirming shipment of goods. Generally, an irrevocable agreement.

leverage. The ratio of total debt to equity. Rating agencies commonly monitor a finance company's leverage in determining its credit rating.

leveraged lease. A lease involving at least three parties: a lessee, a long-term creditor, and a lessor (commonly called the **equity participant**). The long-term creditor commonly has recourse only to the leased assets.

lien. The right to satisfy a claim, if default occurs, by seizing the debtor's property subject to the lien and converting the property in accordance with procedures provided by law.

line of credit. An agreement to lend a specified amount of money at an agreed rate as long as there is no material adverse change in the business; such a line does not have to be used, but the funds normally are available upon request.

loan application. A form for completion by the prospective borrower generally providing for personal data such as family, residence, salary, employer, other indebtedness, and resources. The form is used to document certain matters considered significant by the lender before deciding whether to make a loan.

loan file. A record that usually contains the loan application and documents, credit checks, references, records of past loans, and other matters. Notes, contracts, titles, and collateral usually will be physically stored elsewhere for security reasons.

mandatory securities valuation reserve. Reserve required by law or regulation to provide for possible losses on securities held by insurance companies.

maturity. Date on which, or time period in which, repayment of a debt is to be made.

maturity date (in factoring). The average due date of a month's invoices plus collection days.

maturity factoring. Factoring arrangement under which a client is not entitled to cash advances before invoice maturity dates.

maturity spread. A tabulation of estimated or scheduled maturities of installment receivables by months or year due.

mortgage loans. Loans collateralized by real estate.

net interest spread. The excess of interest income accruable over interest expense incurred in a period.

no-mail account. An account in which no contact is to be made with the borrower by mail.

nonaccrual loans (nonearning assets). Loans on which accrual of interest has been suspended because collectibility is doubtful.

nonnotification factoring. Sale of trade accounts receivable in which the debtor is not informed of the sale.

nonrecourse. A situation in which a finance company has no legal right to compel payment from a seller of accounts receivable or from a prior endorser or drawer of a negotiable instrument in the event of default.

nonrefundable fee. Any charge made in connection with a loan that does not have to be refunded to the borrower when the loan is prepaid.

notification. Informing debtors that their accounts have been sold to and are now payable directly to a finance company.

old-line factor. A factor engaged primarily in the nonrecourse purchase of accounts receivable with notification.

open account sales. Credit extended that is not supported by a note, mortgage, or other formal written evidence of indebtedness; for example, shipments of merchandise for which a buyer is billed later.

open approvals. Credit is granted without immediate proof of a borrower's ability to repay.

origination fee. An amount charged by finance companies for originating, refinancing, or restructuring a loan. The amount may be intended to cover costs such as underwriting, loan application processing, and reviewing legal title to property involved.

overadvance (in factoring). An amount advanced to a client in excess of the amount of uncollected receivables purchased by the factor.

pari passu. A participation that provides for a pro rata sharing of risk among all lenders.

participation. A loan funded by two or more financial institutions. Participations may be either first out or pari passu.

participation manager. Commercial finance company originating and supervising a loan shared by one or more participants.

perfection. Protecting a security interest in collateral against conflicting claims through proper filing under the UCC. See **lien.**

points. Amounts, generally expressed as a percent of the loan, charged for granting loans, that primarily are adjustments of yield but also may be intended to cover costs such as underwriting, loan application processing, and reviewing title to collateral.

prebilling. Occurs when a company assigns invoice copies to a finance company for items that have not been shipped.

precompute loan. See **discount loan.**

prepayment penalty. An amount that the borrower pays to the lender, in addition to the remaining outstanding principal, if the borrower pays off the loan prior to contractual maturity.

rebate. Cancellation of a portion of the precomputed interest charge when the balance due on a discount loan is paid off prior to the originally scheduled maturity date.

receivables portfolio purchase agreements. The bulk purchase of a portfolio of accounts receivable, either on a single liquidating or a revolving arrangement. The purchase is typically nonrecourse and without customer notification. The seller continues to handle all communications, billings, and collections with customers.

recency-of-payments method. A method of determining delinquent accounts based on when recent collections have been received, without regard to when they were scheduled to be received in the original loan agreement.

recourse. The legal right to compel payment from a prior guarantor or drawer of a negotiable instrument, if dishonored.

recourse (in factoring). The right to charge a customer's uncollectible account back to the client.

renewed (refinanced) loan. A direct loan to a present borrower that is rewritten by the execution of a new note with or without an additional amount of funds being advanced.

repossess. To gain custody; to take collateral from a debtor for nonpayment or default on a loan.

retail sales contracts. Contractual receivables arising from sales of consumer goods such as automobiles, furniture, and appliances by retail dealers. Retail sales contracts also are referred to as **three-party paper** (customer/consumer, dealer, and finance company) when finance companies make advances against outstanding contracts.

revolving loan. A continuous loan made against an agreed percentage of the value of collateral, usually accounts receivable or inventory. The amount of the loan varies with the amount of collateral assigned.

rewrite. Renewal of an account, when little or no payment has been received, with the purpose of removing delinquency status.

Robert Morris Associates. A national association of bank loan and credit officers.

rule of 78s. A method of computing finance charges on a loan using a sum-of-digits approach (for example, 78 is the sum of the monthly periods of a twelve-month loan).

security agreement. An agreement between a borrower and a lender in which the borrower gives the lender a security interest or lien on equipment, accounts receivable, inventory, or other assets as security for amounts due to the lender.

security interest. A contractual interest in or lien on collateral to secure payment of an obligation.

senior debt. Borrowings that, by their terms, are not subordinate in payment priority to other debt.

springing lien. An interest in, or right to, collateral pledged as payment of an obligation, which is perfected on the occurrence of an agreed event, such as a default.

subordinated debt. Borrowings that by their terms are subordinate and junior in priority of payment to senior borrowings. Various levels of subordination include both senior and junior subordinations.

tax lease. An agreement that qualifies under tax rules that permit the lessee to claim rental payments as tax deductions and the lessor to claim tax benefits of ownership; that is, investment tax credits and depreciation.

three-party paper. See **retail sales contracts.**

time loan. A loan that has a fixed maturity date.

Uniform Commercial Code (UCC). A set of statutes designed to provide consistent state laws dealing with commercial transactions, including secured transactions, negotiable instruments, and sales of goods.

vendor leasing. Arrangements under which a finance company offers leases through a vendor's sales representatives to the vendor's customers as a basic financial package.

wholesaling. See **floor planning.**

working capital loan. See **revolving loan.**

yield. Annual rate of return to the lenders on a loan.

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