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Auditing interpretation AU 9336, Using the Work of a Specialist: Use of legal interpretations as evidential matter to support management's assertion that a transfer of financial assets has met the isolation criterion in paragraph 9(a) of Statement of Financial Accounting Standard no. 125

American Institute of Certified Public Accountants. Auditing Standards Board. Audit Issues Task Force

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Recommended Citation

American Institute of Certified Public Accountants. Auditing Standards Board. Audit Issues Task Force, "Auditing interpretation AU 9336, Using the Work of a Specialist: Use of legal interpretations as evidential matter to support management's assertion that a transfer of financial assets has met the isolation criterion in paragraph 9(a) of Statement of Financial Accounting Standard no. 125" (1998). *AICPA Professional Standards*. 462.

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Auditing Interpretation AU
9336, Using the Work of a
Specialist

The Use of Legal
Interpretations as Evidential
Matter to Support Management's
Assertion That a Transfer of
Financial Assets Has Met the
Isolation Criterion in
Paragraph 9(a) of Statement of
Financial Accounting Standard
No. 125

January 1, 1998

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Auditing Standards Board.
Audit Issues Task Force

The Audit Issues Task Force (AITF) of the Auditing Standards Board (ASB) has issued an interpretation, "The Use of Legal Interpretations As Evidential Matter to Support Management's Assertion That a Transfer of Financial Assets Has Met the Isolation Criterion in Paragraph 9(a) of Statement of Financial Accounting Standards No. 125," of Statement on Auditing Standards No. 73, *Using the Work of a Specialist*.

Statement of Financial Accounting Standards No. 125 (SFAS 125), *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, requires that a transferor of financial assets must surrender control over the financial assets to account for the transfer as a sale. Several conditions that must be met to provide evidence of surrender of control are specified in paragraph 9 of SFAS 125. The AITF has issued this auditing interpretation to provide guidance to auditors relating to evidential matter to support management's assertion that the condition stated in Paragraph 9(a) is met, that is, that "the transferred assets have been isolated from the transferor and its creditors, even in bankruptcy or other receivership."

The interpretation addresses: *i*) when the use of a legal specialist's work may be appropriate; *ii*) factors that should be considered in assessing the adequacy of the legal response; and *iii*) the use, as audit evidence, of legal opinions that restrict the use of the opinion to management or parties other than the auditor.

The interpretation is effective for auditing procedures related to transactions required to be accounted for under SFAS 125 that are entered into on or after January 1, 1998. The interpretation does not apply to transfers of financial assets by banks for which a receiver, if appointed, would be the Federal Deposit Insurance Corporation or its designee as referred to in Paragraph 58 of SFAS 125.

The auditing interpretation was drafted by the FASB 125 Audit Issues Task Force (Task Force) whose membership includes auditors with practice specializations in this audit area, an attorney who participated actively in the discussions leading to the adoption of SFAS 125, a representative of the brokerage industry, and FASB staff representatives. The Task Force will continue meeting in 1998 to draft additional auditing guidance that addresses transfers of financial assets by banks subject to FDIC receivership.

The ASB cleared the issuance of the interpretation by the AITF following a discussion at the December ASB meeting of comments received on a working draft of the interpretation.

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AU Section 9336

Interpretation of AU Section 336, *Using the Work of a Specialist*

1. The Use of Legal Interpretations As Evidential Matter to Support Management's Assertion That a Transfer of Financial Assets Has Met the Isolation Criterion in Paragraph 9(a) of Statement of Financial Accounting Standards No. 125

.01 Introduction—Statement of Financial Accounting Standards No. 125 (SFAS 125), *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, requires that a transferor of financial assets must surrender control over the financial assets to account for the transfer as a sale. Paragraph 9(a) states one of several conditions that must be met to provide evidence of surrender of control:

The transferred assets have been isolated from the transferor--put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.

Paragraph 23 of SFAS 125 describes in greater detail the evidence required to support management's assertion that transferred financial assets have been isolated:

The nature and extent of supporting evidence required for an assertion in financial statements that transferred financial assets have been isolated--put presumptively beyond the reach of the transferor and its creditors, either by a single transaction or a series of transactions taken as a whole--depend on the facts and circumstances. All available evidence that either supports or questions an assertion shall be considered. That consideration includes making judgments about whether the contract or circumstances permit the transferor to revoke the transfer. It also may include making judgments about the kind of bankruptcy or other receivership into which a transferor or special-purpose entity might be placed, whether a transfer of financial assets would likely be deemed a true sale at law, whether the transferor is affiliated with the transferee, and other factors pertinent under applicable law. Derecognition of transferred assets is appropriate only if the available evidence provides reasonable assurance that the transferred assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor or any of its affiliates, except for an affiliate that is a qualifying special-purpose entity designed to make remote the possibility that it would enter bankruptcy or other receivership.

A determination about whether the isolation criterion has been met to support a conclusion regarding surrender of control is largely a matter of law. This aspect of surrender of control, therefore, is assessed primarily from a legal perspective.

.02 Effective Date and Applicability—This interpretation is effective for auditing procedures related to transactions required to be accounted for under SFAS 125 that are entered into on or after January 1, 1998. This interpretation does not apply to transfers of financial assets by banks for which a receiver, if appointed, would be the Federal Deposit Insurance Corporation or its designee

as referred to in Paragraph 58 of SFAS 125.

.03 Question—What should the auditor consider in determining whether to use the work of a legal specialist¹ to obtain persuasive evidence to support management’s assertion that a transfer of financial assets meets the isolation criterion of SFAS 125?

.04 Interpretation—Section 336, *Using the Work of a Specialist*, paragraph .06, states that “during the audit...an auditor may encounter complex or subjective matters potentially material to the financial statements. Such matters may require special skill or knowledge and in the auditor’s judgment require using the work of a specialist to obtain competent evidential matter.”

.05 Use of a legal specialist may not be necessary to obtain competent evidential matter to support management’s assertion that the isolation criterion is met in certain situations, such as when there is a routine transfer of financial assets that does not result in any continuing involvement by the transferor (e.g., the transferor does not provide full or limited recourse, retain servicing of the transferred assets, retain any other interest in the transferred assets, or have an equity interest in the transferee).

.06 Many transfers of financial assets involve complex legal structures, continuing involvement by the transferor, or other legal issues that, in the auditor’s judgment, make it difficult to determine whether the isolation criterion is met. In these situations, use of a legal specialist usually is necessary. A legal specialist formulating an opinion as to whether a transfer isolates the transferred assets beyond the reach of the transferor and its creditors may consider, among other things, the structure of the transaction taken as a whole, the nature of the transferor’s continuing involvement, if any, the type of insolvency or other receivership proceedings to which the transferor might be subject if it fails, and other factors pertinent under applicable law.

.07 If a legal opinion is used as evidence to support the accounting conclusion related to multiple transfers under a single structure, and such transfers occur over an extended period of time under that structure, the auditor should evaluate the need for management to obtain periodic updates of that opinion to confirm that there have been no subsequent changes in relevant law that may change the applicability of the previous opinion to such transfers.²

.08 If management’s assertion with respect to a new transaction is that the transaction structure is the same as a prior structure for which a legal opinion that complies with this interpretation was used as evidence to support an assertion that the transfer of assets met the isolation criterion, the auditor should evaluate the need for management to obtain an update of that opinion

¹Client’s internal or external attorney who is knowledgeable about relevant sections of the U.S. Bankruptcy Code and other federal, state, or foreign law, as applicable.

²For structures that include ongoing transfers, such as revolving structures, this interpretation applies to transfers occurring on or after January 1, 1998.

to confirm that there have been no changes in relevant law or in the pertinent facts of the transaction that may affect the applicability of the previous opinion to the new transaction.

.09 Question—If the auditor determines that the use of a legal specialist is required, what should he or she consider in assessing the adequacy of the legal opinion?

.10 Interpretation—In assessing the adequacy of the legal opinion, the auditor should consider whether the legal specialist has experience with relevant matters, including knowledge of the U.S. Bankruptcy Code, and other federal, state, or foreign law, as applicable, as well as knowledge of the transaction upon which management’s assertion is based. The auditor should obtain an understanding of the assumptions that are used by the legal specialist, and make appropriate tests of any information that management provides to the legal specialist and upon which the specialist indicates it relied.

.11 The auditor also should consider the form and content of the documentation that the legal specialist provides and evaluate whether the legal specialist’s findings support management’s assertions with respect to the isolation criterion. Section 336.13 states that “if the auditor determines that the specialist’s findings support the related assertions in the financial statements, he or she reasonably may conclude that sufficient competent evidential matter has been obtained.” SFAS 125's requirement regarding reasonable assurance that the transferred assets would be isolated provides the basis for what auditors should consider in evaluating the work of a legal specialist.

.12 Findings of a legal specialist that relate to the isolation of transferred financial assets are often in the form of a reasoned legal opinion that is restricted to particular facts and circumstances relevant to the specific transaction. The reasoning of such opinion may rely upon analogy to legal precedents that may not involve facts and circumstances that are comparable to that specific transaction.

.13 An example of the conclusions in a legal opinion for an entity that is subject to the U.S. Bankruptcy Code that provides persuasive evidence, in the absence of contradictory evidence, to support management’s assertion that the transferred financial assets have been put presumptively beyond the reach of the entity and its creditors, even in bankruptcy or other receivership, follows:

“We believe (or it is our opinion) that in a properly presented and argued case, as a legal matter, in the event the Seller were to become a Debtor, the transfer of the Financial Assets from the Seller to the Purchaser would be considered to be a sale (or a true sale) of the Financial Assets from the Seller to the Purchaser and not a loan and, accordingly, the Financial Assets and the proceeds thereof transferred to the Purchaser by the Seller in accordance with the Purchase Agreement would not be deemed to be property of the Seller’s estate for purposes of (the relevant sections) of the U.S. Bankruptcy Code....

...Based upon the assumptions of fact and the discussion set forth above, and on a reasoned analysis of analogous case law, we are of the opinion that in a properly presented and argued

case, as a legal matter, in a proceeding under the U.S. Bankruptcy Code³, in which the Seller is a Debtor, a court *would not* grant an order consolidating the assets and liabilities of the Purchaser with those of the Seller in a case involving the insolvency of the Seller under the doctrine of substantive consolidation.”⁴

In the case of a transferor that is not entitled to become a debtor under the U.S. Bankruptcy Code, a legal opinion regarding whether the isolation criterion is met would consider whether isolation is satisfactorily achieved under the insolvency or receivership laws that apply to the transferor.

.14 A legal opinion that includes an inadequate opinion or a disclaimer of opinion, or that effectively limits the scope of the opinion to facts and circumstances that are not applicable to the transaction, does not provide persuasive evidence to support the entity’s assertion that the transferred assets have been put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership. Likewise, a legal letter that includes conclusions that are expressed using some of the following language would not provide persuasive evidence that a transfer of financial assets has met the isolation criterion of SFAS 125 (see paragraphs 17 and 18 of this interpretation):

- C “We are unable to express an opinion...”
- C “It is our opinion, based upon limited facts...”
- C “We are of the view...” or “it appears...”
- C “There is a reasonable basis to conclude that...”
- C “In our opinion, the transfer would *either* be a sale *or*...”⁵
- C “In our opinion, there is a reasonable possibility...”
- C “In our opinion, the transfer *should* be considered a sale...”
- C “It is our opinion that the company will be able to assert meritorious arguments...”

³For an entity subject to additional regulation (e.g., a broker-dealer subject to the Securities Investor Protection Act), the legal opinion also generally should address the effect of such regulation and the policies of the regulators implementing such regulations (e.g., the Securities Investor Protection Corporation).

⁴The second paragraph in the sample opinion addressing non-consolidation is not applicable in all cases and may, therefore, not be included. The auditor should evaluate whether such exclusion is appropriate. Further, when an affiliate of the transferor has entered into transactions with the transferee that could affect the issue of substantive consolidation, the opinion should address such issue.

⁵Certain transferors are subject *only* to receivership (and not to proceedings under the U.S. Bankruptcy Code) under laws that do not allow a receiver to reach assets in which a security interest has been granted. In such circumstances, an opinion that concludes that the transfer would either be a sale or a grant of a security interest that puts the transferred assets beyond the reach of such receiver would provide persuasive evidence.

- C “In our opinion, it is more likely than not ...”
- C “In our opinion, the transfer would *presumptively* be...”
- C “In our opinion, it is probable that...”

Furthermore, conclusions about hypothetical transactions may not be relevant to the transaction that is the subject of management’s assertions. Section 326, *Evidential Matter*, paragraph .21, states that “to be competent, evidence, regardless of its form, must be both valid and relevant.” Additionally, conclusions about hypothetical transactions may not contemplate all of the facts and circumstances or the provisions in the agreements of the transaction that is the subject of management’s assertions, and generally would not provide persuasive evidence.⁶

.15 Question—Are legal opinions that restrict the use of the opinion to the client, or to third parties other than the auditor, acceptable audit evidence?

.16 Interpretation—No. Footnote 5 to section 336.09 states: “In some cases, the auditor may decide it is necessary to contact the specialist to determine that the specialist is aware that his or her work will be used for evaluating the assertions in the financial statements.” Given the importance of the legal opinion to the assertion in this case, and the precision that legal specialists use in drafting such opinions, an auditor should not use as evidence a legal opinion that he or she deems otherwise adequate if the letter restricts use of the findings expressed therein to the client or to third parties other than the auditor. In that event, the auditor should request that the client obtain the legal specialist’s written permission for the auditor to use the opinion for the purpose of evaluating management’s assertion that a transfer of financial assets meets the isolation criterion of SFAS 125.

.17 Question—If the auditor determines that it is appropriate to use the work of a legal specialist, and either the resulting legal response does not provide persuasive evidence that a transfer of assets has met the isolation criterion, or the legal specialist does not grant permission for the auditor to use a legal opinion that is restricted to the client or to third parties other than the auditor, what other steps might an auditor consider?

.18 Interpretation—When other relevant evidential matter exists, the auditor should consider it before reaching a conclusion about the appropriateness of management’s accounting for a transfer.⁷ However, since the isolation aspect of surrender of control is assessed primarily from a legal

⁶For example, a memorandum of law from a legal specialist usually analyzes (and may make conclusions about) a transaction that may be completed subsequently. Such memorandum generally would not provide persuasive evidence unless the conclusions conform with this interpretation and a legal specialist opines that such conclusions apply to a completed transaction that is the subject of management’s assertion.

⁷See section 336.13 as to additional procedures that may be applied.

perspective, the auditor usually will not be able to obtain persuasive evidence in a form other than a legal opinion. In the absence of persuasive evidence that a transfer has met the isolation criterion, derecognition of the transferred assets is not in conformity with generally accepted accounting principles and the auditor should consider the need to express a qualified or adverse opinion in accordance with section 508, *Reports on Audited Financial Statements*, paragraphs .35-.60. However, if permission for the auditor to use a legal opinion that he or she deems otherwise adequate is not granted, this would be a scope limitation and the auditor should consider the need to express a qualified opinion or to disclaim an opinion in accordance with section 508.22-.26 and 508.61-.63.