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AUDIT & ACCOUNTING GUIDE

Depository and Lending Institutions

Banks and Savings Institutions, Credit Unions, Finance Companies, and Mortgage Companies

August 1, 2011

Audit & Accounting Guide: Depository and Lending Institutions
August 1, 2011

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AUDIT & ACCOUNTING GUIDE

Depository and Lending Institutions

Banks and Savings Institutions, Credit Unions, Finance Companies, and Mortgage Companies

WITH CONFORMING CHANGES AS OF

AUGUST 1, 2011

This edition of the AICPA Audit and Accounting Guide *Depository and Lending Institutions: Banks and Savings Institutions, Credit Unions, Finance Companies, and Mortgage Companies*, which was originally issued in 2004, has been modified by the AICPA staff to include certain changes necessary because of the issuance of authoritative pronouncements since the guide was originally issued and other changes necessary to keep the guide current on industry and regulatory matters. The schedule of changes identifies all changes made in this edition 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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Preface

About AICPA Audit and Accounting Guides

This AICPA Audit and Accounting Guide has been developed by the AICPA Guides Combination Task Force to assist management in the preparation of their financial statements in conformity with accounting principles generally accepted in the United States of America (U.S. GAAP) and to assist auditors in auditing and reporting on such financial statements.

The financial accounting and reporting guidance contained in this guide, when developed by the original task force or committee, was approved by the affirmative vote of at least two-thirds of the members of the Financial Reporting Executive Committee (FinREC) (formerly the Accounting Standards Executive Committee). FinREC is the senior technical body of the AICPA authorized to speak for the AICPA in the areas of financial accounting and reporting. Conforming updates made to the financial accounting and reporting guidance contained in this guide in years subsequent to the original development are reviewed by select FinREC members, among other reviewers where applicable.

This guide does the following:

- Identifies certain requirements set forth in the Financial Accounting Standards Board (FASB) *Accounting Standards Codification*™ (ASC).
- Describes FinREC's understanding of prevalent or sole industry practice concerning certain issues. In addition, this guide may indicate that FinREC expresses a preference for the prevalent or sole industry practice, or it may indicate that FinREC expresses a preference for another practice that is not the prevalent or sole industry practice; alternatively, FinREC may express no view on the matter.
- Identifies certain other, but not necessarily all, industry practices concerning certain accounting issues without expressing FinREC's views on them.
- Provides guidance that has been supported by FinREC on the accounting, reporting, or disclosure treatment of transactions or events that are not set forth in FASB ASC.

Accounting guidance for nongovernmental entities included in an AICPA Audit and Accounting Guide is a source of nonauthoritative accounting guidance. As discussed later in this preface, FASB ASC is the authoritative source of U.S. accounting and reporting standards for nongovernmental entities, in addition to guidance issued by the Securities and Exchange Commission (SEC). Accounting guidance for governmental entities included in an AICPA Audit and Accounting Guide is a source of authoritative accounting guidance described in category (*b*) of the hierarchy of GAAP for state and local governmental entities, and has been cleared by the Governmental Accounting Standards Board (GASB). AICPA members should be prepared to justify departures from GAAP as discussed in Rule 203, *Accounting Principles* (AICPA, *Professional Standards*, ET sec. 203 par. .01).

Auditing guidance included in an AICPA Audit and Accounting Guide is recognized as an interpretive publication pursuant to AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*). Interpretive publications are recommendations on the application of Statements on Auditing Standards (SASs) in specific circumstances, including engagements for entities in specialized industries. An interpretive publication is issued under

the authority of the Auditing Standards Board (ASB) after all ASB members have been provided an opportunity to consider and comment on whether the proposed interpretive publication is consistent with the SASs. The members of the ASB have found this guide to be consistent with existing SASs.

The auditor should be aware of and consider interpretive publications applicable to his or her audit. If an auditor does not apply the auditing guidance included in an applicable interpretive publication, the auditor should be prepared to explain how he or she complied with the SAS provisions addressed by such auditing guidance.

This AICPA Audit and Accounting Guide, which also contains attestation guidance, is recognized as an interpretive publication pursuant to AT section 50, *SSAE Hierarchy* (AICPA, *Professional Standards*). Interpretive publications include recommendations on the application of Statements on Standards for Attestation Engagements (SSAEs) in specific circumstances, including engagements for entities in specialized industries. Interpretive publications are issued under the authority of the ASB. The members of the ASB have found this guide to be consistent with existing SSAEs.

A practitioner should be aware of and consider interpretive publications applicable to his or her attestation engagement. If the practitioner does not apply the guidance included in an applicable AICPA Audit and Accounting Guide, the practitioner should be prepared to explain how he or she complied with the SSAE provisions addressed by such guidance.

Recognition

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Financial Reporting Executive Committee

Darrel R. Schubert, *Chair*
Auditing Standards Board

Guides Combination Task Force (1997–2003)

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Guidance Considered in This Edition

This edition of the guide has been modified by the AICPA staff to include certain changes necessary due to the issuance of authoritative guidance since the guide was originally issued. Authoritative guidance issued through August 1, 2011, has been considered in the development of this edition of the guide. Authoritative guidance discussed in the text of the guide (as differentiated from the temporary footnotes, which are denoted by a symbol rather than a number) is effective for entities with fiscal years *ending* on or before August 1, 2011. Authoritative guidance discussed only in temporary footnotes is not yet effective as of August 1, 2011, for entities with fiscal years ending after that same date.

This includes relevant guidance issued up to and including the following:

- Accounting Standards Update (ASU) No. 2011-07, *Health Care Entities (Topic 954): Presentation and Disclosure of Patient Service Revenue, Provisions for Bad Debts, and the Allowance for Doubtful Accounts for Certain Health Care Entities (a consensus of the FASB Emerging Issues Task Force)*
- SAS No. 121, *Revised Applicability of Statement on Auditing Standards No. 100,* Interim Financial Reporting (AICPA, *Professional Standards*, AU sec. 722 par. .05)
- Interpretation No. 11, "Dating the Auditor's Report on Supplementary Information," of AU section 551, *Supplementary Information in Relation to the Financial Statements as a Whole* (AICPA, *Professional Standards*, AU sec. 9551 par. .01–.04)
- Revised interpretations issued through August 1, 2011, including Interpretation Nos. 1–4 of AU section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, AU sec. 9325 par. .01–.13)

- Statement of Position 09-1, *Performing Agreed-Upon Procedures Engagements That Address the Completeness, Accuracy, or Consistency of XBRL-Tagged Data* (AICPA, *Technical Practice Aids*, AUD sec. 14,440)
- SSAE No. 17, *Reporting on Compiled Prospective Financial Statements When the Practitioner's Independence is Impaired* (AICPA, *Professional Standards*, AT sec. 301 par. .23)
- Interpretation No. 1, "Reporting Under Section 112 of the Federal Deposit Insurance Corporation Improvement Act," of AT section 501, *An Examination of an Entity's Internal Control Over Financial Reporting That Is Integrated With an Audit of its Financial Statements* (AICPA, *Professional Standards*, AT sec. 9501 par. .01–.07)
- SSARS No. 19, *Compilation and Review Engagements* (AICPA, *Professional Standards*)
- Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 15, *Audit Evidence* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards)

Users of this guide should consider guidance issued subsequent to those items listed previously to determine their effect on entities covered by this guide. In determining the applicability of recently issued guidance, its effective date should also be considered.

The changes made to this edition of the guide are identified in the schedule of changes in appendix E. The changes do not include all those that might be considered necessary if the guide were subjected to a comprehensive review and revision.

Applicability of U.S. Generally Accepted Auditing Standards and PCAOB Standards

Audits of the financial statements of *nonissuers* (those entities not subject to the Sarbanes-Oxley Act of 2002 or the rules of the SEC—that is, private entities, generally speaking) are conducted in accordance with U.S. generally accepted auditing standards (GAAS) as issued by the ASB, the senior technical committee of the AICPA with the authority to promulgate auditing standards for nonissuers. The ASB develops and issues standards in the form of SASs through a due process that includes deliberation in meetings open to the public, public exposure of proposed SASs, and a formal vote. The SASs and their related interpretations are codified in the AICPA's *Professional Standards*. Paragraph .03 of AU section 150 establishes that an AICPA member's failure to follow ASB standards for audits of nonissuers is a violation of Rule 202, *Compliance With Standards* (AICPA, *Professional Standards*, ET sec. 202 par. .01), of the AICPA Code of Professional Conduct.

Audits of the financial statements of *issuers*, as defined by the SEC (those entities subject to the Sarbanes-Oxley Act of 2002 or the rules of the SEC—that is, public entities, generally speaking), are conducted in accordance with standards established by the PCAOB, a private sector, nonprofit corporation created by the Sarbanes-Oxley Act of 2002 to oversee the audits of issuers. The SEC has oversight authority over the PCAOB, including the approval of its rules, standards, and budget.

For audits of a nonissuer, in accordance with both GAAS and PCAOB standards, Interpretation No. 18, "Reference to PCAOB Standards in an Audit Report on a Nonissuer," of AU section 508, *Reports on Audited Financial Statements*

(AICPA, *Professional Standards*, AU sec. 9508 par. .89–.92), provides reporting guidance applicable to such engagements.

References to Professional Standards

In citing GAAS and their related interpretations, references use section numbers within the codification of currently effective SASs and not the original statement number, as appropriate. For example, SAS No. 54, *Illegal Acts by Clients*, is referred to as AU section 317, *Illegal Acts by Clients* (AICPA, *Professional Standards*). In those sections of the guides that refer to specific auditing standards of the PCAOB, references are made to the AICPA's *PCAOB Standards and Related Rules* publication.

FASB ASC Overview

Released on July 1, 2009, FASB ASC is a major restructuring of accounting and reporting standards designed to simplify user access to all authoritative U.S. GAAP by topically organizing the authoritative literature. FASB ASC disassembled and reassembled thousands of nongovernmental accounting pronouncements (including those of FASB, the Emerging Issues Task Force, and the AICPA) to organize them under approximately 90 topics.

FASB ASC also includes relevant portions of authoritative content issued by the SEC, as well as selected SEC staff interpretations and administrative guidance issued by the SEC; however, FASB ASC is not the official source of SEC guidance and does not contain the entire population of SEC rules, regulations, interpretive releases, and SEC staff guidance. Moreover, FASB ASC does not include governmental accounting standards.

FASB published a notice to constituents that explains the scope, structure, and usage of consistent terminology of FASB ASC. Constituents are encouraged to read this notice to constituents because it answers many common questions about FASB ASC. FASB ASC, and its related notice to constituents, can be accessed at http://asc.fasb.org/home and are also offered by certain third party licensees, including the AICPA. FASB ASC is offered by FASB at no charge in a Basic View and for an annual fee in a Professional View.

Issuance of Amendments to the Codification

Amendments to FASB ASC are now issued through ASUs and serve only to update FASB ASC. FASB does not consider the ASUs authoritative in their own right; such amendments become authoritative when they are incorporated into FASB ASC.

The ASUs issued are in the form of ASU No. 20YY-XX, in which "YY" is the last two digits of the year and "XX" is the sequential number for each update. For example, ASU No. 2011-01 is the first update in the calendar year 2011. The ASUs include the amendments to the codification and an appendix of FASB ASC update instructions. ASUs also provide background information about the amendments and explain the basis for the board's decisions.

Pending Content in FASB ASC

Amendments to FASB ASC issued in the form of ASUs (or other authoritative accounting guidance issued prior to the release date of FASB ASC) that are not fully effective, or became effective within the last six months, for all entities or transactions within its scope are reflected as "Pending Content" in FASB ASC. This pending content is shown in text boxes below the paragraphs being

amended in FASB ASC and includes links to the transition information. The pending content boxes are meant to provide users with information about how a paragraph will change when new guidance becomes authoritative. When an amended paragraph becomes fully effective, the outdated guidance will be removed, and the amended paragraph will remain without the pending content box. FASB will keep any outdated guidance in the applicable archive section of FASB ASC for historical purposes.

Because not all entities have the same fiscal year-ends, and certain guidance may be effective on different dates for public and nonpublic entities, the pending content will apply to different entities at different times. As such, pending content will remain in place within FASB ASC until the "roll-off" date. Generally, the *roll-off* date is six months following the latest fiscal year end for which the original guidance being amended or superseded by the pending content could be applied as specified by the transition guidance. For example, assume an ASU has an effective date for fiscal years beginning after November 15, 2010. The latest possible fiscal year end of an entity still eligible to apply the original guidance being amended or superseded by the pending content would begin November 15, 2010, and end November 14, 2011. Accordingly, the roll-off date would be May 14, 2012.

Entities cannot disregard the pending content boxes in FASB ASC. Instead, all entities must review the transition guidance to determine if and when the pending content is applicable to them. This Audit and Accounting Guide identifies pending content where applicable. As explained in the section of the preface "Guidance Considered in This Edition," pending content discussed in the text of the guide (as differentiated from the temporary footnotes, which are denoted by a symbol rather than a number) is effective for entities with fiscal years *ending* on or before August 1, 2011. Pending content discussed only in temporary footnotes is not yet effective as of August 1, 2011 for entities with fiscal years ending after that same date.

New AICPA.org Website

The AICPA encourages you to visit the new website at www.aicpa.org. It was launched in 2010 and provides significantly enhanced functionality and content critical to the success of AICPA members and other constituents. Certain content on the AICPA's website referenced in this guide may be restricted to AICPA members only.

Select Recent Developments Significant to This Guide

Summary of Significant Differences Between the PCAOB and AICPA Risk Assessment Standards

On August 5, 2010, the PCAOB issued Release No. 2010-004, *Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards* (AICPA, *PCAOB Standards and Related Rules*, Select PCAOB Releases). This release includes eight auditing standards (collectively referred to as the "PCAOB Risk Assessment Standards") as adopted by the PCAOB. The eight standards, which were approved by the SEC on December 23, 2010, are as follows:

1. Auditing Standard No. 8, *Audit Risk*
2. Auditing Standard No. 9, *Audit Planning*
3. Auditing Standard No. 10, *Supervision of the Audit Engagement*

4. Auditing Standard No. 11, *Consideration of Materiality in Planning & Performing an Audit*
5. Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*
6. Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*
7. Auditing Standards No. 14, *Evaluating Audit Results*
8. Auditing Standards No. 15

The release also includes conforming amendments to other interim standards related to PCAOB Risk Assessment Standards. The effective date of the PCAOB Risk Assessment Standards is for audits of financial statements of issues with fiscal periods beginning on or after December 15, 2010.

In general, the PCAOB Risk Assessment Standards are consistent with the AICPA SASs related to risk assessment (the "AICPA Risk Assessment Standards"). Where differences exist, they are primarily due to the PCAOB

a. addressing audits of financial statements in conjunction with audits of effectiveness of internal control (often referred to as "Integrated Audits"). The AICPA Risk Assessment Standards only address audits of financial statements.

b. presenting, content in standards different than the AICPA Risk Assessment Standards. For example, the PCAOB

   i. incorporated fraud risk assessment procedures into the PCAOB Risk Assessment Standards,

   ii. created Auditing Standard No. 10 to separately address supervision of the audit engagement,

   iii. created Auditing Standards No. 14 to separately address the evaluation of audit results, and

   iv. moved content related to other audit areas such as analytical review procedures and audits of group financial statements.

The PCAOB Risk Assessment Standards are not as voluminous as the AICPA Risk Assessment Standards because the PCAOB standards do not contain as much application guidance as does the AICPA Risk Assessment Standards. Appendix 11 of the release contains a more detailed comparison of the differences between the PCAOB Risk Assessment Standards and the AICPA Risk Assessment Standards.

ASB's Clarity Project

To address concerns over the clarity, length, and complexity of its standards, the ASB has made a significant effort to clarify the SASs. In order to address practice issues timely, SAS Nos. 117–120 have already been issued in the clarity format and are already effective. The majority of the clarified standards will be issued as one SAS, SAS No. 122, *Statements on Auditing Standards: Clarification and Recodification*. SAS No. 122 will contain 39 clarified SASs and will recodify and supersede all outstanding SASs through SAS No. 121 except:

- SAS No. 51, *Reporting on Financial Statements Prepared for Use in Other Countries* (AU sec. 534);
- SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, as amended (AU sec. 341);

- SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AU sec. 322);
- SAS No. 87, *Restricting the Use of an Auditor's Report* (AU sec. 532);
- SAS Nos. 117–120

SAS No. 122 will also withdraw SAS No. 26, *Association With Financial Statements*, as amended.

SAS No. 122 will initially be codified in *Professional Standards* as "AU-C" section numbers instead of "AU" section numbers, and includes AU-C section numbers in its original release.

"AU-C" is a temporary identifier to avoid confusion with references to existing "AU" sections, which remain effective through 2013, in AICPA *Professional Standards*. The "AU-C" identifier will revert to "AU" in 2014, by which time SAS No. 122 becomes fully effective for all engagements.

SAS No. 122 will be effective for audits of financial statements for periods ending on or after December 15, 2012. Refer to individual AU-C sections for specific effective date language.

The ASB established clarity drafting conventions and undertook to redraft all of its SASs in accordance with those conventions, which include the following:

- Establishing objectives for each clarified SAS
- Including a definitions section, where relevant, in each clarified SAS
- Separating requirements from application and other explanatory material
- Numbering application and other explanatory material paragraphs using an A- prefix and presenting them in a separate section that follows the requirements section
- Using formatting techniques, such as bulleted lists, to enhance readability
- Including, when appropriate, special considerations relevant to audits of smaller, less complex entities within the text of the clarified SAS
- Including, when appropriate, special considerations relevant to audits of governmental entities within the text of the clarified SAS

The project also has an international convergence component. AU-C section numbers for clarified SASs based on equivalent ISAs are the same as the equivalent ISA numbers. AU-C section numbers for clarified SASs with no equivalent International Standards on Auditing (ISAs) have been assigned new numbers. The ASB believes that this recodification structure will aid firms and practitioners that use both ISAs and generally accepted auditing standards.

Consistent with the ASB's strategy to converge its SASs with ISAs promulgated by the International Auditing and Assurance Standard Board while avoiding unnecessary conflict with standards of the PCAOB, clarified SASs have been developed using equivalent ISAs as a base, when applicable. Substantive differences in objectives, definitions, or requirements between a clarified SAS and the equivalent ISA are identified in an exhibit to each applicable clarified SAS.

AICPA audit and accounting guides, as well as other AICPA publications, will be conformed to reflect the new standards resulting from the Clarity Project after issuance and as appropriate based on the effective dates.

International Financial Reporting Standards

International Financial Reporting Standards (IFRSs) consist of accounting standards and interpretations developed and issued by the International Accounting Standards Board (IASB), a London-based independent accounting standard-setting body. The IASB began operations in 2001, when it succeeded the International Accounting Standards Committee (IASC). IASC was formed in 1973, soon after the formation of FASB. In 2001, when the IASB replaced the IASC, a new, independent oversight body, the IASC Foundation, was created to appoint the members of the IASB and oversee its due process. The IASC Foundation's oversight role is very similar to that of the Financial Accounting Foundation in its capacity as the oversight body of FASB.

The term IFRSs has both a narrow and a broad meaning. Narrowly, IFRSs refer to the new numbered series of pronouncements issued by the IASB, as differentiated from International Accounting Standards (IASs) issued by its predecessor, the IASC. More broadly, however, IFRSs refer to the entire body of authoritative IASB pronouncements, including those issued by the IASC and their respective interpretive bodies. Therefore, the authoritative IFRSs literature, in its broadest sense, includes the following:

- Standards, whether labeled IFRSs or IASs
- Interpretations, whether labeled IFRIC (referring to the International Financial Reporting Interpretations Committee, the current interpretive body of the IASC Foundation) or SIC (Standing Interpretations Committee, the predecessor to IFRIC and former interpretive body of the IASC)
- IFRS framework

As of March 31, 2010, IFRIC formally changed its name to the IFRS Interpretations Committee and on July 1, 2010, the IASC Foundation formally changed its name to the IFRS Foundation.

The preface to the IFRS 2010 bound volume states that IFRSs are designed to apply to the general purpose financial statements and other financial reporting of all profit-oriented entities including commercial, industrial, and financial entities regardless of legal form or organization. Included within the scope of profit-oriented entities are mutual insurance companies and other mutual cooperative entities providing dividends or other economic benefits to their owners, members, or participants.

IFRSs are not designed to apply to not-for-profit entities or those in the public sector, but these entities may find IFRSs appropriate in accounting for their activities. In contrast, U.S. GAAP is designed to apply to all nongovernmental entities, including not-for-profit entities, and includes specific guidance for not-for-profit entities, development stage entities, limited liability entities, and personal financial statements.

The AICPA Governing Council voted in May 2008 to recognize the IASB as an accounting body for purposes of establishing international financial accounting and reporting principles. This amendment to appendix A of Rule 202 and Rule 203 of the AICPA's Code of Professional Conduct gives AICPA members the option to use IFRS as an alternative to U.S. GAAP. As a result, private entities in the U.S. can prepare their financial statements in accordance with U.S. GAAP as promulgated by FASB; an other comprehensive basis of accounting, such as cash- or tax-basis; or IFRSs, including small- and medium-sized entities, among others. However, domestic issuers are currently required to follow U.S. GAAP and rules and regulations of the SEC. In contrast, foreign private issuers may present their financial statements in accordance with IFRSs as issued by the

IASB without a reconciliation to U.S. GAAP, or in accordance with non-IFRS home-country GAAP reconciled to U.S. GAAP as permitted by Form 20-F.

The growing acceptance of IFRSs as a basis for U.S. financial reporting could represent a fundamental change for the U.S. accounting profession. Acceptance of a single set of high-quality accounting standards for worldwide use by public companies has been gaining momentum around the globe for the past few years. See appendix D for a discerning look at the status of convergence with IFRSs in the United States and the important issues that accounting professionals need to consider now.

Private Company Financial Reporting Blue Ribbon Panel/ Standard Setting for Nonpublic Entities

The Blue Ribbon Panel on Private Company Financial Reporting was established in December 2009 and was sponsored by the AICPA, the Financial Accounting Foundation (FAF), and the National Association of State Boards of Accountancy. This panel was formed to consider how U.S. accounting standards can best meet the needs of users of private company financial statements. Members of the panel represent a cross-section of financial reporting constituencies, including lenders, investors, owners, preparers, and auditors.

In late 2010, the Blue Ribbon Panel voted to recommend that the FAF accept a new standard-setting model for private companies and the creation of a separate board to set those standards. In January 2011, the Blue Ribbon Panel submitted a report of its recommendations to the FAF. The Blue Ribbon Panel concluded its work upon the issuance of its report to the FAF. For updates of developments regarding standard setting for nonpublic entities visit the AICPA website at www.aicpa.org/privateGAAP.

In March 2011, the board of trustess of the FAF announced the establishment of a Trustee Working Group to further address the topic of accounting standard setting for nonpublic entities. The working group has elected to include both nonprofit entities and private companies in its consideration of this issue. For more information visit www.accountingfoundation.org/home.

Purpose and Applicability

This AICPA Audit and Accounting Guide has been prepared to assist financial institutions in preparing financial statements in conformity with GAAP and to assist independent accountants in reporting on financial statements (and, as discussed in appendix A, other written management assertions) of those entities.

Chapters of the guide are generally organized by financial statement line item into four sections:

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

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

c. *Accounting and Financial Reporting* guidance that addresses accounting and financial reporting issues. FASB ASC 105, *Generally Accepted Accounting Principles*, establishes FASB ASC as the source of authoritative U.S. GAAP recognized by FASB to be applied by nongovernmental entities.

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

Scope

This guide applies to all banks, savings institutions, credit unions, finance companies, and other entities (including entities with trade receivables). That population includes the following:

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

This guide does not apply to the following:

a. Investment companies, broker dealers in securities, employee benefit plans and similar entities that carry loans and trade receivables at fair value with the unrealized gains and losses included in earnings
b. Governmental or federal entities that follow the principles of GASB or the Federal Accounting Standards Advisory Board

As used in this guide, the term *depository institution* means a bank, credit union, and savings institution. The terms *financial institutions* or *institutions* refer to all entities covered by this guide.

As stated in the previous list, this guide applies to the financing activities of all kinds of enterprises. Certain entities may have financing activities but are

not otherwise covered by this guide—for example, the financing subsidiary, unit, or division of a manufacturing company or retailer. Only those sections and chapters of this guide related to financing activities are intended to apply to such entities. The remaining portions are not intended to apply to such entities, but may otherwise be useful to financial statement preparers and auditors.

Certain terms are used interchangeably throughout the guide as follows:

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

Limitations

In July 1990, the AICPA's Board of Directors authorized the AICPA staff to make conforming changes to the Audit and Accounting Guides with the approval of the chairman of the ASB or the chairman of FinREC, as appropriate. The board resolution defines *conforming changes* as "revisions intended to effect changes necessitated by the issuance of authoritative pronouncements." Conforming changes are carefully and judiciously made and normally limited to items that result from the issuance of new authoritative literature. Conforming changes also include nonaccounting and nonauditing revisions that modify, add, or delete regulatory guidance and industry background information in response to changes in the regulatory and industry environment. Conforming changes do not include recent legislative programs or other governmental measures or industry actions that may have been taken as a result of the current economic environment.

The Audit Risk Alert *Current Economic Crisis: Accounting and Auditing Considerations—2010* was issued by the AICPA to assist in planning and performing audits in the current economic environment and addresses areas of audit concern during these difficult and uncertain economic times. In addition, the AIPCA will issue the Audit Risk Alert *Financial Institutions Industry Developments—2011* to address areas of audit concern specific to the deposit and lending institutions industry. This guide is intended to be used in conjunction with these alerts to provide a more comprehensive understanding of accounting and reporting guidance under U.S. GAAP, requirements of regulatory agencies, and current economic conditions that affect the depository and lending institutions industry.

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Chapter 1

Industry Overview—Banks and Savings Institutions

Description of Business

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

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

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

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

1.04 In addition, competition arose from within the industry, and also from other competitors such as investment companies, brokers and dealers in securities, insurers, and financial subsidiaries of commercial enterprises. These entities increased business directly with potential depositors and borrowers in transactions traditionally executed through banks and savings institutions.

This disintermediation increased the need for innovative approaches to attracting depositors and borrowers.

1.05 This disintermediation also led to a sharp increase in consolidation within the financial institution industry, which created several large and highly complex financial holding companies. With the changes previously mentioned and the increased size of many financial institutions, a dramatic shift in lending, capital market activities, and sources of funding occurred. During this transformation of the industry, the regulatory system issued additional guidance in an effort to keep pace with the changes in the industry.

1.06 The economic recession, which officially began in 2007, revealed vulnerabilities in financial institutions and the regulatory system which contributed to unprecedented strain and stress on financial institutions, and in financial markets. As a result, certain financial institutions have either failed or have come close to failure and many additional widespread repercussions continue to affect this industry. Total assets of "problem" institutions reached their highest levels since 1993 during the first quarter of 2010, per the Federal Deposit Insurance Corporation's (FDIC's) Quarterly Banking Profile. In addition, the number of bank failures was at the highest level since 1992. The economic crisis fueled the demand for financial reform. As a result, on July 21, 2010, the president signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) into law in response to weaknesses in the financial services industry that were believed to have contributed to the economic recession. See further discussion of the Dodd-Frank Act beginning at paragraph 1.28.

1.07 The innovation and complexity related to this industry creates a constantly changing body of business and economic risks. These risk factors, and related considerations for auditors, are identified and discussed throughout this Audit and Accounting Guide.

Regulation and Oversight

1.08 As previously discussed, the importance of financial intermediation has driven governments to play a role in the banking and savings institutions industry from its beginning. Banks and savings institutions have been given unique privileges and protections, including the insurance of their deposits by the federal government through the FDIC and access to the FRS's discount window and payments system. (See chapter 2, "Industry Overview—Credit Unions," for the roles and responsibilities of the National Credit Union Administration [NCUA]). Currently, the federal oversight of institutions receiving these privileges falls to the following four agencies:

a. The Board of Governors of the FRS (FRB), established in 1913 as the central bank of the United States with supervisory responsibilities for bank holding companies, state chartered banks that are members of the FRS, and foreign banking organizations operating in the United States

b. The FDIC, established in 1934 to restore confidence in the banking system through the federal insurance of deposits with supervisory responsibilities for state chartered banks that are not members of the FRS

c. The Office of the Comptroller of the Currency (OCC), created in 1863 to regulate and provide federal charters for national banks

d. The Office of Thrift Supervision (OTS), which replaced the Federal

Home Loan Bank Board in 1989 as the primary regulator for savings institutions (see discussion of transfer of power of the OTS in paragraph 1.39)

1.09 The FRB and FDIC are independent agencies of the federal government. The OCC and OTS are separate bureaus of the U.S. Department of Treasury (Treasury). Each state has a banking department and are members of an organization called the Conference of State Bank Supervisors.

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

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

1.11 Given the nature of their duties to consider a bank's risk characteristics and loss behavior, the banking agencies also have significant influence in aiding banks and savings institutions with technical details on the application of accounting principles generally accepted in the United States of America (U.S. GAAP) in regulatory reporting. For example, the agencies also have certain authority over the activities of auditors serving the industry. Further, the FRB, FDIC, OCC, OTS, and NCUA constitute the Federal Financial Institutions Examination Council (FFIEC). The FFIEC sets forth uniform examination and supervisory guidelines in certain areas related to banks' and savings institutions' and credit unions' activities, including those involving regulatory reporting matters.

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

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

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

Regulatory Background

1.15 Declining real estate markets in the mid-1980s contributed heavily to widespread losses in the savings institutions industry, evidenced by the insolvency of the savings industry's federal deposit insurance fund. The FIRREA provided funds for the resolution of thrift institutions, replaced the existing regulatory structure, introduced increased regulatory capital requirements, established limitations on certain investments and activities, and enhanced regulators' enforcement authority. The FIRREA redefined responsibilities for federal deposit insurance by designating separate insurance funds, the Bank Insurance Fund (BIF), and the Savings Associations Insurance Fund (SAIF). The FIRREA also established the Resolution Trust Corporation (RTC) to dispose of the assets of failed thrifts. The RTC is no longer in existence and its work is now being done by the FDIC.

1.16 As the 1980s came to a close, record numbers of bank failures began to drain the BIF. The FDICIA provided additional funding for the BIF but also focused the least-cost resolution of and prompt corrective action for troubled institutions and improved supervision and examinations. The FDICIA also focused the regulatory enforcement mechanism on capital adequacy. Many of the FDICIA's provisions were amendments or additions to the existing Federal Deposit Insurance Act (FDI Act).

1.17 In April 2006, the FDIC merged the BIF and the SAIF to form the Deposit Insurance Fund (DIF). This action was pursuant to the provisions in the Federal Deposit Insurance Reform Act of 2005 (Reform Act). Under the Reform Act, the FDIC may set the designated reserve ratio within a range of 1.15 percent to 1.50 percent of estimated insured deposits.

1.18 A desire to allow banks to serve a broad spectrum of customer financial needs caused Congress to pass legislation in 1999. The Gramm-Leach-Bliley Act (or also known as the Financial Services Modernization Act) changed the types of activities that are permissible for bank holding company affiliates and for subsidiaries of banks. The bill created so-called financial holding companies that may engage in a broad array of activities. Financial holding company affiliates could provide insurance as principal, agent, or broker and may issue annuities. These affiliates may engage in expanded underwriting, dealing in, or making a market in securities, as well as engage in expanded merchant banking activities. The legislation affirmed the concept of functional regulation.

1.19 Federal banking regulators continue to be the primary supervisors of the banking affiliates of financial holding companies and state insurance authorities supervise the insurance companies, and the SEC and securities self-regulatory organizations supervise the securities business. Each functional regulator determines appropriate capital standards for the companies it supervises. The Treasury and the FRB have the authority to approve additional activities to be permissible for financial holding companies. To maintain financial holding company status, all of a bank holding company's insured deposit taking subsidiaries must be "well capitalized," "well managed," and have at least a satisfactory Community Reinvestment Act rating.

1.20 In 1970, the Bank Secrecy Act (BSA) was enacted to address the problem of money laundering. The BSA authorized the Treasury to issue regulations requiring financial institutions to file reports, keep certain records, implement anti-money-laundering programs and compliance procedures, and report suspicious transactions to the government. (See Title 31 U.S. *Code of Federal Regulations* [CFR] Chapter X).[*] These regulations, promulgated under the authority of the BSA, and subsequently the USA-Patriot Act of 2001, are intended to help federal authorities detect, deter, and prevent criminal activity. The Financial Crimes Enforcement Network (FinCEN), an arm of the Treasury, administers these regulations.

1.21 On July 28, 2006, the FFIEC and related agencies released the revised Bank Secrecy Act/Anti-Money Laundering (BSA/AML) Examination Manual (manual). The manual emphasizes a banking organization's responsibility to establish and implement risk-based policies, procedures, and processes to comply with the BSA and safeguard its operations from money laundering and terrorist financing. The revised manual reflects the ongoing commitment to provide current and consistent guidance on risk-based policies, procedures, and processes for banking organizations to comply with the BSA and safeguard operations from money laundering and terrorist financing. The manual has been updated to further clarify supervisory expectations and incorporate regulatory changes since the manual's 2006 release.

1.22 In 2002, the Sarbanes-Oxley Act was enacted in response to high-profile business failures which called into question the effectiveness of the CPA profession's self-regulatory process as well as the effectiveness of the audit to uphold the public trust in the capital markets. The requirements of the Sarbanes-Oxley Act and the SEC regulations implementing the Act are wide-ranging. The banking regulatory agencies also passed regulations implementing certain provisions of the Sarbanes-Oxley Act. Paragraphs 1.87–.99 provide additional information regarding regulatory issuances related to the Sarbanes-Oxley Act. In addition, the Sarbanes-Oxley Act created the Public Company Accounting Oversight Board (PCAOB), which has the authority to set and enforce auditing, attestation, quality control, and ethics (including independence) standards for auditors of issuers. It also is empowered to inspect the auditing operations of public accounting firms that audit issuers as well as impose disciplinary and remedial sanctions for violations of the board's rules, securities laws, and professional auditing and accounting standards.

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

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[*] The Financial Crimes Enforcement Network (FinCEN) issued a final rule on October 26, 2010, reorganizing and transferring the Bank Secrecy Act (BSA) regulations to a new chapter in the U.S. Code of Federal Regulations (CFR). Those modifications were effective on March 1, 2011. The rule transferred the BSA regulations from Title 31 CFR Part 103 to 31 CFR Chapter X. The new structure organizes BSA regulations by industry and identifies regulations that are applicable to all regulated industries and individuals subject to the BSA in order to make the regulatory obligations uniform. Federal and state banking agencies should refer to the citation of the BSA relative to examination findings beginning on or after March 1, 2011. FinCEN has developed online tools to assist in the transition to Chapter X that can be found at www.fincen.gov/statutes_regs/ChapterX.

Recent Regulatory Updates

1.24 On October 7, 2008, the FDIC established a Restoration Plan for the DIF to return the DIF to its statutorily mandated minimum reserve ratio of 1.15 percent within 5 years. In February 2009, the FDIC amended its Restoration Plan to extend the restoration period from 5 to 7 years. Congress then amended the statute governing the Restoration Plan, in May 2009, to allow the FDIC up to 8 years to return the DIF reserve ratio to 1.15 percent. In September 2009, the FDIC amended the Restoration Plan consistent with the statutory change and, pursuant to the amended Restoration Plan, adopted a uniform 3 basis point increase in initial assessment rates effective January 1, 2011.

1.25 The Dodd-Frank Act requires the FDIC to set a designated reserve rate of not less than 1.35 percent for any year. The Dodd-Frank Act also requires the FDIC to increase the level of the DIF to 1.35 percent of estimated insured deposits by September 30, 2020. Under the Dodd-Frank Act, the FDIC is required to offset the effect of requiring that the reserve rate ratio reach 1.35 percent by September 30, 2010, rather than 1.15 percent by the end of 2016, on insured depository institutions (IDIs) with total consolidated assets of less than $10 billion.

1.26 In October 2010, the FDIC adopted a new Restoration Plan, which superseded the Amended Restoration Plan adopted on September 29, 2009, based on the provisions of the Dodd-Frank Act. Under the new Restoration Plan, the period of the Restoration Plan was extended to September 30, 2020, and the uniform 3 basis point increase in initial assessment rates was foregone. In addition, the Restoration Plan noted that further rulemaking regarding the method that will be used to reach the 1.35 percent ratio would be determined in 2011. In February 2011, the FDIC Board of Directors adopted a final rule, *Deposit Insurance Assessment Base, Assessment Rate Adjustments, Dividends, Assessment Rates, and Large Bank Pricing Methodology*, to redefine the deposit insurance assessment base as required by the Dodd-Frank Act, alter assessment rates, implement the Dodd-Frank Act's DIF dividend provisions, and revise the risk-based assessment system for all large IDIs (those with at least $10 billion in total assets).[†]

1.27 Readers are encouraged to visit the FDIC website for the final rules in their entirety and for additional developments regarding this topic.

The Dodd-Frank Wall Street Reform and Consumer Protection Act

1.28 On July 21, 2010, the president signed the Dodd-Frank Act into law. The two main goals of the reform are to lower the systemic risks of the financial system and enhance consumer protections. The Dodd-Frank Act, among many other changes, creates new regulations to be imposed related to systemic risk, orderly liquidation, proprietary trading, minimum leverage and risk-based capital requirements, and securities and derivative trading. The Dodd-Frank Act contains many provisions; some highlights that may be of particular interest to readers are summarized in the following sections.

[†] In April 2011, the Federal Deposit Insurance Corporation (FDIC) issued *Proposed Assessment Rate Adjustment Guidelines for Large and Highly Complex Institutions* to determine how adjustments could be made to the total scores that are used in calculationng the deposit insurance assessment rates of large and highly complex insured institutions. Readers should remain alert for final regulation.

1.29 *Financial Stability Oversight Council.* The Dodd-Frank Act created a new systemic risk regulator called the Financial Stability Oversight Council (FSOC). The two main goals of the FSOC are to identify risks to the financial stability of the United States and to promote market discipline by eliminating the moral hazard of "too big to fail." To meet these goals, the FSOC has many powers to identify any company, product, or activity that could threaten U.S. financial stability. The FSOC is chaired by the Secretary of the Treasury, and voting members are heads of nine federal financial regulatory agencies, including chairmen of the Federal Reserve, the FDIC, and the SEC, among others. The FSOC is authorized to facilitate regulatory coordination, facilitate information sharing and collection, designate nonbank financial companies for consolidated supervision, designate systemic financial market utilities and systemic payment, clearing or settlement activities, and recommend stricter standards for the largest, most interconnected firms, break up firms that pose a "grave threat" to financial stability, and recommend Congress close specific gaps in regulation. Further information on the FSOC and proposed rulings can be found at www.treasury.gov/initiatives/Pages/FSOC-index.aspx.

1.30 *Leverage and Risk-Based Capital Requirements.* Title 1, "Financial Stability," of the Dodd-Frank Act requires the appropriate federal banking agencies to establish minimum leverage and risk-based capital requirements, on a consolidated basis, for IDIs, depository institution holding companies, and nonbank financial companies supervised by the Federal Reserve. The minimum leverage and risk-based capital requirements for IDIs established by the agencies under this section of the Dodd-Frank Act shall not be less than the generally applicable requirements, which shall serve as a floor for any capital requirements that the agencies may require, nor be quantitatively lower than the generally applicable requirements that were in effect for IDIs as of the date of enactment. See discussion of risk-based capital floor requirements in paragraphs 1.59–.62. The provisions of Section 171 of the Dodd-Frank Act regarding trust preferred securities can be found in paragraph 17.20 of this guide.

1.31 Title VI, "Improvements to Regulation," of the Dodd-Frank Act mandates stronger capital requirements for all IDIs, depository institution holding companies, and any company that controls an IDI and provides that any company in control be accountable for the financial strength of that entity.

1.32 *Bureau of Consumer Financial Protection.* The Bureau of Consumer Financial Protection (BCFP) is the new independent agency (although it is housed at the Federal Reserve) that consolidates most federal regulation of financial services offered to consumers. The BCFP is expected to ensure that consumers receive clear, accurate information to shop for mortgages, credit cards, and other financial products (but not products subject to securities or insurance regulations); to provide consumers with one dedicated advocate; and to protect them from hidden fees and deceptive practices. The BCFP also oversees the enforcement of federal laws intended to ensure the fair, equitable, and nondiscriminatory access to credit for individuals. The director of the BCFP replaces the director of the OTS on the FDIC board (the OTS was abolished by the Dodd-Frank Act; see discussion in paragraph 1.39). The BCFP is led by an independent director appointed by the president and confirmed by the Senate and has a dedicated budget in the Federal Reserve.

1.33 The BCFP has the authority to examine and enforce regulations for banks and credit unions with assets of over $10 billion; all mortgage-related businesses (nondepository institution lenders, servicers, mortgage brokers, and foreclosure operators); providers of payday loans; student lenders; and other nonbank financial entities, such as debt collectors and consumer reporting

agencies. Banks and credit unions with assets of $10 billion or less will be examined for consumer compliance by the appropriate regulator. The BCFP also is able to autonomously write rules for consumer protections governing all financial institutions (banks and nonbanks) offering consumer financial services or products.

1.34 *Derivatives Trading.*[‡] The Dodd-Frank Act provided the SEC and the Commodity Futures Trading Commission (CFTC) with the authority to regulate over-the-counter derivatives and required central clearing and exchange trading for derivatives. The SEC has authority over specific security-based swaps (including credit default swaps). The CFTC has authority over all other swaps, including energy-rate swaps, interest-rate swaps, and broad-based security group or index swaps. Standardized swaps will be traded on an exchange or in other centralized trading facilities, which will promote transparency; standardized derivatives will also have to be handled by central clearinghouses. *Cleared* is defined as when trades are routed through a central clearinghouse that covers losses if a party to the trade is unable to complete the transaction. The Dodd-Frank Act requires all cleared swaps to be traded on a registered exchange or board of trade.

1.35 The Dodd-Frank Act also provides regulators the authority to impose capital and margin requirements on swap dealers and major swap participants, not end users.[||] The credit exposure from derivative transactions will be considered in banks' lending limits.

1.36 Banks are allowed to continue engaging in principal transactions involving interest-rate, foreign-exchange, gold, silver, and investment-grade credit default swaps, subject to Volcker Rule limitations on proprietary trading.

[‡] The Securities and Exchange Commission (SEC) has proposed numerous rulings related to the provisions of derivative trading included in the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act). Readers are encouraged to stay alert for final rulings related to such proposals. A listing of the proposed rulings follows:

- Release No. 34-63727, *Trade Acknowledgment and Verification of Security-Based Swap Transactions*
- Release No. 34-63825, *Registration and Regulation of Security-Based Swap Execution Facilities*
- Release No. 34-64017, *Clearing Agency Standards for Operation and Governance*
- Release No. 34-64018, *Ownership Limitations and Governance Requirements for Security-Based Swap Clearing Agencies, Security-Based Execution Facilities, and National Securities Exchanges with Respect to Security-Based Swaps under Regulation MC*
- Release No. 34-64087, *Beneficial Ownership Reporting Requirements and Security-Based Swaps*
- Release No. 33-9204, *Product Definitions Contained in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act*
- Release No. 33-9204A, *Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement'; Mixed Swaps; Security Based Swap Agreement Recordkeeping*
- Release No. 33-9222, *Exemptions for Security-Based Swaps Issued by Certain Clearing Agencies*
- Release No. 34-64766, *Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants*

[||] In May 2011, the FDIC, Office of the Comptroller of the Currency (OCC), Board of Governors of the Federal Reserve System (FRB), Farm Credit Administration, and the Federal Housing Finance Agency (FHFA) (collectively, the agencies) issued Notice of Proposed Rulemaking *Margin and Capital Requirements for Covered Swap Entities* to implement sections 731 and 764 of the Dodd-Frank Act. The proposed regulations are intended to establish minimum margin and capital requirements for registered swap dealers, major swap participants, security-based swap dealers, and major security-based swap participants for which one of the agencies is the prudential regulator. Readers should remain alert for final regulations.

See discussion of the Volcker Rule in paragraph 1.38. For commodities, most other metals, energy, and equities, banks must shift their swap operations to a separately capitalized affiliate within the holding entity.

1.37 *Securitization.* The Dodd-Frank Act also makes changes to securitization rules. Entities that sell products such as mortgage-backed securities will now be required to retain at least five percent of the credit risk, unless the underlying loans meet standards that reduce the risk.[#] Issuers of these securities are also required to disclose more information about the underlying assets, including analysis of the quality of the underlying assets. See footnote 2 in paragraph 4.38 of this guide for more on final rulings related to asset-backed securities disclosures.

1.38 *Volcker Rule.* The Volcker Rule prohibits banking entities from proprietary trading; acquiring or retaining any equity, partnership, or other ownership interest in a hedge fund or private equity fund; and sponsoring a hedge fund or private equity fund. *Proprietary trading* consists of transactions made by an entity that affect the entity's own account but not the accounts of its clients. Banks are allowed to make de minimis investments in hedge funds and private equity funds using no more than three percent of their tangible common equity in all such funds combined. Also, a bank's investment in a private fund may not exceed three percent of the fund's total ownership interest. Nonbank financial institutions supervised by the Federal Reserve also have restrictions on proprietary trading, hedge fund investments, and private equity investments. See discussion on final rulings enacted as a result of the Volcker Rule in paragraph 18.76 of this guide.

1.39 *Thrift Regulations.* Title III, "Transfer of Powers to the Comptroller, the FDIC, and the FED," of the Dodd-Frank Act abolishes the OTS, the current federal supervisor for thrifts and thrift holding companies, and transfers authority mainly to the OCC, which also regulates federally chartered national banks.[**,††,‡‡] However, the thrift charter has been preserved. The transfer of responsibilities took place on July 21, 2011.

1.40 In addition, the Dodd-Frank Act provides that all orders; resolutions; determinations; agreements; and regulation interpretative rules, other interpretations, guidelines, procedures, and advisory material issued, made, or

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[#] In March 2011, the OCC, FRB, FDIC, SEC, FHFA, and Department of Housing and Urban Development proposed rules to implement the credit risk retention requirements of Section 15G of the Securities Exchange Act of 1934, as added by Section 941 of the Dodd-Frank Act. Section 15G generally requires the securitizer of asset-backed securities to retain not less than five percent of the credit risk of the assets collateralizing the asset-backed securities. Readers should remain alert for final regulations.

[**] In February 2011, the Office of Thrift Supervision (OTS), OCC, FDIC, and FRB issued a joint proposal, *Proposed Agency Information Collection Activities*, to require savings associations currently filing the Thrift Financial Report (TFR) to convert to filing the Consolidated Reports of Condition and Income (call reports) beginning with the reporting period ending on March 31, 2012. Readers should remain alert for final regulation.

[††] In May 2011, the OCC issued Notice of Proposed Rulemaking *Office of Thrift Supervision Integration; Dodd-Frank Act Implementation* to amend its regulations governing organization and functions, availability and release of information, and postemployments restrictions for senior examiners; and assessment of fees to incorporate the transfer of certain functions of the OTS to the OCC pursuant to Title III of the Dodd-Frank Act. Readers should remain alert for final regulation.

[‡‡] In July 2011, the FRB issued Notice of Proposed Rulemaking *Continued Application of Regulations to Savings and Loan Holding Companies*. This proposed ruling was issued to provide notice of and seek comment on the FRB's intention to continue to enforce certain regulations previously issued by the OTS after assuming supervisory responsibility for savings and loan holding companies and their nondepository subsidiaries in July 2011. Readers should remain alert for final regulation.

proscribed by the OTS remain in effect and shall remain enforceable by the OCC, the FDIC, or the Federal Reserve. See Section 316 of the Dodd-Frank Act for additional information.

1.41 A copy of the full Dodd-Frank Act, as signed by the president, can be found at www.gpo.gov/fdsys/pkg/BILLS-111hr4173ENR/pdf/BILLS-111hr 4173ENR.pdf. The AICPA is also following any developments related to the Dodd-Frank Act on its website at www.aicpa.org under "Advocacy—Federal Issues."

Regulatory Capital Matters

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

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

Capital Adequacy

1.44 The FDIC, OCC, and the FRB historically had common capital adequacy guidelines which differed in some respects from those of the OTS involving minimum (*a*) leverage capital and (*b*) risk-based capital requirements.[2] Capital adequacy guidelines are now substantially the same for banks and savings associations. A summary of the general requirements follows. Specific requirements are set forth in Title 12, *Banks and Banking*, of U.S. CFR and in the instructions for the FFIEC Consolidated Reports of Condition and Income (call reports), the OTS's Thrift Financial Reports,[**] and the FRB's Consolidated Financial Statements for Bank Holding Companies. The reports are required to be filed quarterly and contain certain financial information, including that used in calculating regulatory capital amounts.[3]

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

[2] Savings institution holding companies are not subject to regulatory capital requirements separate from those of their subsidiaries. Bank holding companies do have capital requirements separate from those of their subsidiaries. Chapter 17, "Equity and Disclosures Regarding Capital Matters," provides additional guidance.

[**] See footnote ** in paragraph 1.39.

[3] Banking agencies provide additional regulatory capital guidance through examination manuals and other communications, such as Supervision and Regulation Letters issued by the FRB, Financial Institution Letters' issued by the FDIC, and institution-specific guidance issued

1.45 The first requirement establishes a minimum ratio of capital as a percentage of total assets. The FDIC, OCC, FRB, and OTS require institutions to maintain a minimum leverage ratio of tier 1 capital (as defined) to average total consolidated assets[4] based on the institution's rating under the regulatory composite CAMELS rating system. (The CAMELS rating derives its name from the various components of a depository institution that are rated, namely, capital adequacy, asset quality, management, earnings, liquidity, and sensitivity to interest rates. Actually, the "S" is sensitivity to market risk and a component of market risk is sensitivity to interest rate changes or more commonly expressed as sensitivity to interest rate risk [IRR].) The minimum tier 1 leverage ratio for institutions with CAMELS ratings of 1 is 3 percent. For all others the minimum ratio is 4 percent. As a practical matter, a tier 1 leverage ratio of less than 6 percent will generally result in concern by the regulators. By statute, OTS also requires all savings institutions to maintain a tangible capital requirement of 1.5 percent of assets.

1.46 The second requirement also establishes a minimum ratio of capital as a percentage of total assets but gives weight to the relative risk of each asset, including off-balance-sheet positions. The FDIC, OCC, OTS, and FRB require institutions to maintain a minimum ratio of tier 1 capital to risk-weighted assets of 4 percent. According to those regulations, banks must also maintain a minimum ratio of total capital to risk-weighted assets of 8 percent. Banks are expected to maintain capital above these minimum levels.

1.47 For savings associations, tier 2 supplemental capital is included in total risk based capital up to a maximum of 100 percent of tier 1 capital. The OTS-required minimum total risk-based capital ratio (that is, the total of core and supplemental capital) is also 8 percent. Tier 2 supplemental capital may not exceed 100 percent of tier 1 (leverage) capital.

1.48 Risk-based capital standards of the FDIC, OCC, and FRB explicitly identify concentrations of credit risk, risks of nontraditional activities, and IRR as qualitative factors to be considered in examiner assessments of an institution's overall capital adequacy; however, the standards require no specific quantitative measure of such risks. OTS does not have explicit standards in its capital rule but does have similar written guidelines, standards, and criteria that are virtually the same as the banking agencies.

1.49 The FDIC, OCC, and FRB have augmented their IRR requirements through a joint policy statement, *Joint Agency Policy Statement on Interest Rate Risk*, that explains how examiners will assess institutions' IRR exposure.[5] The policy statement also suggests that institutions with complex systems for measuring IRR may seek assurance about the institution's risk management

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(footnote continued)

by the OCC. The OTS provides additional regulatory capital guidance through examination manuals and other communications such as CEO memos, thrift bulletins, and regulatory bulletins.

[4] As a general matter, average total consolidated assets are defined as the quarterly average total assets (defined net of the allowance for loan and lease losses) reported on the organization's consolidated financial statements, less goodwill; amounts of mortgage servicing assets; certain nonmortgage servicing assets and purchased credit card relationships; all other identifiable intangible assets; any investments in subsidiaries or associated companies that the FRB determines should be deducted from tier 1 capital; deferred tax assets that are dependent upon future taxable income, net of their valuation allowance, in excess of certain limitations; and the amount of the total adjusted carrying value of nonfinancial equity investments that is subject to a deduction from tier 1 capital. Appendix D of 12 CFR 225 provides additional information.

[5] *Federal Register* Vol. 61, No. 124 [26 June 1996], pp. 33166–33172.

process from external auditors. OTS is not a part of the joint policy statement. OTS, like the other banking agencies, has provided written guidance on sound practices for managing IRR, and directs examiners to take into account IRR when assessing capital adequacy during each safety and soundness examination. In addition, OTS collects quarterly consolidated maturity and rate data from savings associations to measure exposure to IRR by estimating how a change in interest rates affects the market value of assets, liabilities, and off-balance sheet contracts.[||||] OTS sends the output reports of the model to savings associations after the submitted information has passed the data edits.

1.50 The Federal Reserve's Market Risk Rule (MRR) establishes regulatory capital requirements for bank holding companies and state member banks (collectively, banking organizations) with significant exposure to certain market risks. The other banking agencies have also adopted a market risk rule in their capital guidelines. The MRR implements the Amendment to the Capital Accord to incorporate market risks (Market Risk Amendment, or MRA) issued by the Basel Committee on Banking Supervision (BCBS) in 1996 and modified in 1997 and 2005. As of June 2, 2009, the BCBS was in the process of further modifying the MRA. Once finalized, the FRB will work with the other banking agencies to implement a revised U.S. rule. However, many aspects of the core rule, which are addressed in Federal Reserve Supervisory Letter 09-1, issued on January 14, 2009, will be retained. The MRR is set forth at appendix E of 12 CFR 208 for state member banks and appendix E of 12 CFR 225 for bank holding companies.[##]

1.51 The effect of the market risk capital rules is that any bank or bank holding company regulated by the federal banking agencies, with significant exposure to market risk, generally must measure that risk using its own internal value at risk model, and hold a commensurate amount of capital. The amount of capital required to be held includes tier 1, tier 2 and tier 3 capital. Tier 3 capital is included for bank holding companies and banks that are subject to the market risk capital rules as a result of the FDIC, OCC, and FRB's amendments to their respective risk-based capital standards to incorporate a measure for market risk. The regulatory capital requirements only apply to banks and bank holding companies whose trading activity on a worldwide consolidated basis equals 10 percent or more of the total assets or totals $1

[||||] On July 7, 2011, the Federal Financial Institutions Examination Council (FFIEC) published in a *Federal Register* notice that the OCC, FRB, FDIC, and OTS will proceed with the proposed changes to the regulatory reporting requirements for savings associations formerly regulated by the OTS. All affected institutions will be required to discontinue filing the TFR and begin filing the call report as of the March 31, 2012, report date. Institutions preferring to file the call report earlier than the March 2012 report date may opt to begin filing call reports as of the first report date after the July 21, 2011, transition date (that is, September or December 2011 reports).

Please note that savings associations with a Composite "1" or "2" CAMELS ratings *and* that have the means to adequately monitor and assess interest rate risk through internal processes are required to stop filing TFR CMR, "Consolidated Maturity and Rate," after the June 30, 2011, reporting period. All other savings associations are required to continue filing Schedule CMR through the December 31, 2011, reporting period. Readers should remain alert for final regulation.

[##] In December 2010, the OCC, FRB, and FDIC jointly issued Notice of Proposed Rulemaking *Risk-Based Capital Guidelines: Market Risk* to revise their market risk capital rules to modify their scope to better capture positions for which the market risk capital rules are appropriate; reduce procyclicality in market risk capital requirements; enhance the rules' sensitivity to risks that are not adequately captured under the current regulatory measurement methodologies; and increase transparency through enhanced disclosures. Readers should remain alert for final regulation.

billion or more. Market risk rules may be applied to any insured state nonmember bank if the FDIC deems it necessary for safety and soundness practices.

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

Recent Regulatory Capital Matters

1.53 Under the risk based and leverage capital rules of the OCC, FRB, FDIC, and OTS, a banking organization must deduct certain assets from tier 1 capital. A banking organization is permitted to net any associated deferred tax liability against some of those assets prior to making the deduction from tier 1 capital. Included among the assets eligible for this netting treatment are certain intangible assets arising from a nontaxable business combination. Such netting generally was not permitted for goodwill and other intangible assets arising from a taxable business combination. On January 2, 2009, the OCC, FRB, FDIC, and OTS amended their regulatory capital rules to permit banks, bank holding companies, and savings associations to reduce the amount of goodwill that a banking organization must deduct from tier 1 capital by the amount of any deferred tax liability associated with that goodwill. For a banking organization that elects to apply this rule, the amount of goodwill the banking organization must deduct from tier 1 capital would reflect the maximum exposure to loss in the event that such goodwill is impaired or derecognized for financial reporting purposes. This rule became effective on January 29, 2009.

1.54 On April 17, 2009, the OCC issued OCC Bulletin No. 2009-11, "Other-than-Temporary Impairment Accounting," to address the effect of recent accounting changes related to other-than-temporary impairments (OTTI) of debt securities on regulatory capital requirements (see Financial Accounting Standards Board [FASB] *Accounting Standards Codification* 320-10-35). As stated in the bulletin, under existing regulatory capital requirements, the portion of OTTI for debt securities that flows through other comprehensive income would not affect a bank's tier 1 capital.

1.55 On May 14, 2009, the OTS issued CEO Letter No. 303, "New FASB Guidance on Other-than-Temporary Impairment," which provides a brief overview of the recent OTTI guidance and states that the regulatory capital treatment of losses on debt securities has not changed. As noted in the memo, the new accounting guidance may result in an amount of noncredit losses on available for sale and held-to-maturity debt securities being recognized in other comprehensive income instead of earnings. These noncredit losses in accumulated other comprehensive income will be added back as part of unrealized losses in determining tier 1 capital on The Thrift Financial Report, Schedule CCR, "Consolidated Capital Requirements."[**] See detailed discussion of OTTI in chapter 7, "Investments in Debt and Equity Securities."

1.56 The OCC, FRB, FDIC, and OTS published in the *Federal Register* on November 20, 2009, a final rule concerning the risk-based capital treatment for one-to-four family residential mortgages modified under the Treasury's Home Affordable Mortgage Program. The final rule allows banks, savings associations, and bank holding companies to risk weight, for purposes of the agencies'

[**] See footnote ** in paragraph 1.39.

capital guidelines, mortgage loans modified pursuant to the Home Affordable Mortgage Program with the same risk weight assigned to the loan prior to the modification so long as the loan continues to meet other applicable prudential criteria. (See "Risk-Based Capital Guidelines"; "Capital Adequacy Guidelines"; "Capital Maintenance"; "Capital—Residential Mortgage Loans Modified Pursuant to the Home Affordable Mortgage Program" in the *Federal Register* [Vol. 74, No. 223 [20 November 2009], pp. 60137–60143] for additional information).

1.57 On January 7, 2010, the FFIEC released an advisory reminding institutions of supervisory expectations for sound practices to manage IRR. This advisory, adopted by each of the financial regulators, including the FRB, FDIC, OCC, OTS, and NCUA, reiterates the importance of effective corporate governance, policies and procedures, risk measuring and monitoring systems, stress testing, and internal controls related to the IRR exposures of depository institutions. It also clarifies elements of existing guidance and describes some IRR management techniques used by effective risk managers. Appendix A of this advisory provides a list of the relevant guidance issued by each of the financial regulators. Readers may find the advisory on the FFIEC website at www.ffiec.gov/press/pr010710.htm.

1.58 In January 2010, the OCC, FRB, FDIC, and OTS issued a final rule that amended their respective general risk-based and advanced risk-based capital adequacy frameworks in response to recent accounting changes related to transfers and servicing and consolidations. The final rule included the following provisions:

a. Eliminated the exclusion of certain consolidated asset-backed commercial paper programs from risk-weighted assets

b. Provided for an optional two-quarter implementation delay followed by an optional two-quarter partial implementation of the effect on risk-weighted assets that resulted from changes to U.S. GAAP from FASB Accounting Standards Update (ASU) No. 2009-16, *Transfers and Servicing (Topic 860): Accounting for Transfers of Financial Assets*, and No. 2009-17, *Consolidations (Topic 810): Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities*

c. Provided for an optional two-quarter delay, followed by an optional two-quarter phase-in, of the application of the agencies' regulatory limit on the inclusion of the allowance for loan and lease losses in tier 2 capital for the portion of the allowance for loan and lease losses associated with the assets a banking organization consolidates as a result of ASU No. 2009-17

d. Provided a reservation of authority to permit the agencies to require banking organizations to treat entities that are not consolidated under accounting standards as if they were consolidated for risk-based capital purposes, commensurate with the risk relationship of the banking organization to the structure

1.59 In June 2011, the OCC, FRB, and FDIC issued *Risk-Based Capital Standards: Advanced Capital Adequacy Framework—Basel II: Establishment of a Risk-Based Capital Floor*. The final ruling was effective July 28, 2011, and amends the advanced risk-based capital adequacy standards in a manner that is consistent with certain provisions of the Dodd-Frank Act and the general risk-based capital rules to provide limited flexibility consistent with Section 171(b) of the Dodd-Frank Act for recognizing the relative risk of certain assets generally not held by depository institutions.

1.60 Each organization implementing the advanced approaches rules will continue to calculate its risk-based capital requirements under the agencies' general risk-based capital rules, and the capital requirement it computes under those rules will serve as a floor for its risk-based capital requirement computed under the advanced approaches rules. The effect of this rule on banking organizations is to preclude certain reductions in capital requirements that might have occurred in the future, absent the rule and absent any further changes to the capital rules. The rule will not have an immediate effect on banking organizations' capital requirements because all organizations subject to the advanced approaches rules are currently computing their capital requirements under the general risk-based capital rules.

1.61 For bank holding companies subject to the advanced approaches rule, the final rule provides that they must calculate their floor requirement under the general risk-based capital rules for state member banks. However, in accordance with the Dodd-Frank Act, these organizations may include certain debt or equity instruments issued before May 19, 2010, as described in Sections 171(b)(4)(B) of the Dodd-Frank Act.

1.62 The only insured banks in this category to which this rule applies are those whose parent organizations use the advanced approaches rule and that have not been exempted from the requirement to also use the advanced approaches rule. Parent organizations that use the advanced approaches rule include mandatory banking organizations with total consolidated assets of $250 billion or more or on-balance sheet foreign exposure of $10 billion or more and those that have elected to use the advanced approaches rule.

Prompt Corrective Action

1.63 The FDICIA made capital an essential tool of regulators to monitor the financial health of insured banks and savings institutions. Regulatory intervention is now focused primarily on an institution's capital levels relative to regulatory standards. In Section 38, "Rules, Regulations, and Orders" of the FDI Act, the FDICIA added (to the existing capital adequacy guidelines set forth by each agency) a uniform framework for prompt corrective regulatory action. Holding companies are not subject to the prompt corrective action provisions.

1.64 Section 38 provides for supervisory action at certain institutions based on their capital levels. Each institution falls into one of five regulatory capital categories (see paragraph 1.67) based primarily on three capital measures, namely, tier 1 leverage; total risk-based; and tier 1 risk-based capital. These capital ratios are defined in the same manner for Section 38 purposes as under the respective agencies' capital adequacy guidelines and regulations. For savings institutions, tier 1 leverage capital is comparable to core capital.

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

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

1.67 Under Section 38 of the act, an institution is considered

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

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

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

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

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

1.68 The minimum levels are defined as follows:

Category	*Total Risk-Based Ratio (Percent)*	*Tier 1 Risk-Based Ratio (Percent)*	*Tier 1 Leverage Capital Ratio (Percent)*
Well capitalized	≥10 and	≥6 and	≥5
Adequately capitalized	≥8 and	≥4 and	≥4 *
Undercapitalized	<8 or	<4 or	<4 *
Significantly undercapitalized	<6 or	<3 or	<3

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

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

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

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

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

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

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

Annual Independent Audits and Reporting Requirements

1.74 The primary source of annual independent audits and reporting requirements is Section 36, *Early Identification of Needed Improvements in Financial Management*, of the FDI Act. In 1991, Section 112 of the FDICIA added Section 36 of the FDI Act. 12 CFR 363 (Part 363) of the FDIC's regulations implements Section 36 of the FDI Act. Part 363 was initially adopted by the FDIC's Board of Directors in 1993 and was most recently amended in June 2009. Section 36 establishes annual independent audits and reporting requirements for reports by management and auditors. It also establishes minimum qualifications for auditors serving the affected institutions. Despite the asset threshold, Section 36 does not override any non-FDICIA requirements for audited financial statements or other requirements that an institution exempt from Section 36 must otherwise satisfy.[6]

1.75 Notwithstanding the requirements of Section 36 of the FDI Act and Part 363, the FRB requires certain bank holding companies to submit audited financial statements (under authority of 12 CFR 225.5 [Regulation Y]).

1.76 Also, the OTS Audit Rule at 12 CFR 562.4 requires the following entities to be audited:

- Thrifts, regardless of size, with a composite safety and soundness CAMELS rating of 3, 4, or 5
- Holding companies, which control insured financial institution subsidiary(ies) with aggregate consolidated assets of $500 million or more
- Any other entity for which the OTS determines an audit is required for safety and soundness reasons

All audited financial statements submitted to the OTS are subject to the SEC independence requirements.

1.77 Part 363, "Annual Independent Audits and Reporting Requirements," of the FDIC's rules and regulations, which implements Section 36 of the FDI Act, also includes guidelines and interpretations (guidelines) to facilitate a better understanding of, and full compliance with, the provisions of the Section 36. On July 20, 2009, a final rule which amended the regulation and guidelines in Part 363 was published in the *Federal Register* (Vol. 74, No. 137 [20 July 2009], pp. 35726–35761). The final rule applies to Part 363 Annual Reports with

[6] The banking agencies adopted the FFIEC *Interagency Policy Statement on External Auditing Programs of Banks and Savings Associations*, in 1999. The interagency policy statement encourages institutions to adopt an annual external auditing program and, where practicable, to establish an audit committee composed entirely of outside directors. The interagency policy statement states that the banking agencies consider an annual audit of an institution's financial statements performed by an independent public accountant to be the preferred type of external auditing program. The statement also describes two alternatives to a financial statement audit that an institution may elect to have performed annually in order to have an acceptable external auditing program. Users of this guide should monitor the FFIEC and FDIC websites for proposed rules and updates affecting depository institutions.

filing deadlines on or after the effective date of the amendments, which was August 6, 2009. The compliance date for the provision of the final rule that requires institutions' boards of directors to develop and adopt written criteria pertaining to audit committee member independence was delayed until December 31, 2009. The provision of the final rule that requires the consolidated total assets of a holding company's IDI subsidiaries to comprise 75 percent or more of the holding company's consolidated total assets in order for an institution to be eligible to comply with Part 363 at the holding company level is effective for fiscal years ending on or after June 15, 2010.

1.78 Part 363 applies to IDI with total assets above certain thresholds and requires annual independent audits, assessments of the effectiveness of internal control over financial reporting, and compliance with laws and regulations pertaining to insider loans and dividend restrictions, the establishment of independent audit committees, and related reporting requirements. The asset size threshold for reporting on an institution's internal control is $1 billion and the threshold for the other requirements generally is $500 million. The FDIC's Financial Institution Letter (FIL) No. 33-2009, "Annual Audit and Reporting Requirements: Final Amendments to Part 363," issued on June 23, 2009, provides a summary of the final rule and highlights certain amended annual and other reporting requirements. The general requirements, as amended, are summarized in the following text.

1.79 *Annual reporting requirements.* According to Sections 363.2 and 363.4, management is required to prepare and file a Part 363 Annual Report that includes the following:[7]

a. Comparative financial statements in accordance with U.S. GAAP, which should be audited by an independent public accountant.

b. A management report that must contain the following:

   i. A statement of management's responsibilities for preparing the institution's annual financial statements, for establishing and maintaining an adequate internal control structure and procedures for financial reporting, and for complying with laws and regulations relating to safety and soundness pertaining to insider loans and dividend restrictions, which are designated by the FDIC and the appropriate federal banking agency.

   ii. An assessment by management of the institution's compliance with the designated laws and regulations pertaining to insider loans and dividend restrictions during such fiscal year. The assessment must state management's conclusion regarding compliance and disclose any noncompliance with these laws and regulations. The assessment must clearly state whether the institution has or has not complied with these regulations. Disclosure is not dependent on the degree or materiality of any noncompliance. Statements such as "management believes that the institution complied, in all material respects with the designated safety and soundness laws and regulations" do not present a definitive and unconditional conclusion regarding compliance as envisioned under Part 363.

   iii. For an institution with consolidated total assets of $1 billion or more at the beginning of its fiscal year, an assessment by

[7] The reporting requirements may be satisfied for certain subsidiaries through reporting by their holding companies. These exemptions are discussed in Section 363.1(b) of the rule.

management of the effectiveness of such internal control structure and procedures as of the end of such fiscal year. (See paragraphs 1.92–.93 for additional information regarding the internal control reporting requirements.)

c. The management report must be signed by the CEO and the chief accounting officer or CFO at the insured depository level or the holding company level as specified in Section 363.2(c).

1.80 *Independent public accountant*. As amended, Section 363.3 clarifies the independence standards applicable to accountants and requires the following:

a. Each IDI shall engage an independent public accountant to audit and report on its annual financial statements in accordance with generally accepted auditing standards or the PCAOB's auditing standards, if applicable, and Section 37 of the FDI Act.

b. For each IDI with total assets of $1 billion or more at the beginning of the institution's fiscal year, the independent public accountant who audits the institution's financial statements shall examine, attest to, and report separately on the assertion of management concerning the effectiveness of the institution's internal control structure and procedures for financial reporting. The attestation and report shall be made in accordance with attestation standards established by the AICPA or the PCAOB's auditing standards, if applicable. The accountant's report must not be dated prior to the date of the management report and management's assessment of the effectiveness of internal control over financial reporting.

c. When the independent public accountant performing services under Part 363 ceases to be the institution's accountant, the accountant must provide the FDIC, the appropriate Federal banking agency, and any appropriate State bank supervisor with written notification of such termination within 15 days after the occurrence of such an event. Guideline 20 to Part 363 provides additional guidance regarding an independent public accountant's notice of termination.

d. The auditors must report certain communications on a timely basis to the audit committee. The requirements for communications with audit committees, consistent with the requirements under Section 363.3(d), are set forth in the applicable professional standards. The applicable AICPA *Professional Standards*, which include AU section 380, *The Auditor's Communication With Those Charged With Governance*; AU section 316, *Consideration of Fraud in a Financial Statement Audit*; AU section 325, *Communicating Internal Control Related Matters Identified in an Audit*; and AT section 501, *An Examination of an Entity's Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements* (AICPA, *Professional Standards*), provide guidance regarding certain matters required to be communicated to those charged with governance, such as audit committees. PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), addresses the requirements for communication of certain matters to audit committees for audits of public companies.

e. The auditors must retain the working papers related to the audit of

the IDI's financial statements and, if applicable, the evaluation of the institution's internal control over financial reporting for seven years from the report release date, unless a longer period of time is required by law.

f. The auditors must comply with the independence standards and interpretations of the AICPA, the SEC, and the PCAOB. To the extent that any of the rules within any one of these independence standards (AICPA, SEC, and PCAOB) is more or less restrictive than the corresponding rule in the other independence standards, auditors must comply with the more restrictive rule.

g. Prior to commencing any services for an IDI under Part 363, the independent public accountant must have received a peer review, or be enrolled in a peer review program, that meets acceptable guidelines. Acceptable peer reviews include peer reviews performed in accordance with the AICPA's Peer Review standards and inspections conducted by the PCAOB. For auditors required to conduct their audits in accordance with PCAOB standards, registration with the PCAOB is mandatory. Within 15 days of receiving notification that a peer review has been accepted or a PCAOB inspection report has been issued, or before commencing any audit under this part, whichever is earlier, the independent public accountant must file two copies of the most recent peer review report and the public portion of the most recent PCAOB inspection report, if any, accompanied by any letters of comments, response, and acceptance, with the FDIC. Also, within 15 days of the PCAOB making public a previously nonpublic portion of an inspection report, the independent public accountant must file two copies of the previously nonpublic portion of the inspection report with the FDIC.

1.81 *Filing and notice requirements.* As amended, Section 363.4 extends the annual report filing deadline for nonpublic institutions and includes the following requirements:

a. A Part 363 Annual Report must contain the following;

  i. Audited comparative annual financial statements

  ii. The independent public accountant's report thereon

  iii. A management report (see appendix B to Part 363 for illustrative management reports)

  iv. If applicable, the independent public accountant's attestation report on management's assessment concerning the institution's internal control structure and procedures for financial reporting

Generally, under the amended guidance, the filing deadline for a Part 363 Annual Report is 120 days after the end of the fiscal year for an institution that is neither a public company nor a subsidiary of a public company, and 90 days after the end of the fiscal year for an institution that is a public company or a subsidiary of public company.

b. Except for the Part 363 Annual Report and the peer reviews and inspection reports, as previously described, which shall be available for public inspection, all other reports and notifications required under Part 363 are exempt from public disclosure by the FDIC.

c. Institutions must file with the FDIC a copy of any management letter

or other report issued by its independent public accountant with respect to such institution and the services provided by such accountant pursuant to Part 363 within 15 days after receipt. (See Section 363.4(c) for examples of such reports.)

1.82 *Audit committees*. Section 363.5 and Guidelines 27 to 35 to Part 363 provide guidance, address the composition requirements for audit committees, specify the audit committee's duties regarding the independent public accountant, require audit committees to ensure that audit engagement letters do not contain unsafe and unsound limitation of liability provisions, and require boards of directors to develop and apply written criteria for evaluating audit committee members' independence.

1.83 *General qualifications*. Section 36(g)(3)(A) of the FDI Act provides that all audit services required by Section 36 should be performed by an independent public accountant who has agreed to provide regulators with access to audit documentation related to such services, if requested; and has received a peer review that meets guidelines acceptable to the FDIC. Guideline 13 to Part 363 also requires accountants to agree to provide copies of audit documentation to regulators. Interpretation No. 1, "Providing Access to or Copies of Audit Documentation to a Regulator," of AU section 339, *Audit Documentation* (AICPA, *Professional Standards*, AU sec. 9339 par. .01–.15), and AU section 339 provide additional information to auditors.

1.84 *Enforcement actions against auditors.* In August 2003, the FDIC, OCC, FRB, and OTS jointly issued final rules that establish procedures under which the agencies can remove, suspend, or bar an accountant or firm from performing audit and attestation services for IDIs subject to the annual audit and reporting requirements of Section 36 of the FDI Act. The final rule can be accessed at www.fdic.gov/news/news/financial/2003/fil0366.html.

1.85 Under the final rules, certain violations of law, negligent conduct, reckless violations of professional standards, or lack of qualifications to perform auditing services may be considered good cause to remove, suspend, or bar an accountant or firm from providing audit and attestation services for institutions subject to Section 36 of the FDI Act and Part 363. In addition, the rules prohibit an accountant or accounting firm from performing these services if the accountant or firm has been removed, suspended, or debarred by one of the agencies, or if the SEC or the PCAOB takes certain disciplinary actions against the accountant or firm. The rules also permit immediate suspensions of accountants and firms in limited circumstances.

1.86 *Communication with independent auditors.* Section 36(h) of the FDI Act and Guideline 17 to Part 363 require an institution to provide its auditor with certain information including copies of the institution's most recent reports of condition and examination; any supervisory memorandum of understanding or written agreement with any federal or state regulatory agency; and a report of any action initiated or taken by Federal or State banking regulators.

Additional Regulatory Requirements Concerning the Sarbanes-Oxley Act, Corporate Governance, and Services Outsourced to External Auditors

1.87 In connection with the Sarbanes-Oxley Act of 2002, the SEC issued regulations implementing sections of the act, addressing various areas such as certification of financial statements, auditor independence, non-U.S. GAAP

financial measures, accounting firms' record retention, audit committees, influencing auditors, and other matters. These regulations are not unique to financial institutions. Management, the board of directors, the audit committee, and auditors generally should be aware of the requirements of the Sarbanes-Oxley Act and the implementing SEC regulations.

1.88 In addition to the previously mentioned regulations, in June 2003, the SEC adopted rules requiring companies subject to the reporting requirements of the Exchange Act, other than registered investment companies, to assess the effectiveness of their internal control and include in their annual reports a report of management on the company's internal control over financial reporting. The rule also mandates quarterly reports on changes in internal control. See paragraphs 1.90–.93 and 1.99 for additional information regarding these rules.

1.89 The banking regulatory agencies also implemented regulations in connection with the Sarbanes-Oxley Act. These regulations can affect nonpublic as well as public entities. These regulations include the following:

- On March 17, 2003, the FDIC, OTS, OCC, and FRB issued *Interagency Policy Statement on the Internal Audit Function and Its Outsourcing*. This policy statement reflects the passage of the Sarbanes-Oxley Act and prohibits an external auditor from providing internal audit services during the same period for which the external auditor expresses an opinion on the financial statements. This prohibition applies to banks, savings associations, and their holding companies that
    - have a class of securities registered with either the SEC or the OTS under Section 12 of the Exchange Act or are required to file reports with the SEC under Section 15(d) of that act (commonly referred to as *public companies*) and, therefore, required to have an external audit.
    - are savings associations and banks with assets of $500 million or more that are subject to the FDIC's external audit and reporting requirements under Part 363.
    - are savings associations and savings association holding companies that are required to have an external audit by the OTS pursuant to 12 CFR 562.

  For all other banks, savings associations, and their holding companies that have external audits of their financial statements but are not mandated to do so, the policy encourages such organizations to follow the internal audit outsourcing prohibition in Section 201 of the Sarbanes-Oxley Act when the SEC's regulations implementing this prohibition take effect.

  On March 5, 2003, the FDIC issued FIL 17-2003, "Corporate Governance, Audits, and Reporting Requirements," and the FRB, OCC, and OTS, in May 2003, issued *Statement on Application of Recent Corporate Governance Initiatives to Non-Public Banking Organizations*. This letter and statement require or recommend that certain nonpublic financial institutions comply with certain sections of the Sarbanes-Oxley Act. Familiarity with this guidance is recommended for external auditors.

- On August 12, 2003, the FDIC, OCC, FRB, and OTS jointly issued final rules that establish procedures under which the agencies could

remove, suspend, or bar an accountant or firm from performing audit and attestation services for IDIs subject to the annual audit and reporting requirements of Section 36. Section 36 applies to institutions with $500 million or more in total assets.

- Effective April 1, 2003, the FRB adopted a final rule to reflect the amendments made to Section 12(i) of the Exchange Act. These amendments vest the FRB with the authority to administer and enforce several of the enhanced reporting, disclosure, and corporate governance obligations imposed by the Sarbanes-Oxley Act in respect to state member banks that have a class of securities registered under the Exchange Act.
- On April 8, 2003, the OTS issued CEO letter number 173, "Filing of Section 906 Sarbanes-Oxley Act Certifications with OTS." Certain thrifts that are issuers of public securities file their public reports with the OTS instead of the SEC under Section 12(i) of the Exchange Act. Pending any different guidance from the Department of Justice, the Section 906 certificates should accompany the periodic reports that are filed with the OTS. The certificates should be worded in the same manner as the statutory requirement and each certifying officer should sign a separate certificate.
- On June 30, 2005, the FFIEC issued the BSA/AML manual. The manual was the result of a collaborative effort of the federal banking agencies and the Treasury's FinCEN. The manual does not set new standards; instead, it is a compilation of existing regulatory requirements, supervisory expectations, and sound practices in the BSA/AML area.
- On November 28, 2005, the FDIC amended Part 363 of its regulations by raising the asset-size threshold from $500 million to $1 billion for internal control assessments by management and external auditors. For institutions between $500 million and $1 billion in assets, the audit committee of its board of directors should be outside directors, the majority of whom should be independent of management of the institution.
- In June 2009, as previously noted, the FDIC's Board of Directors approved amendments to Part 363 of its regulations. Among other requirements, the amendments require both management's assessment and the auditor's report on internal control over financial reporting to disclose the internal control framework used by management and the auditor and to identify all material weaknesses that have been identified that have not been remediated as of the end of the institution's fiscal year. See the following for additional information.

1.90 *Sarbanes-Oxley Act Section 404 and Part 363.* Public companies that are subject to Section 36 of the FDI Act and Part 363 (more than $500 million in assets) must prepare reports for the SEC, FDIC, and other regulators that are similar in nature. Section 404(a) of the Sarbanes-Oxley Act mandates that registrants (*a*) take responsibility for establishing and maintaining adequate internal control structure and procedures and (*b*) assess their effectiveness at the end of each fiscal year. According to SEC final rule *Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports* management generally must create a Management's Annual Internal Control Report as part of the Annual Report. (Quarterly

updating is necessary only if the internal control environment has changed or is likely to change materially.) The report must contain the following:

- A statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the company.
- A statement identifying the framework used by management to evaluate the effectiveness of this internal control.
- Management's assessment of the effectiveness of internal control as of the end of the company's most recent fiscal year, including a statement about whether internal control over financial reporting is effective.
- Disclosure of any material weaknesses. Management is not permitted to conclude that the registrant's internal control over financial reporting is effective if there are one or more material weaknesses in the issuer's internal control over financial reporting.
- A statement that its auditor has issued an attestation report on management's assessment, which is normally included in the company's annual report.

1.91 The SEC coordinated with the FDIC to eliminate any unnecessary duplication between the aforementioned requirements and Section 36 of the FDI Act and Part 363. Many internal control requirements of the Sarbanes-Oxley Act were structured after Section 36 of the FDI Act and Part 363. A comparison of Sarbanes-Oxley and the Part 363 management requirements are indicated in the following table for clarity.

Sarbanes-Oxley	*Federal Deposit Insurance Corporation Improvement Act of 1991*
A statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the company	Insured depository institutions (IDIs) with at least $500 million in total assets, a statement of management's responsibility for establishing and maintaining an adequate internal control structure and procedures for financial reporting (Financial reporting generally must encompass both financial statements prepared in accordance with U.S. generally accepted accounting principles and those prepared for regulatory purposes.)
Not required by Sarbanes-Oxley	IDIs with at least $500 million in total assets, a statement of management's responsibility for preparing the institution's financial statements

Sarbanes-Oxley	*Federal Deposit Insurance Corporation Improvement Act of 1991*
Not required by Sarbanes-Oxley	IDIs with at least $500 million in total assets, a statement of management's responsibility for complying with designated laws and regulations relating to safety and soundness pertaining to insider loans and dividend restrictions
A statement identifying the framework used by management to evaluate the effectiveness of internal control over financial reporting	IDIs with $1 billion or more in total assets, a statement identifying the internal control framework used by management to evaluate the effectiveness of internal control over financial reporting
Management's assessment of the effectiveness of internal control over financial reporting as of the end of the company's most recent fiscal year	IDIs with $1 billion or more in total assets, a statement expressing management's conclusion as to whether internal control over financial reporting is effective as of the end of its fiscal year
Disclosure of any material weakness (and the related stipulation that management is not permitted to conclude that the company's internal control over financial reporting is effective if there are one or more material weaknesses)	For IDIs with $1 billion or more in total assets, management must disclose all material weaknesses in internal control over financial reporting, if any, that it has identified that have not been remediated prior to the IDI's fiscal year-end. Management is precluded from concluding that the institution's internal control over financial reporting is effective if there are one or more material weaknesses
A statement that a registered public accounting firm has issued an attestation report on management's assessment	Not required by Part 363
Inclusion of the registered public accounting firm's attestation report on management's assessment in the annual report	For IDIs with $1 billion or more in total assets, the management report component of the annual report must include the independent public accountant's attestation report concerning the effectiveness of the institution's internal control structure over financial reporting

1.92 IDIs with $1 billion or more in total assets as of the beginning of its fiscal year that are subject to both Part 363 and the SEC's rules implementing

Section 404 of Sarbanes-Oxley Act (as well as holding companies permitted to file an internal control report on behalf of their IDI subsidiaries in satisfaction of the FDIC and SEC regulations) can choose to either prepare two separate management reports to satisfy the FDIC's and Sarbanes-Oxley Act Section 404 requirements or prepare a single management report that satisfies both the FDIC and Sarbanes-Oxley Act Section 404 requirements.

1.93 If a single report is prepared it must contain the following combined requirements of the preceding chart:

- A statement of management's responsibility for preparing the registrant's annual financial statements, for establishing and maintaining adequate internal control over financial reporting for the registrant, and for the institution's compliance with laws and regulations relating to safety and soundness designated by the FDIC and the appropriate federal banking agencies.
- A statement identifying the framework used by management to evaluate the effectiveness of the registrant's internal control over financial reporting as required by the Exchange Act Rule 13a-15 or 15d-15.
- Management's assessment of the effectiveness of the registrant's internal control over financial reporting as of the end of the registrant's most recent fiscal year, including a statement as to whether or not management has concluded that the registrant's internal control over financial reporting is effective, and of the institution's compliance with the designated safety and soundness laws and regulations pertaining to insider loans and dividend restrictions during the fiscal year. This discussion must include disclosure of any material weakness in the registrant's internal control over financial reporting identified by management and disclosure of any instances of noncompliance with the designated safety and soundness laws and regulations pertaining to insider loans and dividend restrictions.
- A statement that the registered public accounting firm that audited the financial statements included in the registrant's annual report, has issued an attestation report on management's assessment of the registrant's internal control over financial reporting.

Finally, it is important to note that the institution or holding company will have to provide the registered public accounting firm's attestation report on management's assessment in its annual report filed under the Exchange Act. For purposes of the report of management and the attestation report, financial reporting generally must encompass both financial statements prepared in accordance with U.S. GAAP and those prepared for regulatory reporting purposes.

1.94 Section 404(b) of the Sarbanes-Oxley Act and Part 363 require the external auditor to attest to, and publicly report on management's assessments of the effectiveness of the company's internal controls and procedures for financial reporting. Section 404(b) states, that any such attestation shall not be the subject of a separate engagement. Auditors are expected to expand their scope in relation to internal control.

1.95 In September 2010, the SEC issued Final Rule Release No. 33-9142, *Internal Control Over Financial Reporting in Exchange Act Periodic Reports of Non-Accelerated Filers*, to conform its rules to Section 404(c) of the Sarbanes-Oxley Act, as added by Section 989G of the Dodd-Frank Act. Section 404(c)

provides that Section 404(b) of the Sarbanes-Oxley Act shall not apply with respect to any audit report prepared for an issuer that is neither an accelerated filer nor a large accelerated filer as defined in Rule 12b-2 under the Exchange Act. Prior to enactment of the Dodd-Frank Act, a nonaccelerated filer would have been required, under existing SEC rules, to include an attestation report of its registered public accounting firm on internal control over financial reporting in the filer's annual report filed with the SEC for fiscal years ending on or after June 15, 2010. For further information on conforming changes adopted as a result of this ruling, this final ruling can be accessed at www.sec.gov/rules/final/2010/33-9142.pdf. Notwithstanding the SEC's final rule, IDIs subject to Part 363 of the FDIC's rules and regulations must continue to comply with the requirements of Section 363.3(b) regarding the independent public accountant's attestation report on management's assessment of the effectiveness of internal control over financial reporting.

1.96 For an institution that is a public company or a subsidiary of a public company that is required to comply with the auditor attestation requirement of Section 404 of the Sarbanes-Oxley Act, the auditor's report would be prepared in accordance with PCAOB Auditing Standard No. 5.

1.97 Generally, for an institution that is not a public company or a subsidiary of a public company, the auditor's report would be prepared in accordance with AT section 501.

1.98 Guideline 18A of Part 363 of the FDIC's regulations provides additional guidance regarding the standards that auditors should follow when reporting on internal control.

1.99 Section 404 of the Sarbanes-Oxley Act does not specify where the management report might appear. However, SEC Final Rule Release No. 33-8238, *Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports*, explains that it is important for management's report to be in close proximity to the corresponding attestation report issued by the company's registered public accounting firm. Positioning the report near the company's Management's Discussion and Analysis disclosure or immediately preceding the company's financial statements would be two appropriate locations.

Other Reporting Considerations

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

a. *Student loans.* Lenders participating in the Federal Family Education Loan Program may be required to engage an auditor to examine and report on management's assertions regarding compliance with certain U.S. Department of Education requirements. This examination is performed in accordance with (i) *Government Auditing Standards* (also known as the Yellow Book) issued by the Comptroller General of the United States, (ii) AT section 601, *Compliance Attestation* (AICPA, *Professional Standards*), and (iii) the Audit Guide *Compliance Audits (Attestation Engagements) for Lenders and Lender Servicers Participating in the Federal Family Education Loan Program* issued by the U.S. Department of Education. This examination

requirement applies to lenders with origination levels exceeding a specified dollar amount.[8]

b. *Federal Home Loan Mortgage Corporation borrowings*. Banks or savings institutions that are members of the Federal Home Loan Mortgage Corporation system may borrow from their respective district Federal Home Loan Bank. Borrowings are generally secured by the pledging of assets, often in the form of a blanket lien. The district banks maintain separate and distinct credit policies that have varying requirements as to a member bank's engagement of auditors to render assurance services relating to the adequacy of collateral maintenance levels. It is incumbent on the auditor to ascertain the professional standards that may be applicable to the requested services. The engagement generally takes the form of (i) an agreed-upon procedures engagement performed in accordance with AT section 201, *Agreed-Upon Procedures Engagements* (AICPA, *Professional Standards*) or (ii) an audit engagement performed in accordance with AU section 623, *Special Reports* (AICPA, *Professional Standards*).

c. *Loan servicing*. Lenders who service mortgage loans for others may be required to engage an auditor to examine management's assertions about compliance with minimum servicing standards set forth in the Uniform Single Attestation Program for Mortgage Bankers (the USAP). Companies that are issuers or servicers, or both, of publicly registered commercial-mortgage backed securities and private label residential-mortgage backed securities must also submit reports prepared in accordance with Item 1122; and compliance with applicable servicing criteria, of Regulation AB, *Asset-Backed Securities*, published by the SEC in 2004. The Item 1122 engagement largely encompasses and expands upon the USAP engagement. Both the USAP and Regulation AB are attestation engagements performed in accordance with AT section 601 as further described in paragraphs 4.37–.38 of this guide.

d. *Department of Housing and Urban Development programs*. To the extent that a bank or savings institution originates or services Department of Housing and Urban Development (HUD) loans through a subsidiary that is designated a *nonsupervised mortgagee*, or a *supervised mortgagee*, compliance with the Consolidated Audit Guide for Audits of HUD programs is required, as further described in paragraphs 4.32–.36 of this guide.

e. *FDIC Loss Sharing Purchase and Assumption Transactions.* The FDIC's Resolutions Handbook (Handbook) states that a loss sharing transaction is a purchase and assumption (P&A) transaction that the FDIC commonly uses as a resolution tool for handling failed institutions with more than $500 million in assets. A P&A is a resolution transaction in which a healthy institution purchases some or all of the assets of a failed bank or thrift and assumes some or all of the liabilities, including all insured deposits. The Handbook also states that a loss sharing P&A uses the basic P&A structure, except for the provision regarding transferred assets. Instead of selling some or all of the assets to the acquirer at a discounted price, the FDIC agrees

[8] Readers are encouraged to visit the National Council of Higher Education Loan Program's website (www.nchelp.org/elibrary/index.cfm?parent=373) for the most recent audit guide and related amendments.

to share in future loss experienced by the acquirer on a fixed pool of assets (covered assets). The Handbook for P&A agreements requires in that "[w]ithin 90 days after each calendar year end, the acquiring bank must furnish the FDIC a report signed by its independent public accountant containing specified statements[9] relative to the accuracy of any computations made regarding shared loss assets. AICPA Technical Questions and Answers section 9110.16, "Example Reports on Federal Deposit Insurance Corporation Loss Sharing Purchase and Assumption Transactions" (AICPA, *Technical Practice Aids*), provides examples of how the auditor might respond.

Regulatory Requirements for Internationally Active Banks

1.101 On November 2, 2007, the FDIC, OCC, OTS, and FRB approved final rules to implement risk based capital requirements for the large, internationally active banks in the United States. The new advanced capital adequacy framework, known as Basel II, more closely aligns regulatory capital requirements with actual risks and should further strengthen banking organizations' risk-management.[***]

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[9] The term *specified statements* is not defined in the FDIC's *Resolutions Handbook*. The practitioner is advised to read the terms of the loss share agreement and confirm that the audit requirement in that agreement provides for the receipt of a report expressing negative assurance.

[***] The Basel Committee on Banking Supervision issued a consultative paper on *Guidelines for Computing Capital for Incremental Default Risk in the Trading Book*. This paper provides additional guidance on how the general principles for calculating the incremental default risk charge as required in paragraphs 718(xcii)–718(xciii) of the comprehensive version of the Basel II Framework (July 2006) may be met and contains both guidance on how supervisors will evaluate internal models and fallback options deemed acceptable by the committee. Banks are expected to fulfill the principles for the incremental default risk capital charge laid out in this document to receive specific risk model recognition.

Chapter 2

Industry Overview—Credit Unions

Description of Business

2.01 The first credit union in the United States was organized in 1908. Although credit unions originally arose within communities, greater success was achieved by organizing credit unions to serve employee groups—particularly government employees, teachers, railway workers, and telephone company employees.

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

- The creation of the National Credit Union Share Insurance Fund (NCUSIF) to insure share (deposit) accounts up to applicable limits in all federal credit unions and many state-chartered credit unions
- The Depository Institution Deregulation and Monetary Control Act of 1980
- The Financial Institutions Reform, Recovery, and Enforcement Act of 1989
- The Credit Union Membership Access Act of 1998 (CUMAA)
- The Gramm-Leach-Bliley Act of 1999 (also known as the Financial Services Modernization Act)
- The Financial Services Regulatory Relief Act of 2006
- The Emergency Economic Stabilization Act of 2008
- The Helping Families Save Their Homes Act of 2009 (Helping Families Act)
- The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act)

2.03 Each credit union is organized around a defined *field of membership*, and each member shares a *common bond* of affiliation with other members. The field of membership is a key characteristic of a credit union and is defined in its charter or bylaws as those who may belong to it and use its services. All credit unions, except corporate credit unions, are referred to as *natural person credit unions*. The common bond is a characteristic of the members themselves. Congress, in the FCUA, has recognized three types of membership fields: single common bond credit unions, multiple common bond credit unions, and community credit unions. Single common bond credit unions consist of one group that has a common bond of occupation or association. Multiple common bond credit unions include multiple groups, each of which having a common bond of occupation or association limited in the numbers of members by the FCUA. Community membership fields are defined by the FCUA as persons or organizations within a well-defined local community, neighborhood, or rural district.

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

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

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

The Board of Directors

2.07 The board of directors establishes the general operation of a credit union and ensures that it follows applicable laws and regulations and adheres to its bylaws. In addition, the board is responsible for ensuring that a credit union maintains its financial stability, follows good business practices, and is properly insured and bonded. As membership organizations, credit unions are democratically controlled. Federal and state laws require that a board of directors be elected by the membership on the basis of one member, one vote. The board of directors, in turn, appoints the supervisory committee. The supervisory committee, which is similar to an audit committee, plays a major role in monitoring a credit union's financial affairs. A credit committee may be appointed or elected to oversee the lending transactions. Other committees may include a budget or finance committee, a marketing or member-relations committee, an educational committee, and various *ad hoc* committees. Credit unions depend heavily on member volunteers to set policy, make decisions, and sometimes even to operate them. Some officials (board members and board appointed persons) of state chartered credit unions may receive compensation for services, as allowed by law. However, federally chartered credit unions, except as expressly stated in Part 701.33(b) of the NCUA *Rules and Regulations*, are generally prohibited from compensating officials.

The Supervisory Committee

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

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

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

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

The Credit Committee

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

Chapter, Bylaws, and Minutes

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

Financial Structure

2.12 Because they are nonstock cooperatives, credit unions' primary source of funds is members' share and savings account deposits. To be entitled to membership, each member must generally own at least one share in the credit

union. Members' shares or share accounts are savings accounts that represent the members' ownership in the credit union. Credit unions pay interest (commonly referred to as *dividends*) on shares. This interest cannot be guaranteed (as interest on deposits can), but ordinarily must be declared by the board and may be paid from current earnings or undivided earnings.

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

Credit Union System

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

2.15 The National Association of State Credit Union Supervisors (NASCUS) was founded in 1965 and serves both state-chartered credit unions and the state credit union regulators who supervise them. Currently, there are more than 3,079 state-chartered credit unions (including U.S. territories) represented by NASCUS. NASCUS promotes a dual-chartering system and the advancement of the autonomy and expertise of state credit union regulatory agencies.

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

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

Corporate Credit Union Network[*]

2.18 U.S. Central serves as a financial intermediary for corporate credit unions. A corporate credit union is defined as a credit union organized by credit

[*] In October 2010, the National Credit Union Administration (NCUA) issued final amendments to its rule governing corporate credit unions contained in Title 12 U.S. *Code of Federal Regulations* (CFR) Part 704. The major revisions involve corporate credit union capital, investments, asset-liability management, governance, and credit union service organization (CUSO) activities. The amendments establish a new capital scheme, including risk-based capital requirements; impose new prompt corrective action requirements; place various new limits on corporate investments; impose new asset-liability management controls; amend some corporate governance provisions; and limit a corporate CUSO to categories of services preapproved by NCUA. The amendments are effective January 18, 2011, and have been incorporated

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

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

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

2.21 On May 20, 2009, the Helping Families Act was signed into law. The Helping Families Act authorized tools to assist in stabilizing the financial system during the recent economic downturn. The legislation amended the FCUA providing several provisions favorable to credit unions that include the following:

- Create a Temporary Corporate Credit Union Stabilization Fund (stabilization fund) to mitigate corporate credit union stabilization costs with NCUA authority to assess premiums over 7 years. The stabilization fund is administered by the NCUA and is separate from the NCUSIF.
- Extend through 2013 the $250,000 share and deposit insurance ceiling enacted as part of the Emergency Economic Stabilization Act

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(footnote continued)

into this guide, with the exception of amendments to 12 CFR 702.15(a), 703.14, 704.2 (Definitions), 704.3 (Corporate credit union capital), 704.4 (Prompt Corrective Action), and subpart M of 12 CFR 747, which are not effective until October 20, 2011 (and have not been incorporated into guide). See further discussion of these final amendments as they relate to capital matters in chapter 17, "Equity and Disclosures Regarding Capital Matters."

In April 2011, the NCUA amended the Corporate Credit Union rules issued in September 2010. The final rules issued in April 2011 included the following amendments:

- Establish internal control and reporting requirements similar to those required for banks under the Federal Deposit Insurance Act and the Sarbanes Oxley Act of 2002 (Part 704.15).
- Establish an enterprise risk management committee staffed with at least one risk management expert (Part 704.21).
- Require that all board votes be recorded votes and include the votes of the individual directors in the minutes (Part 704.13).
- Permit corporate credit unions to charge members reasonable, one-time membership fees to facilitate retained earnings growth (Part 704.22).
- Require disclosure of certain compensation received from the corporate CUSOs, for senior Corporate Credit Union Executives of CUSOs (Parts 704.11 and 704.19).

This rule became effective May 31, 2011, with the exception of the amendments to Part 704.2 (new definitions generally related to terms used in the proposed internal control and reporting amendments) and 704.15, which are effective January 1, 2012, and the addition of 704.21, which is effective April 29, 2013.

of 2008. This limit of coverage was made permanent by the NCUA in 2010 to conform to Section 335 of the Dodd-Frank Act.

- Provide the NCUSIF authority to assess premiums over 8 years to rebuild the equity ratio should the ratio fall below 1.20 percent.
- Increase NCUA borrowing authority to $6 billion.
- Establish NCUA emergency borrowing authority of $30 billion.

Regulation and Oversight

Government Supervision

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

2.23 State-chartered credit unions are supervised by the regulatory agency of the chartering state. Most state-chartered credit unions are ordinarily required to obtain NCUSIF share insurance coverage. Such credit unions are subject to a periodic insurance examination by the NCUSIF generally performed jointly with their state supervisory authority. A few credit unions obtain insurance from other sources that are sponsored by a private insurer. Participation in an insurance program is mandatory for most credit unions.

2.24 Credit unions are subject to the federal, state, and local laws applicable to financial institutions in general. Such laws include the Uniform Commercial Code, the Truth-in-Lending Laws, the Uniform Consumer Code, Truth-in-Savings regulations, and various federal and state tax codes. As financial institutions, they are also subject to a wide variety of federal regulations issued by such agencies as the Treasury Department, the Federal Reserve Board, and the IRS. Rules and regulations issued by the federal and state regulatory agencies address such issues as accounting practices, qualifications for membership, interest rate controls, permissible investments, consumer-protection issues, liquidity reserves, and other operational aspects. The Sarbanes-Oxley Act of 2002 and the Securities and Exchange Commission implementing regulations do not specifically apply to federal credit unions. However, the NCUA issued Letter to Federal Credit Unions No. 03-FCU-07, *Guidance on Selected Provisions of the Sarbanes-Oxley Act of 2002 for Federal Credit Unions (FCUs)*, in October 2003 to provide a summary of certain provisions within the Sarbanes-Oxley Act of 2002 that NCUA believes are relevant to federal credit unions.

National Credit Union Administration

2.25 Approximately 60 percent of all credit unions are federally chartered by the NCUA, which issues regulations for both federal credit unions and federally insured, state-chartered credit unions. Federally insured, state-chartered credit unions sign an insurance agreement with the NCUA when they secure federal insurance that stipulates the regulations by which they

agree to be bound. NCUA publications that provide useful background information to credit union auditors include the following:

- The FCUA
- NCUA *Rules and Regulations* (and periodic updates)
- NCUA Letters to Credit Unions, Legal Opinions, and Regulatory Updates
- Federal credit union bylaws
- NCUA *Chartering and Field of Membership Manual*
- NCUA *Examiner's Guide*
- *Accounting Manual for Federal Credit Unions* (and interim *Accounting Bulletins*)
- *Supervisory committee manual for Federal credit unions*
- *The Federal Credit Union Handbook*

Many of the previously mentioned documents can be found at the NCUA's website at www.ncua.gov.

2.26 The *Accounting Manual for Federal Credit Unions* had the force of NCUA regulatory authority until 1981, when, except for Section 2000 on basic accounting policies and procedures, it was deregulated. Credit unions with under $10 million in assets are provided this accounting manual, which includes some regulatory accounting practices as a guide in accounting for financial transactions and reporting. In accordance with the CUMAA, credit unions with $10 million or more in assets must follow U.S GAAP in the call reports they file with NCUA. These credit unions should not look to this manual, but should seek the advice of an independent accountant to gain a full understanding of U.S. GAAP and its implementation. The manual may be adopted by federally insured, state-chartered credit unions under $10 million in assets at the option of the credit unions and their state supervisor.

Regulatory Capital Matters

Natural Person Credit Unions

Capital Adequacy

2.27 The CUMAA was signed into law in 1998. Title III of this act established a system of tiered net worth requirements for all insured credit unions other than corporate credit unions. These requirements did not take effect until August 2000. The act required that the NCUA establish a net worth standard for insured credit unions as well as risk-based capital standards for complex credit unions as defined by the NCUA. A separate system of PCA was mandated for new credit unions. A *new credit union* is defined as a federally insured credit union that both has been in operation for less than ten years and has $10 million or less in total assets. A summary of general requirements follows. In 2000, the NCUA published PCA guidelines in the *Federal Register* and PCA guidelines with respect to the risk-based net worth requirement (RBNWR). Specific requirements are set forth in Title 12 U.S. *Code of Federal Regulations* (CFR), Parts 700, 702, 741, and 747.

2.28 Under the net worth standard, a credit union's net worth, the numerator of the net worth ratio, is defined as *retained earnings* as determined

under U.S. GAAP together with any amounts that were previously retained earnings of any other credit union with which the credit union has combined.[1]

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

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

2.31 In 1998, Congress amended the FCUA to require the NCUA board to adopt a system of PCA to be applied to federally insured credit unions that become undercapitalized. The new FCUA provision imposes a series of progressively more stringent restrictions and requirements indexed to five net worth categories. The provision also mandates a separate system for new credit unions and additional RBNWRs for complex credit unions. Part 702 of the NCUA's *Rules and Regulations* provides details of the system of PCA.

2.32 A credit union is defined as *complex* and a RBNWR is applicable only if the credit union meets both of the following criteria as reflected in its most recent call report:

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

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

a. *Well capitalized* if it has a net worth ratio of 7 percent or greater and also meets any applicable RBNWR.

b. *Adequately capitalized* if it has a net worth ratio of 6 percent or more but less than 7 percent and meets any applicable RBNWRs.

c. *Undercapitalized* if it has a net worth ratio of 4 percent or more but less than 6 percent or fails to meet any applicable RBNWR.

d. *Significantly undercapitalized* if it

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[1] In response to the Financial Accounting Standards Board projects on business combinations, Congress passed the Regulatory Relief Act of 2006, which changed the definition of *net worth* to include premerger retained earnings. The change was necessary to correct the unintended regulatory capital consequences in mutual to mutual combinations of the recent accounting guidance. The recent accounting guidance working in conjunction with the existing Prompt Corrective Action rule resulted in the dilution of the retained earnings of the continuing credit union (its net worth) by the total assets of both the continuing and target credit unions without benefit of the fair value of the acquiree's equity or member interests. The preferred remedy of redefining net worth as retained earnings plus equity acquired in combination was not advanced by Congress; thus, the premerger retained earnings outcome binding on current combinations was a compromise remedy.

i. has a net worth ratio of 2 percent or more but less than 4 percent, or

ii. has a net worth ratio of 4 percent or more but less than 5 percent and either

(1) fails to submit an acceptable net worth restoration plan within the time prescribed, or

(2) materially fails to implement a net worth restoration plan approved by the NCUA board.

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

Exhibit 2-1

Net Worth Classifications

Classification	*Net Worth Ratio*	*Prompt Corrective Action*
Well capitalized	7% or greater	None
Adequately capitalized	> 6% but < 7%	Earnings transfer
Undercapitalized—first tier	> 5% but < 6%	Mandatory for level
Undercapitalized—second tier	> 4% but < 5%	Mandatory and discretionary for level
Significantly undercapitalized	Either *a.* > 2% but < 4% *b.* or > 4% but < 5% and either i. fails to submit an acceptable net worth restoration plan; or ii. materially fails to implement a restoration plan approved by the NCUA board.	Mandatory and discretionary for level
Critically undercapitalized	< 2%	Mandatory and discretionary for level

2.34 Determining the net worth category of a credit union (other than a new credit union) is a multiple-step process. In the first step, an initial net worth category is determined by calculating the ratio of the credit union's net worth (equal to retained earnings as defined under U.S. GAAP) to total assets (computed under any of the four methods described previously). This ratio determines an initial category based on the net worth classifications in exhibit 2-1.

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

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

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

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

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

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

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

2.41 According to regulations, credit unions classified as undercapitalized, significantly undercapitalized, or critically undercapitalized must submit a net worth restoration plan for restoring the credit union to adequate capitalization. Among other things, the plan could

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

2.42 Under the FCUA, a *new* credit union is classified as

a. *well capitalized* if it has a net worth ratio of 7 percent or greater,

b. *adequately capitalized* if it has a net worth ratio of 6 percent or more but less than 7 percent,

c. *moderately capitalized* if it has a net worth ratio of 3.5 percent or more but less than 6 percent,

d. *marginally capitalized* if it has a net worth ratio of 2 percent or more but less than 3.5 percent,

e. *minimally capitalized* if it has a net worth ratio of 0 percent or greater but less than 2 percent, and

f. *undercapitalized* if it has a net worth of less than 0 percent.

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

2.44 New credit unions classified as moderately, marginally, minimally, or undercapitalized generally must file a revised business plan. At a minimum, the following items should be included in the business plan:

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

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

Notice and Effective Date of Net Worth Classification

2.46 A federally-insured credit union shall have notice of its net worth ratio (including any applicable RBNWR) and shall be classified within the corresponding net worth category as of the earliest to occur of the following:[2]

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

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

Corporate Credit Unions*

2.48 Corporate credit unions have regulatory capital requirements that are different from those of other credit unions. Corporate credit unions are not covered by the net worth requirements applicable to other credit unions by virtue of the CUMAA. By statute, the equity or capital of a corporate credit union consists of reserves, undivided earnings, and contributed capital. The NCUA has established a regulatory capital requirement applicable to all corporate credit unions. A state-chartered corporate credit union is also subject

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[2] Readers may refer to the NCUA *Rules and Regulations* Part 741.6(a) for additional information.

* See footnote * to the heading above paragraph 2.18.

to its applicable state law capital requirement, if any. For NCUA regulatory purposes, corporate credit union capital consists of the sum of the corporate credit union's reserves and undivided earnings, paid-in capital, and membership capital. Paid-in capital and membership capital are typically different types of subordinated share accounts.

2.49 The essential function of paid-in capital and membership capital is to serve as an additional reserve of capital to absorb losses in excess of retained earnings. Therefore, when there is a retained earnings deficit in a corporate credit union, the paid-in capital and membership capital are depleted to the extent necessary to resolve the deficit. Paid-in capital and membership capital are at-risk capital reserves and because they are so designated, a corporate credit union has no legal obligation or authorization as a going concern to restore, replenish, or recoup depleted paid-in capital and membership capital out of future retained earnings, even if retained earnings substantially improve. (See NCUA Letter to Credit Unions No. 09-CU-10, *Matters Related to "Paid-in Capital" and "Membership Capital" of Corporate Credit Unions*, dated May 2009, for addition information.)

2.50 For NCUA purposes, a corporate credit union is required to maintain a monthly minimum capital ratio of 4 percent. The capital ratio is determined by dividing the corporate credit union's capital by the moving daily average net assets (MDANA). MDANA is defined in Part 704.2 of the NCUA's *Rules and Regulations* as the average of daily average net assets for the month being measured and the previous 11 months. Net assets are defined in Part 704.2 of NCUA's *Rules and Regulations* as total assets less various specified types of assets.

2.51 If a corporate credit union's prior month-end retained earnings ratio is less than 2 percent, it is subject to the earnings retention requirements of Part 704.3(i) of the NCUA's *Rules and Regulations*. If the prior month-end retained earnings ratio is less than 2 percent and the core capital ratio is less than 3 percent, the earnings retention factor is .15 percent per annum; or if the prior month-end retained earnings ratio is less than 2 percent and the core capital ratio is equal to or greater than 3 percent, the earnings retention factor is .10 percent per annum.

2.52 The monthly earnings retention amount is determined by multiplying the earnings retention factor by the prior month-end MDANA. The quarterly earnings retention amount is determined by multiplying the earnings retention factor by the MDANA for each of the prior three month-ends.

2.53 NCUA may also establish different minimum capital or retained earnings ratio requirements, or both, for an individual corporate credit union based on its circumstances.

Annual Audits

2.54 As discussed in paragraph 2.05, CUMAA requires that all federally insured credit unions with assets of $10 million or more must follow U.S. GAAP for all reports or statements required to be filed with the NCUA board and obtain one of the following 4 services:

a. If the credit union is federally insured with assets of $500 million or more, a financial statement audit performed in accordance with generally accepted auditing standards by a CPA or public accountant

licensed by the appropriate state or jurisdiction in which the audit is conducted.

b. If the credit union is federally chartered with assets of more than $10 million but less than $500 million, the credit union has 4 options:

i. Follow the requirement in item (*a*).

ii. Obtain an opinion audit on the credit union's balance sheet performed by an independent accountant licensed by the state or jurisdiction in which the audit is conducted.

iii. Obtain an examination of management's assertions regarding internal controls over call reporting conducted by an independent accountant licensed by the state or jurisdiction in which the audit is conducted.

iv. Obtain a supervisory committee audit that meets the minimum requirements of the Supervisory Committee Guide.

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

2.56 Although U.S. GAAP basis accounting is not mandated for internal reporting, U.S. GAAP is required for call reports filed with the NCUA board for credit unions with assets of $10 million or more.[3] Because most auditors typically perform financial statement audits at a quarter-end and credit unions are directed to file quarterly call reports, management ordinarily should provide the independent accountant U.S. GAAP-based financial statements to work with in connection with his or her audit.

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

2.58 NCUA requires credit union service organizations to obtain a separate financial statement audit from a CPA if it is included in the annual consolidated audit of a federal credit union unless the credit union service organization is wholly owned by the credit union. See 12 CFR 712 for additional information.

Other Reporting Considerations

2.59 The independent accountant may be requested to perform assurance services other than those required by CUMAA to the extent that a credit union may be

[3] Readers may refer to the NCUA *Rules and Regulations* Part 741.6(b) for additional information.

a. originating or holding student loans,

b. servicing residential mortgage loans for others,

c. borrowing from a district Federal Home Loan Bank,

d. participating in an automated-teller-machine network,

e. originating or receiving automated-clearinghouse transactions,

f. using outside technology partners, and

g. subject to the provisions of the Bank Secrecy Act.

Chapter 3

Industry Overview—Finance Companies[1]

Description of Business

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

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

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

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

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

3.06 Commercial loans are either secured by various types of assets, including notes and accounts receivable; inventories; and property, plant, and equipment; or they are unsecured.

3.07 Increased competition has come from both within the industry and from nontraditional players such as investment companies, brokers and dealers in securities, insurers, and financial subsidiaries of commercial entities. These

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[1] This guide covers entities under Financial Accounting Standards Board *Accounting Standards Codification* 942-10-15-2, which includes finance companies and finance company subsidiaries.

entities now do business directly with potential customers in transactions traditionally executed through finance companies. This disintermediation has increased the need for innovative approaches to attracting customers. It has also led to an increased need for more complex financing structures such as use of tax oriented vehicles, the ability to offer longer term financing than traditional banks, and a higher level of asset knowledge to take more aggressive residual positions and collateral risk.

Debt Financing

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

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

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

3.11 The Risk Management Association, 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. More information can be found at www.rmahq.org.

Regulation and Oversight

3.12 Publicly held finance companies are generally subject to requirements of federal securities laws, including the Securities Act of 1933, the

Securities Exchange Act of 1934 (the Exchange Act), and the Sarbanes-Oxley Act of 2002. Companies whose securities are registered under the Exchange Act must comply with its reporting requirements through periodic filings with the Securities and Exchange Commission.

3.13 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 address financial accounting and reporting. Certain of the more significant state and federal laws related to consumer lending are discussed in chapter 8, "Loans."

Chapter 4

Industry Overview—Mortgage Companies

Description of Business

4.01 As a result of the relative imbalance between the supply and demand for residential mortgage funds, mortgage banking entities play an integral role in providing mortgage capital based on housing demands of the general public in various geographic locations referred to as the primary market. The market where loans and mortgage backed securities (MBS) trade is referred to as the *secondary market*.

4.02 The principal participants in the secondary market for residential financing are government sponsored enterprises, such as the Federal Home Loan Mortgage Corporation (Freddie Mac) and the Federal National Mortgage Association (Fannie Mae). Also active in the secondary market are federal agencies such as the Government National Mortgage Association (Ginnie Mae), the Department of Veterans' Affairs (VA), and the Federal Housing Administration (FHA). These entities participate in the secondary market as issuers, investors, or guarantors of asset backed securities (ABSs) such as MBSs, real estate mortgage investment conduits, and collateralized mortgage obligations. Many private entities are also active in the secondary market as issuers, investors, and guarantors. (Chapter 7, "Investments in Debt and Equity Securities," describes ABS transactions and considerations for investors in ABSs.)

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

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

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

4.06 In 2008, Fannie Mae and Freddie Mac experienced dramatic repercussions as a result of the financial crisis and were placed into conservatorship of the Federal Housing Finance Agency. The U.S. Treasury Department acquired $1 billion of preferred shares in each government sponsored entity and is providing additional capital as necessary.

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

4.08 With the dominant role of the mortgage securities markets and economic changes throughout the mortgage lending industry, nontraditional participants in the secondary market (as opposed to the traditional bank and thrift portfolio lenders) continue to evolve. Securities underwriters, commercial banks, financial guaranty companies, insurance companies, and nonfinancial corporate entities, are playing a part in mortgage banking. In addition, mortgage lending entities have securitized other types of loan products, such as subprime loans and home equity lines of credit.

4.09 The Mortgage Partnership Finance (MPF) Program, which is available through most Federal Home Loan Banks (FHLBs), provides member financial institutions an alternative method for funding home mortgages for their customers. Under the MPF Program, the lender effectively originates loans for, or sells loans to, the respective FHLB. The lender retains some or all of the credit risk and customer relationship (through servicing) inherent in the loan, and shifts the interest rate risk and prepayment risk to the FHLB. The lender receives a credit enhancement fee from the FHLB in exchange for managing the credit risk of the loan. Effectively, the FHLBs offer an alternative funding strategy to the traditional secondary mortgage market. The Mortgage Purchase Program (MPP) was introduced in 2000 to further support the FHLBs' mission of expanding housing finance opportunities in the several districts for members that originate-and-hold mortgages on their books. The MPP, similar to the MPF program shifts the interest rate risk and prepayment risk to the FHLB while the member retains the customer relationship and credit risk of the loan.

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

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

4.12 Mortgage banking activities primarily consist of two separate but interrelated activities, namely, (*a*) the origination or acquisition of mortgage

loans for the purpose of selling those loans to permanent investors in the secondary market, and (*b*) the subsequent servicing of those loans. Mortgage loans are acquired for sale to permanent investors from a variety of sources, including in-house origination and purchases from third-party correspondents.

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

4.14 The servicing function includes collecting payments from borrowers, transmitting insurance and tax payments to the related recipients, remitting payments to investors, performing the collection and loss mitigation functions for delinquent loans, and handling all phases of foreclosure proceedings. The precise nature of the servicing function is dependent on the specific requirements of the investor and the pooling and servicing agreement.

4.15 The servicing rights attributable to a mortgage portfolio are generally viewed as a primary asset of a mortgage banking entity. The value of the servicing asset is a function of the anticipated life of the servicing right (how long the loan is expected to be outstanding and serviced) and the estimated net servicing revenues attributable to the servicing function. In an active market for the purchase and sale of loan servicing rights, there is a certain degree of liquidity to servicing rights. Conversely, servicing portfolios are subject to significant impairment risk as unanticipated periods of rapid prepayments, increases in loan losses, increases in servicing costs, and changes in the discount rates can cause substantial declines in the value of the servicing asset. Accordingly, the assumptions upon which the value of servicing transactions are based are critical to the financial performance of the servicing entity. Refer to Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 860, *Transfers and Servicing*, for accounting requirements relating to servicing rights. See paragraphs 4.21–.31 for regulatory guidance about servicing assets.

4.16 FASB ASC 948, *Financial Services—Mortgage Banking*, establishes accounting and reporting standards for mortgage banking entities and entities that engage in certain mortgage banking activities. Some of the items subject to the guidance in FASB ASC 948 are financial instruments. FASB ASC 825, *Financial Instruments*, allows entities to choose, at specified election dates, to measure eligible items at fair value (the fair value option) with unrealized gains and losses recorded in earnings at each subsequent reporting date. FASB ASC 820, *Fair Value Measurement*, defines *fair value*, establishes a framework for measuring fair value, and requires certain disclosures about fair value measurements. A summary of the guidance in FASB ASC 820 may be found in chapter 20, "Fair Value."

4.17 For mortgage banking, FASB ASC 820 provides guidance that may be applied to certain mortgage related items such as derivative loan commitments, derivative sales contracts, loans held for sale, and servicing rights. FASB ASC 825 allows the fair value option election for loans held for sale. Applying the fair value election to loans held for sale eliminates the need to document and achieve hedge accounting, in accordance with the requirements of FASB ASC 815, *Derivatives and Hedging*.

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

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

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

Regulation and Oversight

4.21 Publicly held mortgage companies are generally subject to requirements of federal securities laws, including the Securities Act of 1933, the Securities Exchange Act of 1934, and the Sarbanes-Oxley Act of 2002. Companies whose securities are registered under the Exchange Act must comply with its reporting requirements through periodic filings with the Securities and Exchange Commission (SEC).

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

4.23 The mortgage lending process is regulated by both state and federal law. Regulations are generally designed to protect the consumer from unfair lending practices, and noncompliance with the regulations may result in financial liability, including the imposition of civil money penalties and reimbursements to borrowers, where applicable. Certain of the more significant regulations are discussed in chapter 8, "Loans," and chapter 9, "Credit Losses." On February 25, 2003, the Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation (FDIC), Federal Reserve Board, and Office of Thrift Supervision (collectively, the federal banking agencies) issued *Interagency Advisory on Mortgage Banking*. This important document discusses examination concerns about the valuation and modeling of servicing assets and discusses the need to determine if an impaired servicing asset should be written

off. In May 2005, the federal banking agencies and National Credit Union Administration (NCUA) issued *Interagency Advisory on Accounting and Reporting for Commitments to Originate and Sell Mortgage Loans*. This advisory provides guidance related to the origination of mortgage loans that will be held for resale, and the sale of mortgage loans under mandatory delivery and best efforts contracts.

4.24 On October 4, 2006, the federal banking agencies and NCUA jointly issued *Interagency Guidance on Nontraditional Mortgage Product Risks*. The guidance discusses how institutions can offer nontraditional mortgage products in a safe and sound manner and in a way that clearly discloses the benefits and risks to borrowers. On June 8, 2007, the federal banking agencies and NCUA jointly published guidance entitled *Illustrations of Consumer Information for Nontraditional Mortgage Products*. The illustrations are intended to assist institutions in implementing the consumer protection portion of the *Interagency Guidance on Nontraditional Mortgage Product Risks* (interagency guidance).

4.25 On May 29, 2008, the federal banking agencies and NCUA published *Illustrations of Consumer Information for Hybrid Adjustable Rate Mortgage Products*. The illustrations are intended to assist institutions in implementing the consumer protection portion of the *Interagency Statement on Subprime Mortgage Lending* adopted on July 10, 2007, and to provide information to consumers on hybrid adjustable rate mortgage products as recommended by that interagency statement. The illustrations are not model forms and institutions may choose not to use them.

4.26 On March 4, 2009, the Treasury announced guidelines under the Home Affordable Mortgage Program to promote sustainable loan modifications for homeowners at risk of losing their homes due to foreclosure. A second program, Home Affordable Mortgage Program—Principal Reduction Alternative, became effective on October 1, 2010. This program makes it possible for borrowers to earn a principal reduction over a three-year period by making all of the payments according to the modified terms of the mortgage loan.

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

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

4.29 To obtain approval to sell and service mortgage loans for Fannie Mae or Freddie Mac, or both, a mortgage lender must meet various requirements including maintaining an acceptable net worth. Upon approval, a mortgage lender enters into a selling and servicing contract and must comply with the

terms of the respective selling and servicing guides, which set forth detailed requirements regarding underwriting, mortgage delivery, and servicing.

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

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

Reporting Considerations

HUD Programs

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

4.33 HUD Mortgagee Letter No. 2011-05, *Revised Audited Financial Statement Reporting Requirements for Supervised Lenders in Parent—Subsidiary Structures and New Financial Reporting Requirements for Multifamily Mortgagees*, was issued in January 2011.[1] This mortgagee letter amends certain requirements referenced in the OIG's *Consolidated Audit Guide for Audits of HUD Programs* only for supervised lenders in parent/subsidiary relationships.

4.34 Mortgagee Letter No. 2011-05 states that FHA-approved supervised lenders in parent/subsidiary structures (that is, subsidiaries) are permitted to submit the audited consolidated financial statements of a parent company, accompanied by internally prepared consolidating schedules, if they meet one of the following conditions:

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[*] The U.S. Department of Housing and Urban Development (HUD) issued notice of a Federal Housing Administration program change as a result of Mortgagee Letter 2009-31, *Strengthening Counterparty Risk Management*, issued in September 2009. See www.hud.gov/offices/adm/hudclips/letters/mortgagee/files/09-31ml.doc. The policy change affected all supervised mortgagees. Effective for fiscal years ending on or after January 1, 2010, all supervised mortgagees, including financial institutions, must submit annual audited financial statements to HUD within 90 days of their fiscal-year end.

[1] See http://portal.hud.gov/hudportal/documents/huddoc?id=11-05ml.pdf.

- The FHA-approved subsidiary accounts for at least 40 percent of the parent company's assets.
- The FHA-approved subsidiary provides FHA with an executed corporate guarantee agreement, acceptable to the Secretary of HUD, between it and the parent company in which the parent company guarantees the ongoing net worth and liquidity compliance of the FHA-approved subsidiary.

4.35 An FHA-approved lender electing to submit audited consolidated pursuant to one of the preceding conditions must also submit its fourth quarter call report as an attachment to its annual audited financial statements submission in HUD's Lender Assessment Subsystem (LASS). A Compliance Report and Internal Control Report must still be prepared and included as an attachment to the FHA-approved lender's audited financial statements submission in LASS.

4.36 In August 2002, HUD released the Final Uniform Financial Reporting Standards Rule (Title 24 U.S. *Code of Federal Regulations* Part 5) requiring electronic submission of the financial statement package required for annual mortgagee recertification. In order to ensure the integrity of this audited financial information, mortgagees' auditors are required to attest to the data electronically. Refer to HUD Mortgagee Letter No. 2003-03, *Mandatory Electronic Submission of Financial Statement Package for Annual Mortgagee Recertification*.

Residential Loan Servicing for Investors

4.37 Lenders that service residential mortgage loans for investors may be required to engage an auditor to provide assurance relating to management's written assertions about compliance with the SEC Regulation AB or the minimum servicing standards set forth in the Uniform Single Attestation Program for Mortgage Bankers (USAP), or both. This examination engagement is performed in accordance with AT section 601, *Compliance Attestation* (AICPA, *Professional Standards*). The USAP was developed by the Mortgage Bankers' Association of America and is intended to provide the minimum servicing standards with which an investor should expect a servicing entity to comply.

4.38 Regulation AB[2] codifies requirements for registration, disclosure, and reporting for all publicly registered ABS, including MBS. Regulation AB requires the issuance of an attestation report on assessment of compliance with servicing criteria for ABSs, establishes the required disclosures associated with the securities registration process, establishes the reporting requirements for ABSs, and necessitates an annual servicing assertion. The servicing criteria adopted as part of Item 1122 of Regulation AB, "Compliance With Applicable Servicing Criteria," is consistent with the criteria in AT section 601 and the audit procedures to be performed are incremental to procedures performed under the USAP.

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[2] Readers may refer to the Securities and Exchange Commission (SEC) Regulation AB issued December 22, 2004, www.sec.gov/rules/final/33-8518.htm, and an amendment issued November 29, 2005, www.sec.gov/rules/final/33-8518a.pdf. In addition, the SEC adopted new rules related to representations and warranties in asset-backed securities offerings as outlined in Release No. 33-9175, *Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act*, issued in January 2011. The final rules require securitizers of asset backed securities to disclose fulfilled and unfulfilled repurchase requests. See www.sec.gov/rules/final/2011/33-9175.pdf for additional information.

Chapter 5

Audit Considerations and Certain Financial Reporting Matters

Overview

5.01 In accordance with AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*), an auditor plans, conducts, and reports the results of an audit in accordance with generally accepted auditing standards (GAAS). Auditing standards provide a measure of audit quality and the objectives to be achieved in an audit. This section of the guide provides guidance, primarily on the application of the standards of fieldwork.

5.02 Depository and lending institutions are subject to certain risks as a result of the regulatory environment and the current economic climate in which these entities operate as well as the complex nature of these entities and the transactions in which these entities are engaged. This chapter provides guidance on the risk assessment process and general auditing considerations for depository and lending institutions.

Planning and Other Auditing Considerations

5.03 The objective of an audit of a deposit and lending institution's financial statements is to express an opinion on whether its financial statements present fairly, in all material respects, its financial position, results of operations, and its cash flows in conformity with generally accepted accounting principles (GAAP). To accomplish that objective, the auditor's responsibility is to plan and perform the audit to obtain reasonable assurance (a high, but not absolute, level of assurance) that material misstatements, whether caused by errors or fraud, are detected. This section addresses general planning considerations, assessment of risks of material misstatement, and other auditing considerations relevant to deposit and lending institutions.

Audit Planning

5.04 The first standard of field work states, "The auditor must adequately plan the work and must properly supervise any assistants." AU section 311, *Planning and Supervision* (AICPA, *Professional Standards*), establishes standards and provides guidance to the auditor conducting an audit in accordance with GAAS on the considerations and activities applicable to planning and supervision, including preparing an audit plan, obtaining an understanding of the entity and its environment, and dealing with differences of opinion among firm personnel. Such considerations on activities involve appointing the auditor; establishing an understanding with the client; performing preliminary engagement activities; preparing a detailed, written audit plan; determining the extent of involvement of professionals with specialized skills; and communicating with those charged with governance. Audit planning also involves developing an overall audit strategy for the expected conduct, organization, and staffing of the audit. The nature, timing, and extent of planning vary with the size and complexity of the entity, and with the auditor's experience with the

entity and understanding of the entity and its environment, including its internal control.

5.05 The auditor's assessment of the risks of material of misstatement in an engagement affects staffing, the extent of supervision, overall audit scope and strategy, and the degree of professional skepticism applied. Financial institutions are subject to certain risks that are less prevalent in commercial, industrial, and other nonfinancial businesses, and they operate in a particularly volatile and highly regulated environment. Accordingly, the auditor might design appropriate overall responses to that higher risk with personnel who have appropriate relevant experience, providing more extensive supervision, and maintaining a heightened degree of professional skepticism. See paragraphs 5.16–.18 for more guidance regarding the auditor's overall responses to audit risk.

5.06 Paragraph .03 of AU section 311 (AICPA, *Professional Standards*) states that the auditor must plan the audit so that it is responsive to the assessment of the risks of material misstatement based on the auditor's understanding of the entity and its environment, including its internal control. Planning is not a discrete phase of the audit, but rather an iterative process that begins with engagement acceptance and continues throughout the audit as the auditor performs audit procedures and accumulates sufficient appropriate audit evidence to support the audit opinion.

> *Considerations for Audits Performed in Accordance with Public Company Accounting Oversight Board (PCAOB) Standards*
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> Paragraph .01 of AU section 311,[*] *Planning and Supervision* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards), states that when performing an integrated audit of financial statements and internal control over financial reporting refer to paragraph 9 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), regarding planning considerations in addition to the planning considerations set forth in AU section 311 (AICPA, *PCAOB Standards and Related Rules*, Interim Standards).[1]

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[*] In December 2010, the Securities and Exchange Commission (SEC) approved the Public Company Accounting Oversight Board's (PCAOB's) suite of risk assessment standards (Auditing Standard Nos. 8–15). These standards set forth requirements that are intended to enhance the effectiveness of the auditor's assessment of, and response to, the risks of material misstatement in the financial statements. The risk assessment standards address audit procedures performed throughout the audit, from the initial planning stages through the evaluation of the audit results. The standards will be effective for audits of fiscal periods beginning on or after December 15, 2010.

The new suite of risk assessment standards supersedes the guidance contained in AU section 311, *Planning and Supervision* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards). The guidance contained in AU section 311 is now included in PCAOB Auditing Standard No. 9, *Audit Planning*, and Auditing Standard No. 10, *Supervision of the Audit Engagement* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards).

[1] PCAOB Staff Audit Practice Alert No. 3, *Audit Considerations in the Current Economic Environment* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400.03), assists auditors in identifying matters related to the current economic environment that might affect audit risk and require additional emphasis. This practice alert is organized into six sections: (1) overall audit considerations; (2) auditing fair value measurements; (3) auditing accounting estimates; (4) auditing the adequacy of disclosures; (5) auditor's consideration of an entity's ability to continue as a going concern; and (6) additional audit considerations for selected financial reporting areas. PCAOB Staff Audit Practice Alerts are not rules of the board, nor have they been approved by the PCAOB.

Scope of Services

5.07 The scope of services rendered by auditors generally depends on the types of reports to be issued as a result of the engagement. Paragraph .08 of AU section 311 (AICPA, *Professional Standards*) states that the auditor should establish an understanding with the client regarding the services to be performed for each engagement and should document the understanding through a written communication with the client. Such an understanding reduces the risk that either the auditor or the client may misinterpret the needs or expectations of the other party.

5.08 An understanding with the client also may include other matters, such as additional services to be provided relating to regulatory requirements, as stated in paragraph .10 of AU section 311 (AICPA, *Professional Standards*). Engagements to meet regulatory requirements are described in chapter 1, "Industry Overview—Banks and Savings Institutions," as well as any additional legal or contractual requirements, such as the following:

- Auditing the financial statements of common trust funds and applying agreed-upon procedures related to trust activities. (chapter 21, "Trust and Asset Management Activities," includes a description of trust services and activities.)
- Reporting on management's assertions about compliance with the requirements of the Consolidated Audit Guide for Audits of Department of Housing and Urban Development programs, compliance with the minimum servicing standards set forth in Uniform Single Audit Program for Mortgage Bankers, and compliance with servicing criteria for asset-backed securities as required by Regulation AB. (See chapter 4, "Industry Overview—Mortgage Companies.")
- Applying minimum agreed-upon procedures to assist the supervisory committee in fulfilling its responsibilities. (The scope of services are expanded beyond the minimum procedures. See chapter 2, "Industry Overview—Credit Unions," and chapter 23, "Reporting Considerations.")
- Reporting on management's assertions about compliance with certain Department of Education requirements relative to student loan activities.[2] (See chapter 1.)
- Reporting on the processing of transactions by banks and savings institutions or credit union service organizations functioning as service organizations in accordance with AU section 324, *Service Organizations* (AICPA, *Professional Standards*).[3,†] (See chapter 10,

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[2] Readers are encouraged to visit the National Council of Higher Education Loan Program's website (www.nchelp.org/) for the most recent audit guide and related amendments, if applicable.

[3] The Audit Guide *Service Organizations: Applying SAS No. 70, as Amended* has been revised by a task force of the Auditing Standards Board (ASB) to reflect the requirements and guidance in Statement on Standards for Attestation Engagements (SSAE) No. 16, *Reporting on Controls at a Service Organization* (AICPA, *Professional Standards*, AT sec. 801). The revised Audit Guide, *Service Organizations: Applying SSAE No. 16,* Reporting on Controls at a Service Organization, is currently available to readers. Also, the newly released Audit Guide *Reporting on Controls at a Service Organization Relevant to Security, Availability, Processing Integrity, Confidentiality, or Privacy* addresses reporting on a service provider's controls over subject matter other than financial reporting.

[†] The guidance contained in AU section 324, *Service Organizations* (AICPA, *Professional Standards*), has now been split into an attest standard and an auditing standard to better reflect the nature of the work being performed. The ASB has finalized a new clarified auditing

"Transfers and Servicing—Including Mortgage Banking," chapter 13, "Deposits," and chapter 20, "Fair Value," as they relate to loan servicing, deposits, and trust activities, respectively.)

Using the Work of a Specialist

5.09 AU section 336, *Using the Work of a Specialist* (AICPA, *Professional Standards*), establishes standards and provides guidance to the auditor who uses the work of a specialist in audits performed in accordance with GAAS. Paragraph .01 of AU section 336 states that a specialist is a person (or firm) possessing special skill or knowledge in a particular field other than accounting or auditing.

5.10 AU section 336 applies whenever the auditor uses a specialist's work as audit evidence in performing substantive procedures to evaluate material financial statement assertions, regardless of whether

- management engages or employs specialists;
- management engages a specialist employed by the auditor's firm to provide advisory services; or
- the auditor engages the specialist.

5.11 AU section 336 does not apply if a specialist employed by the auditor's firm participates in the audit. For example, if the auditor's firm employs an appraiser and decides to use that appraiser as part of the audit team to evaluate the carrying value of properties, AU section 336 would not apply. In such cases, AU section 311 (AICPA, *Professional Standards*) would apply.

5.12 AU section 336 states that the auditor should evaluate the professional qualifications of the specialist to determine whether he or she possesses the necessary skill or knowledge. AU section 336 states that the auditor should evaluate the specialist's experience in the type of work under consideration. For example, if the auditor is using an appraisal of commercial real estate values in connection with the audit of financial statements, he or she should evaluate the appraiser's professional qualifications and his or her experience with commercial real estate.

5.13 Paragraph .09 of AU section 336 states that the auditor should obtain an understanding of the nature of the work performed or to be performed by the specialist. In a number of cases, the specialist's work may have been prepared for another purpose (such as, an appraiser's report prepared for a loan origination). In these situations, the auditor might consider the appropriateness of using the specialist's work to evaluate financial statement assertions.

(footnote continued)

standard on service organizations, *Audit Considerations Relating to an Entity Using a Service Organization*. This auditing standard will supersede AU section 324 and addresses the user auditor's responsibility for obtaining sufficient appropriate audit evidence in an audit of the financial statements of a user entity that uses one or more service organizations. This clarified auditing standard has been finalized but not yet issued. See the preface of this guide for further information on the ASB's Clarity Project. The effective date of this clarified standard is for audits of financial statements for periods ending on or after December 15, 2012, unless otherwise established (early adoption would not be appropriate).

The related attest standard, SSAE No. 16, was issued in April 2010. It addresses examination engagements undertaken by a service auditor to report on controls at organizations that provide services to user entities when those controls are likely to be relevant to user entities' internal control over financial reporting. SSAE No. 16 supersedes the guidance for service auditors in AU section 324 and is effective for service auditors' reports for periods ending on or after June 15, 2011. Early implementation is permitted.

AU section 336 acknowledges that, in some cases, an auditor may need to contact the specialist to determine whether the specialist is aware that his or her work will be used for evaluating the assertions in the financial statements.

5.14 AU section 336 does not preclude the auditor from using a specialist who has a relationship with the client, including situations where the client has the ability to directly or indirectly control or significantly influence the specialist. Paragraphs .10–.11 of AU section 336 do state, however, that the auditor should evaluate the relationship, including circumstances that might impair the specialist's objectivity. If the auditor believes that the specialist's objectivity might be impaired, the auditor should perform additional procedures with respect to some or all of the specialist's assumptions, methods or findings to determine that the findings are not unreasonable or should engage another specialist for that purpose.

5.15 The Audit Issues Task Force of the Auditing Standards Board issued Interpretation No. 1, "The Use of Legal Interpretations As Audit Evidence to Support Management's Assertion That a Transfer of Financial Assets Has Met the Isolation Criterion in Paragraphs 7–14 of Financial Accounting Standards Board *Accounting Standards Codification* 860-10-40," of AU section 336 (AICPA, *Professional Standards*, AU sec. 9336 par. .01–.21).[4] The guidance relates to examples of legal opinions that auditors will need to obtain and review with regard to transfers of financial assets by banks subject to receivership or conservatorship under provisions of the Federal Deposit Insurance Act (FDI Act). This interpretation is for auditing procedures related to transfers of financial assets that are accounted for under Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 860, *Transfers and Servicing*.

Audit Risk

5.16 Paragraph .12 of AU section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*), states that audit risk is a function of the risk that the financial statements prepared by management are materially misstated and the risk that the auditor will not detect such material misstatement. The auditor should consider audit risk in relation to the relevant assertions related to individual account balances, classes of transactions, and disclosures and at the overall financial statement level.

5.17 At the account balance, class of transactions, relevant assertion, or disclosure level, audit risk consists of (*a*) the risk of material misstatement (consisting of inherent risk and control risk) and (*b*) the detection risk. Paragraph .23 of AU section 312 (AICPA, *Professional Standards*) states that the auditor should assess the risk of material misstatement at the relevant assertion level as a basis for further audit procedures (tests of controls or substantive procedures). It is not acceptable to simply deem risk to be "at the maximum." This assessment may be in qualitative terms such as high, medium, and low, or in quantitative terms such as percentages.

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[4] Financial Accounting Standards Board (FASB) Accounting Standards Update No. 2009-16, *Transfers and Servicing (Topic 860): Accounting for Transfers of Financial Assets*, specifically amended paragraphs 5 and 7–14 of Financial Accounting Standards Board *Accounting Standards Codification* (ASC) 860-10-40, which are discussed in Interpretation No. 1, "The Use of Legal Interpretations As Audit Evidence to Support Management's Assertion That a Transfer of Financial Assets Has Met the Isolation Criterion in Paragraphs 7–14 of FASB *Accounting Standards Codification* 860-10-40," of AU section 336, *Using the Work of a Specialist* (AICPA, *Professional Standards*, AU sec. 9336 par. .01–.21). Readers should be aware of amended references in applying the guidance addressed in Interpretation No. 1.

5.18 In considering audit risk at the overall financial statement level, paragraph .15 of AU section 312 (AICPA, *Professional Standards*) states that the auditor should consider risks of material misstatement that relate pervasively to the financial statements taken as a whole and potentially affect many relevant assertions. Risks of this nature often relate to the entity's control environment and are not necessarily identifiable with specific relevant assertions at the class of transactions, account balance, or disclosure level. Such risks may be especially relevant to the auditor's consideration of the risks of material misstatement arising from fraud, for example, through management override of internal control.

> *Considerations for Audits Performed in Accordance with PCAOB Standards*
>
> Paragraph .03 of AU section 312,[‡] *Audit Risk and Materiality in Conducting an Audit* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards), states when performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraph 20 of PCAOB Auditing Standard No. 5 regarding materiality considerations.

Materiality

5.19 The auditor's consideration of materiality is a matter of professional judgment and is influenced by the auditor's perception of the needs of users of financial statements. Materiality judgments are made in light of surrounding circumstances and necessarily involve both quantitative and qualitative considerations. (See paragraphs .59–.60 of AU section 312 (AICPA, *Professional Standards*) for further guidance regarding qualitative considerations in evaluating audit findings.)

5.20 In accordance with paragraphs .27–.28 of AU section 312 (AICPA, *Professional Standards*), the auditor should determine a materiality level for the financial statements taken as a whole when establishing the overall audit strategy for the audit. The auditor often may apply a percentage to a chosen benchmark as a step in determining materiality for the financial statements taken as a whole. See paragraphs .17–.26 of AU section 312 (AICPA, *Professional Standards*) for materiality considerations at the individual account balance, class of transactions, or disclosure level.

Tolerable Misstatement

5.21 The initial determination of materiality is made for the financial statements taken as a whole. However, the auditor should allow for the possibility that some misstatements of lesser amounts than the materiality levels could, in the aggregate, result in a material misstatement of the financial statements. To do so, the auditor should determine one or more levels of tolerable misstatement. Paragraph .34 of AU section 312 (AICPA, *Professional*

[‡] As a result of the new suite of risk assessment standards (see further discussion at footnote *), the guidance contained in AU section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards), has now been superseded by Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit*, and Auditing Standard No. 14, *Evaluating Audit Results* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards). Auditing Standard No. 11 establishes requirements regarding the auditor's consideration of materiality in planning and performing an audit, whereas Auditing Standard No. 14 establishes requirements regarding the auditor's evaluation of audit results and determination of whether he or she has obtained sufficient appropriate audit evidence.

Standards) defines *tolerable misstatement (or tolerable error)* as the maximum error in a population (for example, the class of transactions or account balance) that the auditor is willing to accept. Paragraph .35 of AU section 312 (AICPA, *Professional Standards*) states that such levels of tolerable misstatement are normally lower than the materiality levels.

Qualitative Aspects of Materiality

5.22 As indicated previously, judgments about materiality include both quantitative and qualitative information. As a result of the interaction of quantitative and qualitative considerations in materiality judgments, misstatements of relatively small amounts that come to the auditor's attention could have a material effect on the financial statements. For example, a loan made to a related party of an otherwise immaterial amount could be material if there is a reasonable possibility that it could lead to a material contingent liability or a material loss of revenue.

5.23 Qualitative considerations also influence the auditor in reaching a conclusion about whether misstatements are material. Paragraph .60 of AU section 312 (AICPA, *Professional Standards*) provides qualitative factors that the auditor may consider relevant in determining whether misstatements are material.

Use of Assertions in Obtaining Audit Evidence

5.24 Paragraphs .14–.19 of AU section 326, *Audit Evidence* (AICPA, *Professional Standards*), discuss the use of assertions in obtaining audit evidence. In representing that the financial statements are fairly presented in accordance with GAAP, management implicitly or explicitly makes assertions regarding the recognition, measurement, presentation, and disclosure of information in the financial statements and related disclosures. Assertions used by the auditor fall into the following categories:

Categories of Assertions

	Description of Assertions		
	Classes of Transactions and Events During the Period	*Account Balances at the End of the Period*	*Presentation and Disclosure*
Occurrence/ Existence	Transactions and events that have been recorded have occurred and pertain to the entity.	Assets, liabilities, and equity interests exist.	Disclosed events and transactions have occurred.

(continued)

	Description of Assertions		
	Classes of Transactions and Events During the Period	*Account Balances at the End of the Period*	*Presentation and Disclosure*
Rights and Obligations	—	The entity holds or controls the rights to assets, and liabilities are the obligations of the entity.	Disclosed events and transactions pertain to the entity.
Completeness	All transactions and events that should have been recorded have been recorded.	All assets, liabilities, and equity interests that should have been recorded have been recorded.	All disclosures that should have been included in the financial statements have been included.
Accuracy/ Valuation and Allocation	Amounts and other data relating to recorded transactions and events have been recorded appropriately.	Assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are recorded appropriately.	Financial and other information is disclosed fairly and at appropriate amounts.
Cut-off	Transactions and events have been recorded in the correct accounting period.	—	—
Classification and Understandability	Transactions and events have been recorded in the proper accounts.	—	Financial information is appropriately presented and described and information in disclosures is expressed clearly.

5.25 According to paragraph .17 of AU section 326, the auditor should use relevant assertions for classes of transactions, account balances, and presentation and disclosures in sufficient detail to form a basis for the assessment of risks of material misstatement and the design and performance of further audit procedures. The auditor should use relevant assertions in assessing risks by considering the different types of potential misstatements that may occur, and then designing further audit procedures that are responsive to the assessed risks.

Risk Assessment Procedures

5.26 As described in paragraph .20 of AU section 326, audit procedures performed to obtain an understanding of the entity and its environment, including its internal control, and to assess the risks of material misstatement at the financial statement and relevant assertion levels are referred to as *risk assessment procedures*. Paragraph .21 of AU section 326 states that the auditor must perform risk assessment procedures to provide a satisfactory basis for the assessment of risks at the financial statement and relevant assertion levels. Risk assessment procedures by themselves do not provide sufficient appropriate audit evidence on which to base the audit opinion and must be supplemented by further audit procedures in the form of tests of controls, when relevant or necessary, and substantive procedures.

5.27 In accordance with paragraph .06 of AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), the auditor should perform the following risk assessment procedures to obtain an understanding of the entity and its environment, including its internal control:

- Inquiries of management and others within the entity
- Analytical procedures
- Observation and inspection

Paragraphs .07–.13 of AU section 314 establish standards and provide additional guidance on risk assessment procedures.

Understanding the Entity and Its Environment

5.28 AU section 314 establishes standards and provides guidance about implementing the second standard of field work. Paragraph .01 of AU section 314 states that the auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures.

5.29 In accordance with paragraph .04 of AU section 314, the auditor should use professional judgment to determine the extent of the understanding required of the entity and its environment, including its internal control. The auditor's primary consideration is whether the understanding that has been obtained is sufficient (*a*) to assess risks of material misstatement of the financial statements, and (*b*) to design and perform further audit procedures (for example, tests of controls and substantive tests).

5.30 Paragraph .21 of AU section 314 states that the auditor's understanding of the entity and its environment consists of an understanding of the following aspects:

- Industry, regulatory, and other external factors
- Nature of the entity
- Objectives and strategies and the related business risks that may result in a material misstatement of the financial statements
- Measurement and review of the entity's financial performance
- Internal control, which includes the selection and application of accounting policies (see paragraphs 5.62–.82 for further discussion)

Appendixes A and B of AU section 314 provide examples of matters that the auditor may consider in obtaining an understanding of the entity and its environment relating to the preceding categories.

5.31 Paragraph .22 of AU section 329, *Analytical Procedures* (AICPA, *Professional Standards*), states that when

> an analytical procedure is used as the principal substantive test of a significant financial statement assertion, the auditor should document all of the following:
>
> *a.* The expectation, where that expectation is not otherwise readily determinable from the documentation of the work performed, and factors considered in its development
>
> *b.* Results of the comparison of the expectation to the recorded amounts or ratios developed from recorded amounts
>
> *c.* Any additional auditing procedures performed in response to significant unexpected differences arising from the analytical procedure and the results of such additional procedures

5.32 The auditor considers the level of assurance, if any, he wants from substantive testing for a particular audit objective and decides which procedure or combination of procedures can provide that level of assurance. Paragraph .11 of AU section 329 states the effectiveness and efficiency of an analytical procedure in identifying potential misstatements depends on, among other things, (*a*) the nature of the assertion, (*b*) the plausibility and predictability of the relationship, (*c*) the availability and reliability of the data used to develop the expectation, and (*d*) the precision of the expectation. For this reason, substantive analytical procedures alone are not well suited to detecting fraud. In addition, before using results obtained from substantive analytical procedures, the auditor might either test the design and operating effectiveness of controls over financial information used in the substantive analytical procedures or perform other procedures to support the completeness and accuracy of the underlying information.

5.33 A number of the ratios that may be useful to the auditor in an audit of the financial statements of an institution are listed here with a brief description of the information they provide:

- *Investments to total assets.* Measures the mix of earning assets
- *Loans to total assets*. Measures the mix of earning assets
- *Investments by type divided by total investments.* Measures the composition of investment portfolio
- *Loans to deposits.* Indicates the funding sources for the loan base
- *Loans by type to total loans.* Measures the composition of loan portfolio and of lending strategy and risk

- *Allowance for loan losses to total loans.* Measures loan portfolio credit risk coverage
- *Loan loss recoveries to prior-year write-offs.* Indicates write-off policy and measure recovery experience
- *Classified loans to total loans.* Indicates asset quality
- *Investment income to average total securities.* Measures investment portfolio yield
- *Allowance for loan losses to classified loans.* Measures management's estimate of losses
- *Loan income to average net loans.* Measures loan portfolio yield
- *Total deposit interest expense to average total deposits.* Measures costs of deposit funds
- *Overhead to total revenue (net interest income plus noninterest income).* Measures operating efficiency
- *Net income to average total assets.* Measures return on assets
- *Net income to average capital.* Measures return on equity
- *Capital ratios.* Measures financial strength and regulatory compliance
- *Noninterest income to total revenue (net interest income plus noninterest income).* Measures the extent of noninterest income
- *Liabilities to shareholders' equity.* Measures the extent equity can cover creditors' claims in the event of liquidation

5.34 Obtaining an understanding of the entity and its environment, including its internal control, is a continuous, dynamic process of gathering, updating, and analyzing information throughout the audit. Throughout this process, the auditor should also follow the guidance in AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*).

Analytical Procedures

5.35 AU section 329 establishes standards and provides guidance on the use of analytical procedures and requires the use of analytical procedures in the planning and overall review stages of all audits. For risk assessment purposes, such procedures focus on (*a*) enhancing the auditor's understanding of the institution's business and transactions and events that have occurred since the last financial statement audit and (*b*) identifying areas that may present specific risks relevant to the financial statement audit. The objective of analytical procedures is to identify unusual transactions[5] and events, and amounts, ratios, and trends that might indicate matters that have financial statement and audit planning ramifications.

5.36 Analytical procedures used in risk assessment generally use data aggregated at a high level. The nature, extent, and timing of the procedures,

[5] PCAOB Staff Audit Practice Alert No. 3 assists auditors in identifying matters related to the current economic environment that might affect audit risk and require additional emphasis. This practice alert is organized into six sections: (1) overall audit considerations; (2) auditing fair value measurements; (3) auditing accounting estimates; (4) auditing the adequacy of disclosures; (5) auditor's consideration of an entity's ability to continue as a going concern; and (6) additional audit considerations for selected financial reporting areas. PCAOB Staff Audit Practice Alerts are not rules of the board, nor have they been approved by the PCAOB.

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

5.37 Ratios, operating statistics, and other analytical information that may be useful in assessing an institution's position relative to other similar institutions and to industry norms, as well as in identifying unusual relationships between data about the institution itself, are generally readily available. Ratios and statistics developed for use by management or regulators often can be effectively used by the auditor in performing analytical procedures for risk assessment purposes. Many institutions disclose analytical information in their annual and quarterly reports. Other sources of information that may be useful for risk assessment purposes are the institution's call reports and the disclosures made by publicly held institutions in accordance with the Securities and Exchange Commission's Industry Guide No. 3, *Statistical Disclosures by Bank Holding Companies*. The *Uniform Bank Performance Reports*, published by the Federal Financial Institutional Examination Council (FFIEC), and various reports published by the Federal Deposit Insurance Corporation (FDIC) contain industry data and statistics. There are also several sources of industry data published by private companies. Many of these reports use a peer group format. It is important to understand the relevance of any peer group data to the client institution before making any judgments.

5.38 Analytical procedures involve the comparison of recorded amounts or ratios developed from recorded amounts with expectations developed by the auditor. Examples of analytical procedures that may be useful to auditors in obtaining an understanding of a bank or savings institution include comparison of account balances with budgeted and prior-period amounts as well as analysis of ratios that indicate relationships among elements of financial information within the period and relationships to similar information about other institutions. The objective of analytical procedures used in the overall review stage of the audit is to assist the auditor in assessing the conclusions reached and in the evaluation of the overall financial statement presentation. Analytical procedures also may be used as substantive tests to identify potential misstatements. These procedures focus on comparing actual with expected balances and ratios and investigating and evaluating significant differences.

Discussion Among the Audit Team

5.39 In obtaining an understanding of the entity and its environment, including its internal control, AU section 314 states that there should be discussion among the audit team. In accordance with paragraph .14 of AU section 314, the members of the audit team, including the auditor with final responsibility for the audit, should discuss the susceptibility of the entity's financial statements to material misstatements. This discussion could be held concurrently with the discussion among the audit team that is specified by AU section 316 (AICPA, *Professional Standards*) to discuss the susceptibility of the entity's financial statements to fraud.

Understanding of the Client's Business

5.40 In addition to an understanding of the industry, including matters such as those described in chapter 1, chapter 2, chapter 3, "Industry Overview—Finance Companies," and chapter 4, the auditor should obtain an understanding of matters that are unique to the entity under audit. With regard to financial institutions, such matters include risk management strategies, organizational structure, product lines and services, capital structure, locations, and other operating characteristics. The auditor's knowledge of the institution's business should be sufficient to provide an understanding of events, transactions, and practices that may have a significant effect on the institution's financial statements. For issuers, the auditor should also obtain an understanding of the operating segments of the business, as defined by FASB ASC 280-10-50.

5.41 An understanding of the entity may also be obtained or supplemented by reading documents such as the following:

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

5.42 *Related parties*. Obtaining an understanding of a client's business should also include performing the procedures in AU section 334, *Related Parties* (AICPA, *Professional Standards*), to determine the existence of related-party relationships and transactions with such parties. The FASB ASC glossary defines *related parties* as

a. affiliates of the institution (according to the FASB ASC glossary, an *affiliated entity* is an entity that directly or indirectly controls, is

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[||] In February 2011, the Office of Thrift Supervision (OTS), Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation (FDIC), and Board of Governors of the Federal Reserve System (collectively, the federal banking agencies) issued joint proposal *Proposed Agency Information Collection Activities* to require savings associations currently filing the Thrift Financial Report to convert to filing the Consolidated Reports of Condition and Income beginning with the reporting period ending on March 31, 2012. Readers should remain alert for final regulation.

controlled by, or is under common control with another entity; also, a party with which the entity may deal if one party has the ability to exercise significant influence over the other's operating and financial policies as discussed in FASB ASC 323-10-15);

b. entities for which investments would be required, absent the election of the fair value option under the "Fair Value Option" subsections of FASB ASC 825-10-15, to be accounted for by the equity method by the institution;

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

d. principal owners of the institution and members of their immediate families;

e. management of the institution and members of their immediate families;

f. other parties with which the institution may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests; and

g. other parties that can significantly influence the management or operating policies of the transacting parties or that have an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

5.43 Paragraph .02 of AU section 334 states that the auditor should be aware that the substance of a particular transaction could be significantly different from its form and that financial statements should recognize the substance of particular transactions rather than merely their legal form. Except for routine transactions, it will generally not be possible to determine whether a particular transaction would have taken place if the parties had not been related, or assuming it would have taken place, what the terms and manner of settlement would have been. Accordingly, it is difficult to substantiate representations that a related-party transaction was consummated on terms equivalent to those that prevail in arm's-length transactions.[6] If the institution includes such a representation in the financial statements and the auditor believes that the representation is unsubstantiated by management, he or she should express a qualified or adverse opinion because of a departure from GAAP, depending on materiality. AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*)[7] establishes standards and applies to auditors' reports issued in connection with audits of historical financial

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[6] FASB ASC 850-10-50-5 states that if representations are made about transactions with related parties, the representations should not imply that the related party transactions were consummated on terms equivalent to those that prevail in arm's length transactions unless such representations can be substantiated.

[7] Interpretation No. 19, "Financial Statements Prepared in Conformity With International Financial Reporting Standards as Issued by the International Accounting Standards Board," of AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, AU sec. 9508 par. .93–.97), designates the International Accounting Standards Board (IASB) as an accounting body for purposes of establishing international financial accounting and reporting principles. Interpretation No. 19 states that an independent auditor may apply the guidance in AU section 508 when engaged to report on financial statements presented in conformity with International Financial Reporting Standards (IFRSs) as issued by the IASB. Accordingly, when

statements that are intended to present financial position, results of operations, and cash flows in conformity with GAAP.

> *Considerations for Audits Performed in Accordance with PCAOB Standards*
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> Paragraph .01 of AU section 508, *Reports on Audited Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards), states when performing an integrated audit of financial statements and internal control over financial reporting, the auditor may choose to issue a combined report or separate reports on the company's financial statements and on internal control over financial reporting. Refer to paragraphs 85–98 of PCAOB Auditing Standard No. 5 and appendix C, "Special Reporting Situations," of PCAOB Auditing Standard No. 5 for direction on reporting on internal control over financial reporting. In addition, see paragraphs 86–88 of PCAOB Auditing Standard No. 5, which include an illustrative combined audit report.

Chapter 23 of this guide provides additional discussion on auditor reports.

Industry Risk Factors

5.44 Auditors with clients in the industry should obtain audit evidence about the general business and economic risk factors that affect the industry. No list of risk factors covers all of the complex characteristics that affect transactions in the industry.[8] However, some of those risk factors are competition for business, innovations in financial instruments, and the role of regulatory policy that are discussed in paragraph 5.30. Emerging regulatory and accounting guidance is discussed throughout this guide. Other primary risk factors (discussion to follow) involve the sensitivity of an institution's earnings to changes in interest rates, liquidity, asset quality, fiduciary, and processing risk. Auditors should obtain an understanding of such risk factors when planning the audit of an institution's financial statements. Practical considerations of these risk factors for certain transactions are provided in each chapter where appropriate.

Interest Rate Risk[9]

5.45 In general, financial institutions derive their income primarily from the excess of interest collected over interest paid. The rates of interest an

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(footnote continued)

the auditor reports on financial statements prepared in conformity with IFRSs in the auditor's report, the auditor would refer to IFRSs rather than U.S. generally accepted accounting principles.

In addition, Interpretation No. 14, "Reporting on Audits Conducted in Accordance With Auditing Standards Generally Accepted in the United States of America and in Accordance With International Standards on Auditing," of AU section 508 (AICPA, *Professional Standards*, AU sec. 9508 par. .56–.59), was revised to remove mention of the International Auditing Practices Committee of the International Federation of Accountants and clarified that the International Auditing and Assurance Standards Board promulgates International Standards on Auditing.

[8] An important source of such information is the AICPA's Audit Risk Alert series.

[9] The Federal Financial Institutions Examination Council's (FFIEC's) *Advisory on Interest Rate Risk Management*, issued in January 2010, reminds institutions of supervisory expectations for sound practices to manage interest rate risk (IRR). This advisory reiterates the importance of effective corporate governance, policies and procedures, risk measuring and monitoring systems, stress testing, and internal controls related to the IRR exposures of

institution earns on its assets and owes on its liabilities generally are established contractually for a period of time. Market interest rates change over time. Accordingly, an institution is exposed to lower profit margins (or losses) if it cannot adapt to interest rate changes.

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

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

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

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

5.50 Another technique used to analyze interest rate risk involves simulation models. These models measure the effect of changes in interest rates on the market value of an institution under a premise that interest rate changes are not static but dynamic. Simulation analysis involves the projection of various interest rate scenarios over future periods. The estimated cash flows for each rate scenario are discounted to arrive at a present value calculation for

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(footnote continued)

depository institutions. It also clarifies elements of existing guidance and describes some IRR management techniques used by effective risk managers. For the complete text of the advisory see the FFIEC website at www.ffiec.gov.

each rate scenario. The resulting range of probable risk exposures reflects both current and expected interest rate risk. The rate scenarios often reflect variations of factors such as the mix of assets and liabilities and related pricing strategies. As with gap and duration analyses, if the assumptions are not valid, the results may not provide an accurate reflection of the institution's interest rate risk.

5.51 Several ways an institution can affect interest rate risk includes the following:

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

5.52 An institution might also invest in more complex financial instruments intended to hedge or otherwise change interest rate risk. Interest rate swaps, futures contracts, options on futures, and other such derivative instruments often are used for this purpose. Because these instruments are sensitive to interest rate changes, they generally require management expertise to be effective. Accounting and regulatory guidance for these instruments continue to evolve. Chapter 18, "Derivative Instruments: Futures, Forwards, Options, Swaps, and Other Derivative Instruments," discusses specific accounting and regulatory guidance in this area, as well as related audit considerations.

5.53 Financial institutions are subject to a related risk—prepayment risk—in falling rate environments. For example, mortgage loans and other receivables may be prepaid by a debtor so that the debtor may refund its obligations at new, lower rates. Prepayments of assets carrying the old, higher rates reduce the institution's interest income and overall asset yields. Prepayment risk is discussed further in chapter 7, "Investments in Debt and Equity Securities."

Liquidity Risk[10]

5.54 A large portion of an institution's liabilities may be short term or due on demand, although most of its assets may be invested in long-term loans or investments. Accordingly, the institution needs to have in place sources of cash to meet short-term demands. These funds can be obtained in cash markets, by borrowing, or by selling assets. Also, the secondary mortgage, repurchase agreement, and Euro-markets have become increasingly important sources of liquidity for banks and savings institutions. However, if an institution resorts to sales of assets or loans to obtain liquidity, immediate losses will be incurred when the effective rates those assets carry are below market rates at the time of sale. Related audit considerations are addressed in chapter 7.

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[10] In March 2010, the federal banking agencies and National Credit Union Administration issued *Interagency Policy Statement on Funding and Liquidity Risk Management* to provide sound practices for managing funding and liquidity risk and strengthening liquidity risk management practices. The policy statement emphasizes the importance of cash flow projections, diversified funding sources, stress testing, a cushion of liquid assets and a formal, well-developed contingency funding plan as primary tools for measuring and managing liquidity risk. The agencies expect each financial institution to manage funding and liquidity risk using processes and systems that are commensurate with the institution's complexity, risk profile and scope of operations. This guidance can be found in *Federal Register* Vol. 75, No. 54 [22 March 2010], pp. 13656–13666.

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

Asset-Quality Risk

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

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

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

Fiduciary Risk

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

Processing Risk

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

5.61 Financial institutions utilize information systems to process large volumes of transactions (for example, arising from banks' electronic funds transfer and check processing operations) on an accurate and timely basis. Related considerations are discussed in subsequent chapters.

Understanding Internal Control[11,12]

5.62 The way that internal control is designed and implemented varies with an entity's size and complexity. The assets of financial institutions generally are more negotiable and more liquid than those of other enterprises. As a result, they may be subject to greater risk of loss. In addition, the operations of financial institutions are characterized by a high volume of transactions; as a result, the effectiveness of internal control is a significant audit consideration.

5.63 Paragraph .40 of AU section 314 states that the auditor should obtain an understanding of the five components of internal control sufficient to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures (see paragraph 5.67 for a list of the five components). The auditor should obtain a sufficient understanding by performing risk assessment procedures to

a. evaluate the design of controls relevant to an audit of financial statements; and

b. determine whether they have been implemented.

5.64 The auditor should use such knowledge to

- identify types of potential misstatements;
- consider factors that affect the risks of material misstatement; and
- design tests of controls, when applicable, and substantive procedures.

5.65 The objective of obtaining an understanding of internal control is to evaluate the design of controls and determine whether they have been implemented for the purpose of assessing the risks of material misstatement. In contrast, the objective of testing the operating effectiveness of internal control is to determine whether the controls, as designed, prevent or detect a material misstatement.

5.66 Paragraph .41 of AU section 314 explains that internal control is a process—effected by those charged with governance, management, and other personnel—designed to provide reasonable assurance regarding the achievement of the entity's objectives in (*a*) the reliability of financial reporting, (*b*) the effectiveness and efficiency of operations, and (*c*) compliance with applicable laws and regulations.

5.67 Paragraph .41 of AU section 314 states that internal control consists of five interrelated components:

a. *Control environment* sets the tone of an institution, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure.

b. *Risk assessment* is the institution's identification and analysis of relevant risks to the achievement of its objectives, forming a basis for determining how the risks should be managed.

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[11] The AICPA's Technical Questions and Answers (TIS) section 8200, *Internal Control* (AICPA, *Technical Practice Aids*), provides nonauthoritative guidance to auditors. For more information, visit the AICPA website.

[12] This section discusses the consideration of internal control in a financial statement audit; it does not address reporting on a written management assertion about financial reporting controls.

c. *Control activities* are the policies and procedures that help ensure management directives are carried out.

d. *Information and communication systems* support the identification, capture, and exchange of information in a form and time frame that enable people to carry out their responsibilities.

e. *Monitoring* is a process that assesses the quality of internal control performance over time.

5.68 Paragraph .48 of AU section 314 states, that for significant risks (for additional information on significant risk, see paragraph 5.86), the auditor should evaluate the design of the entity's related controls, including relevant control activities, and determine whether they have been implemented. In exercising that judgment, the auditor should consider the circumstances, the applicable component, and factors such as the following:

- Materiality
- The institution's size
- The institution's organization and ownership characteristics
- The diversity and complexity of the institution's operations
- Applicable legal and regulatory requirements
- The nature and complexity of the systems that are part of the institution's internal control, including the use of service organizations.

5.69 Paragraph .48 of AU section 314 states that, ordinarily, controls that are relevant to an audit pertain to the institution's objective of preparing financial statements for external purposes that are fairly presented in conformity with GAAP or a comprehensive basis of accounting other than GAAP.

5.70 Paragraph .50 of AU section 314 states the controls relating to operations and compliance objectives may be relevant to an audit if they pertain to data the auditor may evaluate or use in applying audit procedures. For example, controls pertaining to detecting noncompliance with laws and regulations that may have a direct and material effect on the financial statements, such as compliance with income tax laws and regulations used to determine the income tax provision, may be relevant to an audit.

Considerations of Audits Performed in Accordance with PCAOB Standards

Regardless of the assessed level of control risk, the auditor should perform substantive procedures for all relevant assertions related to all significant accounts and disclosures in the financial statements. Refer to PCAOB Auditing Standard No. 5 for requirements and direction that applies when an auditor is engaged to perform an audit of management's assessment of the effectiveness of internal control over financial reporting that is integrated with an audit of the financial statements.

When a company reports material weaknesses in its Internal Control over Financial Reporting, management has the option to seek auditor agreement that the material weakness no longer exists prior to the next annual audit. PCAOB Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards),

describes the steps to be used by auditors when a company voluntarily engages them to report on whether a previously disclosed material weakness no longer exists.

The main objective for auditors performing an engagement in accordance with PCAOB Auditing Standard No. 4 is to obtain a reasonable assurance as to whether the previously reported material weakness still exists. The work performed by the auditor focuses on whether controls specified by management are operating effectively to properly address the material weakness, as of a specified date by management.

5.71 *IT considerations.* Financial institutions' operations are characterized by large volumes of transactions and, therefore, generally rely heavily on computers. AU section 314 and AU section 326 establish standards and provide guidance for auditors who have been engaged to audit an entity's financial statements when significant information is transmitted, processed, maintained, or accessed electronically.

5.72 Paragraph .57 of AU section 314 states that an entity's use of IT may affect any of the five components of internal control relevant to the achievement of the entity's financial reporting, operations, or compliance objectives, and its operating units or business functions. The auditor might consider matters such as

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

5.73 Some of the accounting data and corroborating audit evidence may be available only in electronic form. For example, entities may use electronic data interchange or image processing systems. In image processing systems, documents are scanned and converted into electronic images to facilitate storage and reference, and the source documents may not be retained after conversion. Certain electronic evidence may exist at a certain point in time. However, such evidence may not be retrievable after a specified period of time if files are changed and if backup files do not exist. Therefore, the auditor might consider the time during which information exists or is available in determining the nature, timing, and extent of his or her substantive tests and, if applicable, tests of controls.

5.74 Information technology may be performed solely by the institution, shared with others, or provided by an independent organization supplying specific data processing services for a fee. AU section 324 (AICPA, *Professional Standards*)[†] establishes standards and provides guidance on the factors that an auditor should consider when auditing the financial statements of entities that obtain services that are part of its information system from another organization.

> *Considerations for Audits Performed in Accordance with PCAOB Standards*
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> Paragraph .01 of AU section 324, *Service Organizations* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards), states that when performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs B17–B27 of appendix B, "Special Topics," of PCAOB Auditing Standard No. 5 regarding the use of service organizations.

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

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

a. controls over the accurate conversion of data to new or upgraded systems;

b. the effectiveness of data provided to perform analyses, such as those of the institution's performance versus its plan for asset-liability management; and

c. the adequacy of the institution's disaster recovery plan and system.

5.77 *Communication with those charged with governance.* AU section 380, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*), establishes standards and provides guidance on the auditor's communication with those charged with governance in relation to an audit of financial statements. Although this section applies regardless of an entity's governance structure or size, particular considerations apply where all of those charged with governance are involved in managing an entity. This section does not establish requirements regarding the auditor's communication

[†] See footnote † in paragraph 5.08.

with an entity's management or owners unless they are also charged with a governance role.

5.78 AU section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*), establishes standards and provides guidance on communicating matters related to an entity's internal control over financial reporting identified in an audit of financial statements. It is applicable whenever an auditor expresses or disclaims an opinion on financial statements. In particular, AU section 325 (AICPA, *Professional Standards*)

- defines the terms *deficiency in internal control*, *significant deficiency*, and *material weakness*.
- provides guidance on evaluating the severity of deficiencies in internal control identified in an audit of financial statements.
- requires the auditor to communicate, in writing, to management and those charged with governance significant deficiencies and material weaknesses identified in an audit.

5.79 Paragraphs .17–.18 of AU section 325 (AICPA, *Professional Standards*) state that deficiencies identified during the audit that upon evaluation are considered significant deficiencies or material weaknesses under AU section 325 (AICPA, *Professional Standards*) should be communicated, in writing, to management and those charged with governance as a part of each audit, including significant deficiencies and material weaknesses that were communicated to management and those charged with governance in previous audits and have not yet been remediated. Significant deficiencies and material weaknesses that previously were communicated and have not yet been remediated may be communicated, in writing, by referring to the previously issued written communication and the date of that communication. The written communication referred to is best made by the report release date, which is the date the auditor grants the entity permission to use the auditor's report in connection with the financial statements, but should be made no later than 60 days following the report release date.

5.80 Nothing precludes the auditor from communicating to management and those charged with governance other matters related to an entity's internal control, in accordance with paragraph .21 of AU section 325 (AICPA, *Professional Standards*). For example, the auditor may communicate the following:

- Matters the auditor believes to be of potential benefit to the entity, such as recommendations for operational or administrative efficiency, or for improving controls.
- Deficiencies that are not significant deficiencies or material weaknesses.

If other matters are communicated orally, the auditor should document the communication.

5.81 Exhibit B of AU section 325 (AICPA, *Professional Standards*) includes examples of circumstances that may be deficiencies, significant deficiencies, or material weaknesses.

5.82 AU section 325 (AICPA, *Professional Standards*) is not applicable if the auditor is engaged to examine the design and operating effectiveness of an entity's internal control over financial reporting that is integrated with an audit of the entity's financial statements under AT section 501, *An Examination of*

an Entity's Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements (AICPA, *Professional Standards*).

Considerations for Audits Performed in Accordance with PCAOB Standards

Paragraph 3 of AU section 325, *Communications About Control Deficiencies in an Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards), states that in evaluating whether a deficiency exists and whether deficiencies, either individually or in combination with other deficiencies, are material weaknesses, the auditor should follow the guidance in paragraphs 62–70 of PCAOB Auditing Standard No. 5.

Risk Assessment and the Design of Further Audit Procedures

5.83 As discussed in paragraphs 5.26–.27, risk assessment procedures allow the auditor to gather the information necessary to obtain an understanding of the entity and its environment including its internal control. This knowledge provides a basis for assessing the risks of material misstatement of the financial statements. These risk assessments are then used to design further audit procedures, such as tests of controls and substantive tests. This section provides guidance on assessing the risks of material misstatement and how to design further audit procedures that effectively respond to those risks.

Assessing the Risks of Material Misstatement

5.84 Paragraph .102 of AU section 314 states that the auditor should identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions, account balances, and disclosures.[13] For this purpose, the auditor should

a. identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and considering the classes of transactions, account balances, and disclosures in the financial statements;

b. relate the identified risks to what can go wrong at the relevant assertion level;

c. consider whether the risks are of a magnitude that could result in a material misstatement of the financial statements; and

d. consider the likelihood that the risks could result in a material misstatement of the financial statements.

5.85 Paragraph .03 of AU section 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*), states that in order to reduce audit risk to an acceptably low level, the auditor should determine overall responses to address the assessed risks of material misstatement at the financial statement level and should design and perform further audit procedures whose nature, timing, and extent are responsive to the assessed risks of material misstatement at the

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[13] This requirement provides a link between the auditor's consideration of fraud and the auditor's assessment of risk and the auditor's procedures in response to those assessed risks.

relevant assertion level.[14] (See paragraphs .04–.10 of AU section 318.) Paragraph .104 of AU section 314 states the auditor should determine whether the identified risks of material misstatement relate to specific relevant assertions related to classes of transactions, account balances, and disclosures, or whether they relate more pervasively to the financial statements taken as a whole and potentially affect many relevant assertions.

Identification of Significant Risks

5.86 Paragraph .110 of AU section 314 states that as part of the assessment of the risks of material misstatement, the auditor should determine which of the risks identified are, in the auditor's judgment, risks that require special audit consideration (such risks are defined as *significant risks*). One or more significant risks normally arise on most audits. Paragraph .45 of AU section 318 states that if the auditor plans to rely on the operating effectiveness of controls intended to mitigate the significant risks, the auditor should obtain audit evidence about the operating effectiveness of those controls from tests of controls performed in the current period. The greater the risks of material misstatement, the more audit evidence the auditor should obtain that controls are operating effectively. Accordingly, although the auditor should consider information obtained in prior audits in designing tests of controls to mitigate a significant risk, the auditor should not rely on audit evidence about the operating effectiveness of controls over such risks obtained in a prior audit, but instead should obtain audit evidence about the operating effectiveness of controls over such risks in the current period. Paragraph .54 of AU section 318 states that when the approach to significant risks consists only of substantive procedures, the audit procedures appropriate to address such significant risks consist of tests of details only, or a combination of tests of details and substantive analytical procedures. Refer to paragraphs .45 and .53–.54 of AU section 318 for further audit procedures pertaining to significant risks.

Designing and Performing Further Audit Procedures

5.87 AU section 318 establishes standards and provides guidance about implementing the third standard of field work, which states that the auditor must obtain sufficient appropriate audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit.

5.88 Paragraph .03 of AU section 318 states that in order to reduce audit risk to an acceptably low level, the auditor should determine overall responses to address the assessed risks of material misstatement at the financial statement level and should design and perform further audit procedures whose nature, timing, and extent are responsive to the assessed risks of material misstatement at the relevant assertion level. The overall responses and the nature, timing, and extent of the further audit procedures to be performed are matters for the professional judgment of the auditor.

Overall Responses

5.89 Paragraph .04 of AU section 318 states that the auditor's overall responses to address the assessed risks of material misstatement at the financial statement level may include emphasizing to the audit team the need

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[14] See footnote 13.

to maintain professional skepticism in gathering and evaluating audit evidence, assigning more experienced staff or those with specialized skills or using specialists, providing more supervision, or incorporating additional elements of unpredictability in the selection of further audit procedures to be performed. Additionally, the auditor may make general changes to the nature, timing, or extent of further audit procedures as an overall response, for example, performing substantive procedures at period end instead of at an interim date.

Further Audit Procedures

5.90 Further audit procedures provide important audit evidence to support an audit opinion. These procedures consist of tests of controls and substantive tests. Paragraph .07 of AU section 318 states the auditor should design and perform further audit procedures whose nature, timing, and extent are responsive to the assessed risks of material misstatement at the relevant assertion level.

5.91 Paragraph .08 of AU section 318 states, in part, that in some cases, the auditor may determine that performing only substantive procedures is appropriate for specific relevant assertions and risks. In those circumstances, the auditor may exclude the effect of controls from the relevant risk assessment. This may be because the auditor's risk assessment procedures have not identified any effective controls relevant to the assertion or because testing the operating effectiveness of controls would be inefficient. However, the auditor needs to be satisfied that performing only substantive procedures for the relevant assertions would be effective in reducing detection risk to an acceptably low level. The auditor often will determine that a combined audit approach using both tests of the operating effectiveness of controls and substantive procedures is an effective audit approach.

5.92 In accordance with paragraphs .23–.25 of AU section 318, the auditor should perform tests of controls when the auditor's risk assessment includes an expectation of the operating effectiveness of controls[15] or when substantive procedures alone do not provide sufficient appropriate audit evidence at the relevant assertion level. When, in accordance with paragraph .117 of AU section 314, the auditor has determined that it is not possible or practicable to reduce the detection risks at the relevant assertion level to an acceptably low level with audit evidence obtained only from substantive procedures, he or she should perform tests of controls to obtain audit evidence about their operating effectiveness. Tests of the operating effectiveness of controls are performed only on those controls that the auditor has determined are suitably designed to prevent or detect a material misstatement in a relevant assertion.

5.93 Testing the operating effectiveness of controls is different from obtaining audit evidence that controls have been implemented, as stated in paragraph .26 of AU section 318. When obtaining audit evidence of implementation by performing risk assessment procedures, the auditor should determine that the relevant controls exist and that the entity is using them. When performing tests of controls, the auditor should obtain audit evidence that controls operate effectively. This includes obtaining audit evidence about how controls were applied at relevant times during the period under audit, the

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[15] TIS section 8200.06, "The Meaning of Expectation of the Operating Effectiveness of Controls" (AICPA, *Technical Practice Aids*), states that the phrase *expectation of the operating effectiveness of controls* means that the auditor's understanding of the five components of internal control has enabled him or her to initially assess control risk at less than maximum; and the auditor's strategy contemplates a combined approach of designing and performing tests of controls and substantive procedures.

consistency that they were applied, and by whom or by what means they were applied. If substantially different controls were used at different times during the period under audit, the auditor should consider each separately. The auditor may determine that testing the operating effectiveness of controls at the same time as evaluating their design and obtaining audit evidence of their implementation is efficient.

5.94 Paragraph .27 of AU section 318 states that although some risk assessment procedures that the auditor performs to evaluate the design of controls and to determine that they have been implemented may not have been specifically designed as tests of controls, they may nevertheless provide audit evidence about the operating effectiveness of the controls and, consequently, serve as tests of controls. In such circumstances, the auditor should consider whether the audit evidence provided by those audit procedures is sufficient.

5.95 Paragraph .50 of AU section 318 states that substantive procedures are performed to detect material misstatements at the relevant assertion level, and include tests of details of classes of transactions, account balances, and disclosures and substantive analytical procedures. The auditor should plan and perform substantive procedures to be responsive to the related assessment of the risks of material misstatement.

5.96 Regardless of the assessed risks of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure, in accordance with paragraph .51 of AU section 318.

5.97 Paragraph .52 of AU section 318 states that the auditor's substantive procedures should include the following audit procedures related to the financial statement reporting process:

- Agreeing the financial statements, including their accompanying notes, to the underlying accounting records
- Examining material journal entries and other adjustments made during the course of preparing the financial statements

The nature and extent of the auditor's examination of journal entries and other adjustments depend on the nature and complexity of the entity's financial reporting system and the associated risks of material misstatement.

Evaluating Misstatements

5.98 Based on the results of substantive procedures, the auditor may identify misstatements in accounts or notes to the financial statements. Paragraph .42 of AU section 312 (AICPA, *Professional Standards*) states that auditors must accumulate all known and likely misstatements identified during the audit, other than those that the auditor believes are trivial and communicate them to the appropriate level of management. AU section 312 (AICPA, *Professional Standards*) further states that auditors must consider the effects, both individually and in the aggregate, of misstatements (known and likely) that are not corrected by the entity. For issuers, this consideration includes, among other things, the effect of misstatements related to prior periods.[16]

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[16] The SEC Staff Accounting Bulletin (SAB) No. 108, Topic 1N, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements,* provides guidance on the consideration of the effects of prior year misstatements in quantifying current year misstatements for the purpose of a materiality assessment. The SAB

5.99 AU section 312 (AICPA, *Professional Standards*) and AU section 326 establish standards and provide guidance on evaluating audit findings and audit evidence, respectively.

Audit Documentation—Audits Conducted in Accordance With GAAS

5.100 AU section 150 states in the third standard of field work that an auditor must obtain sufficient appropriate audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit.

5.101 AU section 326 defines *audit evidence* as all the information used by the auditor in arriving at the conclusions on which the audit opinion is based and includes the information contained in the accounting records underlying the financial statements and other information.

5.102 Paragraph .03 of AU section 339, *Audit Documentation* (AICPA, *Professional Standards*), states the auditor must prepare audit documentation in connection with each engagement in sufficient detail to provide a clear understanding of the work performed (including the nature, timing, extent, and results of audit procedures performed), the audit evidence obtained and its source, and the conclusions reached. Audit documentation

a. provides the principal support for the auditor's report that the auditor performed the audit in accordance with GAAS;[17] and

b. provides the principal support for the opinion expressed regarding the financial information or the assertion to the effect that an opinion cannot be expressed.

5.103 Paragraph .04 of AU section 339 states that audit documentation is an essential element of audit quality. Although documentation alone does not guarantee audit quality, the process of preparing sufficient and appropriate documentation contributes to the quality of an audit.[18,19]

(footnote continued)

points out that some registrants do not consider the effects of prior year errors on current year financial statements that allow the entity to report unadjusted (and improper) assets and liabilities. The SAB also notes that an immaterial error on the balance sheet could be material on the income statement.

[17] However, there is no intention to imply that the auditor would be precluded from supporting his or her report by other means in addition to audit documentation.

[18] A firm of independent auditors has a responsibility to adopt a system of quality control policies and procedures to provide the firm with reasonable assurance that its personnel comply with applicable professional standards, including generally accepted auditing standards, and the firm's standards of quality in conducting individual audit engagements. Review of audit documentation and discussions with engagement team members are among the procedures a firm performs when monitoring compliance with the quality control policies and procedures that it has established. The elements of quality control are identified in QC section 10B, *A Firm's System of Quality Control* (AICPA, *Professional Standards*). See also AU section 161, *The Relationship of Generally Accepted Auditing Standards to Quality Control Standards* (AICPA, *Professional Standards*).

[19] PCAOB Auditing Standard No. 7, *Engagement Quality Review* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), provides a framework for the engagement quality reviewer to objectively evaluate the significant judgments made and related conclusions reached by the engagement team in forming an overall conclusion about the engagement. PCAOB Auditing Standard No. 7 applies to all audit engagements and engagements to review interim financial information conducted pursuant to the standards of the PCAOB.

5.104 Paragraphs .05–.06 of AU section 339 states audit documentation is the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached. Audit documentation, also known as *working papers* or workpapers, may be recorded on paper or on electronic[20] or other media. When transferring or copying paper documentation to another media, the auditor should apply procedures to generate a copy that is faithful in form and content to the original paper document. Examples of audit documentation are audit programs, analyses, issues memoranda, summaries of significant findings or issues, letters of confirmation and representation, checklists, abstracts or copies of important documents, correspondence (including e-mail) concerning significant findings or issues, and schedules of work the auditor performed. Abstracts or copies of the entity's records (for example, significant and specific contracts and agreements) should be included as part of the audit documentation if they are needed to enable an experienced auditor to understand the work performed and conclusions reached. The audit documentation for a specific engagement is assembled in an audit file.

5.105 In addition to the requirements discussed previously, AU section 339 establishes further requirements about the content, ownership, and confidentiality of audit documentation. Moreover, appendix A of AU section 339 lists the audit documentation requirements contained in other areas of AICPA *Professional Standards*.

> *Consideration for Audits Conducted in Accordance with PCAOB Standards*
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> PCAOB Auditing Standard No. 3, *Audit Documentation* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), establishes general requirements for documentation the auditor should prepare and retain in connection with engagements conducted pursuant to the standards of the PCAOB. *Audit documentation* is the written record of the basis for the auditor's conclusions that provides the support for the auditor's representations, whether those representations are contained in the auditor's report or otherwise. Audit documentation also facilitates the planning, performance, and supervision of the engagement, and is the basis for the review of the quality of the work because it provides the reviewer with written documentation of the evidence supporting the auditor's significant conclusions. This standard provides specific audit document requirements, provides guidance on documentation of specific matters, and retention of and subsequent changes to audit documentation.

Processing of Transactions by Service Organizations

5.106 Paragraphs .06–.21 of AU section 324 (AICPA, *Professional Standards*)[21] establishes standards and provides guidance on the user auditor's consideration of the effect of a service organization on internal control of the user organization and availability of audit evidence. The user auditor should consider the discussion in paragraphs .06–.21 of AU section 324 (AICPA, *Professional Standards*) when obtaining an understanding of the entity and its environment, including its internal control and performing the audit of an

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[20] Interpretation No. 1, "Use of Electronic Confirmations," of AU section 330, *The Confirmation Process* (AICPA, *Professional Standards*, AU sec. 9330 par. .01–.08), states that secure and properly controlled electronic confirmations may be considered to be reliable audit evidence and discusses auditor considerations when using electronic confirmations.

[21] See footnotes 3 and †.

entity that uses a service organization to process its transactions (for example, using a mortgage banker to service mortgages).

> *Considerations for Audits Performed in Accordance with PCAOB standards*
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> Paragraph .01 of AU section 324 states that when performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs B17–B27 of appendix B of PCAOB Auditing Standard No. 5 regarding the use of service organizations.

Consideration of Fraud in a Financial Statement Audit[22]

5.107 AU section 316 (AICPA, *Professional Standards*) is the primary source of authoritative guidance about an auditor's responsibilities concerning the consideration of fraud in a financial statement audit. AU section 316 (AICPA, *Professional Standards*) establishes standards and provides guidance to auditors in fulfilling their responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud as stated in paragraph .02 of AU section 110, *Responsibilities and Functions of the Independent Auditor* (AICPA, *Professional Standards*).

> *Considerations for Audits Performed in Accordance with PCAOB standards*
>
> Paragraph .01 of AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards) states that when performing an integrated audit of financial statements and internal control over financial reporting refer to paragraphs 14–15 of PCAOB Auditing Standard No. 5 regarding fraud considerations, in addition to the fraud considerations set forth in AU section 316 (AICPA, *PCAOB Standards and Related Rules*, Interim Standards).

5.108 Paragraph .06 of AU section 316 (AICPA, *Professional Standards*) states that there are two types of misstatements relevant to the auditor's consideration of fraud in a financial statement audit:

- Misstatements arising from fraudulent financial reporting
- Misstatements arising from misappropriation of assets

5.109 Three conditions generally are present when fraud occurs according to paragraph .07 of AU section 316 (AICPA, *Professional Standards*). First, management or other employees have an *incentive* or are under *pressure*, which provides a reason to commit fraud. Second, circumstances exist—for example, the absence of controls, ineffective controls, or the ability of management to override controls—that provide an opportunity for a fraud to be perpetrated. Third, those involved are able to *rationalize* committing a fraudulent act.

5.110 *The importance of exercising professional skepticism.* Because of the characteristics of fraud, the auditor's exercise of professional skepticism is important when considering the risk of material misstatement due to fraud. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence. According to paragraph .13 of AU section

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[22] See footnote 16.

316 (AICPA, *Professional Standards*), the auditor should conduct the engagement with a mindset that recognizes the possibility that a material misstatement due to fraud could be present, regardless of any past experience with the entity and regardless of the auditor's belief about management's honesty and integrity. Furthermore, professional skepticism requires an ongoing questioning of whether the information and evidence obtained suggests that a material misstatement due to fraud has occurred.

5.111 *Discussion among engagement personnel regarding the risks of material misstatement due to fraud.*[23] Members of the audit team should discuss the potential for material misstatement due to fraud in accordance with the requirements of paragraphs .14–.18 of AU section 316 (AICPA, *Professional Standards*). The objective of this discussion is for members of the audit team to gain a better understanding of the potential for material misstatements of the financial statements resulting from fraud or error in the specific areas assigned to them, and to understand how the results of the audit procedures that they perform may affect other aspects of the audit, including the decisions about the nature, timing, and extent of further audit procedures. The discussion provides an opportunity for more experienced team members, including the auditor with final responsibility for the audit, to share their insights based on their knowledge of the entity and for the team members to exchange information about the business risks to which the entity is subject and about how and where the financial statements might be susceptible to material misstatement. As specified in AU section 316 (AICPA, *Professional Standards*), particular emphasis should be given to the susceptibility of the entity's financial statements to material misstatement due to fraud. In addition, the audit team should discuss critical issues, such as areas of significant audit risk; areas susceptible to management override of controls; unusual accounting procedures used by the client; important control systems; materiality at the financial statement level and at the account level; and how materiality will be used to determine the extent of testing. The discussion should also address application of GAAP to the entity's facts and circumstances and in light of the entity's accounting policies. Exhibit 5-1, "Fraud Risk Factors," which appears at the end of this chapter, contains a list of fraud risk factors that auditors may consider as part of their planning and audit procedures. The purpose is for audit team members to communicate and share information obtained throughout the audit that may affect the assessment of the risks of material misstatement due to fraud or error or the audit procedures performed to address the risks.

5.112 *Obtaining the information needed to identify the risks of material misstatement due to fraud.* Paragraph .19 of AU section 314 establishes requirements and provides guidance about how the auditor obtains an understanding of the entity and its environment, including its internal control. In performing that work, information may come to the auditor's attention that should be considered in identifying risks of material misstatement due to fraud. As part of this work, the auditor should perform the following procedures to obtain information that is used (as described in paragraphs .35–.42 of AU section 316 [AICPA, *Professional Standards*]) to identify the risks of material misstatement due to fraud:

a. Make inquiries of management and others within the entity to obtain their views about the risks of fraud and how they are addressed. (See

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[23] The brainstorming session to discuss the entity's susceptibility to material misstatements due to fraud could be held concurrently with the brainstorming session required under AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), to discuss the potential of the risk of material misstatement.

paragraphs .20–.27 of AU section 316 [AICPA, *Professional Standards*].)

b. Consider any unusual or unexpected relationships that have been identified in performing analytical procedures in planning the audit. (See paragraphs .28–.30 of AU section 316 [AICPA, *Professional Standards*].)

c. Consider whether one or more fraud risk factors exist. See the appendix in AU section 316 (AICPA, *Professional Standards*) and exhibit 5-1 at the end of this chapter.

d. Consider other information that may be helpful in the identification of risks of material misstatement due to fraud. (See paragraph .34 of AU section 316 [AICPA, *Professional Standards*].)

5.113 According to paragraph .05 of AU section 314 and as described in AU section 326, audit procedures to obtain the understanding of the entity and its environment, including its internal control, and assess the risks of material misstatement are referred to as *risk assessment procedures* because some of the information obtained by performing such procedures may be used by the auditor as audit evidence to support assessments of the risks of material misstatement. In addition, in performing risk assessment procedures, the auditor may obtain audit evidence about the relevant assertions related to classes of transactions, account balances, or disclosures and about the operating effectiveness of controls, even though such audit procedures were not specifically planned as substantive procedures or as tests of controls.

5.114 *Considering fraud risk factors.* As indicated in item (*c*) of paragraph 5.112 in this guide, the auditor may identify events or conditions that indicate incentives/pressures to perpetrate fraud, opportunities to carry out the fraud, or attitudes/rationalizations to justify a fraudulent action. Such events or conditions are referred to as *fraud risk factors*. Fraud risk factors do not necessarily indicate the existence of fraud; however, they often are present in circumstances where fraud exists.

5.115 AU section 316 (AICPA, *Professional Standards*) provides fraud risk factor examples that have been written to apply to most enterprises. Exhibit 5-1 at the end of this chapter contains a list of fraud risk factors specific to financial institutions. Remember that fraud risk factors are only one of several sources of information an auditor considers when identifying and assessing risks of material misstatement due to fraud.

5.116 *Identifying risks that may result in a material misstatement due to fraud.* In identifying risks of material misstatement due to fraud, it is helpful for the auditor to consider the information that has been gathered in accordance with the requirements of paragraphs .19–.34 of AU section 316 (AICPA, *Professional Standards*). Paragraphs .37–.39 of AU section 316 (AICPA, *Professional Standards*) state that the auditor's identification of fraud risks may be influenced by characteristics such as the size, complexity, and ownership attributes of the entity. In addition, the auditor should evaluate whether identified risks of material misstatement due to fraud can be related to specific financial-statement account balances or classes of transactions and related assertions, or whether they relate more pervasively to the financial statements as a whole. Certain accounts, classes of transactions, and assertions that have high inherent risk because they involve a high degree of management judgment and subjectivity also may present risks of material misstatement due to fraud because they are susceptible to manipulation by management.

5.117 *A presumption that improper revenue recognition is a fraud risk*. Paragraph .41 of AU section 316 (AICPA, *Professional Standards*) states that material misstatements due to fraudulent financial reporting often result from an overstatement of revenues (for example, through premature revenue recognition or recording fictitious revenues) or an understatement of revenues (for example, through improperly shifting revenues to a later period). Therefore, the auditor should ordinarily presume that there is a risk of material misstatement due to fraud relating to revenue recognition. (See paragraph .54 of AU section 316 (AICPA, *Professional Standards*) for examples of auditing procedures related to the risk of improper revenue recognition.[24])

5.118 *A consideration of the risk of management override of controls.* Even if specific risks of material misstatement due to fraud are not identified by the auditor, paragraph .42 of AU section 316 (AICPA, *Professional Standards*) states that there is a possibility that management override of controls could occur, and accordingly, the auditor should address that risk in accordance with paragraph .57 of AU section 316 (AICPA, *Professional Standards*) apart from any conclusions regarding the existence of more specifically identifiable risks. Specifically, the procedures described in paragraphs .58–.67 of AU section 316 (AICPA, *Professional Standards*) should be performed to further address the risk of management override of controls. These procedures include (*a*) examining journal entries and other adjustments for evidence of possible material misstatement due to fraud, (*b*) reviewing accounting estimates for biases that could result in material misstatement due to fraud, and (*c*) evaluating the business rationale for significant unusual transactions.

5.119 *Assessing the identified risks after taking into account an evaluation of the entity's programs and controls that address the risks.* Auditors must comply with the requirements of paragraphs .43–.45 of AU section 316 (AICPA, *Professional Standards*) concerning an entity's programs and controls that address identified risks of material misstatement due to fraud. The auditor should consider whether such programs and controls mitigate the identified risks of material misstatement due to fraud or whether specific control deficiencies exacerbate the risks. After the auditor has evaluated whether the entity's programs and controls have been suitably designed and placed in operation, the auditor should assess these risks taking into account that evaluation. This assessment should be considered when developing the auditor's response to the identified risks of material misstatement due to fraud.

5.120 *Responding to the results of the assessment.* Paragraphs .46–.67 of AU section 316 (AICPA, *Professional Standards*) provide guidance about an auditor's response to the results of the assessment of the risks of material misstatement due to fraud. Paragraph .48 of AU section 316 (AICPA, *Professional Standards*) states that the auditor responds to risks of material misstatement due to fraud in the following three ways:

a. A response that has an overall effect on how the audit is conducted—that is, a response involving more general considerations apart from the specific procedures otherwise planned. (See paragraph .50 of AU section 316 [AICPA, *Professional Standards*].)

b. A response to identified risks involving the nature, timing, and extent of the auditing procedures to be performed. (See paragraphs .51–.56 of AU section 316 [AICPA, *Professional Standards*].)

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[24] For a discussion of indicators of improper revenue recognition and common techniques for overstating revenue and illustrative audit procedures, see the AICPA Audit Guide *Auditing Revenue in Certain Industries*.

c. A response involving the performance of certain procedures to further address the risk of material misstatement due to fraud involving management override of controls, given the unpredictable ways that such a override could occur. (See paragraphs .57–.67 of AU section 316 [AICPA, *Professional Standards*].)

5.121 *Evaluating audit evidence.* Paragraphs .68–.78 of AU section 316 (AICPA, *Professional Standards*) provide requirements and guidance for evaluating audit evidence. The auditor should evaluate whether analytical procedures that were performed as substantive tests or in the overall review stage of the audit indicate a previously unrecognized risk of material misstatement due to fraud. The auditor also should consider whether responses to inquiries throughout the audit about analytical relationships have been vague or implausible, or have produced evidence that is inconsistent with other audit evidence accumulated during the audit.

5.122 Paragraph .74 of AU section 318 states the auditor should conclude whether sufficient appropriate audit evidence has been obtained to reduce to an appropriately low level the risks of material misstatement in the financial statements. In developing an opinion, the auditor should consider all relevant audit evidence, regardless of whether it appears to corroborate or to contradict the relevant assertions in the financial statements.

5.123 Paragraph .74 of AU section 316 (AICPA, *Professional Standards*) states at or near the completion of fieldwork, the auditor should evaluate whether the accumulated results of auditing procedures and other observations (for example, conditions and analytical relationships noted in paragraphs .69–.73 of AU section 316 [AICPA, *Professional Standards*]) affect the assessment of the risks of material misstatement due to fraud made earlier in the audit. This evaluation primarily is a qualitative matter based on the auditor's judgment. Such an evaluation may provide further insight about the risks of material misstatement due to fraud and whether there is a need to perform additional or different audit procedures. As part of this evaluation, the auditor with final responsibility for the audit should ascertain that there has been appropriate communication with the other audit team members throughout the audit regarding information or conditions indicative of risks of material misstatement due to fraud.

5.124 *Responding to misstatements that may be the result of fraud.* Paragraph .75 of AU section 316 (AICPA, *Professional Standards*) states, when audit test results identify misstatements in the financial statements, the auditor should consider whether such misstatements may be indicative of fraud. That determination affects the auditor's evaluation of materiality and the related responses necessary as a result of that evaluation. Furthermore, paragraph .76 of AU section 316 (AICPA, *Professional Standards*) states if the auditor believes that misstatements are or may be the result of fraud, but the effect of the misstatements is not material to the financial statements, the auditor, nevertheless, should evaluate the implications, especially those dealing with the organizational position of the person(s) involved. For example, fraud involving misappropriations of cash from a small petty cash fund normally would be of little significance to the auditor in assessing the risk of material misstatement due to fraud because both the manner of operating the fund and its size would tend to establish a limit on the amount of potential loss, and the custodianship of such funds normally is entrusted to a nonmanagement employee. Conversely, if the matter involves higher level management, even though the amount itself is not material to the financial statements, it may be indicative of a more

pervasive problem, for example, implications about the integrity of management. In such circumstances, the auditor should reevaluate the assessment of the risk of material misstatement due to fraud and its resulting impact on (*a*) the nature, timing, and extent of the tests of balances or transactions and (*b*) the assessment of the effectiveness of controls if control risk was assessed below the maximum.

5.125 Paragraph .77 of AU section 316 (AICPA, *Professional Standards*) states if the auditor believes that the misstatement is or may be the result of fraud, and either has determined that the effect could be material to the financial statements or has been unable to evaluate whether the effect is material, the auditor should

a. attempt to obtain additional audit evidence to determine whether material fraud has occurred or is likely to have occurred, and, if so, its effect on the financial statements and the auditor's report thereon;[25]

b. consider the implications for other aspects of the audit (see paragraph .76 of AU section 316 [AICPA, *Professional Standards*]);

c. discuss the matter and the approach for further investigation with an appropriate level of management that is at least one level above those involved, and with senior management and those charged with governance;[26] and

d. if appropriate, suggest that the client consult with legal counsel.

5.126 Paragraph .78 of AU section 316 (AICPA, *Professional Standards*) states the auditor's consideration of the risks of material misstatement and the results of audit tests may indicate such a significant risk of material misstatement due to fraud that the auditor should consider withdrawing from the engagement and communicating the reasons for withdrawal to those charged with governance. The auditor may wish to consult with legal counsel when considering withdrawal from an engagement.

5.127 *Communicating about possible fraud to management, those charged with governance, and others.* Paragraph .79 of AU section 316 (AICPA, *Professional Standards*) states whenever the auditor has determined that there is evidence that fraud may exist, that matter should be brought to the attention of an appropriate level of management. This is appropriate even if the matter might be considered inconsequential, such as a minor defalcation by an employee at a low level in the entity's organization. Fraud involving senior management and fraud (whether caused by senior management or other employees) that causes a material misstatement of the financial statements should be reported directly to those charged with governance. See paragraphs .79–.82 of AU section 316 (AICPA, *Professional Standards*) for further requirements and guidance about communications with management, those charged with governance, and others.

5.128 *Documenting the auditor's consideration of fraud.* Paragraph .83 of AU section 316 (AICPA, *Professional Standards*) establishes requirements and provides guidance on certain items and events to be documented by the auditor.

5.129 *Internal audit considerations.* AU section 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*

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[25] AU section 508 establishes requirements and provides guidance for auditors regarding reports issued in connection with audits of financial statements.

[26] If the auditor believes senior management may be involved, discussion of the matter directly with the those charged with governance may be appropriate.

(AICPA, *Professional Standards*), establishes standards and provides guidance on the auditor's consideration of the existence of an internal audit function in determining the nature, timing, and extent of auditing procedures to be performed, and on using internal auditors to provide direct assistance to the auditor in an audit of financial statements performed in accordance with GAAS.

> *Considerations for Audits Performed in Accordance with PCAOB Standards*
>
> Paragraph .01 of AU section 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards), states that when performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 16–19 of PCAOB Auditing Standard No. 5 for discussion on using the work of others to alter the nature, timing, and extent of the work that otherwise would have been performed to test controls.

Compliance With Laws and Regulations

5.130 Paragraph .01 of AU section 314 states the auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. In performing an audit of financial statements, the auditor considers government regulations in light of how they might affect the financial statement assertions.

5.131 AU section 317, *Illegal Acts by Clients* (AICPA, *Professional Standards*), prescribes the nature and extent of the independent auditor's consideration of the possibility of illegal acts by a client in an audit of financial statements in accordance with GAAS.

5.132 According to paragraph .02 of AU section 317, the term *illegal acts* refers to violations of laws or governmental regulations. Paragraphs .04–.05 of AU section 317 state that illegal acts vary considerably in their relation to the financial statements. The auditor's responsibility to detect and report misstatements resulting from illegal acts is dependent on the relationship between the law or regulation that is violated and the financial statements.

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

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

5.134 Other laws and regulations relate more to an institution's operating aspects than to its financial and accounting aspects, and their effect on the financial statements is indirect. Examples of such laws and regulations include those related to securities trading, occupational safety and health, food and drug administration, environmental protection, equal employment opportunities, money laundering, and antitrust violations. Another example of such laws and regulations are those that require institutions to report certain financial transactions to governmental agencies. In accordance with paragraph .06 of AU section 317, the indirect effect of violations of such laws and regulations is

normally the result of the need to disclose a contingent liability because of the allegation or determination of illegality.

5.135 The ultimate responsibility for compliance with laws and regulations rests with management of the institution. According to paragraph .07 of AU section 317, the auditor should be aware of the possibility that such illegal acts may have occurred. According to paragraph .08 of AU section 317, procedures applied for the purpose of forming an opinion on the financial statements may bring possible illegal acts to the auditor's attention. For example, such procedures include reading minutes; inquiring of the client's management and legal counsel concerning litigation, claims, and assessments; performing substantive tests of details of transactions or balances. The auditor should make inquiries of management concerning the client's compliance with laws and regulations. Normally, an audit in accordance with GAAS does not include audit procedures specifically designed to detect illegal acts.

Going-Concern Considerations

5.136 AU section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*), establishes requirements and provides guidance to auditors in evaluating—as part of every financial statement audit—whether there is substantial doubt about the ability of the entity to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited. The auditor's evaluation of an institution's ability to continue as a going concern may be one of the most complex and important portions of the audit. This section describes the unique issues that an auditor may encounter in evaluating an institution's ability to continue as a going concern.

5.137 Financial institutions operate in a highly regulated environment. As a result, laws and regulations can have a significant effect on their operations. The enactment of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 and the FDIC Improvement Act of 1991 dramatically changed the regulatory environment in the banking and thrift industries and imposed new regulatory capital requirements that are far more stringent than previous requirements. Chapter 1 includes a discussion of regulatory capital requirements for banks and savings institutions and such requirements for credit unions are discussed in chapter 2.

5.138 In accordance with paragraph .03 of AU section 341, the auditor should consider whether there is substantial doubt about an institution's ability to continue as a going concern for a reasonable period of time in the following manner:

a. The auditor considers whether the results of procedures performed in planning, gathering audit evidence relative to the various audit objectives, and completing the audit identify conditions and events that, when considered in the aggregate, indicate there could be substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. It may be necessary to obtain additional information about such conditions and events, as well as the appropriate audit evidence to support information that mitigates the auditor's doubt.

b. If the previous considerations lead the auditor to believe that substantial doubt exists about the entity's ability to continue as a going concern for a reasonable period of time, the auditor should obtain

information about management's plans intended to mitigate the adverse effects of the conditions or events that gave rise to the doubt and assess the likelihood that such plans can be effectively implemented.

c. After evaluating management's plans, the auditor concludes whether he or she has substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. If the auditor concludes there is substantial doubt, he should (i) consider the adequacy of disclosure about the entity's possible inability to continue as a going concern for a reasonable period of time, and (ii) include an explanatory paragraph (following the opinion paragraph) in his audit report to reflect his conclusion. If the auditor concludes that substantial doubt does not exist, he or she should consider the need for disclosure.

5.139 Paragraph .05 of AU section 341 states that it is not necessary to design audit procedures solely to identify conditions and events that, when considered in the aggregate, indicate there could be substantial doubt about the ability of an entity to continue as a going concern for a reasonable period of time. The results of auditing procedures designed and performed to achieve other audit objectives should be sufficient for that purpose. The following are examples of procedures normally performed in audits of the financial statements of banks and savings institutions that may identify such conditions and events:

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

5.140 In performing such audit procedures as noted previously, paragraph .06 of AU section 341 states that the auditor may identify information about certain conditions or events that, when considered in the aggregate, indicate that there could be substantial doubt about the institution's ability to continue as a going concern for a reasonable period of time. The significance of such conditions and events will depend on the circumstances, and some may have significance only when viewed in conjunction with others. The following are examples of such conditions and events that may be encountered in audits of financial institutions:

- Recurring operating losses
- Indications of strained liquidity

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

5.141 Paragraph .10 of AU section 341 states that if, after considering management's plans, the auditor concludes that there is substantial doubt about the institution's ability to continue as a going concern for a reasonable period of time, the auditor should consider the possible effects on the financial statements and the adequacy of the related disclosures. Some of the information that might be disclosed includes

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

5.142 Paragraph .12 of AU section 341 states, if, after considering identified conditions and events and management's plans, the auditor concludes that substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains, the audit report should include an explanatory paragraph (following the opinion paragraph) to reflect that conclusion.

5.143 The auditor's decision about whether modification of the standard report is appropriate may depend also on

- the institution's existing regulatory-capital position;
- the likelihood that the institution's regulatory-capital position will improve or deteriorate within the next 12 months;
- whether the plan has been accepted by regulatory authorities; and
- the auditor's assessment of the institution's ability to achieve its capital plan, if any.

5.144 Chapter 23 of this guide discusses circumstances that the auditor might disclaim an opinion on.

5.145 Paragraph .11 of AU section 341 states the auditor's consideration of disclosure should include the possible effects of such conditions and events, and any mitigating factors, including management's plans. The auditor may have to communicate with the regulator to assist with the auditor's assessment. (Refer to chapter 1 for a discussion of necessary communications with regulators.) Chapter 23 includes an illustration of a report that includes such an explanatory paragraph.

5.146 Paragraph .18 of AU section 341 states that in connection with the guidance stated previously, the auditor should document all of the following:

- The conditions or events that led him or her to believe that there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time.
- The elements of management's plans that the auditor considered to be particularly significant to overcoming the adverse effects of the conditions or events.
- The auditing procedures performed and evidence obtained to evaluate the significant elements of management's plans.
- The auditor's conclusion as to whether substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains or has been alleviated. If substantial doubt remains, the auditor also should document the possible effects of the conditions or events on the financial statements and the adequacy of the related disclosures. If substantial doubt is alleviated, the auditor also should document the conclusion as to the need for disclosure of the principal conditions and events that initially caused him or her to believe there was substantial doubt.
- The auditor's conclusion as to whether he or she should include an explanatory paragraph in the audit report. If disclosures with respect to an entity's ability to continue as a going concern are inadequate, the auditor also should document the conclusions as to whether to express a qualified or adverse opinion for the resultant departure from GAAP.

Client Representations

5.147 AU section 333, *Management Representations* (AICPA, *Professional Standards*), establishes a requirement that the auditor obtain written representations from management as a part of an audit of financial statements performed in accordance with GAAS and provides guidance concerning the representations to be obtained. Such representations are part of the audit evidence the auditor obtains but are not a substitute for the application of auditing procedures. The auditor obtains written representations from management to complement other auditing procedures.

5.148 Paragraph .05 of AU section 333 (AICPA, *Professional Standards*) states that written representations from management should be obtained for all financial statements and periods covered by the auditor's report. The specific written representations to be obtained depend on the circumstances of the engagement and the nature and basis of the presentation of the financial statements. Paragraph .06 of AU section 333 (AICPA, *Professional Standards*) lists matters ordinarily included in management's representation letter. Additional representations specific to banks and savings institutions, credit unions, or both that may be obtained include the following:

- All regulatory examination reports, supervisory correspondence, and similar materials from applicable regulatory agencies (particularly communications concerning supervisory actions or noncompliance with or deficiencies in the rules and regulations or supervisory actions) have been provided to the auditor.

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

5.149 Paragraph .08 of AU section 333 (AICPA, *Professional Standards*) states that management's representations may be limited to matters that are considered either individually or collectively material to the financial statements, provided management and the auditor have reached an understanding on materiality for this purpose. Paragraph .13 of AU section 333 (AICPA, *Professional Standards*) states that management's refusal to furnish written representations constitutes a limitation on the scope of the audit sufficient to preclude an unqualified opinion and is ordinarily sufficient to cause an auditor to disclaim an opinion or withdraw from the engagement.

5.150 Paragraph .09 of AU section 333 (AICPA, *Professional Standards*) states that written representations should be addressed to the auditor. Because the auditor is concerned with events that occurred through the date of his or her report that may require adjustment or disclosure, the representations should be made as of the date of the auditor's report. The letter should be signed by those members of management with overall responsibility for financial and operating matters whom the auditor believes are responsible for and knowledgeable about, directly or through others in the organization, the matters

covered by the representations. Normally this includes the chief executive officer and the chief financial officer, among others.

Considerations for Audits Performed in Accordance with PCAOB standards

Paragraph .05 of AU section 333, *Management Representations* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards), states when performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 75–77 of PCAOB Auditing Standard No. 5 for additional required written representations to be obtained from management.

Information Other Than Financial Statements[#]

5.151 An institution may publish various documents that contain information in addition to audited financial statements and the auditor's report thereon. AU section 550A, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*), establishes standards and provides guidance for the auditors and clarifies that an auditor may issue a report providing an opinion, in relation to the basic financial statements taken as a whole, on supplementary information and other information that has been subjected to the auditing procedures applied in the audit of those basic financial statements.

5.152 In some circumstances, an auditor submits to the client or others a document that contains information in addition to the client's basic financial statements and the auditor's report thereon. AU section 551A, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*), establishes standards and provides guidance on the form and content of reporting when an auditor submits to his client or to others a document that contains information in addition to the client's basic financial statements and the auditor's report thereon.

5.153 AU section 558A, *Required Supplementary Information* (AICPA, *Professional Standards*), states that FASB, the Governmental Accounting Standards Board (GASB), and the Federal Accounting Standards Advisory Board (FASAB) develop standards for financial reporting, including standards for financial statements and for certain other information supplementary to financial statements. This section provides the auditor with guidance on the nature of procedures to be applied to supplementary information required by FASB, GASB, or the FASAB and describes the circumstances that would require the auditor to report such information.

[#] In February 2010, the ASB issued SAS No. 118, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, AU sec. 550), SAS No. 119, *Supplementary Information in Relation to the Financial Statements as a Whole* (AICPA, *Professional Standards*, AU sec. 551), and SAS No. 120, *Required Supplementary Information* (AICPA, *Professional Standards*, AU sec. 558). These standards amend or supersede AU section 550A, *Other Information in Documents Containing Audited Financial Statements*, AU section 551A, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*, and AU section 558A, *Required Supplementary Information* (AICPA, *Professional Standards*), respectively. Collectively, these statements address the auditor's responsibilities with respect to information that is required by a designated standard setter (for example, FASB, Governmental Accounting Standards Board, Federal Accounting Standards Advisory Board, and the IASB) to accompany an entity's basic financial statements and supplementary information that is presented outside the basic financial statements. The effective date of the SASs is for audits of financial statements for periods beginning on or after December 15, 2010, and early application is permitted.

Certain Financial Reporting Matters

Disclosures of Certain Significant Risks and Uncertainties

5.154 FASB ASC 275-10-50-1[27] requires institutions to make disclosures in their financial statements about the risks and uncertainties existing as of the date of those statements in the following areas:

a. The nature of their operations

b. The use of estimates in the preparation of their financial statements

c. Certain significant estimates

d. Current vulnerability due to certain concentrations

5.155 An illustration of the application of these disclosure requirements by a bank or savings institution follows:

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

5.156 The application of these disclosure requirements by a bank or savings institution is discussed and illustrated in the following paragraphs.

Certain Significant Estimates

5.157 Paragraphs 7–9 of FASB ASC 275-10-50 require disclosure regarding estimates used in the determination of the carrying amounts of assets or liabilities or in disclosure of gain or loss contingencies, as described in the following. Disclosure regarding an estimate should be made when known information available before the financial statements are issued or are available to be issued (as discussed in FASB ASC 855-10-25) indicates that both of the following criteria are met:

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

b. The effect of the change would be material to the financial statements.

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[27] See also paragraphs 1–2 of FASB ASC 825-10-55 for a discussion of terms of certain loan products that may increase a reporting entity's exposure to credit risk and thereby may result in a concentration of credit risk, either as an individual product type or as a group of products with similar features. An entity should provide the disclosures required by FASB ASC 825-10-50 for products that are determined to represent a concentration of credit risk.

5.158 The disclosure should indicate the nature of the uncertainty and include an indication that it is at least reasonably possible that a change in the estimate will occur in the near term. If the estimate involves a loss contingency covered by FASB ASC 450-20, the disclosure should also include an estimate of the possible loss or range of loss, or state that such an estimate cannot be made.[28]

5.159 Following is an illustrative disclosure about the allowance for loan losses when no uncertainties meet the disclosure criteria established in FASB ASC 275-10-50-8 and FASB ASC 450-20-50-3.

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

5.160 The following illustrates a paragraph that might be added to the illustrative disclosure in paragraph 5.159 to disclose an uncertainty that meets the disclosure criteria of FASB ASC 275-10-50-8, is a loss contingency covered by FASB ASC 450-20, and affects the estimate of loan losses for only some portion of the institution's loan portfolio:

> Three of the Institution's seven branches are in communities that were flooded in late 200X. These branches made loans to individuals and businesses affected by the flooding and the Institution considered the flood's effect in determining the adequacy of the allowance for loan losses. No estimate can be made of a range of amounts of loss that are reasonably possible with respect to that event.[29]

5.161 The following illustrates a paragraph that might be added to the illustration in paragraph 5.159 to disclose an uncertainty that meets the

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[28] FASB ASC 450-20-50-3 requires reporting entities to disclose certain contingencies, if there is at least a reasonable possibility that a loss or an additional loss may have been incurred and either of the following conditions exist:

a. An accrual is not made for a loss contingency because any of the conditions in FASB ASC 450-20-25-2 are not met.

b. An exposure to loss exists in excess of the amount accrued pursuant to the provisions of FASB ASC 450-20-30-1.

As stated in FASB ASC 450-20-50-4, the disclosure should include both of the following:

a. The nature of the contingency.

b. An estimate of the possible loss or range of loss or a statement that such an estimate cannot be made.

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

disclosure criteria of FASB ASC 275-10-50-8 and is a loss contingency covered by FASB ASC 450-20:

> The Institution lends primarily to individuals employed at ABC Air Force Base and businesses local to the base. On December 19, 20X3, the President of the United States ratified a plan that includes the closing of the base effective November 20X4. It is reasonably possible that a change in estimated loan losses will occur in the near term. No estimate can be made of a range of amounts of loss that are reasonably possible with respect to the base closing.

5.162 FASB ASC 275-10-50-15 gives examples of assets and liabilities and related revenues and expenses, and of disclosure of gain or loss contingencies included in financial statements that, based on facts and circumstances existing at the date of the financial statements, may be based on estimates that are particularly sensitive to change in the near term.

5.163 Besides valuation allowances for loans, examples of similar estimates often included in banks', savings institutions', and credit unions' financial statements include the following:

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

5.164 For example, during 20X5, DEF Bank evaluated the profitability of its branch operations. DEF Bank determined that it will significantly change the extent or manner in which it uses a group of long-lived assets related to six of its branches. In applying FASB ASC 360, *Property, Plant, and Equipment*, DEF Bank determined that the sum of the estimated future cash flows (cash inflows less associated cash outflows) that are directly associated with and that are expected to arise as a direct result of the use and eventual disposition of the asset group, excluding interest charges, exceeds the carrying amount of the long-lived asset group. In addition, the carrying amount of the asset group does not exceed its fair value. Thus, an impairment loss has not been recognized under FASB ASC 360. The significant change in the extent or manner in which the assets are used, however, indicates that the estimate associated with the carrying amounts of those assets may be particularly sensitive in the near term.[30] Following is an illustrative disclosure.

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

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[30] FASB ASC 360-10-35-21 requires that a long-lived asset (asset group) be tested for recoverability whenever events or changes in circumstances indicate that its carrying amount may not be recoverable. A significant adverse change in the extent or manner in which a long-lived asset (asset group) is being used or in its physical condition is an example of such an event or change in circumstances.

Current Vulnerability Due to Certain Concentrations

5.165 FASB ASC 275-10-50-16 requires institutions to disclose the concentrations described in FASB ASC 275-10-50-18 if, based on information known to management before the financial statements are issued or are available to be issued, all of the following criteria are met:

a. The concentration exists at the date of the financial statements

b. The concentration makes the institution vulnerable to the risk of a near-term severe impact

c. It is at least reasonably possible that the events that could cause the severe impact will occur in the near term

5.166 FASB ASC 275, *Risks and Uncertainties*, does not address concentrations of financial instruments. However, as discussed in chapter 7, chapter 8, "Loans," and chapter 18, and elsewhere in this guide, FASB ASC 825, *Financial Instruments*, includes the disclosure provisions about concentrations of credit risk.[31]

5.167 The following concentrations described in FASB ASC 275-10-50-18 require disclosure if they meet the criteria of FASB ASC 275-10-50-16:

a. Concentrations in the volume of business transacted with a particular customer, supplier, lender, grantor, or contributor

b. Concentrations in revenue from particular products, services, or fund-raising events

c. Concentrations in the available sources of supply of materials, labor, or services, or of licenses or other rights used in the entity's operations

d. Concentrations in the market or geographic area in which an entity conducts its operations

5.168 Examples of concentrations that may fall in one or more of these categories and that may exist at certain financial institutions include

- sale of a substantial portion of or all receivables or loan products to a single customer;
- loss of approved status as a seller to or servicer for a third party;
- concentration of revenue from issuances involving a third-party guarantee program;
- concentration of revenue from mortgage banking activities; and
- in the case of a credit union, membership in the institution is concentrated with employees of a specific industry or in a region.

5.169 For example, assume a significant portion of GHI Institution's net income is from sales of originated loans. In 20X5, GHI Institution originated $800 million of loans. GHI Institution sold the loans and servicing rights to a substantial portion of these loans to a single servicer, TCB. TCB has historically purchased a substantial portion of the loans and servicing originated by GHI Institution. Following is an illustrative disclosure:

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

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[31] See footnote 28.

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

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

Segment Reporting

5.171 FASB ASC 280, *Segment Reporting*, provides guidance to public business entities on how to report certain information about operating segments in complete sets of financial statements of the public entity and in condensed financial statements of interim periods issued to shareholders. Refer to FASB ASC 280 for more discussion and detail regarding the statement's requirements.

Regulation and Supervision of Depository Institutions

Introduction

5.172 Laws and their implementing regulations affect the areas and ways in which certain financial institutions operate while creating standards with which those institutions must comply. Some laws and regulations directly address the responsibilities of auditors.[32]

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

5.174 Auditors might consider the effect regulations have on various engagements:

a. Acceptance of engagements in the affected industry

b. Planning activities (that is, development of the expected conduct and scope of an engagement)

c. Responsibility for detection of errors and irregularities

d. Evaluation of contingent liabilities and related disclosures

e. Consideration of an institution's ability to continue as a going concern

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

5.175 AU section 314 indicates that auditors should consider matters affecting the industry in which the entity operates, such as government regulations. In that regard, it is helpful for auditors to be familiar with the nature and purpose of regulatory examinations—including the differences and relationship between examinations and financial statement audits.

5.176 Finally, an understanding of the regulatory environment in which these institutions operate is necessary to complement the auditor's knowledge of existing regulatory requirements. Because the regulatory environment is continually changing, the auditor might consider monitoring relevant regulatory changes and consider their implications in the audit process.

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

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

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

5.180 In addition to the specific regulatory matters outlined in subsequent chapters, the three aspects of the regulatory process that are particularly important to auditors are rule making, examinations, and enforcement.

Rule Making

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

5.182 Discussions of specific regulatory matters found throughout this guide should not be substituted for a complete reading of related regulations, rulings, or other documents where appropriate. It is important for auditors to keep apprised of recent changes in regulations, as the regulatory environment is constantly changing.

Examinations

5.183 As used in this guide, the term *audit* refers to an audit performed by an auditor for the purpose of expressing an opinion on an institution's financial statements, unless the context in which the term is used clearly indicates that the reference is to an internal audit. The term *examination* generally refers to an examination made by a regulatory authority. There are several types of regulatory examinations, including a Safety and Soundness Examination, an Information Systems Examination, a Trust Examination and a Compliance Examination. These examinations may be combined or performed separately. The purpose of the regulatory examination is to determine the safety and soundness of an institution. The term *examiner* as used in this guide means those individuals—acting on behalf of a regulatory agency—responsible for supervising the performance or preparation of reports of examination and, when appropriate, supervisory personnel at the district and national level.

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

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

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

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

5.187 An examination generally begins with a review of various background material and information, including practices, policies or procedures established by an institution. The examiner compares these practices, policies, or procedures to regulatory and supervisory requirements and assesses the institution's adherence to sound fundamental principles in its day-to-day operations. Any additional detailed procedures considered necessary are then

applied. A written report of procedures and findings is then prepared by the examiner. The relationship between the work of the examiner and that of the auditor is further discussed in the following paragraph.

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

Enforcement

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

- ordering an institution to cease and desist from certain practices or violations;
- removing an officer or prohibiting an officer from participating in the affairs of the institution or the industry;
- assessing civil money penalties; and
- terminating insurance of an institution's deposits.

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

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

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

unsafe or *unsound* is not defined in any law or regulation, the potential liability of institution-affiliated parties is great.

5.193 The FDI Act also authorizes the agencies that regulate banks and savings institutions—on a showing of good cause—to remove, suspend, or bar an auditor from performing engagements required under the FDI Act.

5.194 Due to the passage of Credit Union Membership Access Act of 1998 (CUMAA) in 1998, the NCUA adopted stiffer net worth requirements and prompt corrective action regulations. Practitioners should understand these regulations and their effect on the credit union.

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

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

Planning

5.197 AU section 314 establishes standards and provides guidance about how auditors obtain a sufficient understanding of the entity and its environment, including its internal control. The auditor should obtain knowledge about regulatory matters and developments as part of the understanding of an institution's business. The auditor might also consider the results of regulatory examinations, as discussed previously.

Detection of Errors and Fraud

5.198 AU section 316 (AICPA, *Professional Standards*) establishes standards and provides guidance regarding the auditor's responsibilities to plan and perform the audit to obtain reasonable assurance as to whether the financial statements are free of material misstatement whether caused by error or fraud. Noncompliance with laws and regulations (for example, noncompliance with regulatory capital requirements) is one indicator of higher risk that is especially relevant in the industry. Events of noncompliance are often described in

- regulatory reports; and
- cease-and-desist orders or other regulatory actions, whether formal or informal.

5.199 The auditor has similar responsibility for detecting misstatements resulting from illegal acts having a direct and material effect on the determination of financial statement amounts. AU section 317 defines *illegal acts* as violations of laws or governmental regulations and explains the auditor's responsibilities.

Evaluation of Contingent Liabilities and Related Disclosures

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

Going-Concern Considerations

5.201 Paragraphs 5.136–.146 address going-concern considerations. In addition to the matters discussed in those paragraphs, the auditor's consideration might include regulatory matters such as the following:

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

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

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

Regulatory Reporting Matters—Interpretation and Reporting Related to U.S. GAAP

5.203 General purpose financial statements are prepared in accordance with U.S. GAAP. Every national bank, state member bank, and insured state nonmember bank is required to file FFIEC call reports. Every national and state chartered saving and loan association is required to file a TFR.[||] Every federally insured credit union is required to file the NCUA 5300 call report. Call reports (for example, FFIEC and NCUA) and TFR (Regulatory Reports) present an institution's financial condition and results of operations on a consolidated

[||] See footnote || in paragraph 5.41.

basis in accordance with U.S. GAAP. These reports are used by regulators as a basis for supervisory action, a source of statistical information, and other such purposes. In 1997, the banking regulators adopted instructions for these reports that follow U.S. GAAP.

5.204 FDI Act Section 37(a)(2) requires that reports and other regulatory filings for banks and savings institutions follow accounting principles that are uniform and consistent with U.S. GAAP. Regulatory reporting topics noted herein are consistent with acceptable practices under U.S. GAAP. The call report and TFR[||] instructions explain certain specific reporting guidance in greater detail. Information may often be found in the appropriate entries in the "Glossary" section of the call report or in the TFR instructions or, in more detail, in the U.S. GAAP standards. Financial institutions are encouraged to discuss specific events and transactions not covered by U.S. GAAP or the guidance in the regulatory report instructions with their primary supervisory agency for more technical detail on the application of the U.S. GAAP accounting standards.

5.205 Appendix B, "Regulatory Reporting Matters—Interpretation and Reporting related to U.S. GAAP," serves as an aid in specific selected areas and is not intended to be a comprehensive discussion of the principles of bank accounting or reporting.

5.206 For financial institutions, the allowance for loan and lease losses (ALLL) is an area that requires judgment and is a focus of auditors and examiners. At the same time, the *Interagency Policy Statement on the Allowance for Loan and Lease Losses*, dated December 13, 2006, emphasizes that the ALLL should be consistent with GAAP. This policy statement reminds institutions that the ALLL generally should not be based solely on a "standard percentage" of loans. To that end, the policy statement no longer references standardized loss estimates for classified loans. Banks should review the "Allowance for Loan and Lease Losses" section of glossary of the call report instructions, and the interagency policy statement on the ALLL.

5.207 Bank examiners will review the reasonableness of the range and management's best estimate within the range. The agencies believe that an ALLL established in accordance with the December 13, 2006, *Interagency Policy Statement on the Allowance for Loan and Lease Losses* and the *Interagency Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions*, issued July 2001 (2001 Policy Statement) as applicable, falls within the range of acceptable estimates determined in accordance with GAAP. The guidance in the 2001 Policy Statement was substantially adopted by the NCUA through its Interpretive Ruling and Policy Statement 02-3, *Allowance for Loan and Lease Losses Methodologies and Documentation for Federally-Insured Credit Unions*, in May 2002.

Auditor and Examiner Relationship

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

5.209 The primary objective of communicating with examiners is to ensure that auditors consider competent audit evidence produced by examiners before expressing an opinion on audited financial statements. In areas such as

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[||] See footnote || in paragraph 5.41.

the adequacy of credit loss allowances and violations of laws or regulations, for example, information known to or judgments made by examiners generally should be made known to management and the auditor before financial statements are issued or an audit opinion is rendered. Such communication will minimize the possibility that a regulatory agency will subsequently require restatement—based on the examiner's additional knowledge or different judgment—of call reports and TFRs[||] and affect the general purpose financial statements, on which the auditor has already expressed an opinion, dated during or subsequent to the period in which a regulatory examination was being conducted.

5.210 FDI Act Section 36(h) requires that each bank and savings institution provide its auditor with copies of the institution's most recent call report and examination report (see 12 CFR Part 363). According to regulations, the institution must also provide the auditor with any of the following documents related to the period covered by the engagement:

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

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

5.211 The auditor might consider reviewing communications from examiners and, when appropriate, make inquiries of examiners. Specifically, the auditor could

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

b. review the reports of examination and related correspondence between examiners and the institution during the period under audit and through the date of the auditor's opinion;

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

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

5.212 The auditor's attendance at other meetings between examiners and representatives of the institution is based on prior approval by the regulatory agency.

5.213 Auditors may request a meeting with the appropriate regulatory representatives to inquire about supervisory matters relevant to the client institution. The management of the institution would generally be present at such a meeting, and matters discussed would generally be limited to findings already presented to management. Federal regulatory policy also permits meetings between examiners and auditors in the absence of the institution's

[||] See footnote || in paragraph 5.41.

management.[33] In addition, the OTS has established a policy that generally makes OTS examination working papers available for review.[34]

5.214 Management refusal to furnish access to reports or correspondence, or to permit the auditor to communicate with the examiner, would ordinarily be a limitation on the scope of a financial statement audit sufficient to preclude an opinion. Refusal by an examiner to communicate with the auditor may create the same scope limitation, depending on the auditor's assessment of the circumstances. Paragraphs .22–.26 of AU section 508 (AICPA, *Professional Standards*) establish standards and provide additional guidance. (For a detailed discussion on reports issued under the guidance of AU section 508 [AICPA, *Professional Standards*] and related PCAOB requirements when performing integrated audits see chapter 23 of this guide.)

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

5.216 Examiners and others may, from time to time, request auditors of financial statements of banks and savings institutions to provide access to working papers and audit documentation. The FFIEC's *Interagency Policy Statement on External Auditing Programs for Banks and Savings Associations* states that the independent public auditor or other auditor of an institution should agree in the engagement letter to grant examiners access to all the auditor's working papers and other material pertaining to the institution prepared in the course of performing the completed external auditing program. The FDIC issued guidance concerning the review of external auditor's working papers (Regional Director Memorandum No. 2000-019, "Reviews of External Auditors' Workpapers," dated March 21, 2000.) Auditors who have been requested to provide such access must consider Interpretation No. 1, "Providing Access to or Copies of Audit Documentation to a Regulator," of AU section 339 (AICPA, *Professional Standards*, AU sec. 9339 par. .01–.15). The interpretation provides auditors with guidance on

- advising management that the regulator has requested access to (and possibly photocopies of) the audit documentation and that the auditor intends to comply with the request;
- making appropriate arrangements with the regulator for the review;
- maintaining control over the original audit documentation; and
- considering submitting to the regulator a letter clarifying that an audit in accordance with GAAS is not intended to, and does not, satisfy a regulator's oversight responsibilities. An example of such a letter is illustrated in paragraph .06 of Interpretation No. 1 of AU section 339.

In addition, the interpretation addresses situations in which an auditor has been requested by a regulator to provide access to the audit documentation

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

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

before the audit has been completed and the report released. Also, the interpretation notes that if a regulator engages an independent party, such as another independent public auditor, to perform the audit documentation review on behalf of the regulatory agency, there are some precautions auditors might consider observing.

5.217 On February 9, 2006, the FFIEC member agencies issued the *Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provision in External Audit Engagement Letters* (advisory). The advisory informs financial institutions not to enter into audit engagement letters that incorporate unsafe and unsound limitation of liability provisions with respects to audits of financial statements and internal control over financial reporting. Generally, these provisions: (*a*) indemnify the external auditor against claims made by third parties (including punitive damages) (*b*) hold harmless or release the external auditor from liability for claims or potential claims that might be asserted by the client financial institution; or (*c*) limit the remedies available to the client financial institution.

5.218 Information in examination reports, inspection reports, supervisory discussions—including summaries or quotations—is considered confidential. Such information may not be disclosed to any party without the written permission of the appropriate agency, and unauthorized disclosure of such information could subject the auditor to civil and criminal enforcement actions.

Exhibit 5-1
Fraud Risk Factors

Two types of fraud are relevant to the auditor's consideration, namely, fraudulent financial reporting and the misappropriation of assets. For each type of fraud, the risk factors are further classified based on the three conditions generally present when material misstatements due to fraud occur, which are incentives/pressures, opportunities, and attitudes/rationalizations. Although the risk factors cover a broad range of situations, they are only examples and, accordingly, the auditor may wish to consider additional or different risk factors. Also, the order of the examples of risk factors provided is not intended to reflect their relative importance or frequency of occurrence.

Fraudulent financial reporting

An auditor's interest specifically relates to fraudulent acts that cause a material misstatement of financial statements. Some of the following factors and conditions are present in entities in which specific circumstances *do not present a risk of material misstatement*. Also, specific controls may exist that mitigate the risk of material misstatement due to fraud, even though risk factors or conditions are present. When identifying risk factors and other conditions, the auditors might assess whether those risk factors and conditions, individually and in combination, present a risk of material misstatement of the financial statements.

The following are examples of risk factors that might result in misstatements arising from fraudulent financial reporting.

Incentives/Pressures

1. Financial stability or profitability is threatened by economic, industry, or entity operating conditions, such as (or as indicated by):
   - *a.* High degree of competition or market saturation, accompanied by narrowing margins shown by:
     - i. An increase of competitor investment products that are close alternatives for the institution's deposit products (for example, mutual funds, insurance annuities, and mortgage loans), placing pressure on the institution's deposit rates
     - ii. Competitor product pricing that results in loss of customers or market share for such products as loan, deposit, trust, asset management, and brokerage offerings
   - *b.* High vulnerability to rapid changes, such as changes in technology, product obsolescence, or interest rates, exemplified by the following:
     - i. A failure or inability to keep pace with or to afford rapid changes in technology, if the financial stability or profitability of the particular institution is placed at risk due to that failure or inability
     - ii. Significant unexpected volatility (for example, in interest rates, foreign exchange rates, and commodity prices) in financial markets where the institution has a significant capital market presence and is exposed to loss of revenue or has not appropriately hedged its risk to price changes that effect proprietary positions
     - iii. Flattening yield curves or extremely high or low market interest rate environments

c. Significant declines in customer demand and increasing business failures in either the industry or overall economy, such as the following:

i. Deteriorating economic conditions (for example, declining corporate earnings, adverse exchange movements, and real estate prices) within industries or geographic regions in which the institution has significant credit concentrations

ii. For credit unions, losing a very substantial portion of the membership base, which places considerable pressure on management insofar as financial projections are often based on gaining new members and offering commercial loans

d. Rapid growth or unusual profitability, especially compared to that of other peer financial institutions; for example, unusually large growth in the loan portfolio without a commensurate increase in the size of the allowance for loan and lease losses

e. New and existing accounting, statutory, or regulatory requirements, such as the following:

i. Substantially weak CAMELS, (capital adequacy, asset quality, management, earnings, liquidity, and sensitivity to market risk) or, for bank-holding companies, BOPEC (bank's CAMELS rating, operation of significant nonbanking subsidiaries, parent's strength and operations, earnings of the banking organization, and capital of the banking organization) ratings.

ii. Regulatory capital requirements

f. Decline in asset quality due to the following:

i. Borrowers affected by recessionary declines and layoffs

ii. Issuers affected by recessionary declines and industry factors

2. There is excessive pressure on management or operating personnel to meet financial targets set up by those charged with governance management, including incentive goals:

a. Unrealistically aggressive loan goals and lucrative incentive programs for loan originations, shown by, for example:

i. Relaxation of credit standards

ii. Excessive extension of credit standards with approved deviation from policy

iii. Excessive concentration of lending (particularly new lending)

iv. Excessive lending in new products

v. Excessive pricing concessions not linked to enhanced collateral positions or other business rational (for example, sales of other products or services)

vi. Excessive refinancing at lower rates that may delay the recognition of problem loans

b. Perceived or real adverse effects of reporting poor financial results on significant pending transactions, such as business

combinations (For example, the acquisition of another institution has been announced in the press with the terms dependent on the future financial results of the acquiring institution.)

c. Willingness by management to respond to these pressures by pursuing business opportunities for which the institution does not possess the needed expertise

d. Excessive reliance on wholesale funding (brokered deposits)

e. Speculative use of derivatives

f. Failure to establish economic hedges against key risks (for example, interest rate) through effective asset liability committee (ALCO) processes

g. Changes in a bank's loan loss accounting methodology that are not accompanied by observed changes in credit administration practices or credit conditions

h. Frequent or unusual exceptions to credit policy

i. Threat of a downgrade in the institution's overall regulatory rating (for example, CAMEL, MACRO (rating stands for management, asset quality, capital adequacy, risk management and operating results), or BOPEC) that could preclude expansion or growth plans

j. Threat of failing to meet minimum capital adequacy requirements that could cause adverse regulatory actions

3. Management's or those charged with governance's personal net worth is threatened by the entity's financial performance arising from the following:

   a. Heavy concentrations of their personal net worth in the entity

   b. Bank is privately owned by one person or family whose net worth or income (from dividends) is dependent on the bank

Opportunities

1. The nature of the industry or the entity's operations provides opportunities to engage in fraudulent financial reporting that can arise from the following:

   a. Significant-related entity transactions not in the ordinary course of business or with related entities not audited or audited by another firm, such as the following:

      i. Loans and other transactions with directors, officers, significant shareholders, affiliates, and other related parties, particularly those involving favorable terms

      ii. Variable interest entities (VIEs)

      iii. Certain types of lending practices such as, subprime and predetorial lending by banks in an effort to obtain better yields

      iv. Transfers of impaired assets

   b. Assets, liabilities, revenues, or expenses based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate (Significant estimates generally include the allowance for loan losses, and the valuation of servicing rights, residual interests, and deferred tax assets, fair

value determinations, and the recognition of other impairment losses; for example, goodwill and investments)

c. Significant, unusual, or highly complex transactions, especially those close to year end that pose difficult "substance over form" questions, such as the following:

i. Consolidation questions with VIEs

ii. Material amounts of complex financial instruments and derivatives held by the institution that are difficult to value, or the institution's use of complex collateral disposition schemes

d. Frequent or unusual adjustments to the allowance for loan and lease losses

e. Loan sales that result in retained beneficial interests (Valuation of retained beneficial interests is based on estimates and assumptions and are susceptible to manipulation if not properly controlled.)

f. Complex transactions that result in income or gains, such as sale and leasebacks, with arbitrarily short leaseback terms

g. Deferred tax assets, arising from net operating loss carryforwards, without valuation allowances

h. Deferral of loan origination costs that exceed the appropriate costs that may be deferred under FASB ASC 310-20

2. Internal control components are deficient as a result of the following:

a. Inadequate monitoring of controls, including automated controls and controls over financial reporting, such as lack of oversight of critical processes in the following areas:

i. Cash and correspondent banks—Reconciliation and review

ii. Intercompany or interbranch cash or suspense accounts and "internal" demand deposit accounts—Monitoring of activity and resolution of aged items

iii. Lending—Lack of credit committee and lack of stringent underwriting procedures

iv. Treasury—Securities/derivatives valuation (selection of models, methodologies, and assumptions)

v. Regulatory compliance—Lack of knowledge of pertinent regulation

vi. Deposits—Lack of monitoring unusual and significant activity

b. Ineffective internal audit function

c. Lack of board-approved credit (underwriting and administration) or investment policies

d. Vacant staff positions remain unfilled for extended periods, thereby preventing the proper segregation of duties

e. Lack of an appropriate system of authorization and approval of transactions in areas such as lending and investment, in which the policies and procedures for the authorization of transactions are not established at the appropriate level

f. Lack of independent processes for the establishment and review of allowance for loan losses

g. Lack of independent processes for the evaluation of other than temporary impairments

h. Inadequate controls over transaction recording, including the setup of loans on systems

i. Lack of controls over the perfection of interests in lending collateral

j. Inadequate methods of identifying and communicating exceptions and variances from planned performance

k. Inadequate accounting reconciliation policies and practices, including appropriate supervisory review, the monitoring of stale items and out of balance conditions, and the timeliness of writeoffs

l. Failure to establish adequate segregation of duties between approval transactions and the disbursement of funds

m. Lack of control over the regulatory reporting process, in which key decision makers also have control over the process

n. Lack of adequate reporting to the board of directors and executive management regarding credit, interest-rate, liquidity, and market risks

o. Change from an internal audit function that has been outsourced to the external auditor or other provider to a new in-house internal audit department or another outsourcing provider

Attitudes and Rationalizations

Risk factors reflective of attitudes/rationalizations by those charged with governance, management, or employees that allow them to engage in or justify, or both, fraudulent financial reporting, may not be susceptible to observation by the auditor. Nevertheless, the auditor who becomes aware of the existence of such information might consider it in identifying the risks of material misstatement arising from fraudulent financial reporting. For example, auditors may become aware of the following information that may indicate a risk factor:

1. Known history of violations of securities laws or other laws and regulations, or claims against the entity, its senior management, or others charged with governance alleging fraud or violations of laws and regulations:

   a. The existence of a regulatory cease and desist order, memorandum of understanding, or other regulatory agreements (whether formal or informal) that concern management competence or internal control

   b. Repeated criticisms or apparent violations cited in regulatory examination reports that management has ignored

2. Nonfinancial management's excessive participation in or preoccupation with the selection of accounting principles or the determination of significant estimates:

   a. Consideration of "business issues" (for example, shareholder expectations) in determining significant estimates

b. Adjustments to the allowance for loan losses by senior management or the board for which there is no written documentation

c. An unusual propensity to enter into complex asset disposition agreements

3. The disregard of control-related recommendations from internal or external auditors
4. A high level of customer complaints (especially when management does not fix the cause of them promptly)
5. Indications that internal audit is not adequately staffed or trained, and does not have appropriate specialized skills given the environment
6. Indications that internal audit is not independent (authority and reporting relationships) and does not have adequate access to the audit committee (or equivalent)
7. Inappropriate scope of internal audit's activities (for example, the balance between financial and operational audits, coverage, and rotation of decentralized operations)
8. Limited authority of internal audit to examine all aspects of the client's operations or failure to exercise its authority
9. Failure by internal audit to adequately plan, perform risk assessments, or document the work performed or conclusions reached
10. Failure of internal audit to adhere to professional standards
11. Operating responsibilities assigned to internal audit
12. Inability to prepare accurate and timely financial reports, including interim reports
13. Failure of planning and reporting systems (such as business planning; budgeting, forecasting, and profit planning; and responsibility accounting) to adequately set forth management's plans and the results of actual performance
14. A low level of user satisfaction with information systems processing, including reliability and timeliness of reports
15. Understaffed accounting or information technology department, inexperienced or ineffective accounting or information technology personnel, or high turnover
16. Lack of timely and appropriate documentation for transactions
17. Dividend requirements by management or ownership frequently at or near the maximum allowable by law (In closely held companies, executive management/ownership combines high dividends with frequently substantial increases in cash salary or bonus compensation. The bank has been cited for dividend violations by regulatory authorities.)

Misappropriation of assets

An auditor's interest specifically relates to fraudulent acts that cause a material misstatement of financial statements. Some of the following factors and conditions are present in entities in which specific circumstances *do not present a risk of material misstatement*. Also, specific controls may exist that mitigate the risk of material misstatement due to fraud, even though risk factors or conditions are present. When identifying risk factors and other conditions, the

auditor could assess whether those risk factors and conditions, individually and in combination, present a risk of material misstatement of the financial statements.

Risk factors that relate to misstatements arising from the misappropriation of assets are also classified along the three conditions generally present when fraud exists, namely, incentives/pressures, opportunity, and attitudes/rationalizations. Some of the risk factors related to misstatements arising from fraudulent financial reporting also may be present if misstatements arising from misappropriation of assets occur. For example, the ineffective monitoring of management and weakness in internal control may be present if misstatements due to either fraudulent financial reporting or the misappropriation of assets exist. The following sections show examples of risk factors related to misstatements arising from misappropriation of assets.

Incentives and Pressures

AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*), does not require an auditor to plan the audit to discover information that indicates financial stress among employees or adverse relationships between the institution and its employees. If the auditor becomes aware of the existence of such information, he or she might consider it in addressing the risk of material misstatement arising from the misappropriation of assets.

1. Adverse relationships between the institution and employees with access to cash or other assets susceptible to theft may motivate those employees to misappropriate those assets. For example, the following may create adverse relationships:
   - *a.* It is likely that the institution will be merged into or acquired by another institution and there is uncertainty regarding the employees' future employment opportunities.
   - *b.* The institution has recently completed a merger or acquisition, employees are working long hours on integration projects, and morale is low.
   - *c.* The institution is under regulatory scrutiny, and there is uncertainty surrounding the future of the institution.
2. Members of executive management evidence personal financial distress through indications such as frequent informal "loans" or "salary advances" to key executive officers or their family members.

Opportunities

1. Certain characteristics or circumstances may increase the susceptibility of assets to misappropriation. For example, opportunities to misappropriate assets increase when there are the following:
   - *a.* Large amounts of cash on hand and wire transfer capabilities
   - *b.* Easily convertible assets, such as bearer bonds or diamonds, that may be in safekeeping
   - *c.* Inadequate or ineffective physical security controls, for example, overliquid assets or information systems
   - *d.* Access to customer accounts
2. Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets. For example, the misappropriation of assets may occur because there is the following:

a. Inadequate management oversight of employees responsible for assets, such as:

(1) Vacant branch manager positions or managers are away on leave without replacements for an inordinate amount of time, causing a considerable lack of management oversight.

(2) The independent risk management function does not have the appropriate level of sophistication or the capability to effectively monitor and measure the risks, such as capital markets trading activities.

(3) Lack of adherence or enforcement of vacation policy.

b. Inadequate job applicant screening and monitoring of employees, such as:

(1) Federal Bureau of Investigation background checks, credit reports, and bonding eligibility screening are not incorporated into the hiring process for employees with access to significant assets susceptible to misappropriation.

(2) A monitoring process does not identify employees who have access to assets susceptible to misappropriation and who are known to have financial difficulties.

c. Inadequate segregation of duties and independent checks, such as:

(1) Lack of independent monitoring of activity in internal demand deposit accounts and correspondent bank accounts

(2) No independent monitoring and resolution of customer exceptions/inquiries related to electronic funds transfer (EFT) transactions, loan disbursements/payments, customer deposit accounts, securities and derivatives transactions, and trust/fiduciary accounts

(3) Lack of key periodic independent reconciliations (in addition to reconciliations of subledgers to the general ledger) for wire transfer, treasury, trust, suspense accounts, automated teller machines, and cash

(4) Lack of segregation of duties in the following areas:

— EFT—Origination, processing, confirmation, and recordkeeping

— Lending—Relationship management, underwriting (including approval), processing, cash collection/ disbursement, and recordkeeping; no periodic confirmation of customer loan information or indebtedness by personnel independent of the relationship officer.

— Treasury—Trading, processing, settlement, and recordkeeping. (The derivatives positions on the Treasury system are not priced by an independent operations area. The capital markets risk management process is not independent from the trading function. There is no independent confirmation of individual trades.)

- — Trust—Relationship management, transaction authorization, transaction execution, settlement, custody, and account recordkeeping. (There is no annual review of the activity in trust accounts by an investment committee to ensure compliance with the terms of the trust agreement and bank investment guidelines.)
- — Fiduciary—Issuance, registration, transfer, cancellation, and recordkeeping
- — Charged-off loan accounts and recoveries
- — Dormant and inactive demand deposit accounts (DDA) and the escheatment process.

d. No independent mailing of customer statements or monitoring of "Do not Mail/Hold" statements

e. Lack of control over new accounts

f. Failure to reconcile "due from" bank accounts on a regular basis, and review open items

g. Loans are purchased from loan brokers, but the loans are not reunderwritten before purchase

h. Inadequate segregation of duties because the institution is small and has limited staff

i. Lack of appropriate system of authorization and approval of transactions, such as:

(1) No verification of EFT initiation and authorization, including those instances in which bank employees initiate a transaction on a customer's behalf

(2) Frequent underwriting exceptions to board-established credit authorization limits

(3) Frequent instances of cash disbursements on loans that have not yet received all approvals or met all preconditions for funding

(4) Lack of board approval for significant loans or unusually high loan-officer approval limits (Be alert to the existence of multiple loans being funded just below a loan officer's limit.)

j. Poor physical safeguards over cash, investments, customer information, or fixed assets, such as:

(1) Lack of adequate physical security over the EFT operations area and customer records

(2) Failure to appropriately limit access to the vault to authorized employees acting within the scope of their job

(3) Lack of dual control over the vault, negotiable instruments (including travelers' checks and money orders), and blank-check stock

(4) Lack of accountability over negotiable instruments

k. Inadequate training of tellers and operations personnel regarding:

(1) "Knowing your customer"

(2) Recognizing check fraud and kiting activities

(3) Controls over cash, negotiable instruments, and EFT

Chapter 6

Cash and Cash Equivalents

Introduction

6.01 Cash and cash equivalents include cash items in the process of collection (CIPC), deposits with other financial institutions, including corporate credit unions, balances with the Federal Reserve Banks and Federal Home Loan Banks (FHLBs), federal funds sold, and cash and cash equivalents on hand. Instruments that meet the definition of *cash and cash equivalents*, as defined in the Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) glossary, are discussed in this chapter. Investments in debt and equity securities that are accounted for under FASB ASC 320, *Investments—Debt and Equity Securities*, are discussed in chapter 7, "Investments in Debt and Equity Securities." Other investments are discussed in chapter 12, "Other Assets, Other Liabilities, and Other Investments." The fair value option for financial assets and liabilities under FASB ASC 825, *Financial Instruments*, is addressed in chapter 7.

Cash Items in the Process of Collection and Cash Equivalents

6.02 CIPC includes customer deposits drawn on other depository institutions that have not yet cleared, matured instruments (such as coupons and bonds), and other matured items temporarily held pending their liquidation. Such assets are received with deposits and other customer transactions. CIPC are eventually cleared through local clearinghouses, correspondent institutions (correspondents), or a Federal Reserve Bank. Collection of these items generally takes between one to five business days. Cash equivalents are short-term, highly liquid investments that are both readily convertible to known amounts of cash and so near their maturity that they present insignificant risk of changes in value because of changes in interest rates, for example, short-term certificates of deposit (CDs) issued by other federally insured financial institutions.

Deposits With Other Depository Institutions

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

6.04 Many institutions also invest in nonnegotiable or negotiable CDs of other depository institutions. These balances are generally interest bearing and insured up to $250,000[*] and have a range of maturity options.

6.05 Many credit unions hold funds in corporate credit unions. Corporate credit unions, which are regulated by the National Credit Union Administration, provide investment, liquidity, and payment services to natural-person credit unions. These corporate credit unions aggregate funds acquired from natural-person credit unions in order to facilitate the purchase of overnight and term investments. Overnight investments include cash management accounts and overnight certificates. Term investments, with maturities from two days to five years or longer, include fixed-rate and variable-rate shares and certificates.

Balances With Federal Reserve Banks and Federal Home Loan Banks

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

Cash on Hand

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

Federal Funds and Repurchase Agreements

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

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[*] On July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act made permanent the current maximum deposit insurance amount of $250,000, which was originally scheduled to return to $100,000 on January 1, 2014. The Federal Deposit Insurance Corporation coverage limit applies per depositor, per insured depository institution, for each account ownership category.

Accounting and Financial Reporting

Definition of *Cash* and *Cash Equivalents*

6.09 The FASB ASC glossary defines *cash* as currency on hand, demand deposits with banks or other financial institutions, and other kinds of accounts that have the general characteristics of demand deposits in that the customer may deposit additional funds at any time and also effectively may withdraw funds at any time without prior notice or penalty. *Cash equivalents* are defined in the FASB ASC glossary as short-term, highly liquid investments that have both of the following characteristics:

a. Readily convertible to known amounts of cash

b. So near their maturity that they present insignificant risk of changes in value because of changes in interest rates

Generally, only investments with original maturities of three months or fewer qualify under that definition. Original maturity means original maturity to the entity holding the investment. For example, both a three-month U.S. Treasury bill (T-bill) and a three-year U.S. Treasury note (T-note) purchased three months from maturity qualify as cash equivalents. However, a T-note purchased three years ago does not become a cash equivalent when its remaining maturity is three months. Examples of items commonly considered to be cash equivalents are T-bills, commercial paper, money market funds, and federal funds sold (for an entity with banking operations).

6.10 Other examples may include CDs.

6.11 Only instruments that meet both of the previously mentioned criteria and are used as part of an institution's cash-management activities ordinarily would be included in cash equivalents. For example, T-bills purchased for an investment account would be part of the institution's investing activities (not cash-management activities) and would therefore be excluded from cash equivalents. The carrying amount of items classified as cash and cash equivalents generally approximates fair value because of the relatively short period of time between the origination of the instruments and their expected realization.

6.12 Investments, such as negotiable CDs and mutual funds, that meet the definition of a security in the FASB ASC glossary are subject to the reporting, classification, and other provisions of FASB ASC 320. Investments subject to FASB ASC 320 are discussed in chapter 7.

Classification of Cash Flows

6.13 FASB ASC 230, *Statement of Cash Flows*, provides guidance for reporting cash flows in general-purpose financial statements. FASB ASC 230-10-45-4 states the total amounts of cash and cash equivalents at the beginning and end of the period shown in the statement of cash flows should be the same amounts as similarly titled line items or subtotals shown in the statements of financial position as of those dates.

6.14 FASB ASC 230-10-50-1 requires an entity to disclose its policy for determining which items are treated as cash equivalents. Any change to that policy is a change in accounting principle that should be effected by restating financial statements for earlier years presented for comparative purposes.

6.15 The cash equivalents policy is generally disclosed in the accounting policy footnote.

6.16 Specific guidance for applying the direct method and the indirect method of reporting cash flows is provided in FASB ASC 230-10. In reporting cash flows from operating activities, FASB ASC 230-10-45-25 states that entities are encouraged to report major classes of gross cash receipts and gross cash payments and their arithmetic sum—the net cash flow from operating activities (the direct method). If the direct method of reporting net cash flow from operating activities is used, the reconciliation of net income of a business entity to net cash flow from operating activities should be provided in a separate schedule, as stated in FASB ASC 230-10-45-30. Paragraphs 1–5 of FASB ASC 942-230-55 provide implementation guidance and illustrations regarding the statement of cash flows under the direct method for financial institutions.

6.17 Examples of major classes of gross cash receipts reported in operating activities may include interest received and service charges collected. Examples of gross cash disbursements may include interest paid and operating expenses paid.

6.18 Entities that choose not to provide information about major classes of operating cash receipts and payments by the direct method should determine and report the same amount for net cash flow from operating activities indirectly by adjusting net income of a business entity to reconcile it to net cash flow from operating activities (the indirect or reconciliation method), as stated in FASB ASC 230-10-45-28. If the indirect method is used, amounts of interest paid (net of amounts capitalized) and income taxes paid during the period should be disclosed, according to FASB ASC 230-10-50-2.

6.19 According to FASB ASC 230-10-45-10, a statement of cash flows should classify cash receipts and cash payments as resulting from investing, financing, or operating activities. The FASB ASC glossary defines *operating activities* as all transactions and other events that are not defined as investing or financing activities (see paragraphs 12–15 of FASB ASC 230-10-45). Operating activities generally involve producing and delivering goods and providing services. Cash flows from operating activities are generally the cash effects of transactions and other events that enter into the determination of net income.

6.20 Paragraphs 11–12 of FASB ASC 230-10-45 state that cash flows from the purchases, sales, and maturities of available-for-sale securities should be classified as cash flows from investing activities and reported gross in the statement of cash flows. Receipts from sales of loans that were not specifically acquired for resale are cash inflows from investing activities. That is, if loans were acquired as investments, cash receipts from sales of those loans should be classified as investing cash inflows regardless of a change in the purpose for holding those loans.

6.21 Summarized in the following are some typical investing and financing cash flows that may be reported for a financial institution.

Investing Activities

Cash Inflows	*Cash Outflows*
Net loan principal payments	Net loan originations

Cash Inflows	*Cash Outflows*
Portfolio loan sale proceeds	Loan purchases
Security sale and maturity proceeds (disclose separately for held-to-maturity securities and available-for-sale securities)	Security purchases (disclose separately for held-to-maturity securities and available-for-sale securities)
Real estate sale proceeds	Investment in real estate held for development
Net deposits withdrawn from other financial institutions	Net deposits placed with other financial institutions
Sales of loan servicing rights	Purchases of loan servicing rights
Net decrease in reverse repurchase agreements* (repos)	Net increase in repos*
Decrease in National Credit Union Share Insurance Fund (NCUSIF) deposit	Increase in NCUSIF deposit
* Repos are addressed in chapter 14, "Federal Funds and Repurchase Agreements."	

Financing Activities

Cash Inflows	*Cash Outflows*
Net increase in mortgage escrow deposits	Net decrease in mortgage escrow deposits
Net certificates of deposit (CDs) issued	Net CDs matured
Net increase in other deposit accounts	Net decrease in other deposit accounts
Proceeds from Federal Home Loan Banks (FHLB) advances and other borrowings	Repayment of FHLB advances and other borrowings
Net increase in short-term borrowings (original maturity of three months or fewer)	Net decrease in short-term borrowings (original maturity of three months or fewer)
Proceeds from the issuance of common stock or other equity instruments	Reacquisition of equity instruments (for example, purchase of treasury stock)
Net increase in repos and dollar-roll repos	Net decrease in repos and dollar-roll repos
	Dividends and other cash distributions to stockholders

6.22 *Noncash investing and financing activities*. According to paragraphs 3–4 of FASB ASC 230-10-50, information about all investing and financing

activities of an entity during a period that affect recognized assets or liabilities but that do not result in cash receipts or cash payments in the period should be disclosed. Those disclosures may be either narrative or summarized in a schedule, and they should clearly relate the cash and noncash aspects of transactions involving similar items. Examples of noncash investing and financing activities are converting debt to equity; acquiring assets by assuming directly related liabilities, such as purchasing a building by incurring a mortgage to the seller; obtaining an asset by entering into a capital lease; obtaining a building or investment asset by receiving a gift; and exchanging noncash assets or liabilities for other noncash assets or liabilities.

6.23 Other examples of noncash investing and financing activities for financial institutions may include

- originating a mortgage loan to finance the sale of foreclosed real estate or real estate held for development;
- acquiring a real estate property through, or in lieu of, foreclosure of the related loan;
- converting mortgage or other loans into mortgage-backed or other asset-backed securities (commonly referred to as *securitizing* loans); and
- selling or purchasing branch offices when the buyer assumes deposit liabilities in exchange for loans and other assets received from the seller, in which case only the cash paid, net of cash acquired or received, ordinarily should be reported as a cash outflow or inflow.

Acquisition and Sales of Certain Securities and Loans

6.24 Banks, brokers and dealers in securities, and other entities may carry securities and other assets in a trading account, as stated in paragraphs 18–21 of FASB ASC 230-10-45. Cash receipts and cash payments resulting from purchases and sales of securities classified as trading securities as discussed in FASB ASC 320 should be classified pursuant to FASB ASC 230 based on the nature and purpose for which the securities were acquired. Cash receipts and cash payments resulting from purchases and sales of other securities and other assets should be classified as operating cash flows if those assets are acquired specifically for resale and are carried at market value in a trading account. Cash receipts and cash payments resulting from acquisitions and sales of loans also should be classified as operating cash flows if those loans are acquired specifically for resale and are carried at market value or at the lower of cost or market value in accordance with FASB ASC 948, *Financial Services—Mortgage Banking*.

6.25 In applying the guidance stated in the previous paragraph, for the direct method, gross cash receipts and cash payments from these sources should be reported separately as operating cash flows consistent with FASB ASC 230-10-45-25. If the indirect method is used, only the net increases or decreases in loans and securities may be reported in reconciling net income to the net cash flow from operating activities consistent with FASB ASC 230-10-45-28.

Gross and Net Cash Flows

6.26 Paragraphs 7–9 of FASB ASC 230-10-45 state that, generally, information about the gross amounts of cash receipts and cash payments during a period is more relevant than information about the net amounts of cash receipts

and payments. However, the net amount of related receipts and payments provides sufficient information for the following:

- Cash equivalents
- Certain items for which turnover is quick, amounts are large, and maturity is short
- Cash receipts and payments pertaining to any of the following providing that the original maturity of the asset or liability is three months or less:
  - Investments (other than cash equivalents)
  - Loans receivable
  - Debt

6.27 According to FASB ASC 230-10-45-8, for certain other items, such as demand deposits of a bank and customer accounts payable of a broker-dealer, the entity is substantively holding or disbursing cash on behalf of its customers. Only the net changes during the period in assets and liabilities with those characteristics need be reported because knowledge of the gross cash receipts and payments related to them may not be necessary to understand the entity's operating, investing, and financing activities.

6.28 Other items for which the institution is substantively holding, receiving, or disbursing cash on behalf of its customers, may include

- negotiable order of withdrawal (NOW) and super NOW accounts,
- savings deposits,
- money market deposit accounts,
- mortgage escrow funds, and
- collections and remittances on loans serviced for others.

6.29 FASB ASC 942, *Financial Services—Depository and Lending*, provides industry-specific accounting and reporting guidance for depository and lending financial institutions. Paragraphs 1–2 of FASB ASC 942-230-45 state that banks, savings institutions, and credit unions are not required to report gross amounts of cash receipts and cash payments for (*a*) deposits placed with other financial institutions and withdrawals of those deposits, (*b*) time deposits accepted and the repayments of deposits, and (*c*) loans made to customers and principal collections of loans. When those entities constitute part of a consolidated entity, net amounts of cash receipts and cash payments for deposit or lending activities of those entities should be reported separate from gross amounts of cash receipts and cash payments for other investing and financing activities of the consolidated entity, including those of a subsidiary of a bank, savings institution, or credit union that is not itself a bank, savings institution, or credit union.

Cash Receipts and Payments Related to Hedging Activities

6.30 FASB ASC 230-10-45-27 explains that cash flows from derivative instruments that are accounted for as fair value hedges or cash flow hedges may be classified in the same category as the cash flows from the items being hedged provided that the derivative instrument does not include an other-than-insignificant financing element at inception, other than a financing element inherently included in an at-the-market derivative instrument with no prepayments (that is, the forward points in an at-the-money forward contract) and

that the accounting policy is disclosed. If the derivative instrument includes an other-than-insignificant financing element at inception, all cash inflows and outflows of the derivative instrument should be considered cash flows from financing activities by the borrower. If for any reason hedge accounting for an instrument that hedges an identifiable transaction or event is discontinued, then any cash flows after the date of discontinuance should be classified consistent with the nature of the instrument.

Financial Statement Presentation and Disclosure

6.31 FASB ASC 942-305-50-1 states that restrictions on the use or availability of certain cash balances, such as deposits with a Federal Reserve Bank, FHLB, or correspondent financial institutions to meet reserve requirements or deposits under formal compensating balance agreements, should be disclosed in the notes to the financial statements.

6.32 FASB ASC 942-305-05-2 states that a financial institution that accepts deposits may have balances due from the same financial institution from which it has accepted a deposit, also called reciprocal balances. Reciprocal account balances, as explained in FASB ASC 942-305-45-1,[†] should be offset if they will be offset in the process of collection or payment. Overdrafts of such accounts should be reclassified as liabilities, unless the financial institution has other accounts at the same financial institution against which such overdrafts can be offset.

6.33 The presentation of deposits in other depository institutions in the balance sheet varies among financial institutions. For example, if all or some portion of such deposits meet the definition of *cash equivalent*, as defined in the FASB ASC glossary, some institutions may combine all or the applicable portion of deposits in other institutions with cash and cash equivalents as the first line item in the balance sheet. Any portion of deposits not meeting the definition of cash equivalent may then be shown separately in the balance sheet, or it may be combined with other short-term investments or other investments (if interest bearing); in either case, presented after cash and cash equivalents in the statement of financial condition. Alternatively, some institutions may segregate

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[†] In January 2011, the Financial Accounting Standards Board (FASB) issued the proposed Accounting Standards Update *Balance Sheet Offsetting*. The proposed guidance was initiated as a joint project between FASB and the International Accounting Standards Board (IASB) to provide users of financial statements with information to understand the extent of offsetting in the statement of financial position and improve comparability between International Financial Reporting Standards and accounting principles generally accepted in the United States of America (U.S. GAAP). The proposed guidance as issued would eliminate the exception in U.S. GAAP that allows offsetting for some derivative and sale and repurchase (and reverse sale and repurchase) contracts when the right of setoff is conditional, there is no intention to set off, or such intention is conditional. The proposed guidance would also enhance disclosures required by U.S. GAAP by requiring improved information about eligible assets and eligible liabilities subject to setoff, and related arrangements (such as collateral arrangements) and the effect of those arrangements on an entity's financial position.

In June 2011, FASB and the IASB discussed alternative approaches for requiring offsetting of financial assets and financial liabilities on the face of the balance sheet. The majority of FASB board members supported providing an exception from the general offsetting criteria for derivative instruments, which would allow offsetting of fair value amounts recognized for derivatives and fair value amounts recognized for the right to reclaim cash collateral or the obligation to return cash collateral arising from derivative instruments recognized at fair value with the same counterparty under a master netting arrangement. During July 2011, FASB and IASB also discussed revisions to the proposed offsetting disclosures.

Readers are encouraged to visit the FASB website for the latest developments regarding the offsetting project, including a summary of decisions reached to date since the issuance of the proposed guidance. FASB expects to issue final guidance during 2011.

interest-bearing and noninterest-bearing deposits. Noninterest-bearing deposits that meet the definition of cash equivalent are typically combined with cash equivalents. Interest-bearing deposits in other institutions are presented separately in the balance sheet after cash and cash equivalents, or combined with other short-term investments or other investments, regardless of whether all or some portion of such deposits meet the definition of cash equivalent. These practices are considered acceptable, provided that cash and cash equivalents in the balance sheet include only those instruments meeting the definition of cash equivalents, and as discussed further in paragraph 6.09, herein, the institution discloses its policy used to classify items as cash equivalents.

6.34 If deposits in other institutions are material, then deposits should be presented as a separate amount in the balance sheet, as stated in FASB ASC 942-210-45-4.

Auditing

6.35 Regardless of the assessed risks of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions related to cash and cash equivalents.

Objectives

6.36 The primary audit objectives for cash are to obtain sufficient appropriate evidence that

a. recorded balances exist and are owned by the institution;

b. recorded balances are complete and stated at realizable amounts;

c. balances are properly presented in the financial statements;

d. restrictions on the availability or use of cash are appropriately identified and disclosed; and

e. cash receipts, disbursements, and transfers between accounts are recorded in the proper period.

Planning

6.37 In accordance with AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), an auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures (as described in chapter 5, "Audit Considerations and Certain Financial Reporting Matters"). Factors related to cash and cash equivalents that could influence the risks of material misstatement may include (*a*) cash and cash equivalents are generally negotiable, (*b*) involve large volumes of transactions, and (*c*) affect a large number of financial statement accounts.

Internal Control Over Financial Reporting and Possible Tests of Controls

6.38 AU section 314 establishes standards and provides guidance on obtaining a sufficient understanding of the entity and its environment, including its internal control. It provides guidance on understanding the components

of internal control and explains how an auditor should obtain a sufficient understanding of internal control for the purposes of assessing the risks of material misstatement. Paragraph .40 of AU section 314 requires that, in all audits, the auditor should obtain an understanding of the five components of internal control (the control environment, risk assessment, control activities, information and communication systems, and monitoring), sufficient to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. Paragraph .102 of AU section 314 states the auditor should obtain a sufficient understanding by performing risk assessment procedures to evaluate the design of controls relevant to an audit of financial statements and to determine whether they have been implemented. The auditor should identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions, account balances, and disclosures.

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

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

- Vault cash is under the control of more than one person.
- Procedures exist for the credit evaluation of correspondent banking relationships.
- Records of ATM transactions are reconciled to their recording in books of entry on a daily basis.

6.40 The auditor should perform tests of controls when the auditor's risk assessment includes an expectation of the operating effectiveness of controls or when substantive procedures alone do not provide sufficient appropriate audit evidence at the relevant assertion level. The following are examples of tests of controls to be considered:

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

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

Substantive Tests

6.42 Audit risk and materiality, among other matters, need to be considered together in designing the nature, timing, and extent of audit procedures and in evaluating the results of those procedures. Substantive procedures that the auditor may consider include, but are not limited to, the following:

- Counting cash and comparing the balances with tellers' records
- Testing tellers' records for mathematical accuracy
- Testing the reconciliations between recorded balances of cash due from correspondents and statements received from correspondents
- Reconciling and reviewing the cutoff of interbank transfers
- Testing the reconciliations of subsidiary ledgers to the general ledger
- Testing the propriety of authorized accounts and signatures
- Reviewing the composition of suspense accounts, especially noting the recurring use and aging of reconciling items and any failure or inability to reconcile the cash account
- Confirming account balances with and reviewing the creditworthiness of correspondents
- Confirming consigned items with consignors
- Reviewing cash records for unusual transactions or adjustments

- Testing the propriety of due to and due from accounts set off in the balance sheet
- Testing fair value disclosures

Chapter 7

Investments in Debt and Equity Securities

Introduction

7.01 Financial institutions acquire securities for various purposes. In addition to providing a source of income through investment or resale, securities are used to manage interest-rate and liquidity risk as part of an institution's overall asset/liability management strategies. They are also used in certain collateralized transactions. The most common securities acquired by institutions are described in the subsequent paragraphs. Investments that meet the definition of a *security* in the Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) glossary are discussed in this chapter. Other investments, including nonmarketable equity securities such as investments in Federal Home Loan Bank (FHLB) stock and Federal Reserve Bank stock, are discussed in chapter 12, "Other Assets, Other Liabilities, and Other Investments."

7.02 A *direct* relationship generally exists between risk and return (the higher the security's risk, the higher its expected yield). An *inverse* relationship generally exists between the security's liquidity and its yield: Less liquid and longer-term securities generally have higher yields. Achieving the proper mix of safety, liquidity, and yield in an investment portfolio is one of the primary tasks of management. In managing their investment portfolios, financial institutions seek to maximize their returns without jeopardizing the liquidity the portfolios provide. Asset/liability management is discussed further in chapter 5, "Audit Considerations and Certain Financial Reporting Matters."

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

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

documents to ascertain the rights and obligations of all parties to the transaction, as well as the recourse available to each party.

U.S. Government and Agency Obligations

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

7.06 U.S. Treasury bills (T-bills) are the shortest term obligations, having original maturities of one year or less. T-bills are sold at a discount from their face value; income to T-bill investors is the difference between the purchase price and the face value. U.S. Treasury notes and bonds (T-notes and T-bonds, respectively) are longer-term obligations that pay interest in semiannual coupon payments. T-notes have original maturities between 1 and 10 years; T-bonds have maturities of 10 years or longer.

7.07 The debt of U.S. government agencies, such as the Government National Mortgage Association (Ginnie Mae), and government-sponsored enterprises (GSEs), such as the Federal Home Loan Mortgage Corporation (Freddie Mac) and Federal National Mortgage Association (Fannie Mae), trades at yields above treasury yields but historically below that of high credit quality corporate debt. The agencies and GSEs issue debentures, notes, and other debt securities having a wide variety of maturities and other features. The GSEs, as public shareholder owned companies, were placed into conservatorship on September 6, 2008, at the direction of the Secretary of the Treasury, the Chairman of the Federal Reserve Board and the Director of Federal Housing Finance Agency. This changed the perception of both GSEs from being implicitly government backed to explicitly government backed along with Ginnie Mae.

Municipal Obligations

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

7.09 Municipal obligations vary significantly in risk. Credit quality depends heavily on the ability and willingness of the municipality to service its debt or the profitability of the particular project being financed. Liquidity also varies. A number of municipal obligations are traded actively on over-the-counter markets; others are thinly traded. Interest on most municipal obligations is exempt from taxes in the state of the municipality; exemption from

federal income taxes depends on the extent to which the obligations benefit private parties rather than the public. (See chapter 16, "Income Taxes" for additional discussion of tax-exempt income.)

7.10 According to the FASB ASC glossary, a *conduit debt security* is defined as certain limited-obligation revenue bonds, certificates of participation, or similar debt instruments issued by a state or local governmental entity for the express purpose of providing financing for a specific third party (the conduit bond obligor) that is not part of the state or local government's financial reporting entity. Although conduit debt securities bear the name of the governmental entity that issues them, the governmental entity often has no obligation for such debt beyond the resources provided by a lease or loan agreement with the third party on whose behalf the securities are issued. Further, the conduit bond obligor is responsible for any future financial reporting requirements.

7.11 The definition of *public entity*, as stated in the FASB ASC glossary, includes a conduit bond obligor for conduit debt securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets).

Asset-Backed Securities

7.12 *Asset-backed securities* (ABSs) are financial instruments that derive their value and receive cash flows from other financial assets (such as mortgage loans or credit-card receivables). ABSs historically provided a great level of liquidity to financial markets, allowed for a wide variety of innovative products, and, because they often involve incrementally more risk, offered better yields than treasuries.

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

7.14 This chapter focuses on ABSs from the perspective of the security holder. Chapter 10, "Transfers and Servicing—Including Mortgage Banking," and chapter 15, "Debt," discuss matters unique to depository institutions that issue ABSs.

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

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

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

7.17 *Mortgage-backed securities.* The simplest form of the ABS is the basic (or *plain vanilla*) MBS, created by pooling a group of similar mortgages. The collateral of a MBS may be residential real estate or commercial real estate. Most MBSs are issued with a stated minimum principal amount and interest rate and represent a pro rata share in the principal and interest cash flows to be received as the underlying mortgages are repaid by the mortgagors. The mortgages underlying the issuance typically have

a. the same type of collateral, such as single-family residential real estate;

b. fixed or adjustable interest rates within a specified range; and

c. maturities within a specified range.

7.18 MBSs are securities issued by a GSE or government agency (for example, Ginnie Mae, Freddie Mac, or Fannie Mae) or by private issuers (for example, banks, and mortgage banking entities). MBSs may be mortgage participation certificates or pass-through certificates, which represents an undivided interest in a pool of specific mortgage loans. Periodic payments on Ginnie Mae, Freddie Mac, and Fannie Mae participation certificates are backed by those agencies.

7.19 *Risk characteristics of MBSs.* Because the repayment of MBSs is contingent on repayment of the underlying loans, the risk characteristics of specific MBS issuances are driven by the risk characteristics of the underlying loans. For example, underlying mortgages insured by the Federal Housing Administration (FHA) would typically involve less credit risk than unguaranteed conventional mortgages.

7.20 *More complex MBS structures.* More complex MBS structures concentrate or dilute risk to create a range of possible investments with unique risks and rewards. As described in the following, an understanding of the structure and nature of a specific MBS is necessary to understand the related risks. This understanding is important, for example, when evaluating whether an investment in a particular tranche of an MBS is other-than-temporarily impaired under FASB ASC 320, *Investments—Debt and Equity Securities*. Such an understanding is also important in making an assessment of whether an embedded derivative exists that would require bifurcation under FASB ASC 815, *Derivatives and Hedging*.

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

a. a letter of credit;

b. guarantee of scheduled principal or interest payments, often achieved

through a transaction with a federal agency such as Ginnie Mae, or a GSE such as Freddie Mac or Fannie Mae;

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

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

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

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

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

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

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

7.26 Some MBSs are backed by adjustable-rate mortgages (ARMs). Interest rates on ARMs change periodically based on an independent factor plus an interest-rate spread, which is expressed as a specified percentage (1 percent, also referred to as one *point*) or one one-hundredth of a percentage (.01 percent, also referred to as one *basis point*). For example, an ARM might carry a rate that changes every 6 months based on the average rate on 1 year treasuries plus 2 points. Annual increases in an ARM's interest rate are generally capped, as are total interest-rate increases over the life of the loan.

7.27 Although yields on ARMs tend to follow increases in prevailing interest rates, they also follow interest rate declines. This, and the fact that

many ARMs have historically been issued with *teaser* rates that are significantly below market rates as a way to attract borrowers, make it more difficult to predict the overall risk of investments in ARM MBSs. The frequency of interest-rate adjustments, the index, the initial interest rate, and the annual and lifetime caps all generally should be considered. For example, credit risk may be higher for ARM MBSs because when interest rates rise borrowers' ability to pay is diminished as their monthly payments increase.

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

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

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

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

7.31 Two common forms of multiclass MBSs are collateralized mortgage obligations (CMOs) and real estate mortgage investment conduits (REMICs). CMOs are bonds secured by (and repaid with) the cash flows from collateral MBSs or mortgages and generally involve some form of credit enhancement. The collateral is generally transferred to a special-purpose entity (SPE) which may be organized as a trust, a corporation, or a partnership. The SPE is an entity created by an asset transferor or sponsor to carry out a specific purpose,

activity or series of transactions directly related to its specific purpose. The SPE then becomes the issuer of the CMO (see consolidation considerations for SPEs and former qualifying special purpose entities in paragraph 7.114 and beginning in paragraph 10.76 of this guide. Accordingly, a security holder may invest in a CMO in equity form (for example, trust interests, stock, and partnership interests) or nonequity form (for example, participating debt securities). REMICs are a form of CMO specially designated for federal income tax purposes so that the related income is taxed only once (to the security holder). See chapter 16.

7.32 Understanding the risks associated with a particular tranche of a MBS or other ABS often requires an understanding of the security structure, as documented in the offering document and related literature. A tranche is defined as one of several related securities offered at the same time. Tranches from the same offering usually have different risk, reward, or maturity characteristics.

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

7.34 Investment classes that have a contractual right to interest cash flows (interest classes), such as MBS IOs, are extremely interest-rate sensitive and, therefore, carry the risk that the security holder's entire recorded investment could be lost. Investment classes weighted toward principal cash flows (principal classes), such as MBS POs, also carry special risks. The following discussion of related risk concepts can be applied to various other investments in MBSs or other ABSs.

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

7.36 Changes in the prices (and, therefore, the values) of MBSs are heavily dependent on whether the collateral's interest rates are above or below prevailing interest rates. A mortgage will trade at a discount (a discount mortgage) when it carries an interest rate lower than prevailing interest rates. A mortgage that carries an interest rate above prevailing rates will trade at a premium (a premium mortgage).

7.37 An IO backed by a pool of premium mortgages may be a more useful tool for controlling interest-rate risk than one backed by a pool of discount mortgages, as it shows greater appreciation in value when interest rates increase and does not suffer as significant a decrease in value when interest rates fall. Falling interest rates generally result in greater prepayments. Accordingly, the cash generated from an IO over its life usually decreases

because interest is earned on a smaller remaining principal balance. Although the discounting of the stream of interest receipts at a lower interest rate increases the present value of each future dollar of interest, the negative effect of increased prepayments generally outweighs the positive discounting effect, and, therefore, the fair value of the IO generally declines. IOs generally increase in value in a rising rate environment because as prepayments slow, the related mortgage principal balance remains outstanding for a longer period, and, therefore, interest is earned for a longer period (although the present value of each of those future dollars is reduced by the higher discount rate).

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

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

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

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

7.42 *Residual classes.* From a legal perspective, residuals represent an ownership interest in the underlying collateral, subject to the first lien and indenture of the other security holders. Residuals entitle the holder to the excess, if any, of the issuer's cash inflows (including reinvestment earnings) over

cash outflows (which often include any debt service and administrative expenses). Three sources of residual cash flows typically exist:

a. The differential between interest cash flows on the collateral and interest payments on other investment classes

b. Any overcollateralization provided as a credit enhancement

c. Any income earned on reinvestment of other cash flows before they are distributed to other security holders (because payments on collateral mortgages are received monthly but some investment classes are repaid quarterly or semiannually, these receipts are reinvested in the interim)

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

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

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

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

7.47 The fair value of floating-rate residuals usually performs best in a stable interest-rate environment. As with fixed-rate residuals, the main source of cash flow to floating-rate residuals is the interest differential between interest earned on the collateral and interest paid on other investment classes. However, because one or more of the classes is tied to a floating rate, the interest differential changes when the rates on floating-rate classes are reset. For example, when interest rates rise, the rate on the floating-rate class may be reset at a higher rate. More of the cash flows from the underlying collateral would then be paid to the floating-rate classes, leaving less cash flow for the

residual. Higher interest rates also tend to cause prepayments to slow, and thereby increase the period over which the interest-differential income is earned by the residual holders. Conversely, when interest rates decline, rates on floating-rate classes decrease, but prepayments of premium mortgages would tend to accelerate. The loss of interest income as a result of prepayments would typically offset a widening of the interest differential stemming from the lower rate on the floating-rate class, thus reducing the cash flow to the residual. Thus, changes in interest rates produce two opposing effects on the fair value of floating-rate residuals. Whether the value of the residual actually declines or rises when interest rates change depends on the interrelationship between the interest on the floating-rate class and mortgage prepayment speeds.

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

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

Other Structured Credit Products

7.50 The following discussion addresses certain common characteristics of other structure credit products such as structured notes, TPSs, and pooled TPSs. These general characteristics along with those unique to the various securities are important considerations when evaluating the related risks.

7.51 On April 30, 2009, the Federal Deposit Insurance Corporation (FDIC) issued Financial Institution Letter (FIL)-20-2009, "Risk Management of Investments in Structured Credit Products." According to the FDIC FIL, the term *structured credit products* may be broadly defined to refer to all structured investment products where repayment is derived from the performance of the underlying assets or other reference assets, or by third parties that serve to enhance or support the structure. Such products include MBSs and CMOs, as previously discussed. These products also include, but are not limited to, structured investment vehicles, collateralized debt obligations (CDOs), including securities backed by TPSs, and other ABSs. As previously noted, a discussion of the risks associated with all forms of structured credit product is beyond the scope of this guide.

7.52 *Structured notes.* Structured notes are hybrid securities that combine fixed term, fixed or variable rate instruments, and derivative products. Structured notes are debt securities issued by corporations or GSEs, including FHLB, Fannie Mae, and Freddie Mac. Structured notes generally contain embedded

options and have cash flows that are linked to the indexes of various financial variables, such as interest rates, foreign exchange rates, commodity prices, prepayment rates, and other financial variables. Structured notes can be linked to different market sectors or interest rate scenarios, such as the shape of the yield curve, the relationship between two different yield curves, or foreign exchange rates.

7.53 *Trust preferred securities*. Investments in TPSs are also hybrid instruments possessing characteristics typically associated with debt obligations. Although each issue of these securities may involve minor differences in terms, under the basic structure of TPSs a corporate issuer, such as a bank holding company, first organizes a business trust or other special purpose entity. This trust issues two classes of securities: common securities, all of which are purchased and held by the corporate issuer, and TPSs, which are sold to investors. The corporate issuer makes periodic interest payments on the subordinated debentures to the business trust, which uses these payments to pay periodic dividends on the TPSs to the investors. The subordinated debentures have a stated maturity and may also be redeemed under other circumstances. Most TPSs are subject to a mandatory redemption upon the repayment of the debentures. Because of the mandatory redemption provision in the typical TPS, investments in TPSs would normally be considered debt securities under FASB ASC 320.

7.54 TPSs have a payment deferral feature of up to 5 years and, in general, have a 30 year maturity. In the event of bankruptcy, TPSs are below all senior and subordinated debt, but above equity securities in priority. In addition, TPSs generally are rated by nationally recognized rating firms.

7.55 *Pooled trust preferred securities.* In a pooled TPSs offering, an additional trust is added to the structure and is referred to as a business trust. A pooled TPS is a form of CDO backed by various TPSs. The business trust issues securities to investors and uses the proceeds to purchase all of the TPSs from the grantor trust. The TPSs are then securitized, as the business trust is the sole investor of the securities.

7.56 Trust preferred pools issue several classes, or tranches, of securities, which include senior, mezzanine, and residual (also referred to as "income") tranches. The senior tranches have priority of payment, with the subordinated residual interest and mezzanine positions absorbing losses first and serving as credit protection for the senior tranches. The TPSs include credit support provisions such that if performance in the underlying collateral deteriorates below certain levels, cash flows are diverted from the residual tranches to pay the senior and mezzanine tranches. Further deterioration may result in diversion of cash flows from the holders of the mezzanine tranches to pay the holders of the senior tranches. Securitization documents explain the priority of payments and the credit support levels of the various tranches.

7.57 Understanding the list of issuers that compose the portfolio, the current investment ratings, the status of the collateral (for example, the extent of any deferrals or defaults), and the credit quality of the institutions remaining in the pool are important aspects of these investments when considering the related risks.

7.58 The risks associated with pooled TPSs are heavily dependent upon the position in the securitization structure. It is important to understand the structure of the security, the priority of payments, and current credit support

levels (for example, whether income is being diverted from the subordinate tranches to support the credit protection level of the senior tranches).

7.59 The underlying collateral for a significant number of structured credit products, including those previously addressed, has performed poorly in recent years. Although certain structured credit products have performed worse than others, in many instances, the level of credit support for senior tranches has deteriorated, the volume and severity of credit rating downgrades have increased, liquidity has declined, and price volatility has increased. As a result, an increasing number of financial institutions have recognized other-than-temporary impairment (OTTI) charges. (See additional information regarding OTTI charges beginning in paragraph 7.92.) Due to the complex nature of these investments, the structural characteristics and the underlying collateral at the pool and individual investment level are important factors to be considered when evaluating the related risks and determining an appropriate valuation.

Issues of International Organizations and Foreign Governments

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

Other Securities

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

- Common-trust or mutual-investment funds
- Investments in negotiable certificates of deposit[1]
- Equity securities, including venture capital investments
- Corporate bonds and commercial paper

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

Corporate Credit Union Shares and Certificates

7.62 The Corporate Credit Union Network (the network) serves as a primary investment alternative for many credit unions. The network consists of the U.S. Central Credit Union (U.S. Central) and the various corporate credit unions. U.S. Central "wholesales" financial and payment services to the corporate credit unions, which in turn act as financial intermediaries on behalf of the individual credit unions. Surplus funds of the individual credit unions may be aggregated in the corporate credit unions for investment through U.S. Central.

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[1] The AICPA issued Technical Questions and Answers section 2130.40, "Certificates of Deposit and FASB ASC 320" (AICPA, *Technical Practice Aids*), which addresses whether certificates of deposit fall within the scope of Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 320, *Investments—Debt and Equity Securities*. For additional information, visit the AICPA website at www.aicpa.org.

U.S. Central's investment objectives are to offer competitive yields on investments while maintaining safety and liquidity. Overnight investment alternatives offered through the network include regular daily shares and overnight certificates. Term investment alternatives, with maturities of two days to five years and longer, offered through the network include (*a*) liquidity, (*b*) high-yield and redeemable shares, and (*c*) variable-rate shares and certificates.

7.63 In January 2009, U.S. Central announced an unaudited net loss as a result of charges for OTTIs in relation to its portfolio of residential MBSs. At the same time, the National Credit Union Administration (NCUA) announced that the National Credit Union Share Insurance Fund (NCUSIF) issued a capital note of $1 billion to U.S. Central, thereby providing reserves to offset anticipated realized losses on some of the mortgage- and asset-based securities held by U.S. Central. The investment to U. S. Central was immediately written off in the NCUSIF financial statements. On March 20, 2009, the NCUA announced that it placed U.S. Central under conservatorship. On May 20, 2009, the NCUA created a Temporary Corporate Credit Union Stabilization Fund which paid the NCUSIF $1 billion for assignment of the full right, title and interest in the outstanding capital note extended to U.S. Central on January 28, 2009. The May 20th payment effectively spread the cost of the corporate stabilization program for insured credit unions over multiple years.

7.64 In May 2009, the AIPCA issued Technical Questions and Answers section 6995.02, "Evaluation of Capital Investments in Corporate Credit Unions for Other-Than-Temporary Impairment" (AICPA, *Technical Practice Aids*), for evaluating membership capital shares (MCS) and paid-in capital (PIC) issued by U. S. Central and other corporate credit unions as of December 31, 2008. The NCUA Letter to Credit Unions No. 09-CU-10, "Matters Related to 'Paid-in Capital' and 'Membership Capital' of Corporate Credit Unions," which was issued in May 2009, also addresses matters related to MCS and PIC of corporate credit unions. Readers are encouraged to monitor the NCUA website for additional developments regarding this topic.

7.65 On September 24, 2010, the NCUA released its Corporate System Resolution Plan, which involved assuming control of three additional undercapitalized corporate credit unions, announcing a plan to isolate the impaired assets in the corporate credit union system, and finalize a set of stronger regulations. NCUA Letter to Credit Unions No. 10-CU-19, "Corporate Credit Union System Resolution," was also released in September 2010 to address the reform action plan. Additional details on NCUA's Corporate System Resolution can be found at www.ncua.gov/Resources/CorporateCU/CSRMain.aspx.

7.66 In October 2010, the NCUA issued amendments to its rule governing corporate credit unions. The major revisions involved corporate credit union capital, investments, asset-liability management, governance, and credit union service organization activities. In regards to investments, the final amendments now involve a rigorous investment screening process prior to purchase. Some of the significant changes within the process include (*a*) Nationally Recognized Statistical Rating Organization ratings screen, (*b*) additional prohibition of certain highly complex and leverage securities (specifically, a CDO, net interest margin security, private label residential MBS, or security subordinated to any other securities in the issuance), (*c*) single obligor limits tightened from 50 percent of capital to 25 percent of capital, (*d*) portfolio weighted average life (WAL) not to exceed two years, and (*e*) portfolio WAL (assuming prepayment slowdown of 50 percent) not to exceed 2.5 years. In addition, some corporations may hold investments that are in violation of one

or more of these new prohibitions, and these investments will be subject to the investment action plan provisions.[2]

Transfers of Securities

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

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

7.69 An institution may advance cash, pledge other securities, or issue letters of credit as collateral for borrowed securities. The amount of cash or other collateral deemed necessary may increase or decrease depending on changes in the value of the securities.

Regulatory Matters

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

7.71 *Banks and savings institutions.* In Thrift Bulletin (TB) 73a, *Investing in Complex Securities*, the Office of the Thrift Supervision states that TPSs that otherwise meet the requirements of corporate debt securities[3] are permissible investments for federal savings associations. Savings associations are, however, prohibited from purchasing TPSs or any other type of security from the parent holding company or any other affiliate. TB 73a should be consulted for additional limitations and requirements for holding these securities. National banks and state nonmember banks are permitted to invest in trust preferred stock within certain limitations. (See Office of the Comptroller of the Currency [OCC] Interpretation Letter No. 777, April 8, 1997; FDIC FIL-16-99, February 16, 1999.) The Dodd-Frank Act did not change the prohibitions.

7.72 The Federal Financial Institutions Examination Council (FFIEC) issued the *Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities* dated April 23, 1998, that was adopted by all of the federal banking agencies. The policy statement provides guidance to financial institutions on sound practices for managing the risks of investment securities and end-user derivatives activities. The guidance describes the practices that a

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[2] The requirements for corporate credit union investments and the investment action plan are set forth in Title 12 U.S. *Code of Federal Regulations* (CFR) Part 704.5 and Part 704.10.

[3] The requirements of corporate debt securities are set forth in 12 CFR 560.40.

prudent manager normally would follow, but it emphasizes that it is not intended to be a checklist and management should establish practices and maintain documentation appropriate to the institution's individual circumstances.

7.73 The FFIEC supervisory policy statement applies to all securities in held-to-maturity and available-for-sale accounts as described in FASB ASC 320, certificates of deposit held for investment purposes, and end-user derivative contracts not held in trading accounts. This guidance covers all securities used for investment purposes, including money market instruments, fixed-rate and floating-rate notes and bonds, structured notes, mortgage pass-through and other ABSs and mortgage-derivative products. Similarly, the guidance covers all end-user derivative instruments used for nontrading purposes, such as swaps, futures, and options.

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

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

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

- market risk,
- credit risk,
- liquidity risk,
- operational (transaction) risk, and
- legal risk.

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

7.77 As previously noted, the FDIC issued FIL-20-2009, which clarifies the application of existing supervisory guidance to structured credit products, including the 1998 supervisory guidance discussed in paragraphs 7.72–.76. Topics addressed in FIL-20-2009 include investment suitability and due diligence, the use of external credit ratings, pricing and liquidity, and adverse classification of investment securities.

7.78 FIL-20-2009 addresses concerns about the nonagency structured credit market. However, some of the clarifications in this guidance also are

relevant for agency securities. See paragraphs 7.50–.59 regarding further discussion of other structure credit products.

7.79 The FDIC's *Risk Management Manual of Examination Policies* includes a subchapter titled "Securities and Derivatives" which references these interagency guidance documents.

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

7.81 *Credit unions.* Federal regulations describe investments allowed for federal credit unions. These regulations explicitly prohibit federal credit unions from (*a*) purchasing stripped MBSs, residual interests in CMOs and REMICs, mortgage servicing rights, commercial-mortgage-related securities, or small-business-related securities, (*b*) purchasing a zero-coupon investment with a maturity date that is more than 10 years from the settlement date, (*c*) purchasing or selling financial derivatives, such as futures, options, interest rate swaps or forward rate swaps except for certain put options on Ginnie Mae, Fannie Mae, and Freddie Mac MBSs, and (*d*) engaging in adjusted trading or short sales.[4]

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

7.83 See paragraph 7.66 for discussion of investment regulations for corporate credit unions.

Bank Accounting Advisory Series

7.84 The OCC *Bank Accounting Advisory Series* (BAAS) expresses the Office of the Chief Accountant's current views on accounting topics of interest to national banks. See further discussion of the BAAS in paragraph 8.80 of this

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[4] For further discussion of regulations related to prohibited investment activities and prohibited investments, see 12 CFR 703.15-.16. Credit unions who qualify for the Regulatory Flexibility Program (Reg-Flex) can be subject to less strict regulation in this area. Reg-Flex qualifying credit unions can purchase zero coupon investments beyond 10 years of maturity and commercial mortgage related securities provided the securities meet certain qualifications outlined in 12 CFR 742.4.

guide. Topic 1, "Investment Securities" of the BAAS includes interpretations on (*a*) investment in debt and equity securities and (*b*) OTTI. Readers are encouraged to read this publication on the OCC website at www.occ.gov/topics/bank-operations/accounting/index-accounting.html.[*]

Accounting and Financial Reporting

Introduction

7.85 FASB ASC 320 addresses accounting and reporting for investments in equity securities that have readily determinable fair values and for all investments in debt securities, according to FASB ASC 320-10-05-2. FASB ASC 320-10-25-1 requires that at acquisition, an entity should classify debt securities and equity securities into one of these three categories:

a. *Held-to-maturity securities*. Investments in debt securities should be classified as held-to-maturity only if the reporting entity has the positive intent and ability to hold those securities to maturity. According to FASB ASC 320-10-35-1, investments in debt securities classified as held-to-maturity should be measured subsequently at amortized cost in the statement of financial position.

b. *Trading securities*. If a security is acquired with the intent of selling it within hours or days, the security should be classified as trading. However, at acquisition an entity is not precluded from classifying as trading a security it plans to hold for a longer period. Classification of a security as trading should not be precluded simply because the entity does not intend to sell it in the near term. According to FASB ASC 320-10-35-1, trading securities should be measured subsequently at fair value in the statement of financial position and unrealized holding gains and losses should be included in earnings.

c. *Available-for-sale securities*. Available-for-sale securities are investments in debt and equity securities that have readily determinable fair values not classified as held-to-maturity securities or trading securities. According to FASB 320-10-35-1, available-for-sale securities are measured subsequently at fair value in the statement of financial position, with unrealized holding gains and losses excluded from earnings and reported as other comprehensive income until realized except as indicated in the following sentence. All or a portion of the unrealized holding gain and loss of an available-for-sale security that is designated as being hedged in a fair value hedge should be recognized in earnings during the period of the hedge, pursuant to paragraphs 1–4 of FASB ASC 815-25-35.

7.86 Paragraphs 4–18 of FASB ASC 320-10-25 describe certain circumstances not consistent with held-to-maturity classification and circumstances that are consistent with held-to-maturity classification. FASB ASC 320-10-25-6 addresses changes in circumstances that may cause the entity to change its intent to hold a certain security to maturity without calling into question its intent to hold other debt securities to maturity in the future. FASB ASC

[*] Due to a number of accounting rule changes, the October 2010 edition of the *Bank Accounting Advisory Series* (BAAS) has added or revised a number of questions and responses related to Section 2A, "Troubled Debt Restructurings." In addition, Section 1B, "OTTI," was revised in its entirety.

320-10-25-18 provides specific scenarios where sale or transfer of a held-to-maturity security will not call into question an investor's stated intent to hold other debt securities to maturity in the future.[†]

7.87 Paragraphs 10–16 of FASB ASC 320-10-35 address transfers of securities between categories. The transfer of a security between categories of investments should be accounted for at fair value. Transfers from the held-to-maturity category should be rare, except for transfers due to the changes in circumstances identified in paragraphs 6(a)-(f) of FASB ASC 320-10-25. In addition, given the nature of a trading security, transfers into or from the trading category also should be rare. Paragraphs 75–77 of FASB ASC 860-10-55 give an example addressing whether a transferor has the option to classify debt securities as trading at the time of a transfer.

7.88 FASB ASC 948-310-40-1 states that after the securitization of a mortgage loan held for sale that meets the conditions for a sale addressed in FASB ASC 860-10-40-5, any MBSs received by a transferor as proceeds should be classified in accordance with the provisions of FASB ASC 320. However, FASB ASC 948-310-35-3A states that a mortgage banking entity must classify as trading any MBSs received as proceeds that it commits to sell before or during the securitization process. An entity is prohibited from reclassifying loans as investment securities unless the transfer of those loans meets the conditions for sale accounting addressed in FASB ASC 860-10-40-5.

7.89 FASB ASC 740-20-45-11(b) states that the tax effects of *gains and losses included in comprehensive income but excluded from net income* (for example, changes in the unrealized holding gains and losses of securities classified as available-for-sale under FASB ASC 320), as defined in the FASB ASC glossary, occurring during the year should be charged or credited directly to other comprehensive income or to related components of shareholders' equity.

7.90 FASB ASC 320-10-25-5(a) states that a security should not be classified as held-to-maturity if that security can contractually be prepaid or otherwise settled in such a way that the holder of the security would not recover substantially all of its recorded investment. The justification for using historical-cost-based measurement for debt securities classified as held-to-maturity is that no matter how market interest rates fluctuate, the holder will recover its recorded investment and thus realize no gains or losses when the issuer pays the amount promised at maturity. However, that justification does not extend to receivables purchased at a substantial premium over the amount at which they can be prepaid, and it does not apply to instruments whose payments derive from prepayable receivables but have no principal balance. Therefore, a callable debt security purchased at a significant premium might be precluded from held-to-maturity classification under FASB ASC 860-20-35-2 if it can be prepaid or otherwise settled in such a way that the holder of the security would not recover substantially all of its investment. In addition, a mortgage-backed interest-only certificate should not be classified as held-to-maturity. Paragraphs 3–6 of FASB ASC 860-20-35 provide further guidance. Note that a debt security that is purchased late enough in its life such that, even if it was prepaid, the holder would recover substantially all of its recorded investment,

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[†] If the remaining held-to-maturity portfolio is tainted and reclassified to the available-for-sale classification, the length of the taint period under accounting principles generally accepted in the United States of America (GAAP) is not defined. The Securities and Exchange Commission (SEC) recommended a two year time frame minimum for the tainting period. Refer to the guidance in BAAS Question 9 (December 2001) Topic 1A, "Investments in Debt and Equity Securities."

could be initially classified as held-to-maturity if the conditions of FASB ASC 320-10-25-5 and FASB ASC 320-10-25-1 are met. (A debt security that can contractually be prepaid or otherwise settled in such a way that the holder of the security would not recover substantially all of its recorded investment may contain an embedded derivative. Therefore, such a security should be evaluated in accordance with FASB ASC 815-15 to determine whether it contains an embedded derivative that needs to be accounted for separately).

7.91 See chapter 20, "Fair Value," of this guide for a summary of FASB ASC 820, *Fair Value Measurement*.

Other-Than-Temporary Impairment

7.92 Paragraphs 17–35A of FASB ASC 320-10-35 provide guidance regarding the impairment of individual available-for-sale and held-to-maturity securities, including the scope of impairment guidance, the steps for identifying and accounting for impairment, and the recognition of an OTTI. See paragraphs 7.125–.132 and FASB ASC 320-10-50 for disclosure requirements related to OTTI.

7.93 For individual securities classified as either available-for-sale or held-to-maturity, an entity should determine whether a decline in fair value below the amortized cost basis is other than temporary as stated in FASB ASC 320-10-35-18. Providing a general allowance for unidentified impairment in a portfolio of securities is not appropriate. Paragraphs 20–29 of FASB ASC 320-10-35 provide guidance an entity should follow in assessing impairment of individual securities classified as either available-for-sale or held-to-maturity. If the fair value of an investment is less than its amortized cost basis at the balance sheet date of the reporting period for which impairment is assessed, the impairment is either temporary or other than temporary, as stated in FASB ASC 320-10-35-30.

7.94 *Equity securities.* FASB ASC 320-10-35-32A states that for equity securities, an entity should apply the guidance that is pertinent to the determination of whether an impairment is other than temporary, such as FASB ASC 325-40-35. If it is determined that the impairment is other than temporary, then an impairment loss should be recognized in earnings equal to the entire difference between the investment's cost and its fair value at the balance sheet date of the reporting period for which the assessment is made as stated in FASB ASC 320-10-35-34. The measurement of the impairment should not include partial recoveries after the balance sheet date. The fair value of the investment would then become the new amortized cost basis and that cost basis should not be adjusted for subsequent recoveries in fair value.

7.95 *Debt securities.* For debt securities, readers may refer to paragraphs 33A–33I of FASB ASC 320-10-35 for guidance on evaluating whether an impairment is other than temporary. Paragraphs 34A–34E of FASB ASC 320-10-35 provide guidance on determining the amount of an OTTI recognized in earnings and other comprehensive income if the impairment is other than temporary. The following paragraphs highlight certain sections of this guidance.

7.96 If an entity intends to sell the impaired debt security (that is, it has decided to sell the security), an OTTI should be considered to have occurred. If an entity does not intend to sell the impaired debt security, the entity should consider available evidence to assess whether it more likely than not will be required to sell the security before the recovery of its amortized cost basis (for

example, whether its regulatory obligations indicate that the security will be required to be sold before a forecasted recovery occurs). If the entity more likely than not will be required to sell the security before recovery of its amortized cost basis, an OTTI should be considered to have occurred.

7.97 In assessing whether the entire amortized cost basis of the security will be recovered, an entity should compare the present value of cash flows expected to be collected from the security with the amortized cost basis of the security. If the present value of cash flows expected to be collected is less than the amortized cost basis of the security, the entire amortized cost basis of the security will not be recovered (that is, a credit loss exists), and an OTTI should be considered to have occurred.

7.98 In determining whether a credit loss exists, an entity should use its best estimate of the present value of cash flows expected to be collected from the debt security. One way of estimating that amount would be to consider the methodology described in FASB ASC 310-10-35 for measuring an impairment on the basis of the present value of expected future cash flows. Briefly, the entity would discount the expected cash flows at the effective interest rate implicit in the security at the date of acquisition. All of the factors, listed in FASB ASC 320-10-35-33F should be considered when estimating whether a credit loss exists and the period over which the debt security is expected to recover. This list is not meant to be all inclusive.

7.99 In making its OTTI assessment, an entity should consider the factors in paragraphs 33G–33H in FASB ASC 320-10-35. An entity also should consider how other credit enhancements affect the expected performance of the security, including consideration of the current financial condition of the guarantor of a security (if the guarantee is not a separate contract as discussed in FASB ASC 320-10-35-23) or whether any subordinated interests are capable of absorbing estimated losses on the loans underlying the security. The remaining payment terms of the security could be significantly different from the payment terms in prior periods (such as, for some securities backed by nontraditional loans; see FASB ASC 825-10-55-1). Thus, an entity should consider whether a security backed by currently performing loans will continue to perform when required payments increase in the future (including balloon payments). An entity also should consider how the value of any collateral would affect the expected performance of the security. If the fair value of the collateral has declined, an entity should assess the effect of that decline on the ability of the entity to collect the balloon payment.

7.100 If an OTTI has occurred, the amount of the OTTI recognized in earnings depends on whether an entity intends to sell the security or more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss. If an entity does not intend to sell the debt security and it is not more likely than not that the entity will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss, the OTTI should be separated into both of the following:

a. The amount representing the credit loss

b. The amount related to all other factors

The amount of the total OTTI related to the credit loss should be recognized in earnings. The amount of the total OTTI related to other factors should be recognized in other comprehensive income, net of applicable taxes.

7.101 Subsequent increases and decreases (if not an OTTI) in the fair value of available-for-sale securities should be included in other comprehensive income, according to FASB ASC 320-10-35-35.

7.102 The OTTI recognized in other comprehensive income for debt securities classified as held-to-maturity should be accreted over the remaining life of the debt security in a prospective manner on the basis of the amount and timing of future estimated cash flows, as stated in FASB ASC 320-10-35-35A. That accretion should increase the carrying value of the security and should continue until the security is sold, the security matures, or there is an additional OTTI that is recognized in earnings.

7.103 A decline in the value of a security that is other than temporary is also discussed in AU section 332,[‡] *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*), and the Securities and Exchange Commission Codification of Staff Accounting Bulletins Topic 5(M), "Other Than Temporary Impairment of Certain Investments in Equity Securities."

Unrealized Gains and Losses[||]

7.104 FASB ASC 220-10-45-8 requires that comprehensive income and its components be displayed with the same prominence as other financial statements that constitute a full set of financial statements. FASB ASC 220-10 divides comprehensive income into net income and other comprehensive income, as stated in FASB ASC 220-10-45-6. FASB ASC 220-10-45-13 requires

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[‡] The Auditing Standards Board (ASB) has finalized a new clarified auditing standard, *Audit Evidence—Specific Considerations for Selected Items*. This clarified auditing standard will supersede AU section 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*), and addresses specific considerations by the auditor in obtaining sufficient appropriate audit evidence regarding certain aspects of investments in securities and derivatives, among other things. This clarified auditing standard has been finalized but not yet issued. See the preface of this guide for further information on the ASB's Clarity Project. The effective date of this clarified standard is for audits of financial statements for periods ending on or after December 15, 2012, unless otherwise established (early implementation is not permitted).

[||] In June 2011, FASB issued Accounting Standards Update (ASU) No. 2011-05, *Comprehensive Income (Topic 220): Presentation of Comprehensive Income*. Under the amendments in this ASU, an entity has the option to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In both choices, an entity is required to present each component of net income along with total net income, each component of other comprehensive income along with a total for other comprehensive income, and a total amount for comprehensive income. In a single continuous statement, the entity is required to present the components of net income and total net income, the components of other comprehensive income and a total for other comprehensive income, along with the total of comprehensive income in that statement. In the two-statement approach, an entity is required to present components of net income and total net income in that statement of net income. The statement of other comprehensive income should immediately follow that statement of net income and include the components of other comprehensive income and a total for other comprehensive income along with a total for comprehensive income. This ASU eliminates the option to present the components of other comprehensive income as part of the statement of changes in stockholders' equity. An entity is now also required to present on the face of the financial statements reclassification adjustments for items that are reclassified from other comprehensive income to net income in that statement(s) where the components of net income and the components of other comprehensive income are presented.

The amendments in this ASU should be applied retrospectively. For public entities, the amendments are effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. For nonpublic entities, the amendments are effective for fiscal years ending after December 15, 2012, and interim and annual periods thereafter. Early adoption is permitted. Readers should consult the text of ASU No. 2011-05 for further information.

that items included in other comprehensive income be classified based on their nature. For related implementation guidance, see FASB ASC 220-10-55-2. FASB ASC 220-10-45-15 requires that reclassification adjustments be made to avoid double counting in comprehensive income items that are displayed as part of net income for a period that also had been displayed as part of other comprehensive income in that period or earlier periods. For example, gains on investment securities that were realized and included in net income of the current period that also had been included in other comprehensive income as unrealized holding gains in the period in which they arose must be deducted through other comprehensive income of the period in which they are included in net income to avoid including them in comprehensive income twice (see FASB ASC 320-10-40-2).

7.105 FASB ASC 825, *Financial Instruments*, creates a fair value option under which an organization may irrevocably elect fair value as the initial and subsequent measure for many financial instruments and certain other items, with changes in fair value recognized in earnings as those changes occur. Chapter 20 provides a summary of FASB ASC 825, but is not intended as a substitute for reading the guidance in FASB ASC 825.

Premiums and Discounts

7.106 An institution will often pay less (or more) for a security than the security's face value. Accretion of the resulting discount (or amortization of the premium) increases (or decreases) the effective rate of interest on the security, thereby reflecting the security's market yield.

7.107 Dividend and interest income,[5] including amortization of the premium and discount arising at acquisition, for all three categories of investments in securities should be included in earnings, according to FASB ASC 320-10-35-4.

7.108 For a debt security transferred into the held-to-maturity category from the available-for-sale category, the unrealized holding gain or loss at the date of the transfer should continue to be reported in a separate component of shareholders' equity, such as accumulated other comprehensive income, but should be amortized over the remaining life of the security as an adjustment of yield in a manner consistent with the amortization of any premium or discount, as stated in FASB ASC 320-10-35-10(d). The amortization of an unrealized holding gain or loss reported in equity will offset or mitigate the effect on interest income of the amortization of the premium or discount) for that held-to-maturity security. For a debt security transferred into the held-to-maturity category, the use of fair value may create a premium or discount that, under amortized cost accounting, should be amortized thereafter as an adjustment of yield pursuant to FASB ASC 310-20.

7.109 The guidance in FASB ASC 310-20 explicitly includes the accounting for discounts, premiums, and commitments fees associated with the purchase of loans and other debt securities such as corporate bonds, treasury notes and bonds, groups of loans, and loan-backed securities, as stated in FASB ASC 310-20-15-2(b). FASB ASC 310-20-35-18 specifies that net fees or costs that are required to be recognized as yield adjustments over the life of the related loan(s) should be recognized by the interest method except as set forth in paragraphs

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[5] For debt securities for which other-than-temporary impairments were recognized in earnings, the difference between the new amortized cost basis and the cash flows expected to be collected should be accreted as interest income as stated in FASB ASC 320-10-35-35.

21–24 of FASB ASC 310-20-35. The objective of the interest method is to arrive at periodic interest income (including recognition of fees and costs) at a constant effective yield on the net investment in the receivable (that is, the principal amount of the receivable adjusted by unamortized fees or costs and purchase discount or premium).

7.110 FASB ASC 942-320-35-1 states that the period of amortization or accretion for debt securities should generally extend from the purchase date to the maturity date, not an earlier call date. FASB ASC 310-20-35-26 explains that if the entity holds a large number of similar loans for which prepayments are probable and the timing and the amount of the prepayments can be reasonably estimated, the entity may consider estimates of future principal prepayments in the calculation of the constant effective yield necessary to apply the interest method.

7.111 Certain ABSs may meet those conditions, and institutions should consider estimates of prepayments in determining the amortization period for calculation of the constant effective yield.

7.112 FASB ASC 310-20-35-26 states that if the institution anticipates prepayments in applying the interest method and a difference arises between the anticipated prepayments and the actual prepayments received, the effective yield should be recalculated to reflect actual payments to date and anticipated future payments. The net investment in the loans should be adjusted to the amount that would have existed had the new effective yield been applied since the acquisition of the loans. The investment in the loans should be adjusted to the new balance with a corresponding charge or credit to interest income.

7.113 In general, purchase discounts on POs are recognized by the interest method over the contractual life of the related instrument in conformity with FASB ASC 310-20-35. However, POs ordinarily meet the criteria in FASB ASC 310-20-35-26 that permit the accretion of discounts using expected maturity dates.

Consolidation[#]

7.114 A reporting entity that holds a direct or indirect (explicit or implicit) variable interest in a legal entity must determine whether the guidance in the "Variable Interest Entities" subsections of FASB ASC 810-10 applies to that legal entity before considering other consolidation guidance. However, if a reporting entity does not have a direct or indirect (explicit or implicit) variable interest in a legal entity, then the reporting entity is not the primary beneficiary

[#] FASB Statement No. 166, *Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140*, eliminated the exceptions for qualifying special purpose entities (QSPEs) from the consolidation guidance in FASB ASC 810, *Consolidation*. In conjunction with release of FASB Statement No. 166, FASB issued FASB Statement No. 167, *Amendments to FASB Interpretation No. 46(R)*, to improve financial reporting by entity's involved with variable interest entities (VIEs) and to address the potential impacts on certain provisions of FASB Interpretation No. 46(R), *Consolidation of Variable Interest Entities (revised December 2003)—an interpretation of ARB No. 51*, as a result of the QSPE concept. The provisions of FASB Statement No. 166 and No. 167 are found within FASB ASC 860, *Transfers and Servicing*, and FASB ASC 810, respectively.

As a result of this guidance, reporting entity's should now evaluate former QSPEs in consideration of whether the reporting entity has a variable interest in the entity, whether the former QSPE is a VIE, and whether the reporting entity should consolidate the entity, or provide disclosures about its involvement with the former QSPE, or both. Reporting entities should also consider the need to re-evaluate the initial assessments of special purpose entities as VIEs based on the amendments of FASB Statement No. 167.

of that legal entity and is not required to provide disclosures for that legal entity under FASB ASC 810-10, "Variable Interest Entities" subsections. Variable interest entities (VIEs) may appear in various forms, such as TPSs, synthetic leases, asset-backed commercial paper conduits, and CDOs. See detailed discussion of consolidation considerations related to variable interest entities beginning in paragraph 10.76 of this guide.

Special Areas

7.115 The following paragraphs list several specialized accounting issues involving investments in securities.

7.116 *Cost basis of debt security received in restructuring*. FASB ASC 310-40-40-8A states that the initial cost basis of a debt security of the original debtor received as part of a debt restructuring should be the security's fair value at the date of the restructuring. Any excess of the fair value of the security received over the net carrying amount of the loan should be recorded as a recovery on the loan. Any excess of the net carrying amount of the loan over the fair value of the security received should be recorded as a charge-off to the allowance for credit losses. Subsequent to the restructuring, the security received should be accounted for according to the provisions of FASB ASC 320.

7.117 *Sales of marketable securities with put arrangements*. Paragraphs 20–23 of FASB ASC 860-20-55 address transactions that involve the sale of a marketable security to a third-party buyer, with the buyer having an option to put the security back to the seller at a specified future date or dates for a fixed price. If the transfer is accounted for as a sale, a put option that enables the holder to require the writer of the option to reacquire for cash or other assets a marketable security or an equity instrument issued by a third party should be accounted for as a derivative by both the holder and the writer, provided the put option meets the definition of a derivative in FASB ASC 815-10-15-83 (including meeting the net settlement requirement, which may be met if the option can be net settled in cash or other assets or if the asset required to be delivered is readily convertible to cash).

Transfers and Servicing of Securities

7.118 FASB ASC 860-10 establishes accounting and reporting standards for transfers and servicing of financial assets, according to paragraphs 1 and 6 of FASB ASC 860-10-05. This guidance also provides an overview of the types of transfers addressed, including securitization, factoring, transfers of receivables with recourse, securities lending transactions, repurchase agreements, loan participation, and banker's acceptances. Refer to chapter 10 for additional guidance regarding transfers and servicing of securities.

7.119 *Trade date accounting*. FASB ASC 942-325-25-2 states that regular-way purchases and sales of securities should be recorded on the trade date. Gains and losses from regular-way security sales or disposals should be recognized as of the trade date in the statement of operations for the period in which securities are sold or otherwise disposed of.[6]

7.120 *Short sales*. As stated in FASB ASC 942-405-25-1 and FASB ASC 942-405-35-1, the obligations incurred in short sales should be reported as

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[6] Chapter 10, "Transfers and Servicing—Including Mortgage Banking," of this guide discusses accounting for transfers of loans that have not been previously securitized.

liabilities. Such liabilities are generally called securities sold, not yet purchased. The obligations should be subsequently measured at fair value through the income statement at each reporting date. Interest on the short positions should be accrued periodically and reported as interest expense. The fair value adjustment should be classified in the income statement with gain and losses on securities, according to FASB ASC 942-405-45-1.

Troubled Debt Restructurings

7.121 Any loan that was restructured in a troubled debt restructuring involving a modification of terms would be subject to the provisions of FASB ASC 320 if the debt instrument meets the definition of a security. See FASB ASC 310-40-40-9 for additional information.

7.122 FASB ASC 310-40 applies to troubled debt restructurings by creditors. According to FASB ASC 310-40-15-4, receivables that may be involved in troubled debt restructurings commonly result from lending cash, or selling goods or services on credit. Examples are accounts receivable, notes, debentures and bonds (whether those receivables are secured or unsecured and whether they are convertible or nonconvertible), and related accrued interest, if any. FASB ASC 310-40-35-5 states that a creditor in a troubled debt restructuring involving only a modification of terms of a receivable—that is, not involving receipt of assets (including an equity interest in the debtor)—should account for the troubled debt restructuring in accordance with the provisions of FASB ASC 310-40. This topic is discussed in more detail in chapter 8, "Loans."

7.123 Troubled debt restructuring may involve debt securities, including instances in which there is a substitution of debtors, which is addressed in FASB ASC 310-40-25-2.

Loans and Debt Securities Acquired With Deteriorated Credit Quality

7.124 FASB ASC 310-30 provides recognition, measurement, and disclosure guidance regarding loans acquired with evidence of deterioration of credit quality since origination acquired by completion of a transfer for which it is probable, at acquisition, that the investor will be unable to collect all contractually required payments receivable, according to FASB ASC 310-30-05-1. FASB ASC 310-30 is discussed in more detail in chapter 8.

Financial Statement Presentation and Disclosure

7.125 *Other-than-temporary impairments.* Paragraphs 8A and 9A of FASB ASC 320-10-45 state that in periods in which an entity determines that a security's decline in fair value below its amortized cost basis is other than temporary, the entity should present the total OTTI in the statement of earnings with an offset for the amount of the total OTTI that is recognized in other comprehensive income, in accordance with FASB ASC 320-10-35-34D, if any. FASB ASC 320-10-55-21A illustrates the application of this guidance. An entity should separately present, in the financial statement in which the components of accumulated other comprehensive income are reported, amounts recognized therein related to held-to-maturity and available-for-sale debt securities for which a portion of an OTTI has been recognized in earnings.

7.126 FASB ASC 320-10-50 addresses disclosures about other-than-temporary impairments for debt and equity securities and requires a detailed,

risk-oriented breakdown of major security types and related information. Disclosures related to this guidance are required for all interim and annual periods.

7.127 Paragraphs 2 and 5 of FASB ASC 320-10-50 require that the following information about available-for-sale and held-to-maturity securities be disclosed separately for each of those categories:

a. For securities classified as available-for-sale, all reporting entities should disclose all of the following by major security type as of each date for which a statement of financial position is presented:

  i. Amortized cost basis

  ii. Aggregate fair value

  iii. Total OTTI recognized in accumulated other comprehensive income

  iv. Total gains for securities with net gains in accumulated other comprehensive income

  v. Total losses for securities with net losses in accumulated other comprehensive income

  vi. Information about the contractual maturities of those securities as of the date of the most recent statement of financial position presented.

b. For securities classified as held-to-maturity, all reporting entities should disclose all of the following by major security type as of each date for which a statement of financial position is presented:

  i. Amortized cost basis

  ii. Aggregate fair value

  iii. Gross unrecognized holding gains

  iv. Gross unrecognized holding losses

  v. Net carrying amount

  vi. Total OTTI recognized in accumulated other comprehensive income

  vii. Gross gains and losses in accumulated other comprehensive income for any derivatives that hedged the forecasted acquisition of the held-to-maturity securities

  viii. Information about the contractual maturities of those securities as of the date of the most recent statement of financial position presented.

7.128 Maturity information may be combined in appropriate groupings, as stated in FASB ASC 320-10-50-3. Securities not due at a single maturity date, such as MBSs, may be disclosed separately rather than allocated over several maturity groupings; if allocated, the basis for allocation should be disclosed. According to FASB ASC 942-320-50-3, these disclosures should include the fair value and net carrying amount (if different than fair value) of debt securities based on at least the 4 following maturity groupings:

- Within 1 year
- After 1–5 years
- After 5–10 years

- After 10 years

7.129 As stated in FASB ASC 942-320-50-2, in complying with the disclosure requirements mentioned in paragraph 7.127, financial institutions should include all of the following major security types, though additional types also may be included as appropriate:

a. Equity securities, segregated by any one of the following:

  i. Industry type

  ii. Entity size

  iii. Investment objective

b. Debt securities issued by the U.S. Treasury and other U.S. government corporations and agencies

c. Debt securities issued by states within the United States and political subdivisions of the states

d. Debt securities issued by foreign governments

e. Corporate debt securities

f. Residential MBSs

g. Commercial MBSs

h. CDOs

i. Other debt obligations

7.130 Paragraphs 4–5 of FASB ASC 942-320-50 explain that the carrying amount of investment assets that serve as collateral to secure public funds, securities sold under repos, and other borrowings, that are not otherwise disclosed under FASB ASC 860, *Transfers and Servicing*, should be disclosed in the notes to the financial statements. The notes to the financial statements should include an explanation of the institution's accounting policy for securities, including the basis for classification. An entity should disclose the carrying amount of securities deposited by insurance subsidiaries with state regulatory authorities, as stated in FASB ASC 944-320-50-1.

7.131 For all investments in an unrealized loss position, including those within the scope of FASB ASC 325-40, for which OTTI have not been recognized in earnings (including investments for which a portion of an OTTI has been recognized in other comprehensive income), an entity should disclose all of the items listed in FASB ASC 320-10-50-6 in its interim and annual financial statements.

7.132 This guidance also requires disclosures regarding the significant inputs used in determining a credit loss, as well as rollforward of that amount each period. For interim and annual periods in which an OTTI of a debt security is recognized and only the amount related to a credit loss was recognized in earnings, an entity should disclose by major security type, the methodology and significant inputs used to measure the amount related to credit loss. FASB ASC 320-10-50-8A provides examples of significant inputs and FASB ASC 320-10-50-8B addresses the tabular rollforward of the amount related to credit losses recognized in earnings and provides certain items which should be disclosed within the rollforward.

7.133 *Sales or transfers*. For each period for which the results of operations are presented FASB ASC 320-10-50-9 requires that the institution disclose all of the following:

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

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

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

d. The amount of the net unrealized holding gain or loss on available-for-sale securities for the period that has been included in accumulated other comprehensive income and the amount of gains and losses reclassified out of accumulated other comprehensive income into earnings for the period[7]

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

7.134 In accordance with FASB ASC 320-10-50-10, for any sales of or transfers from securities classified as held-to-maturity, an entity should disclose all of the following in the notes to the financial statements for each period for which the results of operations are presented: (*a*) the net carrying amount of the sold or transferred security, (*b*) the net gain or loss in accumulated other comprehensive income for any derivative that hedged the forecasted acquisition of the held-to-maturity security, (*c*) the related realized or unrealized gain or loss, and (*d*) the circumstances leading to the decision to sell or transfer the security. Such sales or transfers should be rare, except for sales and transfers due to the changes in circumstances identified in paragraph 6(a)–6(f) of FASB ASC 320-10-25. FASB ASC 320-10-25-14 sets forth the conditions under which sales of debt securities may be considered as maturities for purposes of the disclosure requirements under FASB ASC 320-10.

7.135 *Offsetting*.[**] A debtor having a valid right of setoff may offset the related asset and liability and report the net amount, as stated in FASB ASC

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[7] FASB ASC 740-20-45-2 requires that income tax expense or benefit for the year be allocated among continuing operations, discontinued operations, extraordinary items, other comprehensive income, and items charged or credited directly to shareholders' equity (such as changes in the unrealized holding gains and losses of securities classified as available for sale, as stated in FASB ASC 740-20-45-11 [see chapter 16, "Income Taxes."]).

[**] In January 2011, FASB issued the proposed ASU *Balance Sheet Offsetting*. The proposed guidance was initiated as a joint project between FASB and the International Accounting Standards Board (IASB) to provide users of financial statements with information to understand the extent of offsetting in the statement of financial position and improve comparability between International Financial Reporting Standards and U.S. GAAP. The proposed guidance as issued would eliminate the exception in U.S. GAAP that allows offsetting for some derivative and sale and repurchase (and reverse sale and repurchase) contracts when the right of setoff is conditional, there is no intention to set off, or such intention is conditional. The proposed guidance would also enhance disclosures required by U.S. GAAP by requiring improved information about eligible assets and eligible liabilities subject to setoff, and related arrangements (such as collateral arrangements) and the effect of those arrangements on an entity's financial position.

In June 2011, FASB and the IASB discussed alternative approaches for requiring offsetting of financial assets and financial liabilities on the face of the balance sheet. The majority of FASB board members supported providing an exception from the general offsetting criteria for derivative instruments, which would allow offsetting of fair value amounts recognized for derivatives and fair value amounts recognized for the right to reclaim cash collateral

210-20-45-2. According to FASB ASB 210-20-45-11, notwithstanding the condition in FASB ASC 210-20-45-1(c), an entity may, but is not required to, offset amounts recognized as payables under repurchase agreements and amounts recognized as receivables under reverse repurchase agreements.

7.136 *Concentration-of-credit-risk*. The concentrations-of-credit-risk disclosures apply to debt securities as well as loans. FASB ASC 825-10-50-20 states that, except as indicated in FASB ASC 825-10-50-22, an entity should disclose all significant concentrations of credit risk arising from all financial instruments, whether from an individual counterparty or groups of counterparties.

7.137 *Mutual funds*. Investments in mutual funds that invest only in U.S. government debt securities may be shown separately rather than grouped with other equity securities in the disclosures by major security type required by FASB ASC 942-320-50-2, according to FASB ASC 320-10-50-4.

Auditing

Objectives

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

a. securities, accrued interest, and discounts and premiums of the institution

  i. exist at the balance-sheet date (definitive securities are on hand or held by others in custody or safekeeping for the account of the institution) and are owned by the institution.

  ii. have been properly classified, described, and disclosed in the financial statements at appropriate amounts (including consideration of any other-than-temporary declines in value and disclosure of any securities pledged as collateral for other transactions).

b. sales of securities and other transactions that occurred

  i. have been recorded during the appropriate period.

  ii. are properly classified, described, and disclosed.

c. realized and unrealized gains and losses, and interest (including premium amortization and discount accretion), dividend, and other revenue components

  i. have been included in the financial statements at appropriate amounts.

  ii. are properly classified, described, and disclosed.

(footnote continued)

or the obligation to return cash collateral arising from derivative instruments recognized at fair value with the same counterparty under a master netting arrangement. During July 2011, FASB and IASB also discussed revisions to the proposed offsetting disclosures.

Readers are encouraged to visit the FASB website for the latest developments regarding the offsetting project, including a summary of decisions reached to date since the issuance of the proposed guidance. FASB expects to issue final guidance during 2011.

Planning

7.139 In accordance with AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), the auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures (see chapter 5 for further information).

7.140 The primary inherent risks related to investments—interest-rate risk, credit risk, and liquidity risk—are interrelated. For example, increases in market interest rates may affect other risk factors by decreasing marketability (that is, liquidity) or by increasing the credit risk of the issuer's obligations. The auditor should have an understanding of the relationship between the interest-rate environment and the market values of securities. The institution's asset/liability and other risk management policies may provide useful information about the possible effects of interest rate and liquidity risks on the institution's securities.

7.141 Another risk inherent to complex investments is the business risk that the institution does not properly understand the terms and economic substance of a significant complex investment. Such misunderstandings could result in the incorrect pricing of a transaction and improper accounting for the investment or related income. (Related guidance on learning the extent of derivatives use is given in chapter 18, "Derivative Instruments: Futures, Forwards, Options, Swaps, and Other Derivative Instruments.") Inquiry of a specialist[8] could be considered by the auditor if a financial institution engaged in holding or trading such complex securities.

7.142 As stated in paragraph .06 of AU section 336, *Using the Work of a Specialist* (AICPA, *Professional Standards*), the auditor's education and experience enable him or her to be knowledgeable about business matters in general, but the auditor is not expected to have the expertise of a person trained for or qualified to engage in the practice of another profession or occupation. Complex or subjective matters, potentially material to the financial statements, may require special skill or knowledge and in the auditor's judgment require using the work of a specialist to obtain appropriate audit evidence.

7.143 Classification of investments in securities among the held-to-maturity, available-for-sale, and trading categories is important because it directly affects the accounting treatment. The classification of securities, which must occur at acquisition, ordinarily should be consistent with the institution's investment, asset/liability, and other risk management policies. The independent auditor should ascertain whether the accounting policies adopted by the entity for investments are in conformity with accounting principles generally accepted in the United States of America (U.S. GAAP). In planning the audit, the independent auditor should consider reading the current year's interim financial statements, investment policy, and other financial information related to securities. The level of inherent risk for securities varies widely from institution to institution depending on, among other things, the nature and complexity of the securities and the extent and effectiveness of the institution's

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[8] Refer to Interpretation No. 1, "The Use of Legal Interpretations As Audit Evidence to Support Management's Assertion That a Transfer of Financial Assets Has Met the Isolation Criterion in Paragraphs 7–14 of Financial Accounting Standards Board *Accounting Standards Codification* 860-10-40," of AU section 336, *Using the Work of a Specialist* (AICPA, *Professional Standards*, AU sec. 9336 par. .01–.21), for guidance regarding legal opinions on FASB ASC 860.

accounting and operational policies and procedures, as well as management's understanding and awareness of the risks. The following factors related to securities may, considered in the aggregate, indicate higher inherent risk:

a. Significant concentrations of credit risk with one counterparty or within one geographic area

b. Significant use of complex securities, particularly without relevant in-house expertise

c. Excessively high volumes of borrowing or lending of securities

d. Relatively high volatility in interest rates

e. Changes in the terms of government guarantees

f. Actual prepayment experience that differs significantly from that anticipated

g. Declines in the values of collateral underlying securities

h. Changes in guarantors' claims processing

i. Significant conversion options related to the collateral (for example, variable to fixed rates)

j. Sales and transfers from the held-to-maturity securities portfolio

k. Uncertainty regarding the financial stability of an ABS servicer or of guarantors

l. Uncertainty regarding the financial stability of a safekeeping agent or other third party holding the institution's securities

m. Changes in accounting systems, including software and manual processes

n. Differing assumptions used in determining fair values will result in different conclusions

o. Significant reliance on outside parties.

Internal Control Over Financial Reporting and Possible Tests of Control

7.144 AU section 314 establishes standards and provides guidance on obtaining a sufficient understanding of the entity and its environment, including its internal control. It provides guidance on understanding the components of internal control and explains how an auditor should obtain a sufficient understanding of internal control for the purposes of assessing the risks of material misstatement. Paragraph .40 of AU section 314 requires that the auditor should obtain an understanding of the five components of internal control (the control environment, risk assessment, control activities, information and communication systems, and monitoring), sufficient to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. The auditor should obtain a sufficient understanding by performing risk assessment procedures to evaluate the design of controls relevant to an audit of financial statements and to determine whether they have been implemented. Paragraph .102 of AU section 314 requires that the auditor should identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions, account balances, and disclosures.

7.145 Effective controls, as they relate to financial reporting of investments in securities, should provide assurance that

a. management's policies are adequate to provide for financial reporting in accordance with GAAP;

b. physical securities are on hand or held in custody or safekeeping by others in accordance with management's authorization;

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

d. securities are monitored on an ongoing basis to determine whether recorded financial statement amounts necessitate adjustment; and

e. the presentation and disclosure of the fair value measurements of investment securities are in accordance with GAAP.

7.146 Control activities that would contribute to internal control over financial reporting in this area include the maintenance of management policies, adopted by the those charged with governance or its investment committee, that establish authority and responsibility for investments in securities.

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

- Procedures exist to identify and monitor credit risk, prepayment risk, and impairment.
- Those charged with governance—generally through an investment committee—oversee management's securities activities.
- Accounting entries supporting securities transactions are periodically reviewed by supervisory personnel to ensure that classification of securities was made and documented at acquisition (and date of transfer, if applicable) and is in accordance with the institution's investment policy and management's intent.
- Recorded securities are periodically reviewed and compared to safekeeping ledgers and custodial confirmations, on a timely basis, including immediate and thorough investigation and resolution of differences and appropriate supervisory review and approval of completed reconciliations.
- Current fair values of securities are determined in accordance with GAAP and reviewed on a timely basis.
- Securities loaned to other entities or pledged as collateral are designated as such in the accounting records.
- Lists of authorized signers are reviewed and updated periodically, and transaction documentation is compared to the authorized lists.
- There is appropriate segregation of duties among those who (*a*) execute securities transactions, (*b*) approve securities transactions, (*c*) have access to securities, and (*d*) post or reconcile related accounting records.
- Buy and sell orders are routinely compared to brokers' advices.
- Adjustments to securities accounts (for example, to recognize impairments) are reviewed and approved by the officials designated in management's policy.

- Periodic tests of interest and dividend income are performed by reference to supporting documentation, which may include using analytical procedures commonly referred to as *yield analysis*. (With this approach, actual yields during the period are compared to expected yields based on previous results and current market trends. Any significant differences should be investigated and explained.)
- Securities are monitored on an ongoing basis and factors affecting income recognition and the carrying amount of the securities are analyzed periodically to determine whether adjustments are necessary.

7.148 The auditor should obtain an understanding of the institution's process for determining fair value measurements and disclosures and of the relevant controls sufficient to develop an effective audit approach, as stated in paragraph .09 of AU section 328, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*). See paragraph .12 of AU section 328 for further considerations.

7.149 Many of the control activities for securities are often performed directly by senior management. Although management's close attention to securities transactions can be an effective factor in internal control, the auditor should address the risk of management override of policies and procedures during an engagement.

7.150 The auditor should perform tests of controls when the auditor's risk assessment includes an expectation of the operating effectiveness of controls or when substantive procedures alone do not provide sufficient appropriate audit evidence at the relevant assertion level. Examples of tests of controls that might be considered include

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

and whether the reconciliations are reviewed and approved by supervisory personnel; and

- examine evidence that the company takes physical inventory and confirms safekeeping on a periodic basis, including reconciliation of differences.

7.151 Many financial institutions outsource the determination of fair value measurements of investment securities to third party service organizations, such as a pricing service. AU section 324, *Service Organizations* (AICPA, *Professional Standards*),[††] provides guidance on the factors an auditor should consider when auditing the financial statements of an entity that uses a service organization to process certain transactions. The auditor may also consider the following:

- Whether the pricing service determines fair value measurements in accordance with the requirements of FASB ASC 820?
- If trades of identical securities in an active market are available, is the pricing service's fair value estimates equal to quoted market prices?
- For trades of identical securities, does the third party pricing service evaluate whether or not the market is active?
- What is the criteria used to evaluate whether the market is active?
- When a model is used to determine fair value, does the pricing service maximize the use of observable inputs and minimize the use of unobservable inputs?

Substantive Tests

7.152 Regardless of the assessed risks of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions related to investments in debt and equity securities.

7.153 AU section 332[‡] provides guidance to auditors in planning and performing further audit procedures for relevant assertions related to investments in securities, as well as derivative instruments and hedging activities. Chapter 7, "Performing Audit Procedures In Response to Assessed Risks," of the AICPA Audit Guide *Auditing Derivative Instruments, Hedging Activities, and*

[††] The guidance contained in AU section 324, *Service Organizations* (AICPA, *Professional Standards*), has now been split into an attest standard and an auditing standard to better reflect the nature of the work being performed. The ASB has finalized a new clarified auditing standard on service organizations, *Audit Considerations Relating to an Entity Using a Service Organization*. This auditing standard will supersede AU section 324 and addresses the user auditor's responsibility for obtaining sufficient appropriate audit evidence in an audit of the financial statements of a user entity that uses one or more service organizations. This clarified auditing standard has been finalized but not yet issued. See the preface of this guide for further information on the ASB's Clarity Project. The effective date of this clarified standard is for audits of financial statements for periods ending on or after December 15, 2012, unless otherwise established (early adoption would not be appropriate).

The related attest standard, Statement on Standards for Attestation Engagements (SSAE) No. 16, *Reporting on Controls at a Service Organization* (AICPA, *Professional Standards*, AT sec. 801), was issued in April 2010. It addresses examination engagements undertaken by a service auditor to report on controls at organizations that provide services to user entities when those controls are likely to be relevant to user entities' internal control over financial reporting. SSAE No. 16 supersedes the guidance for service auditors in AU section 324 and is effective for service auditors' reports for periods ending on or after June 15, 2011. Early implementation is permitted.

[‡] See footnote ‡ in paragraph 7.103.

Investments in Securities, provides detailed guidance and recommendations about designing and performing substantive procedures at the assertion level. Readers may consider this guidance when designing and performing substantive tests.

7.154 Chapter 7 of the AICPA Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* specifically addresses derivatives and securities measured or disclosed at fair value, various methods for determining fair value as specified by U.S. GAAP, and evaluating audit evidence for the valuation assertion of derivative and securities. Readers may consider this guidance when designing and performing substantive tests.

7.155 AU section 328 addresses audit considerations relating to the measurement and disclosure of assets, liabilities, and specific components of equity presented or disclosed at fair value in financial statements. The auditor should obtain sufficient appropriate audit evidence to determine that fair value measurements and disclosures are in conformity with GAAP. As stated in paragraph .15 of AU section 328, the auditor's understanding of the requirements of GAAP and knowledge of the business and industry, together with the results of other audit procedures, are used to evaluate the accounting for assets or liabilities requiring fair value measurements, and the disclosures about the basis for the fair value measurements and significant uncertainties related thereto.[‡‡]

7.156 As stated in paragraph .20–.21 of AU section 328, the auditor should consider whether to engage a specialist and use the work of that specialist as audit evidence in performing substantive tests to evaluate material financial statement assertions. When planning to use the work of a specialist in auditing fair value measurements, the auditor considers whether the specialist's understanding of the definition of fair value and the method that the specialist will use to determine fair value are consistent with those of management and with GAAP.[‡‡]

7.157 Paragraph .23 of AU section 328 states that based on the auditor's assessment of the risks of material misstatement, the auditor should test the entity's fair value measurements and disclosures. Because of the wide range of possible fair value measurements, from relatively simple to complex, and the varying levels of risks of material misstatement associated with the process for determining fair values, the auditor's planned audit procedures can vary significantly in nature, timing, and extent. For example, substantive tests of the fair value measurements may involve (*a*) testing management's significant assumptions, the valuation model, and the underlying data (see paragraphs .26–.39 of AU section 328), (*b*) developing independent fair value estimates for corroborative purposes (see paragraph .40 of AU section 328), or (*c*) reviewing

[‡‡] The ASB has finalized a new clarified auditing standard, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*. This auditing standard, which will supersede AU section 328 and AU section 342, *Auditing Fair Value Measurements and Disclosures and Auditing Accounting Estimates* (AICPA, *Professional Standards*), addresses the auditor's responsibilities relating to accounting estimates, including fair value accounting estimates and related disclosures. Additionally, it expands on how other clarified auditing standards are to be applied in relation to accounting estimates, and includes requirements and guidance related to misstatements of individual accounting estimates and indicators of possible management bias. This clarified auditing standard has been finalized but not yet issued. See the preface of this guide for further information on the ASB's Clarity Project. The effective date of this clarified standard is for audits of financial statements for periods ending on or after December 15, 2012, unless otherwise established (early implementation is not permitted).

subsequent events and transactions (see paragraphs .41–.42 of AU section 328).[‡‡]

7.158 AU section 342, *Auditing Accounting Estimates* (AICPA, *Professional Standards*), provides guidance to auditors on obtaining and evaluating sufficient appropriate audit evidence to support significant accounting estimates in an audit of financial statements in accordance with generally accepted auditing standards. Paragraph .07 of AU section 328 states that the auditor's objective when evaluating accounting estimates is to obtain sufficient appropriate audit evidence to provide reasonable assurance of the following:

a. All accounting estimates that could be material to the financial statements have been developed.

b. Those accounting estimates are reasonable in the circumstances.

c. The accounting estimates are presented in conformity with applicable accounting principles and are properly disclosed.[‡‡]

7.159

Considerations for Audits Performed in Accordance with Public Company Accounting Oversight Board (PCAOB) Standards[9,||||]

Paragraph .02 of AU section 319, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards),[##] states that regardless of the assessed level of control risk, the auditor should perform substantive procedures for all relevant assertions related to all significant accounts and disclosures in the financial statements. Refer to paragraph .A9

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‡‡ See footnote ‡‡ in paragraph 7.155.

9 Public Company Accounting Oversight Board (PCAOB) Staff Audit Practice Alerts are not rules of the board, and do not reflect any PCAOB determination or judgment about the conduct of any particular firm, auditor, or any other person.

|||| The PCAOB, as announced at the Standing Advisory Group (SAG) meeting on March 24, 2011, has formed a task force of the SAG known as the Pricing Sources Task Force. The group focuses on the auditing of fair value of financial instruments that are not actively traded and on the use of third-party pricing sources. The task force assists the Office of the Chief Auditor to gain insight into current issues related to auditing the fair value of financial instruments, which may result in the development of new standards or guidance. The task force is comprised of several members of the SAG, as well as other investors, preparers and auditors, and representatives from pricing services and brokers. Readers should be alert to developments and are encouraged to visit the Pricing Sources Task Force website at www.pcaobus.org/Standards/SAG/Pages/PricingSourcesTaskForce.aspx.

In December 2010, the SEC approved the PCAOB's suite of risk assessment standards (Auditing Standards Nos. 8–15). These standards set forth requirements that are intended to enhance the effectiveness of the auditor's assessment of, and response to, the risks of material misstatement in the financial statements. The risk assessment standards address audit procedures performed throughout the audit, from the initial planning stages through the evaluation of the audit results. The standards will be effective for audits of fiscal periods beginning on or after December 15, 2010.

As a result of the new suite of risk assessment standards, the guidance contained in AU section 319, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards), has now been split into Auditing Standard No. 8, *Audit Risk*, Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, and Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards). Auditing Standard No. 8 discusses the auditor's consideration of audit risk in an audit of financial statements as part of an integrated audit or an audit of financial statements only. Auditing Standard No. 12 discusses the auditor's responsibility for performing risk assessment procedures as well as utilizing the information obtained from risk assessment procedures to identify and assess the risks of material misstatement. Finally, Auditing Standard No. 13 establishes requirements regarding designing and implementing appropriate responses to the risks of material misstatement.

of appendix A, "Definitions," of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), for the definition of a relevant assertion, and paragraphs 28–33 of Auditing Standard No. 5 for discussion of identifying relevant assertions.

Paragraph .01 of AU section 324, *Service Organizations* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards), states that when performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs B17–B27 of appendix B, "Special Topics," of Auditing Standard No. 5.

PCAOB Staff Audit Practice Alert No. 2, *Matters Related to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400 par. .02), provides guidance on auditors' responsibilities for auditing fair value measurements of financial instruments and when using the work of specialists under the existing standards of the PCAOB. This alert is focused on specific matters that are likely to increase audit risk related to the fair value of financial instruments in a rapidly changing economic environment. This practice alert highlights certain requirements in the auditing standards related to fair value measurements and disclosures in the financial statements and certain aspects of U.S. GAAP that are particularly relevant to the economic environment.

PCAOB Staff Audit Practice Alert No. 3, *Audit Considerations in the Current Economic Environment* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400 par. .03), assists auditors in identifying matters related to the current economic environment that might affect audit risk and require additional emphasis. This practice alert is organized into six sections: (*a*) overall audit considerations; (*b*) auditing fair value measurements; (*c*) auditing accounting estimates; (*d*) auditing the adequacy of disclosures; (*e*) auditor's consideration of a company's ability to continue as a going concern; and (*f*) additional audit considerations for selected financial reporting areas.

PCAOB Staff Audit Practice Alert No. 4, *Auditor Considerations Regarding Fair Value Measurements, Disclosures, and Other-Than-Temporary Impairments* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400 par. .04), informs auditors about potential implications of recently issued FASB guidance on reviews of interim financial information and annual audits. This alert addresses the following topics: (*a*) reviews of interim financial information; (*b*) audits of financial statements, including integrated audits; (*c*) disclosures; and (*d*) auditor reporting considerations.

Chapter 8

Loans

Introduction

8.01 Loans usually are the most significant assets of financial institutions and generate the largest portion of revenues. Like investments, an institution's management of its loans is an integral part of its asset/liability management strategy (discussed in chapter 1, "Industry Overview—Banks and Savings Institutions"). Institutions originate loans, purchase loans or participating interests in loans, sell loans or portions of loans, and securitize loans (the latter two activities are discussed in chapter 10, "Transfers and Servicing—Including Mortgage Banking"). The composition of loan portfolios differs considerably among institutions because lending activities are influenced by many factors, including the type of institution, management's objectives and philosophies regarding diversification and risk (credit strategy), the availability of funds, credit demand, interest-rate margins, and regulations. Further, the composition of a particular institution's loan portfolio may vary substantially over time.

The Lending Process

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

Credit Strategy

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

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

Credit Risk

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

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

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

- *Collateral risk*. The institution may be exposed to loss on collateralized loans if its security interest is not perfected or the collateral is not otherwise under the institution's control, if the value of the collateral declines, or if environmental contingencies impair the value of the collateral or otherwise create liability for the institution.
- *Concentration risk*. Inadequate diversification of the loan portfolio in terms of different industries, geographic regions, loan products, terms of loan products, or the number of borrowers may result in significant losses. A high concentration of loans to companies in a single industry would constitute a concentration risk. For example, membership of credit unions may be limited to employees of one organization or to individuals of a geographic region. If the credit union's sponsoring organization is experiencing financial problems or is anticipating layoffs of employees, the credit union could be exposed to significant losses. A high concentration of loans whose contractual features may increase the exposure of the originator to risk of nonpayment or realization would also constitute a concentration risk. For example, interest-only loans are designed to allow the borrower to only pay interest in the early part of the loan's term, which may delay defaults. For these loans, evidence of risk to loss may not become apparent until the contractual provisions of the loans cause a change in required payments.
- *Country or transfer risk*. The economic, social, legal, and political conditions of a foreign country may unfavorably affect a borrower's ability to repay in the currency of the loan. Cross-border loans are those that borrowers must repay in a currency other than their local currency or to a lender in a different country. Losses may result if a country's foreign exchange reserves are insufficient to permit the timely repayment of cross-border loans by borrowers domiciled in that country, even if the borrowers possess sufficient local currency. In addition, foreign government decisions and associated events can affect business activities in a country as well as a borrower's ability to repay its loans.
- *Foreign exchange risk*. Changes in foreign exchange rates may affect lenders unfavorably. Fluctuations in foreign exchange rates could reduce the translated value of the cash flows, earnings, and equity investments in foreign currency denominated subsidiaries. Foreign exchange rate movements, if not effectively hedged, could also increase the funding costs of foreign operations as it is not uncommon for foreign operations to be funded by borrowings in currencies different than their functional currency.

- *Fraud risk*. Loans may expose the institution to loss by not being bona fide transactions.
- *Insider risk*. Loans to executive officers, directors, and principal shareholders of the institution and related interests of such insiders may expose the institution to loss if these loans are made to related individuals or companies, or both, with little credit history; if they lack an identified source of funds for repayment; or if they are made to newly organized or highly leveraged enterprises with insufficient collateral and inadequate financial information.
- *Interest rate risk*. The maturity and repricing characteristics of loans can have a significant impact on the interest-rate risk profile (and, therefore, interest income) of an institution. For example, an institution that holds primarily fixed-rate loans and finances itself with floating rate obligations could be adversely affected by a significant increase in interest rates.
- *Legal and regulatory risk*. Illegally granted loans, loans with usurious interest rates, and loans with terms that are not adequately disclosed to the borrower may expose the institution to loss.
- *Management risk*. Management's competence, judgment, and integrity in originating, disbursing, supervising, collecting, and reviewing loans could substantially affect the collectability of loans.
- *Operations risk*. Funds might be disbursed without proper loan authorization, collateral documentation, or loan documentation. Failure of the institution to evaluate and monitor potentially uncollectible loans also constitutes an operations risk.

Lending Policies and Procedures

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

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

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

- Credit initiation, that is, obtaining complete and informative loan applications, including financial statements and the intended use of proceeds
- Credit investigation, including the following:
  - Credit reports or other independent investigations
  - Proper analysis of customer credit information, including the determination of projected sources of loan servicing and repayment
- Loan approval (new and renewed loans):
  - Loan approval limits according to officer expertise, administrative authority, or both

- Committee approval or board of director approval, or both, for loans exceeding prescribed limits
- The segregation of duties between the loan approval function and the disbursement and collection functions
- Collateral ownership and control verified, including lien searches and documentation of the priority of security interest
- Collateral margin determined

- Documentation of credit, or the inspection of supporting documents for proper form, completeness, and accuracy by someone other than the lending officer
- Perfection of collateral interest or proper security filings and recording of liens
- The disbursement of loan proceeds or, to the extent possible, control of the disbursement to ensure that proceeds are used for the borrower's stated loan purpose

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

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

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

8.14 Loan review includes several distinct activities. The principal emphasis is on determining whether the loans adhere to the institution's written lending policies and is likely to perform in accordance with the agreed-on terms and conditions, including compliance with any restrictive covenants in a loan

agreement. The review normally includes analyzing the borrower's financial statements, reviewing performance since origination or last renewal, and determining if sufficient credit information is available to assess the borrower's current financial conditions.

8.15 Loan file contents should be reviewed as part of the institution's internal loan review process to determine if credit reports, appraisals, and other third-party information existed before the credit or renewal was granted and if the quality of such information supported, and continues to support, the credit decision. If the loan is secured or guaranteed, the review should also determine that collateral is under control, security interest is perfected, and guarantees have been executed properly, and the guarantor's credit worthiness should be evaluated. Also, the value of collateral should be estimated at the review date to identify deficiencies in collateral margins.

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

Types of Lending

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

a. *Line-of-credit arrangements*. The institution provides the borrower with a maximum borrowing limit for a specified period. Lines of credit may be structured in a variety of ways. Letters of credit (discussed in paragraph 8.50), which are commonly used as credit enhancements for other forms of borrowing (such as commercial paper or trade financing), are agreements to lend a specified amount for a specified period (usually less than one year). Revolving credit agreements, which are commonly used in credit-card lending, are agreements to lend up to a specified maximum amount for a specified period, usually more than one year, and provide that repayment of amounts previously borrowed under the agreement are available to the borrower for subsequent borrowing. Repayment schedules may be on an installment, demand, time, or term basis, as discussed subsequently. Other line-of-credit arrangements are applied to

   i. *construction*, whereby the borrower may draw on the line as necessary to finance building costs to supplement (or pending the securing of) a construction loan;

   ii. *liquidity*, used by the borrower in overall management of its liquidity needs; and

   iii. *warehousing*, used by borrowers engaged in mortgage banking activities to fund origination of mortgage loans, generally pending sale of the loans to a secondary market investor.

b. *Installment loans*. These loan contracts require periodic principal and interest payments. Installment loans may be made on either a simple interest or a discounted basis. The discounted basis means

that interest (discount), credit-life insurance premiums, and other charges are generally added to the amount advanced to arrive at the face amount of the note. The discount, called *unearned interest*, is netted against the face amount of the note on the balance sheet and accreted into income over time to achieve a level yield.

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

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

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

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

Commercial, Industrial, and Agricultural Loans

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

- factoring the purchase, usually without recourse, of trade accounts receivable;
- revolving loans or short-term working capital loans, which are generally used by manufacturing companies to finance the purchase of raw materials and other production needs until the finished goods are sold;
- asset-based financing, usually secured by current assets such as accounts receivable or inventories, including receivable portfolio purchases;
- seasonal loans, which are used to provide cash to businesses (such as farms and retailers) during low-revenue periods of the year;
- floor-plan financing, which is used by automobile and durable goods dealers to finance inventories;

- long-term working capital loans;
- loans and leases to finance the purchase of equipment; and
- loans to finance major projects, such as the construction of refineries, pipelines, and mining facilities.

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

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

8.22 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. Usually, if factors do not approve customers' credit, shipments are made at clients' risk. Factors buying accounts with recourse, however, provide bookkeeping and collection services and assume no credit risk, unless both the client and its customers become insolvent. Factors receive fees for services rendered to the client, usually computed as a percentage of net receivables bought.

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

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

8.25 In calculating limits for payments under advance factoring arrangements, factors generally retain a reserve against unpaid receivables to cover claims, returns, allowances, and other adjustments. Reserves ordinarily are a percentage of outstanding receivables based on factors' experience and judgment. Overadvances occur when clients draw cash advances that exceed uncollected receivable balances. Factors may permit overadvances to finance

clients' seasonal business requirements. Such overadvances often can be anticipated. Overadvances also may result from unanticipated chargebacks, such as those resulting from defective merchandise and price disputes, because clients continue to remain contractually responsible for such problems. Overadvances may be collateralized by other assets, such as inventory or fixed assets, or may be secured by personal guarantees. In certain circumstances, overadvances also may be unsecured. Overadvances generally are reduced when receivables from additional sales are factored.

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

8.27 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 demand large inventories in anticipation of the selling season. When the inventories are sold, loans are paid off or accounts receivable generated by the sales replace inventories as collateral for such loans.

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

8.29 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 buyer directly. Receivables acquired under this type of agreement generally are accounted for as assets owned by the buyer and are not considered to represent collateral for loans made to sellers. Instances where participating interests (such as senior interests) are purchased by buyers should be carefully evaluated to determine whether the buyer should recognize the underlying assets for accounting purposes.

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

Consumer Loans

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

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

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

8.34 Retail sales contracts usually are sold at a discount to a lender 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 lenders 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. The Office of the Comptroller of Currency (OCC) frequently issues guidance on retail sales contracts.

8.35 Some agreements provide for a portion of the 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 the credit ratings of the borrowers involved. Dealer reserves and holdbacks may be required even if applicable contracts are bought with recourse.

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

8.37 Credit-card holders receive prenumbered cards under a prearranged line of credit with the institution issuing the card. Though the terms of credit

cards vary, an annual fee is often charged for the use of the card and interest is charged on outstanding balances. Cards typically carry a 20–30 day grace period during which no interest is charged if outstanding balances are paid in full. Furthermore, merchants are generally charged a transaction fee.

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

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

Residential Real Estate Loans

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

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

- reverse mortgages, which provide homeowners with monthly payments in return for increasing the principal amount of a loan (decreasing the equity the homeowner has), wherein the institution may eventually gain ownership of real estate;
- second-lien fixed-term (or closed end) loans through which homeowners borrow a portion of their equity (property value in excess of the first-lien balance) and repay such over a fixed period of time with fixed or variable interest rates;
- home equity lines of credit allow the homeowner to borrow on demand, a portion of their equity, repay such and reborrow, if desired;
- 125 loans allow the homeowner to borrow amounts in excess of their equity, for example, up to 125 percent of the property value; and
- ARMs and negatively amortizing mortgages are nontraditional type loans. Their interest rate and payment may change over time and specialized underwriting and monitoring may be necessary for these loans.

8.42 The Federal Housing Administration (FHA) insures and the Department of Veterans' Affairs (VA) partially guarantees many residential real estate

mortgages.[1] The FHA sets minimum down payments and interest rates for FHA loans. FHA-insured borrowers pay an annual insurance premium computed each year on the loan balance at the beginning of the year. The VA guarantee program, which was initiated to enable veterans to obtain homes when they return from military service, provides certain features, including an interest-rate ceiling that is generally lower than prevailing market rates, a partial guarantee to the lender, a low (or no) down payment, and a prohibition against mortgage brokers' commissions. Residential mortgage loans that are not FHA-insured or VA-guaranteed are called *conventional loans*.

8.43 Chapter 10 includes further discussion on mortgage banking activities.

Lease Financing

8.44 Institutions also may be involved in direct lease financing, in which an institution owns and leases personal property for the use of its customers at the customers' specific request. A typical lease agreement contains an option providing for the purchase of the leased property, at its fair value or at a specified price, by the lessee at the expiration of the lease. Such leases may be financing transactions (discussed in paragraph 8.131). Despite similarities between leases and other forms of installment loans, continuing legal and tax changes have resulted in language and procedures unique to leasing activities.

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

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

8.47 *Leveraged leasing.* Leveraged leasing involves at least three parties, namely, 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 and other lenders 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

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[1] Schedule RC-R of the Federal Financial Institutions Examination Council's Reports of Condition and Income and the Consolidated Capital Requirement (CCR) Schedule in the Thrift Financial Report Instruction Manual should be read in conjunction with the capital guidelines issued by the reporting bank's or thrift's primary federal supervisory authority. Item 38, *Loans and leases held for sale*, of Schedule RC-R indicates that the 20 percent risk weight on loans secured by real estate is limited to the guaranteed portion of closed end loans with first liens secured by 1–4 family homes that are guaranteed by the Federal Housing Administration and the U.S. Department of Veterans Affairs, among others. The 50 percent risk weight would apply for the unguaranteed portion of 1–4 family residential properties and multifamily (5 or more) residential properties if prudently underwritten. The 100 percent risk weight applies to the remaining loans. (CCR Sections 450 and 460 provide similar guidance for thrift institutions.)

leased. The gross return to a finance company or lender is measured using the discounted net cash receipts generated from investment tax credits and the tax effects of timing differences resulting principally from the use of accelerated depreciation in tax returns, rental payments minus debt service costs, and the estimated residual values of equipment leased.

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

Trade Financing

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

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

Commercial Real Estate and Construction Loans

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

8.52 *Construction lending* involves advances of money from a bank or savings institution to finance the construction of buildings or the development of raw land. The institution generally agrees to a specified loan amount, part of which will be disbursed to the borrower at the inception of the project and part of which will be disbursed as construction progresses, based on specified milestones that were agreed to by the institution and the borrower. Construction loans are generally made for the construction period only, which generally runs from one to seven years. Often, both interest and principal are payable at maturity. After construction is completed, the borrower usually obtains long-term mortgage financing from another financial institution. Large CRE and construction loans may involve more than one lender (discussed in paragraphs 8.55–.56).

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

Foreign Loans

8.54 Foreign (or cross-border) loans are made primarily by larger institutions and consist of loans to foreign governments, loans to foreign banks and other financial institutions, and commercial and industrial loans. Foreign loans also include consumer and commercial lending, including real estate loans, made by foreign branches. Such loans may contain certain risks, not associated with domestic lending, such as foreign exchange and country or transfer risks, as described previously in paragraph 8.07. This type of lending exposes the institution to cross-border risk, which is the possibility that the borrowing country's exchange reserves are insufficient to support its repayment obligations.

Loans Involving More Than One Lender

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

8.56 In a loan syndication, the participating institutions arrange a lending syndicate in which the lead syndicator and participants in the syndication fund their respective portions of the loan. A syndication typically involves less risk to a lead institution than a participation because the lead institution funds only

its portion—rather than the entire amount—of the loan at origination. A major difference between syndications and participations relates to the accounting by the agent or lead institution. Refer to paragraphs 19–20 of Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 310-20-25 for additional guidance. Depending on the nature of the loan participation agreement (particularly those that do not involve pari passu loan participations), the lead institution may be unable to derecognize the participations transferred to other banks under FASB ASC 860, *Transfers and Servicing*. See further discussion on transfers of financial assets within chapter 10.

Regulatory Matters

Real Estate Lending Standards

8.57 The Board of Governors of the Federal Reserve System, the OCC, the Office of Thrift Supervision (OTS), and the Federal Deposit Insurance Corporation (FDIC) (collectively, the federal banking agencies have) established real estate lending standards and related guidelines that describe the factors management should address in its real estate lending policies.[2] According to regulations, each institution is required to adopt and maintain written policies that establish limits and standards for extensions of credit related to real estate. The lending policies must establish

a. portfolio diversification standards;

b. underwriting standards, including LTV ratio limitations;

c. loan administration policies; and

d. documentation, approval, and reporting requirements to monitor compliance and appropriateness.

8.58 Management's policies are to be consistent with safe and sound banking practices, appropriate to the size of the institution and the nature and scope of its operation, and reviewed and approved by the institution's board of directors at least annually.

8.59 The policies also outline considerations for loan portfolio management, underwriting standards, loan administration, supervisory LTV limits and excluded transactions, policy exceptions, and supervisory review of real estate lending policy and practices.

8.60 On October 8, 1999, the federal banking agencies jointly issued the *Interagency Guidance on High Loan-to-Value Residential Real Estate Lending*, which highlight the risks inherent in this activity and provides for supervisory limits and capital considerations. The guidelines set forth the supervisory expectation that high LTV portfolios, as defined, will not exceed 100 percent of total capital. Institutions that approach this limit will be subject to increased supervisory scrutiny. If the limit is exceeded, then its regulatory agency will determine if the activity represents a supervisory concern and take action accordingly. Policy and procedure guidelines provided in the 1992 *Interagency Guidelines for Real Estate Lending Policies* apply to these transactions.

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[2] See Title 12 U.S. *Code of Federal Regulations* (CFR) Part 34 (Office of the Comptroller of the Currency [OCC]); Part 208 (Federal Reserve Board [FRB]); Part 365 (Federal Deposit Insurance Corporation [FDIC]); and Part 560 (Office of Thrift Supervision [OTS]).

8.61 The federal banking agencies issued interagency guidance *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*, which was effective on December 6, 2006. The guidance was intended to help ensure that institutions pursuing a significant CRE lending strategy remained healthy and profitable while continuing to serve the credit needs of their communities. The guidance encourages ongoing risk assessments and analysis of CRE lending policies. This includes evaluating the appropriateness of an institution's risk practices, as well as capital levels in relation to the size and complexity of its CRE portfolio. The guidance is applicable for state member banks, bank holding companies, as well as their nonbank subsidiaries.

8.62 The federal banking agencies and the National Credit Union Administration (NCUA) adopted a *Policy Statement on Prudent Commercial Real Estate Loan Workouts* on October 30, 2009. This policy statement provides guidance for examiners, and for financial institutions working with CRE borrowers who are experiencing diminished operating cash flows, depreciated collateral values, or prolonged delays in selling or renting commercial properties. This guidance addresses supervisory expectations for an institution's risk management elements for loan workout programs, loan workout arrangements, classification of loans,[3] and regulatory reporting and accounting considerations. The statement also includes references and materials related to regulatory reporting, but it does not change existing regulatory reporting guidance provided in relevant interagency statements issued by the banking regulators or accounting requirements under accounting principles generally accepted in the United States of America (U.S. GAAP). The guidance includes a series of examples of CRE loan workouts, which are provided for illustrative purposes. This guidance replaces the *Interagency Policy Statement on the Review and Classification of Commercial Real Estate Loans* (November 1991 and June 1993). See the press release at www.ffiec.gov/press/pr103009.htm for additional information.

8.63 *Appraisals*. On December 10, 2010, the federal banking agencies and the NCUA issued interagency guidance *Appraisal and Evaluation Guidelines*, which replaced 1994 guidelines. These guidelines describe the elements of a sound program for conducting appraisals and evaluations and address supervisory matters related to real estate appraisals and evaluations used to support real estate-related financial transactions. The guidelines provide prudent appraisal and evaluation policies, procedures, practices, and standards. The guidelines build on the existing federal regulatory framework and reaffirm longstanding supervisory expectations. They also incorporate the agencies' recent supervisory issuances and, in response to advances in information technology, clarify standards for the industry's appropriate use of analytical methods and technological tools in developing evaluations. The Dodd–Frank Wall Street Financial Reform and Consumer Protection Act of 2010 underscores the importance of sound real estate lending decisions; revisions to the guidelines may be necessary after regulations are adopted to implement the act. Financial institutions should review their appraisal and evaluation programs to ensure they are consistent with the guidelines.

8.64 The federal banking agencies and the NCUA require an appraisal by a state certified or licensed appraiser for all real estate-related financial transactions (as defined in the U.S. Code of Federal Regulation) having a value greater than $250,000. The appraisal regulations do exempt certain real

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[3] See paragraphs 9.08–.09 of this guide for additional information regarding the classification of loans.

estate-related financial transactions from the appraisal requirement.[4] The federal banking agencies and the NCUA also reserve the right to require an appraisal under the appraisal regulations to address safety and soundness concerns in a transaction. As a matter of policy, OTS uses it supervisory authority to require problem associations and associations in troubled condition to obtain appraisals for all real estate-related transactions over $100,000 (unless the transaction is otherwise exempt). NCUA requires a written estimate of market value for all real estate-related transactions valued at the appraisal threshold or less, or that involve an existing extension of credit where there is either an advancement of new monies or a material change in the condition of the property.

Retail Credit Loans and Residential Mortgage Loans

8.65 On June 12, 2000, the federal banking agencies issued the revised *Uniform Retail Credit Classification and Account Management Policy* (initially issued in 1999), which instructs institutions on the review and classification of retail credit loans and residential mortgage loans. Institutions should adopt the standards contained in the policy as part of their loan review program. The guidelines include requirements for the classification and charge-off of retail credit and mortgage loans, as well as fraudulent loans and bankruptcy cases.[5] On April 30, 2009, the FDIC issued Financial Institution Letter-19-2009, "Classification Treatment for High Loan-to-Value (LTV) Residential Refinance Loans," in which the FDIC affirmed that the standards in the *Uniform Retail Credit Classification and Account Management Policy* should be followed relative to the classification treatment for high LTV residential refinance loans. The guidance establishes that retail loan classifications should be based on the borrower's payment performance, not the value of the collateral, which can rise and fall as market conditions change.

8.66 On March 26, 2001, the federal banking agencies and the NCUA issued *Interagency Guidance on Certain Loans Held for Sale*, to provide instruction to institutions and examiners about the appropriate accounting and reporting treatment for certain loans that are sold directly from the loan portfolio or transferred to a held for sale (HFS) account. That guidance also addresses subsequent declines in value for loans within its scope and states that

> [a]fter a loan or group of loans is transferred to the HFS account, those assets must be revalued at each subsequent reporting date until sold and reported at the lower of cost or fair value. Any declines in value (including those attributable to changes in credit quality) and recoveries of such declines in value occurring after the transfer to the HFS account should be accounted for as increases and decreases in a valuation allowance for HFS loans, not as adjustments to the allowance for loan and lease losses (ALLL). Changes in this valuation allowance should be reported in current earnings. The valuation allowance for HFS loans cannot be reduced below zero (that is cannot have a debit balance).

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[4] See 12 CFR Part 34.43 (OCC); Part 225.63 (FRB); Part 323.3 (FDIC); Part 564.3 (OTS); and Part 722.3 (National Credit Union Administration).

[5] See FRB Supervisory and Regulatory Letter 00-8, "Revised Uniform Retail Credit Classification and Account Management Policy," at www.federalreserve.gov/boarddocs/srletters/2000/SR0008.HTM.

8.67 On August 28, 2009, the OTS issued CEO Letter No. 315, which included Thrift Bulletin (TB) 85, "Regulatory and Accounting Issues Related to Modifications and Troubled Debt Restructurings of 1–4 Residential Mortgage Loans." The TB updates Examination Handbook Section 240, "Troubled Debt Restructurings," and provides guidance on the regulatory treatment and accounting for modified loans. It addresses when such modifications constitute troubled debt restructurings (TDRs) and how to classify, as well as risk weight for regulatory capital purposes. Readers are encouraged to read the full text of this bulletin at http://files.ots.treas.gov/84303.pdf.

8.68 In September 2009, the NCUA issued Letter to Credit Union 09-CU-19, "Evaluating Residential Real Estate Mortgage Loan Modification Program," which provides certain financial reporting considerations for credit unions, as well as several other considerations related to loan modifications. (The letter can be found at www.ncua.gov/Resources/LettersCreditUnion.aspx.)

Credit Card Lending

8.69 On January 8, 2003, the federal banking agencies issued *Account Management and Loss Allowance Guidance for Credit Card Lending*. The issuance communicated the expectations for prudent practices in a variety of account management, risk management, and loss allowance practices of institutions engaged in credit card lending. The account management portion of the guidance covers credit lines, overlimit practices, negative amortization, workout programs, and settlements. The loss allowance portion of the guidance covers a number of factors that should be considered by institutions when they estimate and account for their allowance for loan losses. On September 24, 2009, the OTS issued CEO Letter No. 321, "No Interest, No Payment Credit Card Programs," which reminds savings associations of some of the specific requirements of the January 8, 2003, guidance, such as requiring a minimum payment from the borrower each month for all credit card programs, including private label arrangements with retailers.

8.70 For further information, on credit losses, see chapter 9.

Nontraditional Mortgage Products

8.71 Because of increased consumer demand for closed-end residential mortgage loan products that allow borrowers to defer repayments of principal and sometimes interest, mortgage institutions are offering nontraditional mortgage loans such as "interest only" mortgages, or mortgages with subprime interest rates. On October 4, 2006, the federal banking agencies and the NCUA adopted *Interagency Guidance on Nontraditional Mortgage Product Risks* including the use of subprime loans. The guidelines remind banks of the risks inherent in nontraditional mortgage lending and outline the types of risks and controls that are expected for an institution that enters this field of lending. Institutions should establish an appropriate ALLL for estimated credit losses inherent in their nontraditional mortgage loan portfolios. Capital levels should be commensurate with the risk characteristics of the nontraditional mortgage loan portfolios. Institutions should also use "stress tests" to analyze the performance of their nontraditional mortgage portfolios. On June 8, 2007, the federal banking agencies and the NCUA adopted *Illustrations of Consumer Information for Nontraditional Mortgage Products* to assist institutions in implementing the consumer protection portion of the *Interagency Guidance on Nontraditional Mortgage Product Risks*.

Correspondent Concentration Risks

8.72 On May 4, 2010, the federal banking agencies issued *Correspondent Concentration Risks Interagency Guidance*. The interagency guidance outlines the agencies' expectations for identifying, monitoring, and managing correspondent concentration risks between financial institutions. The guidance also addresses the agencies' expectations relative to performing appropriate due diligence on all credit exposures to and funding transactions with other financial institutions.

Income Recognition on Problem Loans

8.73 The federal banking regulators have issued guidance specifically for nonaccrual policies. Following issuance of FASB Statement No. 118, *Accounting by Creditors for Impairment of a Loan-Income Recognition and Disclosures—an amendment of FASB Statement No. 114*, which is codified in FASB ASC 310-10 and 310-40, the federal banking agencies announced they would retain their existing nonaccrual policies governing the recognition of interest income. This guidance was published in the *Federal Register* on February 10, 1995.

8.74 NCUA guidelines state that loans delinquent for 3 months or more should be placed on nonaccrual status and that accrual of interest on loans should be reversed when the loan is determined to be a loss or when it becomes 12 months delinquent, whichever occurs first. State credit union regulators may also have specific requirements for the discontinuance and reversal of accrued income.

Credit Union Lending Restrictions

8.75 Credit unions can generally only make loans to members. Further restrictions include, but are not limited to, LTV limits, limits on loans to one borrower, limits on member business loans, and limits on loans to officers, directors, and employees.

Lending Statutes

8.76 Certain of the more significant federal and state statutes related to consumer and mortgage lending activities follow:

- *Home Mortgage Disclosure Act (HMDA).* The HMDA requires that mortgage lenders compile and report to the institution's regulatory agency, certain information applicable to applications for home acquisition and improvement loans. The objectives of the regulation are to provide information to the public regarding whether the institution is serving the credit needs of the neighborhoods it serves, and to assist public officials in targeting private-sector investments to the areas in which they are most needed.
- *Fair lending statutes.* These statutes include the Equal Credit Opportunity Act and the Fair Housing Act, which prohibit discrimination in lending and housing-related activities, and the Fair Credit Reporting Act, which regulates consumer credit reporting activities.
- *Real Estate Settlement Procedures Act (RESPA).* The RESPA is administered by the U.S. Department of Housing and Urban Development and requires the disclosure of information to mortgage loan

applicants about the costs and procedures involved in loan settlement.

- *Direct consumer lending.* State laws regulating consumer finance operations are designated as licensed-lending, small-loan, or consumer-financing statutes. Diverse state statutes usually regulate mortgage loans and other direct consumer loans. Each branch office of a company that makes direct consumer loans must be licensed by the state in which the office is located. State licensing authorities, many of which are divisions of state banking departments, examine loans to ascertain that they comply with statutory provisions and to determine whether rebates and refunds are properly computed.
- *Retail sales financing.* Laws governing retail sales financing may require offices to be licensed or registered. The laws vary widely among states. For example, all goods statutes may govern consumer goods loans; other goods laws may govern loans for consumer goods excluding automobiles. Additional statutes may affect revolving credit arrangements.
- *Federal Consumer Credit Protection Act (Truth in Lending Act).* The act, through Federal Reserve Regulation Z, requires disclosure of finance charges and annual percentage rates so that consumers can more readily compare various credit terms. It does not set maximum or minimum rates of charges.

Uniform Commercial Code

8.77 The Uniform Commercial Code (UCC), fully adopted by all states, is a set of statutes designed to provide consistency among state laws concerning various commercial transactions. Article 9 of the UCC, which addresses 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. Article 9 generally provides certain rights to the secured parties and the debtors involved in secured transactions. The definition of a secured party includes a lender who obtains a security interest as well as a buyer of trade accounts receivable or retail sales contracts. Similarly, the definition of a debtor includes both the individual obligor and the seller of trade accounts receivable or retail sales contracts.

8.78 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. According to Article 9, those procedures generally require that the creditor file a *financing statement* at a specified public office. The statement, available for public inspection, provides legal notice of a perfected security interest. Consequently, before making collateralized loans, prospective lenders generally search the public files to determine if other lenders have already filed financing statements against the collateral.

8.79 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. 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.

Bank Accounting Advisory Series

8.80 The *Bank Accounting Advisory Series* (BAAS) expresses the Office of the Chief Accountant's current views on accounting topics of interest to national banks. Banks prepare their Consolidated Reports of Condition and Income using U.S. GAAP and regulatory requirements. Accordingly, responses contained in the series are based on GAAP and regulatory requirements. These advisories are not official rules or regulations of the OCC; but rather, represent either interpretation by the OCC's Office of the Chief Accountant of U.S. GAAP, or OCC interpretations of regulatory capital requirements. Topic 2, "Loans," of the BAAS includes interpretations on (*a*) TDR, (*b*) nonaccruals, (*c*) commitments, (*d*) origination fees and costs, (*e*) loans HFS, and (*f*) loan recoveries. Readers are encouraged to read this publication on the OCC website at www.occ.gov/topics/bank-operations/accounting/index-accounting.html.[*]

Accounting and Financial Reporting[†]

8.81 FASB ASC 310-10-35-47 states that loans and trade receivables that management has the intent and ability to hold for the foreseeable future or until maturity or payoff should be reported in the balance sheet at outstanding principal adjusted for any charge-offs, the allowance for loan losses (or the allowance for doubtful accounts), any deferred fees or costs on originated loans, and any unamortized premiums or discounts on purchased loans. (Chapter 9 addresses the allowance for loan losses.) FASB ASC 860-20-35-2 requires financial assets, except for instruments that are within the scope of FASB ASC 815-10, that can contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment, should be subsequently measured like investments in debt securities classified as available for sale or trading under FASB ASC 320, *Investments—Debt and Equity Securities*. Examples of such financial assets include, but are not limited to, interest-only strips, other beneficial interests, loans, or other receivables. Readers may refer to FASB ASC 860-20 for further guidance.

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[*] Due to a number of accounting rule changes, the October 2010 edition of the OCC's *Bank Accounting Advisory Series* has added or revised a number of questions and responses related to Section 2A-D, "Troubled Debt Restructurings," "Nonaccrual Loans," "Commitments," and "Origination Fees and Costs (Including Premiums and Discounts)."

[†] In May 2010, the Financial Accounting Standards Board (FASB) issued proposed Accounting Standards Update (ASU) *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities—Financial Instruments (Topic 825) and Derivatives and Hedging (Topic 815)*. The main objective of this proposal is to provide financial statement users with a more timely and representative depiction of an entity's involvement in financial instruments while reducing the complexity in accounting for those instruments. It develops a consistent framework for classifying financial instruments, removes the threshold for recognizing credit impairments creating a single credit impairment model for both loans and debt securities, and makes changes to the requirements to qualify for hedge accounting.

On February 9, 2011, FASB issued a discussion paper, *Invitation to Comment—Selected Issues about Hedge Accounting*, to solicit input on the International Accounting Standards Board's (IASB's) exposure draft, *Hedge Accounting*, in order to improve, simplify, and converge the financial reporting requirements for hedging activities.

Readers are encouraged to visit the FASB website for the latest developments regarding the accounting for financial instruments project, including a summary of decisions reached to date since the issuance of the proposed guidance.

8.82 Mortgage loans HFS should be reported at the lower of cost or fair value determined as of the balance sheet date, according to FASB ASC 948-310-35-1. If a mortgage loan has been the hedged item in a fair value hedge (as addressed in FASB ASC 815, *Derivatives and Hedging*), the loan's cost basis used in the lower-of-cost-or-fair-value accounting should reflect the adjustments of its carrying amount made pursuant to FASB ASC 815-25-35-1. Per FASB ASC 948-310-40-1, after the securitization of a mortgage loan HFS that meets the conditions for a sale addressed in FASB ASC 860-10-40-5, any mortgage-backed securities received by the transferor as proceeds should be classified in accordance with the provisions of FASB ASC 320. However, FASB ASC 948-310-35-3A states that a mortgage banking entity must classify as trading any retained mortgage-backed securities received as proceeds that it commits to sell before or during the securitization process. An entity is prohibited from reclassifying loans as investment securities unless the transfer of those loans meets the conditions for sale accounting addressed in FASB ASC 860-10-40-5.

8.83 FASB ASC 310-10-35-48 states that nonmortgage loans HFS should be reported at the lower of cost or fair value. Chapter 10 of this guide addresses accounting and reporting at the time the decision is made to sell loans as well as treatment of loans held for investment. This chapter addresses accounting and reporting subsequent to a transfer into a HFS classification.

8.84 Mortgage and nonmortgage loans may qualify for application of the "Fair Value Option" subsections of FASB ASC 825-10 upon origination or purchase. Those subsections, as stated in FASB ASC 825-10-05-5, address circumstances in which entities may choose, at specified election dates, to measure eligible items at fair value (the fair value option). See FASB ASC 825-10-15 for guidance on the scope of the "Fair Value Option" subsections of FASB ASC 825, *Financial Instruments*. See chapter 20, "Fair Value," of this guide for a summary of FASB ASC 825.

8.85 FASB ASC 310-10-25-3 states that transfers of receivables under factoring arrangements meeting the sale criteria of FASB ASC 860-10-40-5 should be accounted for by the factor as purchases of receivables. The acquisition of receivables and accounting for purchase discounts such as factoring commissions should be recognized in accordance with FASB ASC 310-20. Paragraph 8 of FASB ASC 310-10-25 requires that transfers not meeting the sale criteria in FASB ASC 860-10-40-5 should be accounted for as secured loans (that is, loans collateralized by customer accounts or receivables). FASB ASC 860-30-25-5 provides additional guidance in those situations. Factoring commissions under these arrangements should be recognized over the period of the loan contract in accordance with FASB ASC 310-10-25-3. That period begins when the finance company (or an entity with financing activities, including trade receivables) funds a customer's credit and ends when the customer's account is settled.

Interest Income, Delinquency Fees, Prepayment Fees, and Rebates

8.86 Interest income on loans should be accrued and credited to interest income as it is earned, using the interest method.

8.87 Transactions such as those in which captive finance companies offer favorable financing to increase sales of related companies are addressed in paragraphs 1–3 of FASB ASC 835-30-05. FASB ASC 835-30-05-3 provides guidance for the appropriate accounting when the face amount of a note does

not reasonably represent the present value of the consideration given or received in an exchange.

8.88 Delinquency fees are amounts debtors pay because of late payment on loans. Such fees are generally small and are intended to cover additional interest on precomputed loans, to compensate the lender for additional collection costs associated with delinquencies.

8.89 Finance companies may charge various types of fees to customers in connection with lending transactions including prepayment penalties—amounts borrowers pay to lenders, in addition to remaining outstanding principal, if borrowers pay off loans prior to contractual maturity.

8.90 Paragraphs 12–13 of FASB ASC 310-10-25 address recognition guidance related to prepayment and delinquency fees. Prepayment penalties should not be recognized in income until loans (or trade receivables, if applicable) are prepaid, except that the existence of prepayment penalties may affect the accounting resulting from the application of FASB ASC 310-20-35-18(a). Delinquency fees should be recognized in income when chargeable, assuming collectibility is reasonably assured.

8.91 FASB 310-10-05-7 states that rebates represent refunds of portions of the precomputed finance charges on installment loans (or trade receivables, if applicable) that occur when payments are made ahead of schedule. Rebate calculations generally are governed by state laws and may differ from unamortized finance charges on installment loans or trade receivables because many states require rebate calculations to be based on the Rule of 78s or other methods instead of the interest method. FASB ASC 310-10-25-11 states that the accrual of interest income on installment loans or trade receivables should not be affected by the possibility that rebates may be calculated on a method different from the interest method, except that the possibility of rebates affects the accounting resulting from the application of FASB ASC 310-20-35-18(a). Differences between rebate calculations and accrual of interest income merely adjust original estimates of interest income and should be recognized in income when loans or trade receivables are prepaid or renewed.

Loan Fees, Costs, Discounts, and Premiums

8.92 FASB ASC 310-20 provides guidance on the recognition, measurement, derecognition, and disclosure of nonrefundable fees, origination costs, and acquisition costs associated with lending activities and loan purchases.[6] FASB ASC 310-20-35-2 states that loan origination fees deferred in accordance with FASB ASC 310-20-25-2 should be recognized over the life of the loan as an adjustment of yield (interest income). FASB ASC 310-20-30-2 explains that loan origination fees and related direct loan origination costs for a given loan should be offset and only the net amount should be deferred. If the entity holds a large number of similar loans for which prepayments are probable and the timing and amount of prepayments can be reasonably estimated, the entity may consider estimates of future principal prepayments in the calculation of the constant effective yield necessary to apply the interest method, as stated in FASB ASC 310-20-35-26. *Direct loan origination costs* include only incremental direct costs of loan origination incurred in transactions with independent third parties and certain costs directly related to specified activities performed by the

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[6] FASB staff also published the FASB special report *A Guide to Implementation of Statement 91 on Accounting for Nonrefundable Fees and Costs Associated With Originating or Acquiring Loans and Initial Direct Costs of Leases: Questions and Answers*.

lender for that loan, as stated in the FASB ASC glossary. Unsuccessful loan origination efforts and other indirect costs, which include administrative costs, rent, depreciation, and all other occupancy and equipment cost, should be charged to expense as incurred, according to FASB ASC 310-20-25-3.

8.93 Direct loan origination costs must be deferred irrespective of the existence of related loan fees.

8.94 FASB ASC 310-20-35-3 explains that, except as set forth in this paragraph, fees received for a commitment to originate or purchase a loan or group of loans should be, if the commitment is exercised, recognized over the life of the loan as an adjustment of yield or, if the commitment expires unexercised, recognized in income upon expiration of the commitment:

a. If the entity's experience with similar arrangements indicates that the likelihood that the commitment will be exercised is remote, the commitment fee should be recognized over the commitment period on a straight-line basis as service fee income. If the commitment is subsequently exercised during the commitment period, the remaining unamortized commitment fee at the time of exercise should be recognized over the life of the loan as an adjustment of yield. The term *remote* is used here, consistent with its use in FASB ASC 450, *Contingencies*, to mean that the likelihood is slight that a loan commitment will be exercised before its expiration.

b. If the amount of the commitment fee is determined retrospectively as a percentage of the line of credit available but unused in a previous period, if that percentage is nominal in relation to the stated interest rate on any related borrowing, and if that borrowing will bear a market interest rate at the date the loan is made, the commitment fee should be recognized as service fee income as of the determination date.

8.95 FASB ASC 310-20 does not apply to fees and costs related to commitments to originate, sell, or purchase loans that are accounted for as derivatives under FASB ASC 815-10, as stated in FASB ASC 310-20-15-3(d).

8.96 FASB ASC 310-20-25-22 considers that for a purchased loan or a group of loans, the initial investment should include the amount paid to the seller, net of fees paid or received. All other costs related to acquiring purchased loans or committing to purchase loans should be charged to expense as incurred. FASB ASC 310-20-35-15 explains that the difference between the initial investment and the related loan's principal amount at the date of purchase should be recognized as an adjustment of yield over the contractual life of the loan.

8.97 FASB ASC 310-20 also provides guidance on accounting for fees and costs related to loans with no scheduled payment terms (demand loans) and revolving lines of credit. Paragraphs 22–23 of FASB ASC 310-20-35 stipulate that any net fees or costs for a loan that is payable at the lender's demand may be recognized on a straight-line basis over a period that is consistent with (*a*) the understanding between the borrower and the lender or (*b*) if no understanding exists, the lender's estimate of the period over which the loan will remain outstanding. The net fees or costs on revolving lines of credit should be recognized in income on a straight-line basis over the period the revolving line of credit is active, assuming that borrowings are outstanding for the maximum term provided in the loan contract.

8.98 Paragraphs 9–10 of FASB ASC 310-20-35-9 state that if the terms of the new loan resulting from a loan refinancing or restructuring other than a TDR are at least as favorable to the lender as the terms for comparable loans to other customers with similar collection risks who are not refinancing or restructuring a loan with the lender, the refinanced loan should be accounted for as a new loan. This condition would be met if the new loan's effective yield is at least equal to the effective yield for such loans. Any unamortized net fees or costs and any prepayment penalties from the original loan should be recognized in interest income when the new loan is granted.. If the refinancing or restructuring does not meet the condition set forth in FASB ASC 310-20-35-9 or if only minor modifications are made to the original loan contract, the unamortized net fees or costs from the original loan and any prepayment penalties should be carried forward as a part of the net investment in the new loan.

8.99 FASB ASC 310-20-35-11 states that a modification of a debt instrument should be considered more than minor if the present value of the cash flows under the terms of the new debt instrument is at least 10 percent different from the present value of the cash flows under the terms of the original instrument. If the difference between the present value of the cash flows under the terms of the new debt instrument and the present value of the remaining cash flows under the terms of the original debt instrument is less than 10 percent, a creditor should evaluate whether the modification is more than minor based on the specific facts and circumstances (and other relevant considerations) surrounding the modification. The guidance in FASB ASC 470, *Debt*, should be used to calculate the present value of the cash flows for purposes of applying the 10 percent test.

8.100 Paragraphs 17–25 of FASB ASC 310-20-35 also discuss a variety of other amortization matters, including the treatment of increasing, decreasing, and variable-rate loans.

Loans and Debt Securities Acquired With Deteriorated Credit Quality[7]

8.101 FASB ASC 310-30 provides recognition, measurement, and disclosure guidance regarding loans acquired with evidence of deterioration of credit quality since origination acquired by completion of a transfer for which it is probable, at acquisition, that the investor will be unable to collect all contractually required payments receivable.[8]

8.102 FASB ASC 310-30 applies to all loans that are acquired by completion of a transfer and includes an individual loan, a pool of loans, a group of loans, and loans acquired in a purchase business combination as stated in FASB ASC 310-30-15-3. See FASB ASC 310-30-15-2 for a list of scope exceptions. For purposes of applying the recognition, measurement, and disclosure provisions of FASB ASC 310-30, for loans that are not accounted for as debt securities, FASB ASC 310-30-15-6 states that investors may aggregate loans acquired in the same fiscal quarter that have common risk characteristics and thereby use a composite interest rate and expectation of cash flows expected to be collected

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[7] The AICPA issued Technical Questions and Answers sections 2130.09–.37 (AICPA, *Technical Practice Aids*), which address accounting for certain loans or debt securities acquired in a transfer. For additional information visit the AICPA website at www.aicpa.org.

[8] Related financial reporting by liquidating banks is beyond the scope of this guidance. See FASB *Accounting Standards Codification* (ASC) 942-810-45-2 for additional information regarding a liquidating bank.

for the pool. To be eligible for aggregation, each loan first should be determined individually to meet the scope criteria of FASB ASC 310-30-15-2. See paragraph 19.21 of this guide for further discussion of AICPA letter to the Securities and Exchange Commission (SEC) addressing scope of FASB ASC 310-30. After determining that certain acquired loans are within the scope, as defined in FASB ASC 310-30-15-2, the investor may evaluate whether such loans have common risk characteristics, thus permitting the aggregation of such loans into one or more pools.

8.103 Upon completion of a transfer of a credit impaired loan, FASB ASC 310-30 requires that the investor (transferee) should recognize the excess of all cash flows expected at acquisition over the investor's initial investment in the loan as interest income on a level-yield basis over the life of the loan (defined as the accretable yield per the FASB ASC glossary), according to FASB ASC 310-30-35-2.

8.104 FASB ASC 310-30-45-1 requires that the amount of accretable yield should not be displayed in the balance sheet. The loan's contractually required payments receivable in excess of the amount of its cash flows expected at acquisition (defined as the *nonaccretable difference* per the FASB ASC glossary) should not be displayed in the balance sheet or recognized as an adjustment of yield, a loss accrual, or a valuation allowance for credit risk.

8.105 According to paragraphs 6–7 of FASB ASC 310-30-35, an increase in accretable yield establishes a higher effective interest rate and a different threshold for any subsequent impairment determination. The two types of loans to consider for income measurement are loans accounted for as a debt security and loans not accounted for as a debt security.

8.106 For both loans accounted for and not accounted for as a debt security, an investor should continue to estimate cash flows expected to be collected over the life of the loan, in accordance with paragraphs 8 and 10 of FASB ASC 310-30-35, respectively.

8.107 For loans accounted for as a debt security, in accordance with FASB ASC 310-30-35-8, if upon subsequent evaluation:

a. The fair value of the debt security has declined below its amortized cost basis, an entity should determine whether the decline is other than temporary. An entity should apply the impairment of securities guidance in FASB ASC 320-10-35. The investor should consider both the timing and amount of cash flows expected to be collected in making a determination about whether there has been a decrease in cash flows expected to be collected.

b. Based on current information and events, there is a significant increase in cash flows previously expected to be collected or if actual cash flows are significantly greater than cash flows previously expected, the investor should recalculate the amount of accretable yield for the loan as the excess of the revised cash flows expected to be collected over the sum of the initial investment less cash collected less other-than-temporary impairments plus amount of yield accreted to date.

8.108 For loans not accounted for as a debt security, in accordance with FASB ASC 310-30-35-10, if upon subsequent evaluation:

a. Based on current information and events, it is probable that the investor is unable to collect all cash flows expected at acquisition plus

additional cash flows expected to be collected arising from changes in estimate after acquisition, this condition is met. The loan should be considered impaired for purposes of applying the measurement and other provisions of FASB ASC 450 or, if applicable, FASB ASC 310, *Receivables*.

b. Based on current information and events, it is probable that there is a significant increase in cash flows previously expected to be collected or if actual cash flows are significantly greater than cash flows previously expected, the investor should

   i. reduce any remaining valuation allowance (or allowance for loan losses) for the loan established after its acquisition for the increase in the present value of cash flows expected to be collected.

   ii. recalculate the amount of accretable yield for the loan as the excess of the revised cash flows expected to be collected over the sum of the initial investment less cash collected less write-downs plus amount of yield accreted to date.

8.109 For both loans accounted for and not accounted for as a debt security, the investor should adjust the amount of accretable yield by reclassification from nonaccretable difference. The adjustment should be accounted for as a change in estimate in conformity with FASB ASC 250, *Accounting Changes and Error Corrections*, with the amount of periodic accretion adjusted over the remaining life of the loan, in accordance with paragraphs 9 and 11 of FASB ASC 310-30-35, respectively. In addition, for loans not accounted for as a debt security, the resulting yield adjustment should be used as the effective interest rate in any subsequent application of FASB ASC 310-30-35-10(a).

8.110 FASB ASC 310-30-35-14 states that if a loan's contractual interest rate varies based on subsequent changes in an independent factor, such as an index or rate, for example, the prime rate, the London Interbank Offered Rate, or the U.S. Treasury bill weekly average, that loan's contractually required payments receivable should be calculated based on the factor as it changes over the life of the loan. Projections of future changes in the factor should not be made for purposes of determining the effective interest rate or estimating cash flows to be collected. Increases in cash flows expected to be collected should be accounted for according to FASB ASC 310-30-35-8(b) or 310-30-35-10(b). According to these paragraphs the investor should recalculate the amount of accretable yield for the loan as the excess of the revised cash flows expected to be collected over the sum of the initial investment less cash collected less other-than-temporary impairments or write-downs plus amount of yield accreted to date. Decreases in cash flows expected to be collected resulting directly from a change in the contractual interest rate should be recognized prospectively as a change in estimate in conformity with FASB ASC 250 by reducing, for purposes of applying FASB ASC 310-30-35-8(a) and 310-30-35-10(a), all cash flows expected to be collected at acquisition and the accretable yield. The investor should decrease the amount of accretable yield and the cash flows expected to be collected. Thus, for decreases in cash flows expected to be collected resulting directly from a change in the contractual interest rate, the effect will be to reduce prospectively the yield recognized rather than recognize a loss.

8.111 FASB ASC 310-30-30-1 explains that valuation allowances should reflect only those losses incurred by the investor after acquisition—that is, the present value of all cash flows expected at acquisition that ultimately are not

to be received. For loans that are acquired by completion of a transfer, it is not appropriate, at acquisition, to establish a loss allowance. For loans acquired in a business combination, the initial recognition of those loans should be the present value of amounts to be received. The loss accrual or valuation allowance recorded by the investor should reflect only losses incurred by the investor, rather than losses incurred by the transferor or the investor's estimate at acquisition of credit losses over the life of the loan.

8.112 The prohibition of the valuation allowance carryover applies to the initial accounting of all loans acquired in a transfer that are within the scope of FASB ASC 310-30.

Troubled Debt Restructurings[9,‡]

8.113 FASB ASC 310-40 addresses measurement, derecognition, disclosure, and implementation guidance issues concerning TDRs focused on the creditor's records.

8.114 For creditors, TDRs include certain modifications of terms of loans and receipt of assets from debtors in partial or full satisfaction of loans.

8.115 According to FASB ASC 310-40-15-5, a restructuring of a debt constitutes a TDR for purposes of FASB ASC 310-40 if the creditor for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider.

8.116 *Creditor's concession determination.*[||] According to "Pending Content" in paragraphs 13–14 of FASB ASC 310-40-15, a creditor has granted a concession when, as a result of the restructuring, it does not expect to collect all amounts due, including interest accrued at the original contract rate. In that situation, and if the payment of principal at original maturity is primarily

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[9] Center for Audit Quality issued the white paper *Application of FASB Statement No. 114 to Modifications of Residential Mortgage Loans that Qualify as Troubled Debt Restructuring* on December 23, 2008. The purpose of this nonauthoritative paper is to assist preparers and auditors by discussing questions related to the application of existing accounting principles generally accepted in the United States of America (U.S. GAAP) associated with the application of FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan—an amendment of FASB Statements No. 5 and 15*, which is codified in FASB ASC 310-10-35 and 310-40.

[‡] In April 2011, FASB issued ASU No. 2011-02, *Receivables (Topic 310): A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring*. ASU No. 2011-02 clarifies the guidance on a creditor's evaluation of whether it has granted concession and whether a debtor is experiencing financial difficulties. In addition, the amendments clarify that a creditor is precluded from using the effective interest rate test in the debtor's guidance on restructuring of payables (FASB ASC 470-60-55-10) when evaluating whether a restructuring constitutes a troubled debt restructuring. The amended guidance is located in FASB ASC 310-40-15, 310-40-55, and 310-10-50, and is labeled as "Pending Content" due to the transition and effective date information discussed in FASB ASC 310-40-65-1.

For public entities, the amendments in this ASU are effective for the first interim or annual period beginning on or after June 15, 2011, and should be applied retrospectively to the beginning of the annual period of adoption. For nonpublic entities, the amendments in this ASU are effective for annual periods ending on or after December 15, 2012, including interim periods within those annual periods. Early adoption is permitted for public and nonpublic entities. See further discussion on effective date application at FASB 310-40-65-1. Readers should consult the full text of ASU No. 2011-02 for further information.

This guide edition (as of August 1, 2011) has been revised to include the amendments of ASU No. 2011-02. For entities for which the amendments of ASU No. 2011-02 are not effective (and have not adopted early application) as of August 1, 2011, see footnote ||.

[||] For entities for which the amendments of ASU No. 2011-02 are not effective (and have not adopted early application) as of August 1, 2011, this guidance would not apply. See further discussion at footnote ‡.

dependent on the value of collateral, an entity should consider the current value of that collateral in determining whether the principal will be paid. A creditor may restructure a debt in exchange for additional collateral or guarantees from the debtor. In that situation, a creditor has granted a concession when the nature and amount of that additional collateral or guarantees received as part of a restructuring do not serve as adequate compensation for other terms of the restructuring. When additional guarantees are received in a restructuring, an entity should evaluate both a guarantor's ability and its willingness to pay the balance owed.

8.117 "Pending Content" in paragraphs 15–16 of FASB ASC 310-40-15 state, if a debtor does not otherwise have access to funds at a market rate for debt with similar risk characteristics as the restructured debt, the restructuring would be considered to be at a below-market rate, which may indicate that the creditor has granted a concession. In that situation, a creditor should consider all aspects of the restructuring in determining whether it has granted a concession. A temporary or permanent increase in the contractual interest rate as a result of a restructuring does not preclude the restructuring from being considered a concession because the new contractual interest rate on the restructured debt could still be below market interest rates for new debt with similar risk characteristics. In that situation, a creditor should consider all aspects of the restructuring in determining whether it has granted a concession.

8.118 "Pending Content" in paragraphs 17–18 of FASB ASC 310-40-15 provide guidance in evaluating whether a restructuring resulting in a delay in payment is insignificant; and therefore, would not be considered a concession.

8.119 *Debtor's financial difficulties determination*.[||] In evaluating whether a receivable is a TDR, a creditor must determine whether the debtor is experiencing financial difficulties, according to "Pending Content" in FASB ASC 310-40-15-20. In making this determination, a creditor should consider the following indicators:

a. The debtor is currently in payment default on any of its debt. In addition, a creditor should evaluate whether it is probable that the debtor would be in payment default on any of its debt in the foreseeable future without the modification. That is, a creditor may conclude that a debtor is experiencing financial difficulties, even though the debtor is not currently in payment default.

b. The debtor has declared or is in the process of declaring bankruptcy.

c. There is substantial doubt concerning whether the debtor will continue to be a going concern.

d. The debtor has securities that have been delisted, are in the process of being delisted, or are under threat of being delisted from an exchange.

e. On the basis of estimates and projections that only encompass the debtor's current capabilities, the creditor forecasts that the debtor's entity-specific cash flows will be insufficient to service any of its debt (both interest and principal) in accordance with the contractual terms of the existing agreement for the foreseeable future.

f. Without the current modification, the debtor cannot obtain funds from sources other than the existing creditors at an effective interest

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[||] See footnote || in paragraph 8.116

rate equal to the current market interest rate for similar debt for a nontroubled debtor.

The preceding list of indicators is not intended to include all indicators of a debtor's financial difficulties.

8.120 As stated in FASB ASC 310-40-15-9, a TDR may include, but is not necessarily limited to, one or a combination of the following (*a*) transfer from the debtor to the creditor of receivables from third parties, real estate, or other assets to satisfy fully or partially a debt (including a transfer resulting from foreclosure or repossession), (*b*) issuance or other granting of an equity interest to the creditor by the debtor to satisfy fully or partially a debt unless the equity interest is granted pursuant to existing terms for converting the debt into an equity interest, and (*c*) modification of terms of a debt.

8.121 *Modifications of terms.* FASB ASC 310-40-15-9 states that modification of terms of debt may include one or a combination of any of the following:

a. Reduction (absolute or contingent) of the stated interest rate for the remaining original life of the debt

b. Extension of the maturity date or dates at a stated interest rate lower than the current market rate for new debt with similar risk

c. Reduction (absolute or contingent) of the face amount or maturity amount of the debt as stated in the instrument or other agreement

d. Reduction (absolute or contingent) of accrued interest

8.122 A creditor in a TDR involving only a modification of terms of a receivable—that is, not involving receipt of assets (including an equity interest in the debtor)—should account for the TDR in accordance with the provisions of FASB ASC 310, as explained in FASB ASC 310-40-35-5.

8.123 A loan restructured in a TDR is an impaired loan, as stated in FASB ASC 310-40-35-10. It should not be accounted for as a new loan because a TDR is part of a creditor's ongoing effort to recover its investment in the original loan. A loan usually will have been identified as impaired because the conditions specified in paragraphs 16–17 of FASB ASC 310-10-35 will have existed before a formal restructuring. FASB ASC 310-10-35-21 explains that some impaired loans have risk characteristics that are unique to an individual borrower and the creditor should apply the measurement methods described in FASB ASC 310-30-30-2; 310-10-35-22 through 310-10-35-28; and 310-10-35-37 on a loan-by-loan basis. However, some impaired loans may have risk characteristics in common with other impaired loans. A creditor may aggregate those loans and may use historical statistics, such as average recovery period and average amount recovered, along with a composite effective interest rate as a means of measuring impairment of those loans.

8.124 *Receipts of assets.* According to paragraphs 2–3 of FASB ASC 310-40-40, a creditor that receives from a debtor in full satisfaction of a receivable either (*a*) receivables from third parties, real estate, or other assets or (*b*) shares of stock or other evidence of an equity interest in the debtor, or both, should account for those assets (including an equity interest) at their fair value at the time of the restructuring (see FASB ASC 820, *Fair Value Measurement*, for guidance regarding fair value measurements and chapter 20 of this guide for a summary of FASB ASC 820). A creditor that receives long-lived assets that will be sold from a debtor in full satisfaction of a receivable should account for those assets at their fair value less cost to sell as that term is used in FASB ASC 360-10-35-43. The excess of the recorded investment in the

receivable satisfied over the fair value of assets received (less cost to sell, if required) is a loss to be recognized. For purposes of this paragraph, losses, to the extent they are not offset against allowances for uncollectible amounts or other valuation accounts, should be included in measuring net income for the period.

Foreclosed Assets in Troubled Debt Restructurings

8.125 FASB ASC 310-40-40-6 explains that except in the circumstances described in FASB ASC 310-40-40-6A, a TDR that is in substance a repossession or foreclosure by the creditor, that is, the creditor receives physical possession of the debtor's assets regardless of whether formal foreclosure proceedings take place, or in which the creditor otherwise obtains one or more of the debtor's assets in place of all or part of the receivable, should be accounted for according to the provisions of FASB ASC 310-40-35-7 (see paragraph 8.127); FASB ASC 310-40-40-2 through 310-40-40-4; and, if appropriate, FASB ASC 310-40-40-8 (see paragraph 8.126).

8.126 FASB ASC 310-40-40-8 states that a receivable from the sale of assets previously obtained in a TDR should be accounted for according to FASB ASC 835-30 regardless of whether the assets were obtained in satisfaction (full or partial) of a receivable to which that guidance was not intended to apply. A difference, if any, between the amount of the new receivable and the carrying amount of the assets sold is a gain or loss on sale of assets.

8.127 *Combination of types*. TDRs involving receipt of assets (including an equity interest in the debtor) in partial satisfaction of a receivable and a modification of terms of the remaining receivable, should be accounted for as prescribed in FASB ASC 310-40 except that, first, the assets received should be accounted for as prescribed in paragraphs 2–4 of FASB ASC 310-40-40 (see paragraph 8.124) and the recorded investment in the receivable should be reduced by the fair value less cost to sell of the assets received, as stated in FASB ASC 310-40-35-7.

8.128 FASB ASC 320-10-55-2(a) clarifies that any loan that was restructured in a TDR involving a modification of terms would be subject to the provisions of FASB ASC 320 if the debt instrument meets the definition of a *security* (as provided in the FASB ASC glossary). See FASB 310-40-40-8A for additional information.

8.129 FASB ASC 310-40-40-8A discusses how to account for any excess of the fair value of the debt security received in restructuring over the net carrying amount of the loan at the date of the restructuring.

Real Estate Investments

8.130 The "Acquisition, Development, and Construction Arrangements" subsections in FASB ASC 310-10 provide guidance for determining whether a lender should account for an ADC arrangement as a loan or as an investment in real estate or a joint venture, as stated in paragraph 8–9 of FASB ASC 310-10-05. Lenders may enter into ADC arrangements in which they have virtually the same risks and potential rewards as those of owners or joint venturers. If the lender is expected to receive over 50 percent of the expected residual profit from the project, the lender should account for income or loss from the arrangement as a real estate investment as specified by FASB ASC

970, *Real Estate—General*, as stated in FASB ASC 310-10-25-27(a). See chapter 11.

Lease Financing[#]

8.131 Accounting for leases by lessees and lessors is established by FASB ASC 840, *Leases*. FASB ASC 840-40-55-38 states that a transaction should be considered a sale-leaseback transaction subject to FASB ASC 840-40 if the preexisting lease is modified in connection with the sale, except for insignificant changes. Accordingly, transactions with modifications to the preexisting lease involving real estate should be accounted for in accordance with the guidance in FASB ASC 840-40 that addresses sale-leaseback transactions involving real estate. If the preexisting lease is not modified in conjunction with the sale, except for insignificant changes, profit should be deferred and recognized in accordance with FASB ASC 840-40-25-3.

Foreign Loans

8.132 Accounting for foreign loans is generally the same as for single-jurisdiction, domestic loans. However, unique issues arise regarding the accounting for restructured debt of developing countries and the recognition of interest income on such loans.

8.133 FASB ASC 942-310 addresses situations where a financially troubled country may suspend the payment of interest on its loans. Debt-equity swap programs are in place in several financially troubled countries, as stated in FASB ASC 942-310-05-3. Although the programs differ somewhat among the countries, the principal elements of each program generally are as follows:

a. Holders of U.S. dollars-denominated debt of these countries can choose to convert that debt into approved local equity investments.

b. The holders are credited with local currency, at the official exchange rate, approximately equal to the U.S. dollar debt.

c. A discount from the official exchange rate is usually imposed as a transaction fee.

d. The local currency credited to the holder must be used for an approved equity investment.

e. The local currency is not available to the holders for any other purpose.

f. Dividends on the equity investment can generally be paid annually, although there may be restrictions on the amounts of the dividends or on payment of dividends in the early years of the investment.

g. Capital usually cannot be repatriated for several years, and although some countries permit the investment to be sold, the proceeds from

[#] In August 2010, FASB issued an exposure draft, *Leases (Topic 840)*. The proposed guidance was initiated as a joint project between FASB and the IASB to develop a new approach to lease accounting that would ensure that assets and liabilities arising under leases are recognized in the statement of financial position. Based on comments received in response to the exposure draft and decisions reached at the July 20–21, 2011, board meeting, FASB agreed unanimously to re-expose its revised proposals for a leases standard. FASB expects to release a revised proposal during the fourth quarter of 2011. The amendments are expected to result in significant changes to the accounting requirements for both lessees and lessors. Readers are encouraged to visit the FASB website for the latest developments regarding the lease project, including a summary of the proposed model and decisions reached to date.

any such sale are generally subject to similar repatriation restrictions.

8.134 *Debt/equity swaps* (defined in the FASB ASC glossary as an exchange transaction of a monetary asset for a nonmonetary asset) should be measured at fair value at the date the transaction is agreed to by both parties, according to paragraphs 1–2 of FASB ASC 942-310-30. Because the secondary markets for debt of financially troubled countries is presently considered to be thin, it may not be the best indicator of the value of the equity investment or of net assets received. FASB ASC 942-310-30-3 provides factors to consider in determining current fair values of debt/equity swap transactions.

8.135 FASB ASC 942-310-35-2 addresses whether an institution should credit receipt of interest payments on nonaccrual loans to the principal balance of the loan or to income when the loan has been placed on nonaccrual status.

Commitments

8.136 Paragraphs 69 and 71 of FASB ASC 815-10-15 provide guidance on the types of loan commitments that are derivatives under FASB ASC 815-10 (and therefore required to be accounted for as derivatives) and those that are excluded from the scope. Notwithstanding the characteristics discussed in FASB ASC 815-10-15-83, loan commitments that relate to the origination of mortgage loans that will be HFS should be accounted for as derivative instruments by the issuer of the loan commitment (that is, the potential lender). For the holder of a commitment to originate a loan (that is, the potential borrower), the loan commitment is not subject to the requirements of FASB ASC 815-10. For issuers of loan commitments to originate mortgage loans that will be held for investment purposes, as discussed in paragraphs 3–4 of FASB ASC 948-310-25, those loan commitments are not subject to FASB ASC 815-10.

8.137 Loan commitments to originate loans, excluded from the scope of FASB ASC 815-10, are accounted for under FASB ASC 948, *Financial Services—Mortgage Banking*, or FASB ASC 310-20, as appropriate.

8.138 However, commitments to purchase or sell mortgage loans or other types of loans at a future date must be evaluated under the definition of a derivative instrument to determine whether FASB ASC 815-10 applies, according to FASB ASC 815-10-15-70.

8.139 Commitments to originate mortgage loans that will be HFS are recorded at fair value at inception and changes in fair value are recorded in current earnings. Chapters 10 and 18, "Derivative Instruments: Futures, Forwards, Options, Swaps, and Other Derivative Instruments," of this guide address commitments to sell loans. Chapter 9 and subsequent paragraphs of this guide address accounting for loss contingencies in conformity with FASB ASC 450.

8.140 FASB ASC 310-10-05-5 states that entities sometimes enter into forward standby commitments to purchase loans at a stated price in return for a standby commitment fee. In such an arrangement, settlement of the standby commitment is at the option of the seller of the loans and would result in delivery to the entity only if the contract price equals or exceeds the market price of the underlying loan or security on the settlement date. A standby commitment differs from a mandatory commitment in that the entity assumes all the market risks of ownership but shares in none of the rewards. A standby

commitment is, in substance, a written put option that will be exercised only if the value of the loans is less than or equal to the strike price.

8.141 Many entities use standby commitments to supplement their normal loan origination volume. Such standby commitments may be subject to the scope of FASB ASC 815 if they satisfy the definition of a derivative in paragraphs 83–139 of FASB ASC 815-10-15. Standby commitments discussed in the previous paragraph that satisfy the definition of a derivative are recognized in the statement of financial position at inception and measured at the fair value of the commitment. In accordance with FASB ASC 815-10-35-2, changes in fair value of derivative instruments not designated in hedging relationships are recognized currently in earnings.

8.142 FASB ASC 310-10-30-7 states that if a standby commitment is viewed as part of the normal production of loans, as discussed in FASB ASC 310-10-25-6, an entity should record loans purchased under standby commitments at cost on the settlement date, net of the standby commitment fee received, in conformity with FASB ASC 310-20. If a standby commitment is accounted for as a written option as discussed in FASB ASC 310-10-25-6, the option premium received (standby commitment fee) should be recorded as a liability representing the fair value of the standby commitment on the trade date.

8.143 As stated in FASB ASC 310-10-35-46, this guidance applies only to standby commitments to purchase loans. It does not apply to other customary kinds of commitments to purchase loans, nor does it apply to commitments to originate loans. See FASB ASC 310-10-35-46 for subsequent measurement guidance related to standby commitments to purchase loans.

Financial Statement Presentation and Disclosure

8.144 *Loans and trade receivables.*[**] "Pending Content" in FASB ASC 310-10-50-2 states that the summary of significant accounting policies should include the following:

- The basis of accounting for loans and trade receivables.[††]

[**] In July 2010, FASB issued ASU No. 2010-20, *Receivables (Topic 310): Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*. The amendments in this update enhance disclosures about the credit quality of financing receivables and the allowance for credit losses. Existing disclosure guidance has been amended to require an entity to provide a greater level of disaggregated information about the credit quality of its financing receivables and its allowance for credit losses. In addition, the amendments require an entity to disclose credit quality indicators, past due information, and modifications of its financing receivables. The amended guidance is labeled as "Pending Content" due to the transition and effective date information discussed in FASB ASC 310-10-65-2.

For public entities, the disclosures as of the end of a reporting period are effective for interim and annual reporting periods ending on or after December 15, 2010. The disclosures about activity that occurs during a reporting period are effective for interim and annual reporting periods beginning on or after December 15, 2010. For nonpublic entities, the disclosures are effective for annual reporting periods ending on or after December 15, 2011.

This guide edition (as of August 1, 2011) has been revised to include the amendments of ASU No. 2010-20. For entities for which the amendments of ASU No. 2010-20 are not effective (and have not adopted early application) as of August 1, 2011, see footnotes †† and ‡‡‡.

[††] For entities for which the amendments of ASU No. 2010-20 are not effective (and have not adopted early application) as of August 1, 2011, FASB ASC 310-10-50-2(a) states the summary of significant accounting policies should also include the basis of accounting for lease financings, including those classified as held for sale (HFS). See further discussion of ASU No. 2010-20 at footnote **.

- The classification and method of accounting for interest-only strips, loans, other receivables, or retained interests in securitizations that can be contractually prepaid or otherwise settled in a way that the holder would not recover substantially all of its recorded investment.[10]
- The method used in determining the lower of cost or fair value of *nonmortgage* loans HFS (that is, aggregate or individual asset basis).[11]
- The method for recognizing interest income on loans and trade receivables, including a statement about the entity's policy for the treatment of related fees and costs, including the method of amortizing net deferred fees or costs.

8.145 FASB ASC 310-10-45-2 states that loans or trade receivables may be presented on the balance sheet as aggregate amounts. However, such receivables HFS should be a separate balance-sheet category. Major categories of loans or trade receivables should be presented separately either in the balance sheet or in the notes to the financial statements.

8.146 "Pending Content" in FASB ASC 310-10-50-4 states that the allowance for credit losses (also referred to as the allowance for doubtful accounts) and, as applicable, any unearned income, any unamortized premiums and discounts, and any net unamortized deferred fees and costs should be disclosed in the financial statements.[12]

8.147 Except for credit card receivables, "Pending Content" in FASB ASC 310-10-50-4A states that an entity should disclose its policy for charging off uncollectible trade accounts receivable that have both a contractual maturity of one year or less and arose from the sale of goods or services.[‡‡]

8.148 *Nonaccrual and past due financing receivables*. "Pending Content" in FASB ASC 310-10-50-6 states the summary of significant accounting policies for financing receivables should include

- the policy for placing financing receivables, if applicable, on nonaccrual status (or discontinuing accrual of interest) and recording

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[10] Interest-only strips, other interests that continue to be held by a transferor in securitizations, loans, other receivables, or other financial assets that can contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment, except for instruments that are within the scope of FASB ASC 815-10, should be subsequently measured like investments in debt securities classified as available for sale or trading under FASB ASC 320, *Investments—Debt and Equity Securities*. Interest-only strips and similar interests that continue to be held by a transferor that meets the definition of securities are included in the scope of FASB ASC 320. Therefore, all relevant provisions of FASB ASC 320 (including the disclosure requirements) should be applied. According to the FASB ASC glossary, the *recorded investment in the receivable* is the face amount increased or decreased by applicable accrued interest and unamortized premium, discount, finance charges, or acquisition costs and may also reflect a previous write-down of the investment. See paragraphs 2–6 of FASB ASC 860-10-35 for additional information.

[11] A similar requirement exists for mortgage loans HFS.

[12] See footnote 6.

[‡‡] For entities for which the amendments of ASU No. 2010-20 are not effective (and have not adopted early application) as of August 1, 2011, FASB ASC 310-10-50-6(d) also states the summary of significant accounting policies should include the policy for charging off uncollectible trade receivables. However, there is no exclusion for credit card receivables. In addition, trade receivables need not have both the characteristics noted under "Pending Content" in FASB ASC 310-10-50-4A. See further discussion of ASU No. 2010-20 at footnote **.

payments received on nonaccrual financing receivables (if applicable),[||||]

- the policy for resuming accrual of interest, and
- the policy for determining past due or delinquency status.

8.149 According to "Pending Content" in paragraphs 7–7A of FASB ASC 310-10-50, an entity should provide both the following disclosures related to nonaccrual and past due financing receivables as of each balance sheet date: (*a*) the recorded investment in financing receivables on nonaccrual status and (*b*) the recorded investment in financing receivables past due 90 days or more and still accruing. An entity should also provide an analysis of the age of the recorded investment in financing receivables at the end of the reporting period that are past due, as determined by the entity's policy. The guidance in FASB ASC 310-10-50-7A does not apply to the financing receivables listed under "Pending Content" in FASB ASC 310-10-50-7B.[##]

8.150 For trade receivables that do not accrue interest until a specified period has elapsed, nonaccrual status would be the point when accrual is suspended after the receivable becomes past due, as stated in FASB ASC 310-10-50-8.

8.151 The guidance in paragraphs 6–8 of FASB ASC 310-10-50 does not apply to loans acquired with deteriorated credit quality. Instead, disclosures of such loans should be in accordance with "Pending Content" in FASB ASC 310-10-50-5A. In addition, the guidance in paragraphs 6–7A of FASB ASC 310-10-50 should be provided by class of financing receivable except for the financing receivables listed under "Pending Content" in FASB ASC 310-10-50-5B.[***]

8.152 *Impaired loans*. Disclosures about the recorded investment in certain impaired loans, the total unpaid principal balance of the impaired loans, the entity's interest income recognition policy, the entity's loan impairment assessment policy, and factors considered in determining that the loan is impaired are established under "Pending Content" in paragraphs 14A–20 of FASB ASC 310-10-50.[†††]

[||||] For entities for which the amendments of ASU No. 2010-20 are not effective (and have not adopted early application) as of August 1, 2011, FASB ASC 310-10-50-6(a) and 310-10-50-6(b) state that the summary of significant accounting policies should include the policy for placing loans (and trade receivables, if applicable) on nonaccrual status (or discontinuing accrual of interest) and the policy for recording payments received on nonaccrual loans and trade receivables, if applicable. See further discussion of ASU No. 2010-20 at footnote **.

[##] For entities for which the amendments of ASU No. 2010-20 are not effective (and have not adopted early application) as of August 1, 2011, FASB ASC 310-10-50-7 utilizes the terminology loans and trade receivables versus financing receivables as stated under "Pending Content." In addition, the disclosures under (b) are not specified to be required as of each balance sheet date. "Pending Content" under paragraphs 7A–7B of FASB ASC 310-10-50 are also not required. See further discussion of ASU No. 2010-20 at footnote **.

[***] This guidance is not required for entities for which the amendments of ASU No. 2010-20 are not effective (and have not adopted early application) as of August 1, 2011. See further discussion of ASU No. 2010-20 at footnote **.

[†††] For entities for which the amendments of ASU No. 2010-20 are not effective (and have not adopted early application) as of August 1, 2011, guidance in paragraphs 15–20 of FASB ASC 310-10-50 does not require disclosure of the total unpaid principal balance of impaired loans, the entity's policy for determining which loans the entity assesses for impairment under FASB ASC 310-10-35, or factors considered in determining that the loan is impaired. See further discussion at footnote **.

8.153 *Credit quality.*[‡‡‡] According to "Pending Content" in paragraphs 28–30 of FASB ASC 310-10-50, an entity should provide information that enables financial statement users to (*a*) understand how and to what extent management monitors the credit quality of its financing receivables in an ongoing manner and (*b*) assess the quantitative and qualitative risks arising from the credit quality of its financing receivables. To meet this objective, an entity should provide quantitative and qualitative information by class about the credit quality of financing receivables, including all of the following:

- A description of the credit quality indicator
- The recorded investment in financing receivables by credit quality indicator
- For each credit quality indicator, the date or range of dates in which the information was up-dated for that credit quality indicator

If an entity discloses internal risk ratings, then the entity should provide qualitative information on how those internal risk ratings relate to the likelihood of loss. This guidance does not apply to the financing receivables listed in FASB ASC 310-10-50-7B, as stated under "Pending Content" in FASB ASC 310-10-50-27.

8.154 *Modifications.* As required by FASB ASC 310-40-50-1, as of the date of each balance sheet presented, a creditor should disclose, either in the body of the financial statements or in the accompanying notes, the amount of commitments, if any, to lend additional funds to debtors owing receivables whose terms have been modified in TDRs.

8.155 Paragraphs 2–3 of FASB ASC 310-40-50 state that information about an impaired loan that has been restructured in a TDR involving a modification of terms need not be included in the disclosures required by FASB ASC 310-10-50-15(a) and (c) in years after the restructuring if (*a*) the restructuring agreement specifies an interest rate equal to or greater than the rate that the creditor was willing to accept at the time of the restructuring for a new loan with comparable risk and (*b*) the loan is not impaired based on the terms specified by the restructuring agreement. That exception should be applied consistently for FASB ASC 310-10-50-15(a) and (c) to all loans restructured in a TDR that meet the criteria in (*a*) and (*b*).

8.156 For each period for which a statement of income is presented, "Pending Content" in FASB ASC 310-10-50-33 states an entity should disclose the following about TDRs of financing receivables that occurred during the period:

a. By class of financing receivable, qualitative and quantitative information, including how the financing receivables were modified and the financial effects of the modifications

b. By portfolio segment, qualitative information about how such modifications are factored into the determination of the allowance for credit losses[||]

8.157 For each period for which a statement of income is presented, "Pending Content" in FASB ASC 310-10-55-34 states an entity should disclose

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[‡‡‡] Credit quality disclosures are not required for entities for which the amendments of ASU No. 2010-20 are not effective (and have not adopted early application) as of August 1, 2011. See discussion of ASU No. 2010-20 at footnote **.

[||] See footnote || in paragraph 8.116

the following for financing receivables modified as TDRs within the previous 12 months and for which there was a payment default during the period:

a. By class of financing receivable, qualitative and quantitative information about those defaulted financing receivables, including the types of financing receivables that defaulted and the amount of financing receivables that defaulted

b. By portfolio segment, qualitative information about how such defaults are factored into the determination of the allowance for credit losses[||]

8.158 *Assets serving as collateral*. For required disclosures of the carrying amount of loans, trade receivables, securities, and financial instruments that serve as collateral for borrowings see FASB ASC 860-30-50-1A.

8.159 Accounting and financial reporting matters related to the sales or other dispositions of loans are addressed in chapter 10.

8.160 Paragraphs 4–5 of FASB ASC 840-10-50[#] require certain disclosures by lessors when leasing is a significant part of a lessor's business activities in terms of revenue, net income, or assets.

8.161 *Fair value option.* FASB ASC 825-10-50-28(e) states that as of each date for which a statement of financial position is presented, entities should disclose for loans held as assets, for which the fair value option has been elected, all of the following:

a. The aggregate fair value of loans that are 90 days or more past due.

b. If the entity's policy is to recognize interest income separately from other changes in fair value, the aggregate fair value of loans in nonaccrual status.

c. The difference between the aggregate fair value and the aggregate unpaid principal balance for loans that are 90 days or more past due, in nonaccrual status, or both.

8.162 FASB ASC 825-10-50-30(c) explains that for each period for which an income statement is presented, entities should disclose for loans and other receivables held as assets, for which the fair value option has been elected, both of the following:

a. The estimated amount of gains or losses included in earnings during the period attributable to changes in instrument-specific credit risk.

b. How the gains or losses attributable to changes in instrument-specific credit risk were determined.

8.163 Paragraphs 20–21 of FASB ASC 825-10-50 require disclosures about all significant concentrations of credit risk arising from all financial instruments except for the instruments described in FASB ASC 825-10-50-22. The following should be disclosed for each significant concentration:

a. Information about the (shared) activity, region, or economic characteristic that identifies the concentration

b. The maximum amount of loss due to credit risk that, based on the gross fair value of the financial instrument, the entity would incur if parties to the financial instruments that make up the concentration

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[||] See footnote || in paragraph 8.116.

[#] See footnote # in paragraph 8.131.

failed completely to perform according to the terms of the contracts and the collateral or other security, if any, for the amount due proved to be of no value to the entity

c. With respect to collateral, the entity's policy of requiring collateral or other security to support financial instruments subject to credit risk, information about the entity's access to that collateral or other security, and the nature and a brief description of the collateral or other security supporting those financial instruments

d. With respect to master netting arrangements, the entity's policy of entering into master netting arrangements to mitigate the credit risk of financial instruments, information about the arrangements for which the entity is a party, and a brief description of the terms of those arrangements, including the extent to which they would reduce the entity's maximum amount of loss due to credit risk

An entity is encouraged, but not required, to disclose quantitative information about the market risks of financial instruments that is consistent with the way it manages or adjusts those risks. See FASB ASC 825-10-50-23 for possible disclosures.

8.164 Information about loan products and terms of loan products that identifies the concentration may also be disclosed.

8.165 Disclosure requirements under FASB ASC 825 which might be challenging for financial institutions, may include requirements related to loan fair values based on pricing models, the reconciliation of the beginning and ending balances for fair value measurements using significant unobservable inputs (level 3), and nonrecurring measurements such as real estate owned. See FASB ASC 820-10-50[||||||] for the required disclosures for recurring and nonrecurring fair value measurements.

8.166 *Off balance-sheet credit risk.*[###] FASB ASC 942-825-50-1 states that off-balance-sheet credit risk refers to credit risk on off-balance-sheet loan commitments, standby letters of credit, financial guarantees, and other similar

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[||||||] In May 2011, FASB issued ASU No. 2011-04, *Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*. The amendments in this ASU result in common fair value measurement and disclosure requirements in U.S. GAAP and International Financial Reporting Standards (IFRSs). The amendments alter the wording used to describe many of the requirements in U.S. GAAP for measuring fair value and for disclosing information about fair value measurements. The ASU does not require additional fair value measurements and is not intended to establish valuation standards or affect valuation practices outside of financial reporting.

The amendments in this ASU are effective prospectively (1) for public entities, for interim and annual periods beginning after December 15, 2011, and (2) for nonpublic entities, for annual periods beginning after December 15, 2011. Early application is not permitted for public entities. Early application is permitted for nonpublic entities, but only for interim periods beginning after December 15, 2011. See FASB ASC 820-10-65-8 for further information regarding changes in valuation technique as a result of implementation of respective guidance. Readers should consult the text of ASU No. 2011-04 for further information.

[###] In January 2011, FASB issued the proposed ASU *Balance Sheet Offsetting*. The proposed guidance was initiated as a joint project between FASB and the IASB to provide users of financial statements with information to understand the extent of offsetting in the statement of financial position and improve comparability between IFRSs and U.S. GAAP. The proposed guidance as issued would eliminate the exception in U.S. GAAP that allows offsetting for some derivative and sale and repurchase (and reverse sale and repurchase) contracts when the right of setoff is conditional, there is no intention to set off, or such intention is conditional. The proposed guidance would also enhance disclosures required by U.S. GAAP by requiring improved information about eligible assets and eligible liabilities subject to setoff, and related arrangements (such as collateral arrangements) and the effect of those arrangements on an entity's financial position.

instruments, except those instruments within the scope of FASB ASC 815. For financial instruments with off-balance-sheet credit risk, except for those instruments within the scope of FASB ASC 815, an entity should disclose the following information:

a. The face or contract amount

b. The nature and terms, including, at a minimum, a discussion of the

   i. credit and market risk of those instruments

   ii. cash requirements of those instruments

   iii. related accounting policy pursuant to FASB ASC 235-10

c. The entity's policy for requiring collateral or other security to support financial instruments subject to credit risk, information about the entity's access to that collateral or other security, and the nature and a brief description of the collateral or other security supporting those financial instruments

8.167 Examples of activities and financial instruments with off-balance-sheet credit risk include obligations for loans sold with recourse (with or without a floating-interest-rate provision), fixed-rate and variable-rate loan commitments, financial guarantees, note issuance facilities at floating rates, and letters of credit, as stated in FASB ASC 942-825-50-2.

8.168 FASB ASC 850, *Related Party Disclosures*, contains guidance on disclosures about transactions with various related parties. Institutions frequently make loans to parent and affiliated companies, directors, officers, and stockholders, as well as to entities with which directors, officers, and stockholders are affiliated. The aggregate amount of such loans should be disclosed.

8.169 FASB ASC 460, *Guarantees*, establishes the accounting and disclosure requirements to be met by a guarantor for certain guarantees issued and outstanding. Commercial letters of credit and other loan commitments, which are commonly thought of as guarantees of funding, are not included in the scope of FASB ASC 460, as stated in FASB ASC 460-10-55-16(a). FASB ASC 460-10-55-2 states that a financial standby letter of credit is an example of a guarantee contract under the scope of FASB ASC 460. A *financial standby letter of credit* is defined by the FASB ASC glossary as an irrevocable undertaking (typically by a financial institution) to guarantee payment of a specified financial obligation. See paragraphs 4–7 of FASB ASB 460-10-15 for types of guaranteed contracts included and excluded from the scope of FASB ASC 460.

8.170 In accordance with FASB ASC 460-10-25-4, at the inception of a guarantee, the guarantor should recognize in its statement of financial position a liability for that guarantee. FASB ASC 460-10 does not prescribe a specific

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(footnote continued)

In June 2011, FASB and the IASB discussed alternative approaches for requiring offsetting of financial assets and financial liabilities on the face of the balance sheet. The majority of the FASB board members supported providing an exception from the general offsetting criteria for derivative instruments, which would allow offsetting of fair value amounts recognized for derivatives and fair value amounts recognized for the right to reclaim cash collateral or the obligation to return cash collateral arising from derivative instruments recognized at fair value with the same counterparty under a master netting arrangement. During July 2011, FASB and IASB also discussed revisions to the proposed offsetting disclosures.

Readers are encouraged to visit the FASB website for the latest developments regarding the offsetting project, including a summary of decisions reached to date since the issuance of the proposed guidance. FASB expects to issue final guidance during 2011.

account for the guarantor's offsetting entry when it recognizes the liability at the inception of a guarantee. That offsetting entry depends on the circumstances in which the guarantee was issued. The liability that the guarantor initially recognized would typically be reduced (by a credit to earnings) as the guarantor is released from risk under the guarantee, as stated in FASB ASC 460-10-35-1.

8.171 As stated in paragraph 2–3 of FASB ASC 460-10-30, the objective of the initial measurement of a guarantee liability is the fair value of the guarantee at its inception. In the event that, at the inception of the guarantee, the guarantor is required to recognize a liability under FASB ASC 450-20-25 for the related contingent loss, the liability to be initially recognized for that guarantee should be the greater of (*a*) the amount that satisfies the fair value objective or (*b*) the contingent liability amount required to be recognized at inception of the guarantee by FASB ASC 450-20-30.

8.172 FASB ASC 460-10-50-4 requires a number of disclosures about a guarantor's obligations under guarantees. A guarantor should disclose all of the following information about each guarantee, or each group of similar guarantees, even if the likelihood of the guarantor's having to make any payments under the guarantee is remote:

a. The nature of the guarantee, including all of the following:
   i. The approximate term of the guarantee
   ii. How the guarantee arose
   iii. The events or circumstances that would require the guarantor to perform under the guarantee
   iv. The current status (that is, as of the date of the statement of financial position) of the payment/performance risk of the guarantee (for example, the current status of the payment/performance risk of a credit-risk-related guarantee could be based on either recently issued external credit ratings or current internal groupings used by the guarantor to manage its risk)
   v. If the entity uses internal groupings for purposes of item (a)(iv), and how those groupings are determined and used for managing risk

b. The following information about the maximum potential amount of future payments under the guarantee, as appropriate:
   i. The maximum potential amount of future payments (undiscounted) the guarantor could be required to make under the guarantee, which should not be reduced by the effect of any amounts that may possibly be recovered under recourse or collateralization provisions in the guarantee
   ii. If the terms of the guarantee provide for no limitation to the maximum potential future payments under the guarantee, that fact
   iii. If the guarantor is unable to develop an estimate of the maximum potential amount of future payments under its guarantee, the reasons why it cannot estimate the maximum potential amount

c. The current carrying amount of the liability, if any, for the guarantor's

obligations under the guarantee (including the amount if any, recognized under FASB ASC 450-20-30) regardless of whether the guarantee is freestanding or embedded in another contract

d. The nature of any recourse provisions that would enable the guarantor to recover from third parties any of the amounts paid under the guarantee

e. The nature of any assets held either as collateral or by third parties that, upon the occurrence of any triggering event or condition under the guarantee, the guarantor can obtain and liquidate to recover all or a portion of the amounts paid under the guarantee

f. If estimable, the approximate extent to which the proceeds from liquidation of assets held either as collateral or by third parties would be expected to cover the maximum potential amount of future payments under the guarantee

Auditing

Objectives

8.173 The primary objectives of audit procedures in the loan area are to obtain sufficient appropriate evidence that

a. loans exist and are owned by the entity as of the balance-sheet date;

b. the allowance for credit losses is adequate for estimated losses that have been incurred in the loan portfolio (audit procedures to satisfy this objective are discussed in chapter 9);

c. loans are properly classified, described, and disclosed in the financial statements, including fair values of loans and concentrations of credit risk;

d. recorded loans include all such assets of the institution and the financial statements include all related transactions during the period;

e. loan transactions are recorded in the proper period;

f. loans HFS are properly classified and are stated at the lower of cost or fair value;

g. interest income, fees, and costs and the related balance-sheet accounts (accrued interest receivable, unearned discount, unamortized purchase premiums and discounts, and unamortized net deferred loan fees or costs) have been properly measured and recorded;

h. gains and losses on the sale of loans have been properly measured and properly recorded;

i. credit commitments, letters of credit, guarantees, recourse provisions, and loans that collateralize borrowings are properly disclosed in the financial statements; and

j. transfers of loans have been properly accounted for under FASB ASC 860.

Planning

8.174 In accordance with AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), the auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures (see chapter 5, "Audit Considerations and Certain Financial Reporting Matters," for additional information). As described earlier in this chapter, credit risk is normally the principal risk inherent in lending. The composition of an institution's loan portfolio, which can vary widely from institution to institution, is one of the most important factors in assessing the risks of material misstatement related to loans. For example, the risks associated with construction lending are very different from the risks associated with credit-card lending. The current year's interim financial statements and other financial information (for example, board of directors' minutes, asset-classification reports, credit management reports, and reports of the institution's regulators) should be helpful in understanding an institution's credit strategy and loan portfolio characteristics and, thereby, in assessing the related risks of material misstatement. Those reports generally include information about such items as dollar amounts and types of loans; the volume of current originations by type and related net deferred loan fees or costs; identification of TDRs; ADC arrangements; purchases and sales of loans, including gains and losses; and wash sales, among others. Controls over loans should also include controls over allowances and write-offs. Readers may refer to chapter 9 for guidance. As stated in AU section 314, the auditor should perform risk assessment procedures to obtain an understanding of the entity and its environment, including this area.

8.175 The following factors related to loans may be indicative of risks of material misstatement (and, often, higher control risk) for loans and related amounts:

- Lack of a formal written lending policy
- High rate of growth in the loan portfolio
- Concentration of lending authority in one individual
- Lack of personnel with skills and knowledge of a particular kind of loan, such as credit card or construction
- Significant changes in the composition of an institution's portfolio
- Poor underwriting standards and procedures
- Poor recordkeeping and monitoring of principal and interest receipts
- Significant nontraditional lending activities that involve a higher degree of risk, such as highly leveraged lending transactions
- Significant originations or purchases of loans outside the institution's normal activities or market area
- Sales of loans with significant recourse provisions
- Ambiguous transactions involving the sale or transfer of loans, especially when there is a lack of analysis prior to the transactions
- Failure of personnel to follow management's written lending policies for underwriting and documentation
- Loans that are continuously extended, restructured, or modified

- Loans that are of a type, customer, collateral, industry, or geographical location not authorized by management's written lending policies
- Loans of unusual size or with unusual interest rates or terms
- Significant concentrations of loans in a particular industry or geographic area
- The potential for insider abuse because of significant loans to the institution's officers, directors, shareholders, or other related parties that do not meet normal underwriting standards, such as nominee loans, loans with questionable collateral, and multiple transactions with a single related party or group of affiliated parties
- Significant concentrations of loan products with terms that give rise to a credit risk; such as, negative amortization loans, loans with high LTV ratios, multiple loans on the same collateral that when combined result in a high LTV ratio, and interest-only loans

Internal Control Over Financial Reporting and Possible Tests of Controls[13]

8.176 AU section 314 establishes standards and provides guidance on obtaining a sufficient understanding of the entity and its environment, including its internal control. It provides guidance on understanding the components of internal control and explains how an auditor should obtain a sufficient understanding of internal controls for the purposes of assessing the risks of material misstatement. Paragraph .40 of AU section 314 requires that, in all audits, the auditor should obtain an understanding of the five components of internal control (the control environment, risk assessment, control activities, information and communication systems, and monitoring), sufficient to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. The auditor should obtain a sufficient understanding by performing risk assessment procedures to evaluate the design of controls relevant to an audit of financial statements and to determine whether they have been implemented. Paragraph .102 of AU section 314 states that the auditor should identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions, account balances, and disclosures.

8.177 An understanding of the internal control over the financial reporting of loans should include controls over transactions such as granting credit, disbursing loan funds, applying loan payments, amortizing discounts, accruing interest income, purchased loans, participations, and syndications as those transactions relate to each significant type of lending activity. Also, procedures are needed to ensure that all appropriate liens have been filed.

8.178 Effective controls in this area should provide assurance that errors or fraud in management's financial statement assertions about the loan portfolio—including those due to the failure to execute lending transactions in accordance

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[13] On June 23, 2009, the FDIC issued Financial Institution Letter-23-2009, "Annual Audit and Reporting Requirements: Final Amendments to Part 363," which provides guidance on the internal control attestation standards that auditors of insured institutions with $1 billion or more in total assets should follow to comply with FDIC audit and reporting requirements in Part 363 of the FDIC regulations. For more information please refer to chapter 1, "Industry Overview—Banks and Savings Institutions," and appendix A, "FDI ACT Reporting Requirements," of this guide and the FDIC website at www.fdic.gov.

with management's written lending policies—are prevented or detected. For example, failure to document a second lien as mandated by management's written loan documentation policy could affect financial statement assertions about ownership and valuation.

8.179 Factors that contribute to an effective control environment may include

- those charged with governance take an active role in monitoring lending policies and practices;
- information systems which enforce the segregation of duties and the monitoring of activities, and maintain the integrity of information on which management relies upon to identify problem loans;
- a well-defined lending approval and review system that includes established credit limits, limits and controls over the types of loans made, and limits on maturities of loans; and
- a reporting system that provides the institution with the information needed to manage the loan portfolio.

8.180 In obtaining an understanding of the entity and its environment, including its internal control, the auditor should obtain an understanding about the institution's accounting system as it relates to loans receivable, including the methods used by the institution when processing and recording new loans, applying loan payments, accruing interest, and amortizing discounts.

8.181 When, in accordance with paragraph .117 of AU section 314, the auditor has determined that it is not possible or practicable to reduce the detection risks at the relevant assertion level to an acceptably low level with audit evidence obtained only from substantive procedures, he or she should perform tests of controls to obtain audit evidence about their operating effectiveness. Typical controls relating to loans include the following:

- All loans and credit lines (including all new loans, renewals, extensions, and commitments) are approved by officers or committees in conformity with management's written lending policies and authority limits.
- An inventory of loan documents, including evidence of collateral and of the recording of liens, is monitored to ensure the timely receipt of necessary documents.
- Pertinent loan information is entered into the data-processing system on a timely basis and is independently verified to ensure accuracy.
- Subsidiary ledgers and trial balances are maintained and reconciled with the general ledger on a timely basis, differences found are investigated and resolved, and appropriate supervisory personnel review and approve completed reconciliations on a timely basis.
- Loans HFS are properly identified in the accounting records.
- Payments due for principal or interest are monitored for their eventual receipt, aging of delinquencies, and follow-up with late payers.
- There is segregation of duties among those who (*a*) approve loans, (*b*) control notes and collateral, (*c*) receive payments, (*d*) post subsidiary ledgers, and (*e*) reconcile subsidiary and general ledgers.
- Procedures are periodically performed to ensure that interest income is properly accrued and recorded.

- Notes and collateral on hand are kept in secure, locked, fireproof compartments. Negotiable collateral is kept under dual access control. Physical inventory and other processes are in place to identify losses or impairment of collateral.
- Construction loan advances are adequately documented, and periodic on-site inspections of properties are made to ensure construction progress is consistent with amounts advanced.

8.182 *Loan files.* Complete and accurate loan files are an element of internal control over financial reporting. Paragraph 8.183 details information that may be found in a loan file. The contents of the files vary, depending on the type of loan, the requirements of local law, and whether the institution intends to hold the loan or not. However, all loan files should contain a signed note. An inspection of the files supporting loans originated in prior audit periods, as well as new loans (including some of the loans still in the process of disbursement), generally permits the auditor to understand the institution's internal control in this area as a basis for planning substantive tests. It may also be useful to design dual-purpose tests in this area.

8.183 Following are items a loan file may contain. The location of the contents listed will vary from one institution to another depending on the type of loan and a particular institution's policies and procedures:

a. Credit investigation/application/supervision section

- i. Loan application
- ii. Credit approval document that summarizes the following:
  - (1) Borrower
  - (2) Amount of request, rate, payment terms, and fees
  - (3) Purpose
  - (4) Repayment sources (primary and secondary)
  - (5) Collateral description and valuation
  - (6) Guarantors
  - (7) Other conditions and requirements of approval
- iii. Evidence of loan committee or other required approval and date approval was granted
- iv. Financial statements of borrower, guarantor, or both
- v. Spreadsheets and other analyses of the financial situation of the borrower
- vi. Borrower's board resolutions concerning loan approval
- vii. Credit agency reports and other account information reports, as well as direct trade creditor references
- viii. Newspaper clippings about borrower
- ix. Various other pertinent data, including the borrower's history and forecasts
- x. Internal memoranda
- xi. Correspondence
- xii. Loan summary sheet, containing information such as the following:

(1) Lending committee approval date

(2) Drawdown amounts and dates

(3) Interest rates and adjustment dates

(4) Amount of undrawn commitment

(5) Rate of commitment fee and due dates

(6) Date commitment fee received

(7) Repayment terms

(8) Name of country risk

(9) Name and country of any guarantor

(10) Amount of participation fee (if applicable)

(11) Indication of overdue payments of interest, fees, or installments

xiii. Memorandum to the file, by the lending officer, with description of the credit and commentary on its quality and potential future developments

b. Loan documents section, including the following:

i. Signed loan agreement

ii. Legal opinion

iii. Signed note

iv. Signed mortgage or deed of trust, with evidence of recordation

v. Signed guarantee

vi. Periodic report of collateral, including its location and value and any related environmental studies

vii. Participation certificates and participation agreements (if applicable)

viii. Evidence of insurance, including loss payable clauses that protect the bank's interest

ix. Approvals

x. Security agreements or other collateral pledge agreements, titles, or financing statements recorded in the proper jurisdictions to perfect lien position (nonpossessory collateral); negotiable collateral (such as stocks and bonds) with proper endorsements/assignments; hypothecation agreement for third-party pledge of collateral

xi. Collateral ledger used to record the instruments (including stocks and bonds, which are typically held in a vault separate from loan files or with an independent custodian) that secure a borrower's indebtedness

8.184 For commercial loans, a credit file is commonly maintained. This file usually contains the borrower's financial statements, memoranda about the borrower's financial or personal status, financial statements of guarantors (individual or corporate), internally prepared analyses of the credit, copies of supplemental agreements between the institution and the borrower, and other loan-related correspondence.

8.185 Files supporting either direct or indirect installment loans should include the borrower's application, discount sheet (loan computations), credit information, title or financing statement, evidence of the existence of an in-force insurance policy payable to the institution, and the note. Credit files are also maintained on dealers from whom the institution has purchased loan paper.

8.186 Mortgage loan files generally include the note, loan application, appraisal report, verifications of employment and assets, deed of trust, mortgage, title insurance or opinion, insurance policy, settlement statement, and VA guarantee or FHA insurance, if applicable.

8.187 Specific procedures the auditor should consider performing to test the operating effectiveness of controls for loans include

- inspecting loan documents to determine whether the institution's lending policies and procedures are being followed, for example, to test whether
  - — loans are being approved by authorized officers or committees in accordance with the institution's lending policies;
  - — credit investigations are performed;
  - — credit limits are adhered to;
  - — the institution's procedure to capture all required loan documents is functioning; and
  - — the information recorded in the institution's data-processing system and used for management reporting is being tested by personnel independent of the preparer and is accurate.
- testing the institution's reconciliation process. This testing might include the daily activity balancing process as well as the reconciliation of subsidiary ledgers with the general ledger. The auditor should test whether reconciling differences are appropriately investigated and resolved in a timely manner and whether the reconciliations are reviewed and approved by appropriate supervisory personnel.
- testing the accuracy and performing a review of delinquency reports to determine whether the institution initiates follow-up procedures on delinquent loans in accordance with its policies and whether the system identifies potentially troubled loans for purposes of assessing impairment.
- checking the accuracy and perform a review of concentration reports (such as loans to one borrower, in a particular region, or in a specific industry) and related-party loan reports.
- reviewing internal audit, loan review, and examination reports to identify control weaknesses and exceptions.
- observing or otherwise obtain evidence that a proper segregation of duties exists among those who approve, disburse, record, and reconcile loans.
- performing detailed tests of initial recording of loans, application of cash receipts, and changes in loan details (such as adjustment of rates for ARMs and maturity dates).

8.188 *Credit-card activities.* To the extent the institution is involved in credit-card operations, including credit-card issuance and the processing of

transactions, the auditor should consider internal control over financial reporting of credit-card activities. Audit procedures for testing financial statement assertions related to credit-card activities depend on the degree of the institution's involvement in such activities. If the institution owns the customer receivables, the following may be appropriate:

- Review lending policies
- Confirm customer balances
- Test interest and service charges, collections, delinquencies, and chargeoffs may be appropriate

If the institution only processes merchants' deposits and the resulting receivables are owned by other institutions, a review of the arrangements and a test of service fee income is generally performed.

8.189 To the extent the institution relies on other enterprises for some processing activities, the auditor must consider the guidance in AU section 324, *Service Organizations* (AICPA, *Professional Standards*).[****,14]

8.190

> *Considerations for Audits Performed in Accordance with Public Company Accounting Oversight Board (PCAOB) Standards*
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> Paragraph .02 of AU section 319, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards),[††††] states that regardless of the assessed level of control risk, the auditor should perform substantive procedures for all relevant assertions related to all significant accounts

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[****] The guidance contained in AU section 324, *Service Organizations* (AICPA, *Professional Standards*), has now been split into an attest standard and an auditing standard to better reflect the nature of the work being performed. The Auditing Standards Board (ASB) has finalized a new clarified auditing standard on service organizations, *Audit Considerations Relating to an Entity Using a Service Organization*. This auditing standard will supersede AU section 324 and addresses the user auditor's responsibility for obtaining sufficient appropriate audit evidence in an audit of the financial statements of a user entity that uses one or more service organizations. This clarified auditing standard has been finalized but not yet issued. See the preface of this guide for further information on the ASB's Clarity Project. The effective date of this clarified standard is for audits of financial statements for periods ending on or after December 15, 2012, unless otherwise established (early adoption would not be appropriate).

The related attest standard, Statement on Standards for Attestation Engagements (SSAE) No. 16, *Reporting on Controls at a Service Organization* (AICPA, *Professional Standards*, AT sec. 801), was issued in April 2010. It addresses examination engagements undertaken by a service auditor to report on controls at organizations that provide services to user entities when those controls are likely to be relevant to user entities' internal control over financial reporting. SSAE No. 16 supersedes the guidance for service auditors in AU section 324 and is effective for service auditors' reports for periods ending on or after June 15, 2011. Early implementation is permitted.

[14] The Audit Guide *Service Organizations: Applying SAS No. 70, as Amended* has been revised by a task force of the ASB to reflect the requirements and guidance in SSAE No. 16. The revised Audit Guide, *Service Organizations: Applying SSAE No. 16,* Reporting on Controls at a Service Organization, is currently available to readers. Also, the newly released Audit Guide *Reporting on Controls at a Service Organization Relevant to Security, Availability, Processing Integrity, Confidentiality, or Privacy*, addresses reporting on a service provider's controls over subject matter other than financial reporting.

[††††] In December 2010, the Securities and Exchange Commission approved the Public Company Accounting Oversight Board's (PCAOB's) suite of risk assessment standards (Auditing Standard Nos. 8–15). These standards set forth requirements that are intended to enhance the effectiveness of the auditor's assessment of, and response to, the risks of material misstatement in the financial statements. The risk assessment standards address audit procedures performed throughout the audit, from the initial planning stages through the evaluation of the audit results. The standards will be effective for audits of fiscal periods beginning on or after December 15, 2010.

and disclosures in the financial statements. Refer to paragraph A9 in appendix A, "Definitions," of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards), for the definition of a *relevant assertion*, and paragraphs 28–33 of Auditing Standard No. 5 for discussion of identifying relevant assertions.

Paragraph .01 of AU section 324, *Service Organizations* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards), states that when performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs B17–B27 of appendix B, "Special Topics," of Auditing Standard No. 5, regarding the use of service organizations.

Substantive Tests

8.191 Regardless of the assessed risks of material misstatement, it is necessary for the auditor to design and perform substantive procedures for all relevant assertions related to loans.

8.192 It is necessary for the auditor to determine the nature, timing, and extent of substantive tests based the assessment of the risks of material misstatement.

8.193 *Analytical procedures.* AU section 329, *Analytical Procedures* (AICPA, *Professional Standards*), provides guidance on the use of analytical procedures and requires the use of analytical procedures in the planning and overall review stages of all audits. See chapter 5 of this guide for additional guidance regarding analytical procedures.

8.194 Analytical procedures that the auditor may apply in the loan area include the analysis and evaluation of the following:

- Changes in the mix between different types of loans in the portfolio
- Comparison of the aging of past-due loans with similar aging of prior year
- Comparison of loan origination volume by month with that of prior periods
- Current-year income compared with expectations and prior-year income
- Average loan balances by type in the current year compared with those of the prior year

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(footnote continued)

As a result of the new suite of risk assessment standards, the guidance contained in AU section 319, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards), has now been split into Auditing Standard No. 8, *Audit Risk*, Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, and Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards). Auditing Standard No. 8 discusses the auditor's consideration of audit risk in an audit of financial statements as part of an integrated audit or an audit of financial statements only. Auditing Standard No. 12 discusses the auditor's responsibility for performing risk assessment procedures as well as utilizing the information obtained from risk assessment procedures to identify and assess the risks of material misstatement. Finally, Auditing Standard No. 13 establishes requirements regarding designing and implementing appropriate responses to the risks of material misstatement.

- Comparison of yields on loans to the institution's established lending rates or pricing policies
- Reasonableness of balance-sheet accruals based upon underlying terms and amounts of corresponding loans
- Average yield throughout the period computed for each loan category on a monthly or quarterly basis

8.195 In using analytical procedures as a substantive test, the auditor might consider the implications of changes in important relationships and the extent of the difference between actual and expected results that can be accepted without further investigation. It is normally difficult to develop expectations to be used in analyzing yields on aggregated loans as a substantive test of related income amounts. Accordingly, analytical procedures in this area might be considered only as a supplement to other substantive procedures, except where an expected yield can be known with some precision (using computer-assisted audit techniques).

8.196 When designing substantive analytical procedures, the auditor also should evaluate the risk of management override of controls. As part of this process, the auditor might consider evaluating whether such an override allowed adjustments outside of the normal period-end financial reporting process to have been made to the financial statements. Such adjustments might have resulted in artificial changes to the financial statement relationships being analyzed, causing the auditor to draw erroneous conclusions. For this reason, substantive analytical procedures alone are not well suited to detecting fraud. In addition, before using results obtained from substantive analytical procedures, the auditor could either test the design and operating effectiveness of controls over financial information used in the substantive analytical procedures or perform other procedures to support the completeness and accuracy of the underlying information.

8.197 AU section 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*), states that the auditor should obtain audit evidence about the completeness and accuracy of nonfinancial information if the auditor uses such information in performing audit procedures.

8.198 For significant risks of material misstatement, it is unlikely that audit evidence obtained from substantive analytical procedures alone will be sufficient.

8.199 *Subsidiary records.* The auditor obtains detailed schedules of loan principal balances and related accounts (accrued interest receivable, unearned discount, and net deferred loan fees and costs) and reconcile balances with the trial balance, general ledger, and other subsidiary records. The auditor should test significant reconciling items.

8.200 *Confirmation.* Guidance on the extent and timing of audit procedures (that is, considerations involved in determining the number of items to confirm) is found in AU section 350, *Audit Sampling*,[15] and AU section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*). AU section 350 also provides guidance on planning, performing,

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[15] See footnote 7.

and evaluating audit samples. Guidance on the timing of audit procedures is included in AU section 318.[16]

8.201 AU section 330, *The Confirmation Process* (AICPA, *Professional Standards*), discusses the relationship of confirmation procedures to the assessment of audit risk, the design of confirmation requests, the performance of alternative procedures, and the evaluation of confirmation results. AU section 330 stresses the importance of understanding the substance of transactions when determining information to include on confirmation requests and sets forth criteria that must be met for the use of negative confirmations. AU section 330 also establishes a presumption that the auditor will select a sample of loans for confirmation unless certain conditions are met.

8.202 In designing confirmation requests, the auditor should consider the types of information respondents will be readily able to confirm, because the nature of the information being confirmed may directly affect the competence of the evidence obtained as well as the response rate. For example, respondents may not be able to confirm the balances of installment loans, but they may be able to confirm whether their payments are up-to-date, the amounts of the payments, the interest rate, and the term of their loans.

8.203 Auditors may use either positive or negative requests to confirm loans. Paragraph .20 of AU section 330 indicates that negative forms may be used when (*a*) the combined assessed level of inherent and control risk is low, (*b*) a large number of small balances is involved, and (*c*) the auditor has no reason to believe that the recipients of the requests are unlikely to give them consideration. Auditors should consider performing other substantive procedures to supplement the use of negative confirmations. Positive confirmation procedures might be used for larger loans and for loans that necessitate additional assurance or other related information in addition to the loan balance, such as amount and type of collateral.

8.204 *Inspecting loan documents.* Loan files vary considerably in content depending on the type of loan. Inspection of loan documents may provide evidence about the existence and ownership of the loan. It is important for the auditor to be alert when inspecting loan documents. Indicators such as notations could imply problems that merit further investigation or follow up. When loan documents are in the possession of an attorney or other outside parties, the auditor should consider confirming the existence and ownership of such documents.

8.205 When inspecting loan documents, the auditor should consider testing the physical existence and reading any evidence of assignment to the institution of the collateral that supports collateralized loans. For certain loans, the auditor might inspect collateral in the custody of the borrower, such as floor-plan merchandise. However, the auditor may conclude that a review of the reports of institution personnel who inspect collateral is sufficient audit evidence. The auditor may also consider examining or requesting confirmation of collateral not on hand. An inspection of loan documentation could include tests of the adequacy of both the current value of collateral in relation to the outstanding loan balance and, if needed, insurance coverage on the loan collateral.

8.206 While inspecting loan documents, the auditor should keep in mind the audit objectives discussed in chapter 9. For example, reading the financial

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[16] See footnote 7.

statements and other evidence of the financial condition of cosignatories and guarantors could be employed when the auditor tests guaranteed loans. Consideration might also be given to the institution's historical experience with enforcing guarantees or confirmation of terms with guarantor.

8.207 While inspecting loan documents, the auditor might look for evidence of approvals by the board of directors or loan committee as required by management's written lending policies, a comparison of loan amounts with appraisals, and an inspection of whether hazard and title coverage meets coverage requirements set in management's written policy. For loans generated under certain governmental programs and other special arrangements, the auditor may be engaged to perform the additional procedures required under the specific trust or servicing agreement.

8.208 *Construction loans.* Audit procedures should be responsive to the institution's construction lending practices. For example, the auditor might perform tests to determine whether construction loans are properly classified as loans rather than real estate investments. The auditor might test origination, approval, inspection, and disbursements made based on progress on the particular construction project. The auditor might perform on-site inspections of significant construction projects to review the collateral and to determine whether construction has progressed in accordance with the loan terms.

8.209 *Lease financing.* When confirming basic lease terms, the confirmation requests should include cancellation provisions, if any. Confirmation should ordinarily be requested from the lessee. For leveraged leases, the material aspects of the lease agreement, including information necessary for income tax purposes, may be requested from the lease trustee. Although alternative methods may be used for reporting income for tax purposes, the auditor should determine that income for book purposes is being recorded in conformity with FASB ASC 840.[17]

8.210 *Whole loans or participations purchased.* Audit procedures for purchased loans should be similar to those for direct loans, except that requests for the confirmation of balances, collateral, and recourse provisions, if any, are usually sent to the originating or servicing institution. Loan files for purchased participations should be available at the institution and contain pertinent documents, or copies of them, including credit files supporting loans in which the institution has purchased participations from other banks or savings institutions. The auditor should consider confirming the actual status of borrower payments with the servicer. Although it is usually not practicable to confirm balances of serviced loans with the individual borrowers, the servicer's auditors often perform audit procedures on individual loans, such as confirmation with borrowers and examination of loan documents. AU section 324 provides guidance on the factors an auditor should consider when auditing the financial statements of an entity that uses a service organization to process certain transactions. AU section 324 also provides guidance for auditors who issue reports on the processing of transactions by a service organization for use by other auditors. The auditor should obtain copies of any reports issued under AU section 324 by the servicer's auditors when planning the extent of test work necessary in the loan area. Depending on the nature and type of the report, audit procedures performed at the servicer's site may be necessary. In some cases, the auditor may wish to request certain information, such as the scope and findings of the audit procedures performed by the servicer's auditors, directly from the servicer's auditor. The auditor should also consider reviewing

[17] See paragraph 8.131.

the institution's files on the servicer to observe the general reliability of the servicer. The latest remittance report from the servicer ordinarily should be reconciled with the records of the institution.****

8.211 *Accrued interest receivable and interest income.* Provided that a basis exists to rely on loan data recorded in the loan accounting system, interest income may be tested using computer-assisted audit techniques, the recomputation of accrued amounts for individual accounts, analytical procedures, or some combination thereof. If interest rates were relatively stable during a period, interest income can often be tested effectively by using analytical tests by type of loan. The auditor should consider average balances in principal accounts, related yields as compared to averages of rates offered and of rates on existing loans, and other factors and relationships. As discussed in paragraphs 8.195–.196, the effectiveness of such analytical procedures may vary.

8.212 *Computer assisted audit techniques.* Computer-assisted audit techniques may also be used to perform "exception/limit" checks of individual files for unusual or questionable items meriting further investigation. Examples include identifying unusual interest rates, balances, and payments, or testing the accuracy of delinquency reports.

8.213 *Balance sheet classification of loans.* The auditor should consider whether any portion of loans is being HFS and, therefore, whether a corresponding valuation allowance or write-down to lower of cost or market value is necessary. Previous loan sale activity, types of loans sold, transactions subsequent to year-end, pending contracts, and management's intentions are factors that should be considered in identifying loans HFS.

8.214 *Loan fees and costs.* Depending on the auditor's assessment of risks of material misstatement, the auditor should review and test the propriety of the institution's deferral of loan origination fees and costs in accordance with FASB ASC 310-20, as well as evaluating the impact of not deferring loan costs and fees. The auditor should also consider performing a test of the amortization of net deferred loan fees or costs.

8.215 *Undisbursed portion of mortgage loans.* Financial institutions sometimes record loans at the gross amount with an offsetting account entitled loans in process (LIP). As funds are disbursed, the LIP account is reduced. Interest or fees on construction loans also may be debited to this account. The LIP account should be cleared when the loan is fully disbursed. LIP detailed ledgers should be reviewed to determine the propriety of accounting, including that for complex interest calculations. Unusual LIP balances, such as debit balances or balances outstanding for an excessive period of time (for example, over a year), may be indicative of problem loans.

8.216 A review of the LIP detailed activity may be performed in connection with the examination of the current-year loan files. Loans selected for testing may be traced to the LIP account. Construction loans selected for testing may be traced to the LIP ledger, and disbursements may be reviewed in connection with the percentage of completion noted on inspection reports. In addition, if loan fees or interest are being capitalized (added to the loan balance) during construction, a review of the LIP ledgers may point out areas of concern. The auditor should consider whether to send confirmations to the borrower on any undisbursed loan balances.

**** See footnote **** in paragraph 8.189.

8.217 *Troubled debt restructurings*. The auditor should consider performing procedures to identify TDRs and evaluate whether they have been accounted for in conformity with FASB ASC 310-40. Such tests may include procedures to determine whether possession of collateral has been taken as part of a TDR that is in substance a repossession or foreclosure by the creditor, that is, the creditor receives physical possession of the debtor's assets regardless of whether formal foreclosure proceedings take place (as discussed in FASB ASC 310-40-40-6).

8.218 For loans for which there is a market price, the auditor may test fair-value disclosures by reference to third-party market quotations, including information received from brokers or dealers in loans. Fair-value estimates of loans for which there is no market price are highly subjective. There are a variety of methodologies that may be used by institutions to estimate fair values of loans. Most derive a fair value by discounting expected cash flows using appropriate interest rates. Some methodologies are relatively simple, such as methods that derive much of their data from the information used in estimating the allowance for credit losses, and some are relatively complex, such as option pricing models. As with all accounting estimates, the auditor's objective is to obtain sufficient appropriate audit evidence to provide reasonable assurance that the fair-value estimates are reasonable in the circumstances and that they are presented in accordance with GAAP, including proper disclosure. AU section 342, *Auditing Accounting Estimates* (AICPA, *Professional Standards*), provides relevant guidance. AU section 328, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*),[‡‡‡‡] establishes standards and provides guidance on auditing fair-value measurements and disclosures contained in financial statements. In particular, AU section 328 addresses audit considerations relating to the measurement and disclosure of assets, liabilities, and specific components of equity presented or disclosed at fair value in financial statements. The auditor may decide to use the work of a specialist in assessing the entity's fair value estimates. AU section 336, *Using the Work of a Specialist* (AICPA, *Professional Standards*), provides guidance on using the work of a specialist. As described in chapter 5, the guidance of AU section 336 applies when an auditor uses a specialist's work as audit evidence in performing substantive tests to evaluate material financial statement assertions.

8.219

> *Considerations for Audits Performed in Accordance with PCAOB Standards*[18]
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> PCAOB Staff Audit Practice Alert No. 2, *Matters Related to Auditing Fair Value Measurements of Financial Instruments and the Use of*

‡‡‡‡ The ASB has finalized a new clarified auditing standard *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*. This auditing standard, which will supersede AU section 328, *Auditing Fair Value Measurements and Disclosures*, and AU section 342, *Auditing Accounting Estimates* (AICPA, *Professional Standards*), addresses the auditor's responsibilities relating to accounting estimates, including fair value accounting estimates and related disclosures. Additionally, it expands on how other clarified auditing standards are to be applied in relation to accounting estimates, and includes requirements and guidance related to misstatements of individual accounting estimates and indicators of possible management bias. This clarified auditing standard has been finalized but not yet issued. See the preface of this guide for further information on the ASB's Clarity Project. The effective date of this clarified standard is for audits of financial statements for periods ending on or after December 15, 2012, unless otherwise established (early implementation is not permitted).

[18] PCAOB Staff Audit Practice Alerts are not rules of the board and do not reflect any board determination or judgment about the conduct of any particular firm, auditor, or any other person.

Specialists (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400 par. .02), provides guidance on auditors' responsibilities for auditing fair value measurements of financial instruments and when using the work of specialists under the existing standards of the PCAOB. This alert is focused on specific matters that are likely to increase audit risk related to the fair value of financial instruments in a rapidly changing economic environment. This practice alert highlights certain requirements in the auditing standards related to fair value measurements and disclosures in the financial statements and certain aspects of GAAP that are particularly relevant to the current economic environment.

PCAOB Staff Audit Practice Alert No. 3, *Audit Considerations in the Current Economic Environment* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400 par. .03), assists auditors in identifying matters related to the current economic environment that might affect audit risk and require additional emphasis. This practice alert is organized into six sections: (*a*) overall audit considerations; (*b*) auditing fair value measurements; (*c*) auditing accounting estimates; (*d*) auditing the adequacy of disclosures; (*e*) auditor's consideration of a company's ability to continue as a going concern; and (*f*) additional audit considerations for selected financial reporting areas.

PCAOB Staff Audit Practice Alert No. 4, *Auditor Considerations Regarding Fair Value Measurements, Disclosures, and Other-Than-Temporary Impairments* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400 par. .04), informs auditors about potential implications of recently issued FASB guidance on reviews of interim financial information and annual audits. This alert addresses the following topics: (*a*) reviews of interim financial information; (*b*) audits of financial statements, including integrated audits; (*c*) disclosures; and (*d*) auditor reporting considerations.

PCAOB Staff Audit Practice Alert No. 7, *Matters Related to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400 par. .07), advises auditors that the potential risks and costs associated with mortgage and foreclosure-related activities or exposures, such as those discussed in the SEC staff letters, could have implications for audits of financial statements or of internal control over financial reporting. These implications might include accounting for litigation or other loss contingencies and the related disclosures.

Chapter 9

Credit Losses

Introduction

9.01 Financial institutions accept and manage significant amounts of credit risk. Loans and underlying collateral have traditionally been the source of most credit losses incurred by financial institutions. The allowance for loan losses is an accounting estimate of credit losses inherent in an institution's loan portfolio that have been incurred as of the balance-sheet date.

9.02 Institutions may also have off-balance-sheet financial instruments, such as commitments to extend credit, guarantees, and standby letters of credit that are subject to credit risk. Though liabilities related to credit losses associated with such off-balance-sheet instruments are not part of the allowance for loan losses, institutions' processes for evaluation and estimation of the credit losses may include consideration of credit risk associated with those off-balance-sheet instruments, especially when the counterparty to an off-balance-sheet instrument is also a borrower. The information and guidance in this chapter, although generally referring to *loan* losses, may equally be useful in evaluating and estimating credit losses for off-balance-sheet instruments.

9.03 Chapter 8, "Loans," discusses the various kinds of loans institutions make or purchase, the lending process and related internal controls, financial reporting for loans, and audit procedures for loans. However, because of the significance to an institution's financial statements of the allowance and the provision for loan losses and any separate liability for other credit losses, the high degree of subjectivity involved in estimating these amounts, the high degree of regulatory guidance and oversight directed toward institutions' estimates of credit losses, and, consequently, the relatively high inherent audit risk associated with auditing such estimates, careful planning, and execution of audit procedures is essential in this area.

Management's Methodology

9.04 Management is responsible for estimating credit losses. Estimating credit losses is unavoidably subjective and involves management making careful judgments about collectibility and estimates of losses. Management's judgments often depend on micro- and macro-economic factors; past, current, and anticipated events based on conditions that existed at the balance-sheet date; and realistic courses of action it expects to take.

9.05 An institution's method of estimating credit losses is influenced by many factors, including the institution's size, organizational structure, business environment and strategy, management style, loan portfolio characteristics, loan administration procedures, and management information systems. Although different institutions may use different methods, there are certain common elements included in any effective method. They include

a. a detailed and regular analysis of the loan portfolio and off-balance-sheet instruments with credit risk,

b. procedures for timely identification of problem credits,

c. consistent use,

d. consideration of all known relevant internal and external factors that may affect collectibility,

e. consideration of all loans (whether on an individual or pool-of-loans basis) and other relevant credit exposure,

f. consideration of the particular risks inherent in the different kinds of lending,

g. consideration of the current collateral fair values less cost to sell, where applicable,

h. performance by competent and well-trained personnel,

i. current and reliable data are the base,

j. good documentation with clear explanations of the supporting analyses and rationale, and

k. identification of all subsequent events that provide additional evidence about conditions that existed at the date of the balance sheet.

9.06 Methods that rely solely on mathematical calculations, such as a percentage of total loans based on historical experience or the similar allowance percentages of peer institutions, generally fail to contain the essential elements, because they do not involve a detailed analysis of an institution's particular transactions or consider the current economic environment.

9.07 As discussed in the following paragraph, creditors have traditionally identified loans that are to be evaluated for collectibility by dividing the loan portfolio into different segments. Loans with similar risk characteristics, such as risk classification, past-due status, and type of loan, should be grouped together.

9.08 A key element of most methodologies for estimating credit losses is a credit classification process. The classification process involves categorizing loans into risk categories. The categorization should be based on relevant information about the ability of borrowers to service their debt, such as current financial information, historical payment experience, credit documentation, public information, and current trends. Many institutions classify loans using a rating system that incorporates the regulatory classification system.[1] These definitions are as follows:

substandard. Assets classified as substandard are inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

doubtful. Assets classified as doubtful have all the weaknesses inherent in those classified as substandard, with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

loss. Assets classified as loss are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the loan has absolutely no recovery or salvage value but, rather, that it is not practical or desirable to defer

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[1] Interagency Policy Uniform Retail Credit Classification and Account Management Policy, June 12, 2000.

writing off this basically worthless asset even though partial recovery may be affected in the future.

Although the Board of Governors of the Federal Reserve System (FRB), Federal Deposit Insurance Corporation (FDIC), Office of the Comptroller of the Currency (OCC), and Office of Thrift Supervision (OTS) do not require institutions to adopt identical classification definitions, institutions should classify their assets using a system that can be easily reconciled with the regulatory classification system.

9.09 Some loans are also listed for special mention. Such a loan has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or of the institution's credit position at some future date. Special-mention loans are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification.

9.10 Examples of such potential weaknesses are

- poor lending practices that result in significant defects in the loan agreement, security agreement, guarantee agreement, or other documentation and the deteriorating condition of or lack of control over collateral. In other words, these are conditions that may jeopardize the institution's ability to enforce loan terms or that reduce the protection afforded by secondary repayment sources.
- lack of information about the borrower or guarantors, including stale financial information or lack of current collateral valuations.
- economic or market conditions that in the future may affect the borrower's ability to meet scheduled repayments. These may be evidenced by adverse profitability, liquidity, or leverage trends in the borrower's financial statements.

9.11 Institutions generally analyze large loans and loans not conducive to pool analysis on an individual basis by classifying the loans according to credit risk and estimating specific losses. This analysis may be performed by loan officers subject to review by an internal loan review department, or may be performed by a loan review department. The loan review focuses on determining whether individual loans are properly classified according to credit risk and were made in accordance with the institution's written lending policies and whether the borrower is likely to perform in accordance with its contractual terms and conditions. The review typically includes analysis of (*a*) loan performance since origination or the last renewal, (*b*) the current economic situation of a borrower or guarantor, and (*c*) estimates of current fair values of collateral. Borrower and guarantor financial statements are generally reviewed concerning financial resources, liquidity, future cash flows, and other financial information pertinent to the ability to repay the debt. Collateral is reviewed to determine whether it is under the institution's control, whether security interests have been perfected (which is a legal determination), and whether the value is greater than the amount owed. Loan file contents are generally reviewed for completeness and conformity with the institution's written policies for loan documentation. The lack of an internal loan review and classification system may be considered to be an unsafe and unsound practice by regulators. The absence of an internal loan review function may be an indicator of a *significant deficiency* or a *material weakness*, as defined in AU section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*).

Considerations for Audits Performed in Accordance with Public Company Accounting Oversight Board (PCAOB) Standards

Paragraph .03 of AU section 325, *Communications About Control Deficiencies in an Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards), states that in evaluating whether a deficiency exists and whether deficiencies, either individually or in combination with other deficiencies, are material weaknesses, the auditor should follow the direction in paragraphs 62–70 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards).

9.12 Foreign loans should be reviewed and require special consideration because of the transfer risk associated with cross-border lending. Certain foreign loans are required by the Interagency Country Exposure Risk Committee (ICERC) pursuant to the International Supervision Act of 1983 to have allocated transfer risk reserves (ATRRs). ATRRs are minimum specific reserves related to loans in particular countries. Such reserves are minimums, and institutions may determine that a higher allowance is necessary based on its assessment of the probable losses.

Groups of Homogeneous Loans and Leases

9.13 Loans not evaluated individually are included in groups of homogeneous loans. The focus of the pool approach is generally on the historical loss experience for the pool. Loss experience, which is usually determined by reviewing the historical loss (charge-off) rate for each pool over a designated time period, is adjusted for changes in trends and conditions. Trends and conditions that the institution should consider in determining how historical loss rates should be adjusted include, but are not limited to,

- changes in the levels of and trends in delinquencies, nonaccrual loans, adversely classified loans, and impaired loans,
- changes in the levels of and trends in recoveries of prior charge-offs,
- trends in volume and terms of loans,
- effects of any changes in lending policies and procedures,
- effects of changes in the experience, ability, and depth of lending management and other relevant staff,
- changes in international, national, regional, and local economic trends and conditions,
- credit concentrations,
- changes in the quality of the institution's loan review system,
- changes in the value of underlying collateral for collateral dependent loans, and
- other external factors, such as competition and legal and regulatory requirements on the level of estimated credit losses in the institution's portfolio.

Estimating Overall Credit Losses

9.14 Institutions may use a method that results in a range of estimates for the allowance for individual loans and large groups of loans and must apply careful judgment regarding the risks as well as other relevant factors for each segment of loans to determine the amount to record. Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 450-20-30-1 explains that if some amount within the range appears at the time to be a better estimate than any other amount within the range, that amount should be accrued. When no amount within the range is a better estimate than any other amount, however, the minimum amount in the range should be accrued. (However, FASB ASC 310-10-35-26 states that if a creditor bases its measure of loan impairment on a present value calculation, the estimates of expected future cash flows should be the creditor's best estimate based on reasonable and supportable assumptions and projections.) The approach for determination of the allowance should be well documented and applied consistently from period to period, as stated in FASB ASC 310-10-35-4(c).

9.15 Refer to Securities and Exchange Commission (SEC) Staff Accounting Bulletin (SAB) No. 102, *Selected Loan Loss Allowance Methodology and Documentation Issues*, and the Federal Financial Institutions Examination Council (FFIEC) policy statement for further guidance regarding documentation requirements related to the allowance for loan losses.

9.16 Management often considers credit losses associated with certain off-balance-sheet financial instruments (such as commitments to extend credit, guarantees, and letters of credit) at the same time it considers credit losses associated with the loan portfolio. Although it is generally practical to consider credit losses on loans and other financial instruments at the same time, allowances necessary for off-balance-sheet instruments should be reported separately as liabilities and not as part of the allowance for loan losses (see paragraphs 1–3 of FASB ASC 825-10-35).

9.17 Management should consider its overall loan loss allowance and liability for other credit exposures to be appropriate in accordance with U.S. generally accepted accounting principles (GAAP) only if such amounts are considered appropriate to cover estimated losses inherent in the loan portfolio and the portfolio of other financial instruments, respectively. An illustration of a worksheet for an allowance and liability calculation is shown in exhibit 9-1, "Worksheet for Estimating Credit Losses."

Exhibit 9-1
Worksheet for Estimating Credit Losses

Category	Recorded Investment[†]	Estimated Credit Loss Amount[*] High	Estimated Credit Loss Amount[*] Low
	$	$	$
Allowance for Estimated Loan Losses			
I. Individually evaluated for impairment: [‡]			
Impairment identified [||]			
No impairment identified		N/A	N/A
II. Large groups of smaller-balance homogeneous loans collectively evaluated for impairment: [#]			
Credit card			
Residential mortgage			
Consumer			
Other			
III. Other large groups of loans containing unidentified, impaired loans [**]			
IV. Loans measured at fair value or at the lower of cost or fair value [(2)]		N/A	N/A
Total allowance for estimated loan losses		$	$
Liability for Losses on Credit Instruments and Other Credit Exposures			
Standby letters of credit [(1)]			
Commitments [(1)]			
Loans sold with recourse			
Losses on guarantees (Financial Accounting Standards Board [FASB] *Accounting Standards Codification* [ASC] 460, *Guarantees*)			
Other			
Total liability for credit instruments and other credit exposures		$	$

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* For purposes of this worksheet the estimated credit loss amount may be a specific amount or a range of estimated amounts. The measure of impairment under FASB ASC 310-10-35-26, is the creditor's best estimate based on reasonable and supportable assumptions and projections.

† The total of amounts in this column generally should correspond to the institution's total loan (and lease) portfolio.

‡ This category includes loans evaluated for impairment in conformity with FASB ASC 310-10-35.

|| This subcategory includes loans for which it is probable that the creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement and, accordingly, for which impairment is measured in conformity with FASB ASC 310-10-35.

This category comprises large groups of smaller-balance homogeneous loans and leases that are collectively evaluated for impairment.

** This category comprises large group of all other loans and leases not addressed in categories I or II and not individually considered impaired but that, on a portfolio basis, are believed to have some inherent but unidentified impairment.

(1) If subject to the scope of FASB ASC 815, *Derivatives and Hedging*, standby letters of credit and commitments should be excluded from the analysis. Credit exposure for instruments within the scope of that statement is captured by the fair value measurement of the instrument.

(2) Refer to FASB ASC 820, *Fair Value Measurements and Disclosures*, and FASB ASC 825, *Financial Instruments*, in chapter 20, "Fair Value."

9.18 Loan evaluations by management (and tests of such by auditors to the extent they are performed as part of the engagement) should avoid the following:

- *Collateral myopia.* This is the failure to see beyond collateral values to a financial weakness in the borrower. Collateral values and liquidity often tend to decline in periods during which they are most needed to protect against loan losses. For example, if an oversupply in the real estate market causes lower-than-projected occupancy rates (creating cash flow problems for the borrower), the protection afforded by the collateral is diminished. Similar scenarios can be drawn for oil and gas reserves when energy prices decline, for specialized equipment (for example, drilling rigs, mining equipment, farm equipment, steel mills, and construction equipment) during specific industry slowdowns, for farmland during periods of depressed agricultural commodity and livestock prices, and for accounts receivable of a failing company.
- *Inadequate collateral appraisals.* This is the failure to critically review appraisals to understand the methods employed, assumptions made, and limitations inherent in the appraisal process, including undue reliance on management appraisals. Appraisal methods and assumptions may be inappropriate in the current circumstances. Going concern values generally are dramatically different from liquidation values. For example, real estate appraisals made on the income approach are not usually appropriate for incomplete projects or in circumstances in which operating conditions have changed.

- *Outdated or unreliable financial information.* This is the reliance on old, incomplete, or inconsistent data to assess operating performance or financial capacity. Financial information should be current and complete, particularly for borrowers sensitive to cyclical fluctuations or who demonstrate significant growth or changes in operating philosophy and markets.
- *Excessive renewals or unrealistic terms.* This is the reliance on current or performing-as-agreed status if the transaction has been structured to obscure weaknesses. Excessive renewals, unrealistic terms, and interest capitalization may be indications of such a structure. The purpose of a loan and performance against the original agreement should be critically reviewed.
- *Personal bias.* This is the bias of a reviewer for or against industries, companies, individuals, and products. For example, the involvement of a public personality in a venture could influence a reviewer to place more credibility than appropriate on the success of the venture.
- *Overlooking self-dealing.* This concerns directors or large shareholders who improperly use their position to obtain excessive extensions of credit on an unsound basis. In this situation, management is often unduly influenced by persons in these positions because management serves at the pleasure of the board and shareholders.
- *Dependence on management representations.* This is undue reliance on management representations even though there is no supporting evidence. For example, such representations as "the guarantee is not signed but it is still good" or "the future prospects for this troubled borrower are promising" necessitate a critical review.

Regulatory Matters

9.19 The FRB, FDIC, OCC, and OTS's (collectively, the federal banking agencies') *Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions*, published in the *Federal Register* on July 6, 2001, addresses (*a*) responsibilities of the board of directors and management, (*b*) importance of maintaining, and nature of, appropriate documentation supporting the reported amount of the allowance for loan and lease losses (ALLL), (*c*) written policies and procedures regarding the ALLL, and (*d*) appropriate ALLL methodologies, including validation of methodologies. The statement provides various examples of the areas addressed and includes six frequently asked questions along with agencies' interpretive responses. On July 6, 2001, the SEC issued parallel guidance in SAB No. 102, which expresses certain staff views on the development, documentation, and application of a systematic methodology as required by Financial Reporting Release No. 28 for determining ALLL in accordance with U.S. GAAP. In particular, the guidance focuses on the documentation the staff normally would expect registrants to prepare and maintain in support of their allowances for loan losses.

9.20 On March 1, 2004, the federal banking agencies and National Credit Union Administration (NCUA) issued *Update on Accounting for Loan and Lease Losses*, which addressed accounting for loan and lease losses. Among other matters, the issuance identifies sources of U.S. GAAP and supervisory guidance regarding ALLL that institutions should continue to apply. The following describes the financial institutions responsibilities associated with the *Update for the Allowance for Loan and Lease Losses*:

- Maintain adequate controls to ensure the ALLL is consistently determined in accordance with U.S. GAAP, stated policies and procedures, and relevant supervisory guidance.
- Develop, maintain, and document a comprehensive, and consistently applied process to determine the amounts of the ALLL and provisions for loan and lease losses.
- Maintain an ALLL at a level that is appropriate to absorb estimated credit losses inherent in the loan and lease portfolio, consistent with long-standing supervisory guidance.
- Utilize prudent, conservative, but not excessive, judgment to determine that the ALLL represents management's best estimate from within an acceptable range of estimated losses.

9.21 Other guidance was provided to examiners in the FRB, FDIC, and OCC's December 12, 2006, joint issuance *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*[2] in which they clarified final guidance on concentrations in commercial real estate lending. The guidance is intended to help ensure that institutions pursuing a significant commercial real estate lending strategy remain profitable while continuing to serve the credit needs of their communities. Other matters addressed include the following:

- Small- to medium-sized banks facing strong competition should be aware of the risk of unanticipated earnings and capital volatility due to increased real estate loan concentrations. The agencies provide supervisory criteria including the use of numerical indicators in identifying institutions with potentially significant commercial real estate loan concentrations that may warrant greater supervisory scrutiny.
- The guidance also serves to remind institutions that strong risk management practices and appropriate levels of capital are important elements of a sound lending program, particularly when an institution has a concentration in commercial real estate loans.

9.22 The federal banking agencies and the SEC have issued three interagency statements on the allowance (November 1998, March 1999, and July 1999) that remind depository institutions of the requirement to record and report their ALLL in accordance with U.S. GAAP.

9.23 The interagency statements include the *Interagency Policy Statement on the Allowance for Loan and Lease Losses*, which was issued on December 13, 2006, by the federal banking agencies and NCUA. This statement revised the 1993 policy statement on the ALLL to ensure consistency with U.S. GAAP. The revisions make the policy statement applicable to credit unions. The statement addresses (*a*) the nature and purpose of the allowance, (*b*) the related possibilities of the board of directors and management and of the examiners, (*c*) loan review systems, and (*d*) international transfer risk matters. The federal banking agencies and the NCUA also issued 16 frequently asked questions to assist institutions in complying with U.S. GAAP and ALLL supervisory guidance. (See "Allowance for Loan and Lease Losses," in the glossary of the Instructions for Preparation of Consolidated Reports of Condition and Income, for additional information.)

9.24 On March 17, 2008, the FDIC issued FDIC Financial Institution Letter (FIL)-22-2008, "Managing Commercial Real Estate Concentrations in a

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[2] *Federal Register* Vol. 71, No. 238 [12 December 2006], pp. 74585–74588.

Challenging Environment," to re-emphasize the importance of strong capital and loan loss allowance levels, and robust credit risk management practices for institutions with concentrated commercial real estate exposures, consistent with the commercial real estate lending interagency guidance published on December 12, 2006, and the interagency policy statement on the ALLL issued on December 13, 2006.

9.25 On August 3, 2009, the FDIC issued FDIC FIL-43-2009, "Allowance for Loan and Lease Losses: Residential Mortgages Secured by Junior Liens," which reminded financial institutions of several key points in the December 13, 2006, interagency guidance (see paragraph 9.23) and provided specific guidance for residential mortgages secured by junior liens. Institutions were reminded that, when estimating credit losses on each group of loans with similar risk characteristics under FASB ASC 450-20, they should consider their historical loss experience on the group, adjusted for changes in trends, conditions, and other relevant factors that affect repayment of the loans in the group as of the ALLL evaluation date. FDIC FIL-43-2009 stated that the need to consider all significant factors that affect the collectibility of loans is especially important for loans secured by junior liens on one-to-four family residential properties, both closed-end and open-end, in areas where there have been declines in the value of such properties. The letter notes that delaying the recognition of estimated credit losses is not appropriate and could delay appropriate loss mitigation activity, such as restructuring junior lien loans to more affordable payments or reducing principal on such loans to facilitate refinancing. The letter concluded by stating that examiners are evaluating the effectiveness of an institution's loss mitigation strategies for loans as part of their assessment of the institution's overall financial condition.

9.26 The OTS issued CEO Letter No. 304, "ALLL—Observed Practices Including Sound Practices," on May 22, 2009. The letter suggested sound practices that may be appropriate for estimating and evaluating an appropriate ALLL. Readers may read these practices and the full text of the letter on the OTS website at http://files.ots.treas.gov/25304.pdf.

9.27 On December 9, 2009, the OTS issued CEO Letter No. 329, "Accounting for Credit Losses and Impairments" as a reminder regarding the importance of accurately accounting for credit losses or impairments of investments. In the letter, the OTS expressed concern regarding the increasing number of institutions identified by examiners that do not have policies, procedures and written documentation related to impaired loans that is consistent with accounting standards and interagency guidance.

9.28 The OCC's Bank Accounting Advisory Series (BAAS) expresses the Office of the Chief Accountant's current views on accounting topics of interest to national banks. See further discussion of the BAAS in paragraph 8.80 of this guide. Topic 4, "Allowance for Loan and Lease Losses," includes interpretations and responses related to the ALLL. Readers are encouraged to read this publication on the OCC website at www.occ.gov/topics/bank-operations/accounting/index-accounting.html.

9.29 *Nonaccrual loans*. Regulatory guidance provides that loans (and other assets) should be placed on nonaccrual (*a*) when the loan (or asset) is maintained on a cash basis because of deterioration in the financial condition of the borrower, (*b*) when payment in full of principal or interest is not expected, or (c) when principal or interest has been in default for a period of 90 days or more unless the asset is both well secured and in the process of collection. (See the "Nonaccrual Status" section of the glossary of the FFIEC's Instructions for

Preparation of Consolidated Reports of Condition and Income [call report]. See also appendix B of this guide for additional information. Readers can also find questions and answers related to nonaccrual loans in the OCC's BAAS.[*] See further discussion and a link to this publication in paragraph 9.28.)

9.30 Management should provide auditors with regulatory examination reports, which generally disclose classified loans and certain statistics regarding those classifications. If a regulatory examination is in process, the auditor should discuss the status and preliminary findings of the examination with institution management and the examiners. Communications with regulators are discussed further in chapter 5, "Audit Considerations and Certain Financial Reporting Matters."

9.31 The federal banking agencies established a policy on loan documentation effective March 30, 1993, to encourage lending to small and medium-sized businesses. The policy allows certain banks and savings institutions to establish a portfolio of loans exempt from certain documentation requirements. Examiners may not criticize the credit quality of an exempt loan on the basis of documentation and may not classify the loan unless it is delinquent by more than 60 days. The institution's management, however, is still required to fully evaluate the collectibility of exempt loans in determining the appropriateness in accordance with U.S. GAAP of loan loss allowances. (See paragraph 9.93.)

Credit Unions

9.32 Federal credit unions are required by Part 702 of the NCUA *Rules and Regulations* to establish and maintain an allowance for loan losses. Federally insured state-chartered credit unions are usually required by their insurance agreement with the National Credit Union Share Insurance Fund (NCUSIF) to establish and maintain an allowance. The requirements for state-chartered credit unions that are not federally insured vary by state and insurer.

9.33 Credit unions should not base the justification of a lower allowance for loan losses on the maintenance of the regular reserve. Regulators have historically stated that the regular reserve has been established to cover loan losses. Although this may be true in a regulatory sense, the regular reserve constitutes an appropriation of undivided earnings and should not be considered in determining the amount of the allowance for loan losses.

9.34 Some credit unions record a provision for loan losses equal to what would normally be transferred to the regular reserve from undivided earnings. Because the regular reserve may be reduced by the amount equal to the provision made, no regular reserve transfer is effectively made. The consequences of these actions may result in an overstatement of the allowance account. A credit union's allowance may be materially overstated due to strict adherence to this process.

9.35 For regulatory purposes, credit unions have historically used either the experience method or the adjustment method to calculate their allowance for loan losses. The NCUA issued Letter to Credit Unions No. 02-CU-09, "Allowance for Loan and Lease Losses," Interpretive Ruling and Policy Statement (IRPS) 02-3, "Allowance for Loan and Lease Losses Methodologies and

[*] Due to a number of accounting rule changes, the October 2010 edition of the *Bank Accounting Advisory Series* has added or revised a number of questions and responses related to Section 2B, "Nonaccrual Loans."

Documentation for Federally Insured Credit Unions," and Letter to Credit Unions No. 03-CU-01, "Loan Charge-Off Guidance." Although the application of the NCUA's methods may or may not result in substantially the same allowance as management's estimate for the allowance, management should report an allowance in the financial statements prepared under U.S. GAAP that is appropriate in accordance with U.S. GAAP to cover all estimated losses incurred at the statement-of-financial-condition date in the loan portfolio.

9.36 The NCUA also issued Accounting Bulletin No. 06-01. The purpose of the bulletin was to distribute the 2006 Interagency Policy Statement (see paragraph 9.23) that addresses ALLL. The bulletin states that the policy statement applies to all credit unions supervised by the NCUA and insured by the NCUSIF. The policy statement is designed to supplement IRPS 02-03 and the *Update on Accounting for Loan Lease Losses*.

Accounting and Financial Reporting

Loan Impairment

9.37 The following provides an overview of U.S. GAAP for loan impairments, as stated in FASB ASC 310-10-35-4: (*a*) It is usually difficult, even with hindsight, to identify any single event that made a particular loan uncollectible. However, the concept in U.S. GAAP is that impairment of receivables should be recognized when, based on all available information, it is probable that a loss has been incurred based on past events and conditions existing at the date of the financial statements. (*b*) Losses should not be recognized before it is probable that they have been incurred, even though it may be probable based on past experience that losses will be incurred in the future. It is inappropriate to consider possible or expected future trends that may lead to additional losses. Recognition of losses should not be deferred to periods after the period in which the losses have been incurred. (*c*) U.S. GAAP does not permit the establishment of allowances that are not supported by appropriate analyses. The approach for determination of the allowance should be well documented and applied consistently from period to period. (*d*) Under FASB ASC 450-20, the threshold for recognition of impairment should be the same whether the creditor has many loans or has only one loan. FASB ASC 310-10-35-9 requires that if the conditions of FASB ASC 450-20-25-2 are met, accrual should be made even though the particular receivables that are uncollectible may not be identifiable. (*e*) The guidance in FASB ASC 310-10-35 is more specific than FASB ASC 450-20 in that it requires certain methods of measurement for loans that are individually considered impaired, but it does not fundamentally change the recognition criteria for loan losses.

9.38 The allowance for loan losses should be appropriate in accordance with U.S. GAAP to cover probable credit losses related to specifically identified loans as well as probable credit losses inherent in the remainder of the loan portfolio.

9.39 The act of lending money generally is not the event that causes asset impairment. Though some credit losses can be predicted, future losses generally 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. As stated in FASB ASC 942-310-25-1, 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 generally should be recognized at the date of loan origination.

Sources of Guidance to Account for ALLL and Loan Impairment

9.40 FASB ASC 310-10 and FASB ASC 450-20 are the primary sources of guidance on accounting for ALLL and impairment of a loan. FASB ASC 450-20 provides the basic guidance for recognition of impairment losses for all receivables (except those receivables specifically addressed in other guidance, such as debt securities). FASB ASC 310-10-35 provides more specific guidance on measurement and disclosure for a subset of the population of loans. That subset consists of loans that are identified for evaluation and that are individually deemed to be impaired (because it is probable that the creditor will be unable to collect all the contractual interest and principal payments as scheduled in the loan agreement). FASB ASC 310-10 also includes all loans that are restructured in a troubled debt restructuring involving a modification of terms, except for those loans that are excluded from the scope of this guidance, as discussed in paragraph 13(b)–(d) of FASB ASC 310-10-35.

9.41 FASB ASC 310-10-35 addresses both the impairment concepts applicable to all receivables, with references to the guidance in FASB ASC 450-20 where appropriate, and the impairment concepts related to loans that are identified for evaluation and that are individually deemed to be impaired, as discussed in FASB ASC 310-10-35-2. Paragraphs 33–36 of FASB ASC 310-10-35 also address the interaction between FASB ASC 310-10-35 and 450-20.

9.42 FASB ASC 450-20 applies to those groups of smaller-balance loans as well as loans that are not identified for evaluation or that are evaluated but are not individually considered impaired. In estimating the amount of losses to be recognized under FASB ASC 450-20, institutions focus on the appropriateness in accordance with U.S. GAAP of the allowance for loan losses at each reporting date.

Loss Contingencies

9.43 Paragraphs 1 and 3 of FASB ASC 450-20-25 state that when a loss contingency exists, the likelihood that the future event or events will confirm the loss or impairment of an asset can range from remote to probable. (*Probable*, according to the FASB ASC glossary, means the future event or events are likely to occur.) However, the conditions for accrual are not intended to be so rigid that they require virtual certainty before a loss is accrued.

9.44 FASB ASC 450-20-25-2 requires that an estimated loss from a loss contingency should be accrued by a charge to income if both of the following conditions are met:

a. Information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements. It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss.

b. The *amount* of loss can be reasonably estimated.

9.45 FASB ASC 450-20 deals with uncertainty by requiring a probability threshold for recognition of a loss contingency and that the amount of the loss be reasonably estimable. As noted in FASB ASC 450-20-30-1, when both of those

recognition criteria are met, and the reasonably estimable loss is a range, it requires accrual of the amount that appears to be a better estimate than any other estimate within the range, or accrual of the minimum amount in the range if no amount within the range is a better estimate than any other amount.

9.46 The following may be examples of loss contingencies:

- Collectibility of receivables other than loans
- Guarantees of indebtedness of others
- Obligations of commercial banks under standby letters of credit
- Agreements to repurchase receivables (or to repurchase the related property) that have been sold

Loans That Are Identified for Evaluation or That Are Individually Considered Impaired

9.47 FASB ASC 310-10-35 addresses impairment of loans that are identified for evaluation or that are individually considered impaired. This guidance addresses the accounting by creditors for impairment of a loan by specifying how allowances for credit losses related to certain loans should be determined, as stated in FASB ASC 310-10-35-13. This guidance applies to all loans that are identified for evaluation, uncollateralized as well as collateralized, except for (*a*) large groups of smaller-balance homogeneous loans that are collectively evaluated for impairment, (*b*) loans that are measured at fair value or at the lower of cost or fair value, (*c*) leases as defined in FASB ASC 840, *Leases*, and (*d*) debt securities as defined in FASB ASC 320, *Investments—Debt and Equity Securities*. This guidance does not address when a creditor should record a direct write-down of an impaired loan, nor does it address how a creditor should assess the overall adequacy of the allowance for credit losses.

9.48 Paragraphs 20–32 of FASB ASC 310-10-35 address the measurement of impairment. FASB ASC 310-10-35-21 permits a creditor to aggregate impaired loans that have risk characteristics in common with other impaired loans and use historical statistics, such as average recovery period and average amount recovered, along with a composite effective interest rate as a means of measuring those impaired loans.

9.49 FASB ASC 310-10-35-22[†] states that when a loan is impaired as defined in paragraphs 16–17 of FASB ASC 310-10-35, a creditor should measure impairment based on the present value of expected future cash flows

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[†] In May 2011, the Financial Accounting Standards Board (FASB) issued Accounting Standards Updated (ASU) No. 2011-04, *Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*. The amendments in this ASU result in common fair value measurement and disclosure requirements in accounting principles generally accepted in the United States of America (U.S. GAAP) and International Financial Reporting Standards (IFRSs). The amendments alter the wording used to describe many of the requirements in U.S. GAAP for measuring fair value and for disclosing information about fair value measurements. The ASU does not require additional fair value measurements and is not intended to establish valuation standards or affect valuation practices outside of financial reporting.

The amendments in this ASU are effective prospectively (1) for public entities, for interim and annual periods beginning after December 15, 2011, and (2) for nonpublic entities, for annual periods beginning after December 15, 2011. Early application is not permitted for public entities. Early application is permitted for nonpublic entities, but only for interim periods

discounted at the loan's effective interest rate, except that as a practical expedient, a creditor may measure impairment based on a loan's observable market price or the fair value of the collateral if the loan is collateral-dependent. As discussed in FASB ASC glossary, a *collateral-dependent* loan is a loan for which the repayment is expected to be provided solely by the underlying collateral.

9.50 FASB ASC 310-10-35-23 states that, if a creditor uses the fair value of the collateral to measure impairment of a collateral-dependent loan and repayment or satisfaction of a loan is dependent on the sale of the collateral, the fair value of the collateral should be adjusted to consider estimated costs to sell. However, if repayment or satisfaction of the loan is dependent only on the operation, rather than the sale, of the collateral, the measure of impairment should not incorporate estimated costs to sell the collateral.

9.51 Paragraphs 41–42 of FASB ASC 310-10-35 state that credit losses for loans and trade receivables, which may be for all or part of a particular loan or trade receivable, should be deducted from the allowance. The related loan or trade receivable balance should be charged off in the period in which the loans or trade receivables are deemed uncollectible. Recoveries of loans and trade receivables previously charged off should be recorded when received. Practices differ between entities as some industries typically credit recoveries directly to earnings, where as financial institutions typically credit the allowance for loan losses for recoveries. The combination of this practice and the practice of frequently reviewing the adequacy of the allowance for loan losses results in the same credit to earnings in an indirect manner.

9.52 Provisions for loan and other credit losses should be charged to operating income sufficient to maintain the allowance for loan losses or liabilities related to off-balance-sheet credit exposures at a level appropriate in accordance with U.S. GAAP—that is, management should verify that the allowance is appropriate to cover incurred losses in accordance with U.S. GAAP as of the balance sheet date. Thus, the focus is on the appropriateness of the balance of the allowance and the liabilities, not on the provision charged to income.

9.53 As stated in paragraphs 1–3 of FASB ASC 825-10-35, an accrual for credit loss on a financial instrument with off-balance-sheet risk should be recorded separate from a valuation account related to a recognized financial instrument. Credit losses for off-balance-sheet financial instruments should be deducted from the liability for credit losses in the period in which the liability is settled. Off-balance-sheet financial instruments refers to off-balance-sheet loan commitments, standby letters of credit, financial guarantees, and other similar instruments with off-balance-sheet credit risk except for instruments within the scope of FASB ASC 815-10. See chapter 7, "Investments in Debt and Equity Securities," of this guide for a summary of FASB ASC 825, *Financial Instruments*.

9.54 *Credit unions*. A change from a method of calculating the allowance for loan losses that is not generally accepted (for example, a calculation used for regulatory purposes) to a method that is generally accepted and that results in an adjustment to the amount previously reported is considered a correction of an error and is reported as a prior-period adjustment, requiring restatement

(footnote continued)

beginning after December 15, 2011. See FASB ASC 820-10-65-8 for further information regarding changes in valuation technique as a result of implementation of respective guidance. Readers should consult the text of ASU No. 2011-04 for further information.

of prior-period financial statements, in accordance with FASB ASC 250-10-45-23. Such a change frequently arises when a credit union that has in the past undergone only supervisory committee audits initially undergoes an audit in accordance with generally accepted auditing standards (GAAS).

Financial Statement Presentation and Disclosure of Loan Impairment Issues and Allowance for Credit Losses Related to Loans[‡]

9.55 *Impaired loans*. "Pending Content" in paragraphs 14A–20 of FASB ASC 310-10-50 require disclosure of information about loans that meet the definition of an impaired loan in paragraphs 16–17 of FASB ASC 310-10-35. Included are various disclosures about the recorded investment in the impaired loans, the total unpaid principal balance of the impaired loans, the entity's interest income recognition policy, the activity in the allowance for loan losses, the entity's loan impairment assessment policy, and factors considered in determining that the loan is impaired.[||] (See FASB 310-40-50 for disclosure information about an impaired loan that has been restructured in a troubled debt restructuring involving a modification of terms.)

9.56 *Loans acquired with deteriorated credit quality*. FASB ASC 310-30-50 provides disclosure guidance regarding loans acquired with evidence of deterioration of credit quality since origination acquired by completion of a transfer for which it is probable, at acquisition, that the investor will be unable to collect all contractually required payments receivable, according to FASB ASC 310-30-05-1. Paragraphs 8.101–.112 of this guide provide additional information regarding loans and debt securities acquired with deteriorated credit quality.

9.57 *Off-balance-sheet credit exposures*. "Pending Content" in FASB ASC 310-10-50-9 requires that in addition to disclosures required by FASB ASC 450-20, an entity should disclose a description of the accounting policies and methodology the entity used to estimate its liability for off-balance-sheet credit exposures and related charges for those credit exposures. Such a description

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‡ In July 2010, FASB issued ASU No. 2010-20, *Receivables (Topic 310): Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*. The amendments in this update enhance disclosures about the credit quality of financing receivables and the allowance for credit losses. Existing disclosure guidance has been amended to require an entity to provide a greater level of disaggregated information about the credit quality of its financing receivables and its allowance for credit losses. In addition, the amendments require an entity to disclose credit quality indicators, past due information, and modifications of its financing receivables. The amended guidance is labeled as "Pending Content" due to the transition and effective date information discussed in FASB ASC 310-10-65-2.

For public entities, the disclosures as of the end of a reporting period are effective for interim and annual reporting periods ending on or after December 15, 2010. The disclosures about activity that occurs during a reporting period are effective for interim and annual reporting periods beginning on or after December 15, 2010. For nonpublic entities, the disclosures are effective for annual reporting periods ending on or after December 15, 2011.

This guide edition (as of August 1, 2011) has been revised to include the amendments of ASU No. 2010-20. For entities for which the amendments of ASU No. 2010-20 are not effective (and have not adopted early application) as of August 1, 2011, see footnotes || and *.

|| For entities for which the amendments of ASU No. 2010-20 are not effective (and have not adopted early application) as of August 1, 2011, guidance in paragraphs 15–20 of FASB ASC 310-10-50 does not require disclosure of the total unpaid principal balance of impaired loans, the entity's policy for determining which loans the entity assesses for impairment under FASB ASC 310-10-35, or factors considered in determining that the loan is impaired. See further discussion at footnote ‡.

should identify the factors that influenced management's judgment (for example, historical losses and existing economic conditions) and a discussion of risk elements relevant to particular categories of financial instruments.[#]

9.58 *Allowance for credit losses related to financing receivables.*[**] In accordance with "Pending Content" in FASB ASC 310-10-50-11B, an entity should disclose all of the following by portfolio segment:[3]

a. A description of the entity's accounting policies and methodology used to estimate the allowance for credit losses, including all of the following:

  i. A description of the factors that influenced management's judgment, including both historical losses and existing economic conditions

  ii. A discussion of risk characteristics relevant to each portfolio segment

  iii. Identification of any changes to the entity's accounting policies or methodology from the prior period and the entity's rationale for the change

b. A description of the policy for charging off uncollectible financing receivables

c. The activity in the allowance for credit losses for each period, including all the following:

  i. The balance in the allowance at the beginning and end of each period

  ii. Current period provision

  iii. Direct write-downs charged against the allowance

  iv. Recoveries of amounts previously charged off

d. The quantitative effect of changes identified in item (*a*)(iii) on item (*c*)(ii)

e. The amount of any significant purchases of financing receivables during each reporting period

f. The amount of any significant sales of financial receivables or reclassifications of financing receivable to held for sale during each reporting period

g. The balance in the allowance for credit losses at the end of each period disaggregated on the basis of the entity's impairment method

[#] For entities for which the amendments of ASU No. 2010-20 are not effective (and have not adopted early application) as of August 1, 2011, FASB ASC 310-10-50-9 denotes the description of the accounting policy and methodology that the entity used to estimate any liability for off-balance-sheet credit losses and related charges for other credit losses may also include discussion of risk elements relevant to particular categories of financial instruments. Thus, such a discussion of risk elements is not required as of August 1, 2011. See further discussion at footnote ‡.

[**] For entities for which the amendments of ASU No. 2010-20 are not effective (and have not adopted early application) as of August 1, 2011, guidance related to accounting policies for credit losses and doubtful accounts and the allowance for credit losses related to loans can be found at paragraphs 9 and 12–13 of FASB ASC 310-10-50. See further discussion at footnote ‡.

[3] According to "Pending Content" within the FASB ASC glossary, a *portfolio segment* is defined as the level at which an entity develops and documents a systematic methodology to determine its allowance for credit losses. See paragraphs 21–22 of FASB ASC 310-10-55.

h. The recorded investment in financing receivables at the end of each period related to each balance in the allowance for credit losses, disaggregated on the basis of the entity's impairment methodology in the same manner as the disclosure in item (*g*)

According to FASB ASC 310-10-50-11A, the preceding guidance does not apply to financing receivables listed in FASB ASC 310-10-50-7B or lessor's net investments in leveraged leases.

9.59 Pending Content" in FASB ASC 310-10-50-11C states to disaggregate the information required by items (*g*) and (*h*) in the preceding paragraph on the basis of the impairment methodology, an entity should separately disclose the following amounts:

a. Amounts collectively evaluated for impairment (determined under FASB ASC 450-20)

b. Amounts individually evaluated for impairment (determined under FASB ASC 310-10-35)

c. Amounts related to loans acquired with deteriorated credit quality (determined under FASB ASC 310-30)

9.60 *Risks and uncertainties*. Per FASB ASC 310-10-50-25, certain loan products have contractual terms that expose entities to risks and uncertainties that fall into one or more categories, as discussed in FASB ASC 275-10-50-1. See FASB ASC 275-10-50 for disclosure guidance related to those loan products.

Auditing

Objectives

9.61 The primary objectives of audit procedures for credit losses are to obtain sufficient appropriate evidence that

a. the allowances for loan losses and liability for other credit exposures are accurate and appropriate in accordance with GAAP to cover the amount of probable credit losses inherent in the loan portfolio at the balance-sheet date;

b. allowances are not excessive, as long as the loan portfolio is reflected at net realizable value;

c. credit losses and other items charged or credited to the allowance for loan losses, such as loan chargeoffs and recoveries, have been included in the financial statements at appropriate amounts; and

d. disclosures are adequate.

The auditor achieves those objectives by testing management's estimates of the allowance based on available and relevant information regarding loan collectibility. The auditor is not responsible for estimating the amount of the allowance or ascertaining the collectibility of each, or any, specific loan included in an institution's loan portfolio.

Planning

9.62 In accordance with AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), the auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risks of

material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures (as described in chapter 5). Because of the significance of loans to institutions' balance sheets, and because the estimation of loan losses is based on subjective judgments, auditors are likely to assess inherent risk related to the allowance for loan losses as high. Such assessment will influence engagement staffing, extent of supervision, overall scope and strategy, and degree of professional skepticism applied. Further, it is necessary for the auditor to gain familiarity with the applicable regulatory guidance, including guidance on the classification of credits, concentration of credits, foreign loans, and significant related parties. AU section 342, *Auditing Accounting Estimates* (AICPA, *Professional Standards*),[††] establishes requirements and provides guidance to auditors in obtaining and evaluating sufficient appropriate audit evidence to test significant accounting estimates in an audit of financial statements in accordance with GAAS.

9.63 When performing an integrated audit of financial statements and internal control over financial reporting in accordance with PCAOB standards, the work that the auditor performs as part of the audit of internal control over financial reporting should necessarily inform the auditor's decisions about the approach he or she takes to auditing an estimate because, as part of the audit of internal control over financial reporting, the auditor would be required to obtain an understanding of the process management used to develop the estimate and to test controls over all relevant assertions related to the estimate.

9.64 The audit procedures performed in connection with the allowance for loan losses typically are time-consuming and are most efficient if initiated early in the audit. Because of the subjective nature of the loan review process, experienced audit personnel, preferably with prior depository institution engagement experience and, if necessary, with knowledge of industries in which the institution's loans are concentrated, should closely supervise or perform this section of the engagement. The assigned audit staff should also understand the lending environment, including credit strategy; credit risk; and the lending policies, procedures, and control environment of the institution, and should be familiar with known related parties and related-party transactions.

9.65 An important consideration in obtaining an understanding of the entity and its environment is whether an institution's internal loan review and internal audit functions can be considered by the auditor, and permit the auditor to modify the nature, timing, and extent of procedures to be performed. Discussions with internal 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. Also, because the internal audit department is involved in evaluating accounting systems and control activities (as discussed in chapter 8), it can provide the

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[††] The Auditing Standards Board (ASB) has finalized a new clarified auditing standard, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*. This auditing standard, which will supersede AU section 328, *Auditing Fair Value Measurements and Disclosures*, and AU section 342, *Auditing Accounting Estimates* (AICPA, *Professional Standards*), addresses the auditor's responsibilities relating to accounting estimates, including fair value accounting estimates and related disclosures. Additionally, it expands on how other clarified auditing standards are to be applied in relation to accounting estimates, and includes requirements and guidance related to misstatements of individual accounting estimates and indicators of possible management bias. This clarified auditing standard has been finalized but not yet issued. See the preface of this guide for further information on the ASB's Clarity Project. The effective date of this clarified standard is for audits of financial statements for periods ending on or after December 15, 2012, unless otherwise established (early implementation is not permitted).

auditor with important control process descriptions and results of testing that are helpful in understanding internal control. Chapter 5 discusses consideration of the internal audit function.

9.66 In determining the nature, timing, and extent of audit procedures, the auditor should assess the risks of material misstatement and consider factors such as

- composition of the loan portfolio;
- identified potential problem loans, including loans classified by regulatory agencies;
- trends in loan volume by major categories, especially categories experiencing rapid growth, and in delinquencies and restructured loans;
- previous loss and recovery experience, including timeliness of charge-offs;
- concentrations of loans to individuals and their related interests, industries, and geographic regions;
- size of individual credit exposures (few, large loans versus numerous, small loans);
- quality of internal loan review and internal audit functions, and results of their work;
- total amount of loans and problem loans, including delinquent loans, by officer;
- lending, chargeoff, collection, and recovery policies and procedures;
- local, national, and international economic and environmental conditions;
- experience, competence, and depth of lending management and staff;
- results of regulatory examinations; and
- related-party lending.

Internal Control Over Financial Reporting and Possible Tests of Controls

9.67 AU section 314 establishes standards and provides guidance on obtaining a sufficient understanding of the entity and its environment, including its internal control. It provides guidance on understanding the components of internal control and explains how an auditor should obtain a sufficient understanding of internal control for the purposes of assessing the risks of material misstatement. Paragraph .40 of AU section 314 requires that, in all audits, the auditor should obtain an understanding of the five components of internal control (the control environment, risk assessment, control activities, information and communication systems, and monitoring), sufficient to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. The auditor should obtain a sufficient understanding by performing risk assessment procedures to evaluate the design of controls relevant to an audit of financial statements and to determine whether they have been implemented. Paragraph .102 of AU section 314 states that the auditor should

identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions, account balances, and disclosures.

9.68 Effective controls related to estimating the allowance for loan losses should reduce the likelihood of material misstatement of the allowance for loan losses. The auditor should obtain an understanding of how management developed the allowance for loan losses, how the process has changed from prior periods, and an understanding of the institution's loan portfolio, lending process, loan accounting policies, market focus, trade area, and other relevant factors. Specific aspects of effective controls related to the allowance for loan losses may include the following:

- *Management communication of the need for proper reporting of the allowance.* The control environment strongly influences the effectiveness of the system of controls and affects the auditor's assessment of control risk. The control environment reflects the overall attitude, awareness, and action of the board of directors and management concerning the importance of control. The auditor might consider
  - the level of the board of directors' and management's integrity and ethical values;
  - the board and management's commitment to competence;
  - the level of involvement and quality of leadership provided by the board of directors, audit committee, and senior management in evaluating the allowance;
  - management's philosophy and operating style;
  - the organizational structure;
  - the assignment of authority and responsibility; and
  - human resource policies and practices.
- *Accumulation of relevant, sufficient, and reliable data on which to base management's estimate of the allowance.* Management reports summarizing loan activity, renewals, and delinquencies are vital to the timely identification of problem loans. The institution's procedures and controls are important for identifying when loans should be placed on nonaccrual status, provided for, or charged off. Most institutions have written policies covering nonaccrual status, the timing of charge-offs, and transfers of loans to the special asset or workout department. Most institutions have policies and procedures for the gathering and analysis of information from and about debtors.
- *Independent loan review.* Loan reviews should be conducted by competent institution personnel who are independent of the underwriting, supervision, and collections functions. Alternatively, the independent loan review function may be outsourced to a competent third party. The specific lines of reporting depend on the complexity of the institution's organizational structure, but the loan reviewers should report to a high level of management that is independent from the lending process in the institution. The loan review function is designed to test line management's identification and evaluation of existing and potential problem loans in a timely manner. The selection of loans for review should be representative and unbiased except for a bias toward higher risk loans.

- *Loss estimation process.* A loss estimation process for individually impaired loans and groups of other loans. This includes
  - — assigning responsibility for identification of impaired loans;
  - — assigning responsibility for measurement of impairment;
  - — impaired loan tracking and impairment measurement information system;
  - — historical loss tracking and loss rates measurement information system;
  - — a process for documenting current economic conditions that differ from historical loss rates and justification for specific adjustments to historical loss averages; and
  - — a process for accumulating the component needs of the allowance and provision amounts.
- *Adequate review and approval of the allowance estimates by the individuals specified in management's written policy*. This includes
  - — review of sources of relevant information;
  - — review of development of assumptions and methodologies;
  - — review of reasonableness of assumptions, methodologies, and resulting estimates;
  - — consideration of the need to use the work of specialists (such as appraisers or construction specialists); and
  - — consideration of changes in previously established methods to arrive at the allowance.
- *Comparison of prior estimates related to the allowance with subsequent results to assess the reliability of the process used to develop the allowance.*
- *Identification of subsequent events or transactions that provide additional evidence about conditions that existed or did not exist at the balance sheet date. Considerations may include the following:*
  - — Whether loans that become delinquent subsequent to the balance sheet date were impaired as of the balance sheet date.
  - — Updated appraisal information received subsequent to the balance sheet date.

9.69 Because compliance with a well-defined lending policy is essential to an institution's asset quality, failure to follow that policy could have a substantial impact on the reliability of financial statement assertions. For example, authority limits established in management's written underwriting policies are based in large part on (*a*) the knowledge and skill of the reviewing loan officer or committee and (*b*) the credit risk the institution is willing to assume on a particular type of loan. A loan made for an amount in excess of an officer's limit, or for an unauthorized loan type, would normally involve greater amounts of credit or other risks. Accordingly, management's financial statement assertions about impairment and valuation of the loan portfolio, for example, may be affected.

9.70 The auditor should perform tests of controls when the auditor's risk assessment includes an expectation of the operating effectiveness of controls or when substantive procedures alone do not provide sufficient appropriate audit evidence at the relevant assertion level. The auditor may consider performing

the following tests to test the effectiveness of internal controls over financial reporting in the area of credit losses:

- Review the company's accounting policies and procedures describing the process for determining, evaluating, and maintaining the allowance for loan losses and other credit losses in accordance with GAAP. Discuss these policies and procedures with appropriate personnel to determine whether they understand the related financial reporting objective.
- Review evidence that the company has procedures for identifying and reporting potential problem loans (for example, a *watch list*) and following up on such loans, as well as delinquent loan reports and procedures for follow-up on delinquencies.
- Examine evidence that credit officers perform a periodic review of potential problem loans and assign risk ratings that are promptly reflected in a classified loan or other appropriate report.
- Examine evidence that senior management and appropriate board committee review and monitor past due, watch list, classified loans, and assigned risk ratings.
- Test the controls over the preparation of the periodic past due, watch list, and classified loans reports.
- Evaluate the basis for which each report is prepared, including which loans are included and excluded.
- Examine evidence that the delinquent loan report interfaces appropriately with the watch list or problem loan report.
- Test the reports' accuracy by tracing a sample of loans between the trial balance and the applicable report.
- Examine evidence that the company has an independent loan review function to review and evaluate credit officer's analysis of significant loans.
- Evaluate whether the results of loan confirmations support the integrity of loan trial balances, loan files, and delinquency reports.
- Review the company's documentation that analyzes the need for and documents each component of the allowance for credit losses. (For example, test the calculation of historical loss experience for one or more periods and one or more pools of loans, or test the calculation of discounted expected cash flow for one or more impaired loans.)
- Read minutes of meetings of the board or loan committee for evidence of board's periodic review and approval of the appropriateness in accordance with GAAP of the allowance for credit losses based on an appropriate documentation.

9.71

Considerations for Audits Performed in Accordance with PCAOB Standards

Paragraph .02 of AU section 319, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *PCAOB Standards and Related*

Rules, Interim Standards),[‡‡] states that regardless of the assessed level of control risk, the auditor should perform substantive procedures for all relevant assertions related to all significant accounts and disclosures in the financial statements. Refer to paragraph .A9 in appendix A, "Definitions," of Auditing Standard No. 5 for the definition of a *relevant assertion* and paragraphs 28–33 of Auditing Standard No. 5 for discussion of identifying relevant assertions.

Substantive Tests

9.72 Regardless of the assessed risks of material misstatement, it is necessary for the auditor to design and perform substantive procedures for all relevant assertions related to credit losses.

9.73 In evaluating the reasonableness of the allowance for loan losses, the auditor may test key factors and assumptions such as those that are

- significant to the estimate of the amount of the allowance, such as
  - the effectiveness of the institution's internal control related to loans and the allowance for loan losses;
  - current local, national, and international economic conditions and trends, particularly as they have affected collateral values;
  - the amount of recoveries of loans previously charged off;
  - composition of the loan portfolio and trends in volume and terms of loans, as well as trends in delinquent and nonaccrual loans that could indicate historical loss averages do not reflect current conditions;
  - identified potential problem loans and large groups of problem loans, including delinquent and nonaccrual loans and loans classified according to regulatory guidelines;
  - concentrations of loans to individuals or entities and their related interests, to industries, and in geographic regions;
  - size of specific credit exposures (a few large loans versus numerous small loans);
  - quality of the internal loan review and internal audit functions;

[‡‡] In December 2010, the Securities and Exchange Commission approved the Public Company Accounting Oversight Board's suite of risk assessment standards (Auditing Standard Nos. 8–15). These standards set forth requirements that are intended to enhance the effectiveness of the auditor's assessment of, and response to, the risks of material misstatement in the financial statements. The risk assessment standards address audit procedures performed throughout the audit, from the initial planning stages through the evaluation of the audit results. The standards will be effective for audits of fiscal periods beginning on or after December 15, 2010.

As a result of the new suite of risk assessment standards, the guidance contained in AU section 319, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards), has now been split into Auditing Standard No. 8, *Audit Risk*, Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, and Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards). Auditing Standard No. 8 discusses the auditor's consideration of audit risk in an audit of financial statements as part of an integrated audit or an audit of financial statements only. Auditing Standard No. 12 discusses the auditor's responsibility for performing risk assessment procedures as well as utilizing the information obtained from risk assessment procedures to identify and assess the risks of material misstatement. Finally, Auditing Standard No. 13 establishes requirements regarding designing and implementing appropriate responses to the risks of material misstatement.

  - the affects of changes in lending policies and procedures, including those for underwriting, credit monitoring, collection, and chargeoffs that could indicate historical loss averages do not reflect current conditions;
  - results of regulatory examinations; and
  - nature and extent of related-party lending.
- sensitive to variations. Assumptions based on historical trends, such as the amount of late or partial payments in a particular period and the amount of chargeoffs, can have a significant effect on estimates of the allowance.
- subjective and susceptible to misstatement and bias, such as
  - the risk classification and allowance allocation given to problem loans;
  - estimates of collateral values, and the related assumptions that drive the determination of such values, such as cash flow estimates, discount rates, and projected occupancy rates;
  - current economic or market conditions that in the future may affect a borrower's ability to meet scheduled repayments; and
  - contingencies, such as a commitment for funding from a third party.

9.74 The auditor should consider the historical experience of the institution in evaluating the appropriateness in accordance with GAAP of the allowance, as well as the auditor's experience with the industry. Changes in facts, circumstances, or an institution's procedures may cause factors different from those considered in the past to become significant to the estimate of the allowance at the balance sheet date.

9.75 Further, the auditor should consider the total credit exposure of particular borrowers, including that related to standby letters of credit, guarantees, commitments to lend, and other off-balance-sheet exposures in addition to the institution's liability for other credit exposures.

9.76 In performing substantive procedures, the auditor should consider one or a combination of the following approaches:

a. Review and test the process used by management to develop the allowance.

b. Develop an independent expectation of the allowance to corroborate the reasonableness of the allowance.

c. Review subsequent events and transactions occurring prior to completion of fieldwork.

9.77 In a number of situations, the audit strategy will include aspects of all three approaches. The auditor assesses reasonableness by performing procedures to test the process used by management to estimate the allowance. The following are procedures the auditor might perform:

- Identify whether there are controls over the preparation of the estimate of the allowance for loan losses and over the related supporting data that may be useful in the evaluation of the appropriateness in accordance with GAAP of the allowance and test controls.
- Identify the sources of data and other factors that management used in forming the assumptions and, based on information gathered in

other audit tests, consider whether such data and factors are relevant, reliable, and sufficient for determining the allowance.

- Consider whether there are additional key factors or alternative assumptions about the factors.
- Evaluate whether the assumptions are consistent with each other, the supporting data, relevant historical data, and industry data.
- Analyze historical data used in developing the assumptions to assess whether the data are comparable and consistent with data of the period under audit, and consider whether such data are sufficiently reliable for determining the allowance.
- Compare current-year chargeoffs with prior-period estimated losses to determine the historical reliability of prior-period estimates.
- Consider whether changes in the business or industry may cause other factors to become significant to the assumptions.
- Review available documentation of the assumptions used in developing the allowance and inquire about any other plans, goals, and objectives of the institution, and consider their relationship to the assumptions.
- Test the calculations used by management to translate the assumptions and key factors into the estimate of the allowance for loan losses.
- Consider using the work of a specialist regarding certain assumptions.

9.78 The auditor should test management's identification of loans that contain high credit risk or other significant exposures and concentrations. Sources of information the auditor may use include

- recent regulatory examination reports;
- various internally generated listings, such as watch-list loans, past-due loans, loans on nonaccrual and restructured status, loans to insiders (including directors and officers), and overdrafts;
- management reports of total loan amounts by borrower;
- reports of historical loss experience by type of loan or risk rating;
- internal loan review reports on their review of loan files, which may identify whether they are lacking current financial data of borrowers and guarantors or current appraisals and may identify loans that are frequently rolled over;
- loan-documentation and compliance exception reports;
- loan committee minutes;
- inquiries of management regarding the experience and degree of turnover of loan officers;
- reports of the independent loan review function or internal audit;
- written lending policies, especially any recent policy changes; and
- reports containing loans with repayment terms structured and restructured such that collectibility problems and concerns may not be evident until payments come due, such as construction loans with interest included in the loan commitment amount.

9.79 These documents and other sources may identify

a. borrowers experiencing problems such as operating losses, marginal working capital, inadequate cash flow, or business interruptions;

b. loans secured by collateral that is not readily marketable or that is susceptible to deterioration in realizable value;

c. loans to borrowers in industries experiencing economic instability; and

d. loan documentation and compliance exceptions.

9.80 The extent that such information is found in reports prepared by management and is to be relied on in substantive tests, the accuracy and completeness of such information should be evaluated by, for example, testing loan subsidiary ledgers and tracing delinquencies to the past-due reports.

9.81 AU section 336, *Using the Work of a Specialist* (AICPA, *Professional Standards*), provides guidance to the auditor who uses the work of a specialist in performing an audit in accordance with GAAS. To properly evaluate the collectibility of certain loans, the auditor may need information outside of his or her usual experience. For example, the auditor might encounter valuation problems that require special knowledge of types of collateral. Factors to be considered in selecting a specialist include professional recognition of the specialist's competence in his or her field, reputation among peers, and relationship with the client.

9.82 For example, the knowledge of a specialist could be useful for loans based on oil and gas reserves. The specialist might review engineering reports on current reserves and production reports if the wells are in production. If fluctuating market conditions exist, a specialist could answer additional inquiries concerning the current status of oil and gas properties. For example, a loan secured by drilling equipment might have only marginal collateral value in a period of declining petroleum prices, even though the loan was highly secured when it was made.

9.83 Loans to developing countries are another example of instances in which the auditor may necessitate the assistance of a specialist to become familiar with the economic, political, and social factors affecting the country's debt repayment. Other sources of such information include International Monetary Fund publications, international economists, and reports provided to institutions by the ICERC.

9.84 For impaired collateral-dependent loans, the specific reserve is generally based on the fair value of collateral less estimated selling costs. In this situation, auditors generally use an appraisal obtained by management as evidence of the fair value of the collateral, which is another example of using a specialist. When an appraisal is used as audit evidence, the auditor should

a. consider the following to evaluate the professional qualifications of the specialist in determining that the specialist possesses the necessary skill or knowledge in the particular field:

  i. the professional certification, license, or other recognition of the competence of the appraiser;

  ii. the reputation and standing of the appraiser in the views of peers and others familiar with the appraiser's capability or performance;

  iii. the appraiser's experience with the particular type of real estate collateral being valued; and

iv. the appraiser's experience with real estate in the specific geographic location of the collateral.

b. evaluate the objectivity of the appraiser based on any relationships the appraiser has with the financial institution;

c. obtain an understanding of the methods and assumptions used by the appraiser;

d. test the data provided to the appraiser; and

e. evaluate whether the appraiser's findings support the fair value measurement.

9.85 If the auditor finds that the appraisal or valuation information is deficient, the auditor should request that management secure additional information. Also, the auditor might consider selecting and hiring another appraiser or consultant directly.

9.86 *Testing of source documents.* The auditor should consider performing tests to determine that the loans are categorized in accordance with the objectives established and classified in accordance with the institution's loan review system. Documents that provide insight on an institution's methodology may provide useful information to the auditor.

9.87 *Large groups of loans.* For loans that are pooled for purposes of determining the allowance for loan losses, the focus of testing is not on individual loan files, and the collectibility of individual loans is not tested directly. Rather, the auditor generally reviews and tests for compliance with the institution's chargeoff and nonaccrual policy and tests the completeness and accuracy of historical data and reports, such as delinquency reports, that are relied upon in estimating the allowance for such loans.

9.88 For example, loan categories represented by large volumes of relatively small loans with similar characteristics, such as residential real estate mortgages, consumer loans, and credit-card loans, are generally evaluated on an aggregate, or pool, basis. The auditor is generally more concerned with the effectiveness of and adherence to procedures related to valuing such loans than with a critical appraisal of each individual loan. The testing or procedures and the review of delinquency status reports may permit the auditor to draw a conclusion about the appropriateness in accordance with GAAP of the allowance necessary for those loan categories. In evaluating the appropriateness in accordance with GAAP of the portion of the allowance attributable to those loans, use of unadjusted historical annual chargeoff experience may not be sufficient in itself but could be considered in light of consistent application of loan policies, and current and anticipated economic conditions based on facts in evidence at the balance-sheet date.

9.89 *Individual loan review.* Although the auditor's primary responsibility when reviewing the allowance for loan losses is the evaluation of its appropriateness in accordance with GAAP as a whole, practical considerations may dictate that the review be directed to the separate categories of loans that constitute the institution's portfolio. Because the risk and other inherent characteristics of primary loan categories vary, the nature and extent of the separate reviews also can be expected to vary.

9.90 In contrast to large groups of smaller balance loans, an evaluation of commercial loans generally requires a more detailed review, because the amount of an individual loan is generally large and the type of borrower, the purpose of the loan, and the timing of cash flows may be dissimilar. More

important, a relatively small number of potential losses can significantly affect the appropriateness in accordance with GAAP of the allowance. In these circumstances, the auditor will generally select and review in detail a number of problem loans.

9.91 In addition to identified problem loans, the auditor may select other commercial loans to include in the detailed loan file review. The selection of these additional loans generally includes a stratum of large loan balances above specified limits, loans from other sources (such as related parties and industry concentrations), and some loans selected without regard to size or other specific criteria. The auditor generally will be concerned with the total credit exposure of the borrower, including standby letters of credit and other commitments to lend, rather than with individual loan balances. Based on the auditor's evaluations and tests, the number of loans reviewed might be limited when the internal loan review function is deemed appropriate in accordance with GAAP in identifying and classifying problem credits.

9.92 The extent of an individual loan review varies from loan to loan. For example, a loan that has been subjected to a recent management review, an effective internal review, or a recent regulatory review may be reviewed in less detail than a loan that has not had some or all of those reviews.

9.93 An institution's exempt portfolio could be material to its financial statements. The exemption of certain loans from examiner review and criticism pursuant to the March 30, 1993, regulatory policy (see paragraph 9.31) does not extend to management's financial reporting responsibilities or to the auditor's responsibility in financial statement audits or other engagements involving management assertions about the exempt loans. An auditor's assessment of management assertions about the allowance for credit losses may depend on the availability of certain documentation, including adequate collateral appraisals or current and complete financial information about borrowers or guarantors. The March 1993 policy may affect the availability of such documentation. Auditors are cautioned against undue reliance on management representations when no supporting evidence exists.

9.94 For each loan selected for review, the auditor may prepare a loan review worksheet or other memoranda documenting the procedures performed and summarizing the conclusions reached. Exhibit 9-2, "Sample Loan Review Form," is an example of a loan review form that could be used for a commercial loan. It can also be adapted to other types of loans. For loans reviewed previously, the auditor typically updates prior reviews for new information concerning the loan. In addition, the auditor usually reviews correspondence updating classified loans, working papers prepared by the institution's internal loan review personnel, and any regulatory examiner reports (including those with information on shared national credits). Such data often provide additional information concerning the loan and how management considered the loan in determining the allowance for loan losses.

Exhibit 9-2
Sample Loan Review Form

Client: ____________________

Audit Date: ____________________

Borrower's Name: ____________________

Nature of Business: ____________________

Purpose of Loan: ____________________

I. Borrower's Notes

Description	*Effective Interest Rate*	*Direct Loan or Participation*	*Line of Credit/ Commitment Amount*	*Outstandings*	
				Principal	*Interest*
				______	______
Total loans outstanding at preliminary			/ /	______	______
Total loans outstanding at year-end			/ /	______	______

Accrual basis (Y/N) ____________________

Repayment Schedule: ____________________

Indicate probable repayment schedule if different from contractual schedule.

Approach used to estimate impairment (check one):

____ Present value of cash flows

____ Fair value of collateral

____ Market value of loan

Repayment Status: ____________________

	Principal	*Interest*
Amount past due	______	______
Last payment:		
Date	______	______
Amount	______	______

II. Contingencies/Guarantees (for example, letters of credit, participations sold with recourse)

Total at preliminary	______
Total at year-end	______

III. Related Loans

Obligor	*Relationship*	*Maturity Date*	*Commitment Amount*	*Outstandings*
				______
	Total Related Loans			______

IV. Collateral Summary

Description	*Gross Value*	*Prior Liens*	*Value to Lender*	*Basis for and Date of Valuation (for example, appraisal, market value quotes)*
Total				

V. Guarantors

VI. Loan Grade

Regulatory Classification	*Amount*	*Institution's In-House Classification*	*Amount*
Special mention			
Substandard			
Doubtful			
Loss			
Unclassified			
Total			

Is the loan impaired not defined in FASB ASC 310-10 (Y/N)? _______

Has the loan been modified and if so, does the modification constitute a troubled debt restructuring?

VII. Financial Data

Auditors: ____________________

Type of opinion: __________ Last audit date: ________________

	Interim		*Fiscal Year*	
	Current-Year ___ months ended / /	*Prior-Year ___ months ended / /*	*Current Year / /*	*Prior Year / /*
Current assets				
Current liabilities				
Working capital				
Total assets				
Total liabilities				
Net worth				
Net sales				
Net income				
Cash flow				

VIII. Loan Officer ______________________________

Comments

Provide a narrative analysis prepared by [*or through inquiry of*] the loan officer of collectibility including estimated repayment dates, sources of repayment, appropriateness in accordance with U.S. GAAP of collateral to cover outstanding principal and interest, financial data on guarantors, and rationale for any estimated allowance allocation, charge-off, or both. ______________________________

Institution's estimated specific allowance allocation, chargeoff, or both and management's supporting rationale:

____

IX. Auditor's Summary ______________________________

X. Conclusion (including the amount and basis for auditor's estimated loss exposure) ______________________________

____

9.95 For many loans, the auditor should discuss the status and background of the loans reviewed with the responsible loan officer and the loan review officer. In addition to providing information about the loans, such discussions may provide the auditor with information about the loan officer's and loan review officer's attitudes and degree of awareness of the status of loans and internal controls.

9.96 In reviewing individual loans, the auditor could review the institution's analysis of the borrower's financial resources, liquidity and future cash flows, and other financial forecasts, particularly for unsecured loans for which repayment is dependent on the borrower's ability to generate funds from profitable operations. The auditor might consider measuring such financial data against the trends and norms, both historical and forecasted, for both the borrower being reviewed and the industry in which the borrower operates. It is preferable that the institution's analysis be supported by current audited financial statements, although financial statements that have been reviewed or compiled by the borrower's auditor or prepared internally by the borrower may be useful.

9.97 If the auditor deems the financial information inadequate, the auditor should discuss the situation with an appropriate member of management. The discussion may include missing information which may be evidence of an internal control deficiency as well. The results of such discussion or the inability of the institution to obtain financial information that is appropriate in accordance with GAAP should be considered in evaluating the collectibility of the loan. If financial information that is appropriate in accordance with GAAP is not available for significant loans, the auditor should notify management that a scope limitation may result.

9.98 For loans secured by collateral, a careful evaluation and valuation of that collateral is often necessary. In such circumstances, the auditor may evaluate the security interest in the collateral to determine how the institution knows that it has been perfected by execution and recording of the appropriate legal documents. The auditor could also consider the reasonableness of the institution's collateral valuation by referring to quoted market prices or other pertinent sources, such as a specialist's appraisals or engineering reports.

9.99 The auditor may test the existence of the collateral by physical observation, independent confirmation, or other appropriate procedures, especially when the institution is involved in loans secured by marketable securities or in asset-based lending, which may include loans secured by inventories, equipment, or receivables. For collateral in the form of marketable securities, the auditor may evaluate whether such securities are under the institution's control, either in its own vault or in a safekeeping account in the institution's name maintained with an independent, third-party custodian. In the latter case, the auditor may wish to evaluate the independent custodian's ability to perform under its obligation. For other types of collateral, there should be documentation that the institution has verified the existence of the collateral. In the absence of such documentation, the auditor should perform these or other collateral verification procedures, especially for significant loans for which collectibility is otherwise questionable. The auditor should also consider the accounting consequence under FASB ASC 860, *Transfers and Servicing*.

9.100 For loans supported by personal guarantees, the auditor may perform a review solely of the borrower's ability to pay. However, if the review indicates the guarantor may be a source of repayment, the auditor might review the financial statements and other pertinent information about the guarantor as if the guarantor were the borrower. It is also important to consider the extent of, as well as the institution's policies and practices for, pursuing guarantees and to evaluate, perhaps in consultation with an attorney, the enforceability and scope of the guarantee.

9.101 The substance of a personal guarantee depends on (*a*) the ability and willingness of the guarantor to perform under the guarantee, including a determination of whether the guarantor has other guarantees outstanding that might be pursued, (*b*) the practicality of enforcing the guarantee in the applicable jurisdiction, (*c*) the scope of the guarantee (that is, whether it covers all principal and interest or has a limit), and (*d*) a demonstrated intent by the institution to enforce the guarantee. Even if the guarantee is legally enforceable, the auditor should consider making a determination concerning whether there are business reasons that might preclude the institution from enforcing the guarantee. Those business reasons could include the length of time necessary to enforce a guarantee, whether it is normal business practice to enforce guarantees on similar transactions, or whether it is necessary for the institution to choose between pursuing the guarantee or the underlying collateral, instead of pursuing both. See paragraphs 21–25 of FASB ASC 310-10-25 for additional information.

9.102 *Participation and purchased loans.*[||||] Management should have the information necessary to authorize, monitor, and review participation loans

[||||] As stated in the glossary to the Federal Financial Institutions Examination Council (FFIEC) Reports of Condition and Income (call report), a *loan secured by real estate* is a loan secured wholly or substantially by a lien or liens on real property for which the lien or liens are central to the extension of the credit—that is, the borrower would not have been extended credit in the same amount or on terms as favorable without the lien or liens on real property. To be considered wholly or substantially secured by a lien or liens on real property, the estimated value of the real estate collateral (after deducting any more senior liens held by others) must be greater than 50 percent of the principal amount of the loan at origination. Banks should apply this revised definition of *loan secured by real estate* prospectively beginning April 1, 2009. Banks need not reevaluate and, if appropriate, recategorize loans originated before April 1, 2009 that they reported as loans secured by real estate into other loan categories on Schedule RC-C, part I, *Loans and Leases*.

and to estimate any related allowance for loan losses. The collectibility of participation loans (whether at the lead institution or at a participating institution) is normally evaluated in light of the entire amount of the loan, not just of the share held by the institution. Accordingly, the participating institution should supplement documentation by the lead institution with its own investigation and credit analysis. The participating institution should not rely solely on the lead institution to monitor the credit. Certain large participation arrangements are reviewed by regulators, who issue a shared national credit report detailing their classification and rationale to the lead and all participating institutions. The auditor's objectives in testing loans for a participating institution are the same as for other loans. For example, the repayment status, borrowers' financial statements, and appraisals should be considered.

9.103 The auditor usually confirms the existence and terms of significant participations (both purchased and sold) with the debtor and lead institution. In addition, the auditor normally reviews the related loan file documentation. For participations, the loan files should contain the same information as other loan files.

9.104 *Charge-offs and recoveries.* The auditor should test the propriety of chargeoffs and recoveries. Substantive detail testing in this area may be minimized if tests of controls and analytical procedures on chargeoffs and recoveries are performed.

9.105 *Analytical procedures.* AU section 329, *Analytical Procedures* (AICPA, *Professional Standards*), provides guidance on analytical procedures. The auditor should consider analytical procedures as a supplement to the detailed tests of the reasonableness of the allowance. These analytical tests may use statistics relating to the allowance as compared to related income statement accounts, net charge-off rates, nonperforming loan levels and other loan categories, historical experience, and peer results. Various analytical techniques can be utilized to assist the auditor in determining the appropriateness in accordance with GAAP of the allowance. See chapter 5 of this guide for additional guidance regarding analytical procedures.

9.106 *Conclusions.* At the conclusion of the testing, the auditor should determine whether management's estimate of the allowance for loan losses is reasonable in relation to the financial statements taken as a whole. Because no one estimate of the allowance can be considered accurate with certainty, the auditor may, based on the testing performed and understanding of the facts and circumstances, determine a range for the allowance that is in accordance with GAAP considered reasonable. If management's estimate is within the reasonable range determined by the auditor, the auditor would be satisfied that the estimate of the allowance for loan losses is reasonable. However, the auditor should determine whether the allowance estimate is within the range. If the

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(footnote continued)

Loan participations secured by real estate acquired from depository institutions, whether credit was extended to the financial institution or the underlying borrower, are reported as a loan by the participating bank in RC-C, part 1, item, as stated in item 2 in schedule RC-C of the FFIEC call report instructions.

Considering the actual mechanics of the participation is important for management. Management should consider how legal title changes in the foreclosure. For example, depending on the facts and circumstances, each bank may have a perfected interest if the other real estate owned is held in trust or a separate legal entity or the lead bank may have the sole legal interest in the property. In addition, management should consider the following: (*a*) whether an asset and liability should be recorded, (*b*) whether the account will reflect the lower of cost or fair value, and (*c*) if liability is recorded, when will the liability be extinguished.

institution's estimate is outside that reasonable range, the auditor should treat the difference between the institution's estimate and the closest reasonable estimate as a likely error and aggregate it with other likely errors, which the auditor must consider before reporting on the financial statements taken as a whole.

9.107 Furthermore, during their examinations of depository institutions, regulators focus a great deal of attention on the allowance for loan losses. Failure to maintain an adequate allowance is considered an unsafe or unsound practice.

Chapter 10

Transfers and Servicing—Including Mortgage Banking

Introduction

10.01 Mortgage banking activities consist primarily of the purchase or origination of mortgage loans for sale to secondary market investors and the subsequent servicing of those loans. Mortgage loans can be grouped together and sold outright with servicing retained or released or pooled and securitized with or without a credit enhancement such as the guarantee of a federal agency, government-sponsored enterprise (GSE), or financial guaranty companies. This chapter discusses mortgage banking, as well as other sales or securitizations of loans.

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

10.03 Participants in the secondary market for residential financing include GSEs such as Federal Home Loan Mortgage Corporation (Freddie Mac) and Federal National Mortgage Association (Fannie Mae); and federal agencies such as Government National Mortgage Association (Ginnie Mae) and the Department of Veterans' Affairs (VA). These entities participate in the secondary market as issuers, investors, or guarantors of asset-backed securities (ABSs) such as mortgage-backed securities (MBSs), real estate mortgage investment conduits, and collateralized mortgage obligations. (Chapter 7, "Investments in Debt and Equity Securities," describes ABS transactions and considerations for investors in ABSs.) Many private entities are also active in the secondary market as issuers, investors, and financial guaranty companies.

10.04 When mortgage loans are originated for sale, the process includes not only finding an investor but also preparing the loan documents to fit the investor's requirements, specifically with respect to underwriting criteria. Mortgage loans originated for sale normally must comply with specific standards governing documentation, appraisal, mortgage insurance, loan terms, and borrower qualifications. Investors will typically review underlying documentation prior to completing their purchase. Individual loans that fail to meet the specified criteria are eliminated from the pool of loans eligible for sale. If exceptions cannot be corrected, the selling institution may have to either find alternative investors or transfer the loan to the institution's portfolio. In most cases, the originating institution continues to be subject to recourse by the investor for underwriting exceptions identified subsequent to the sale of the loans and any related defaults by borrowers, which are typically included in the representations and warranties of the pooling and servicing agreements.

10.05 The extent to which mortgage loans are originated for sale will differ for each institution. Factors such as liquidity, interest-rate exposure, asset/liability management policy, business plan, and capital considerations will influence the nature and extent of an institution's mortgage banking activities. One institution may manage its interest-rate risk position by intentionally selling all fixed-rate mortgage loans it originates, whereas another institution may originate a variety of both fixed- and variable-rate loan products for sale.

Asset-Backed Securitizations[1]

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

Loan Servicing

10.07 If mortgage or other loans are sold, the selling institution sometimes retains the right to service the loans for a servicing fee, normally expressed as a percentage of the principal balance of the outstanding loans, that is collected over the life of the loans as payments are received. A typical servicing agreement requires the servicer to carry out the servicing function, including billing and collection of borrowers' payments; remittance of payments to the investor, insurers, and taxing authorities; loss mitigation activities; maintenance of custodial bank accounts; and related activities. The agreement also may involve significant risks being retained by the servicer such as allowing the investor recourse to collect certain credit losses from the servicer. These loans may have been originated by the servicer institution itself or by other financial institutions. When servicing mortgages for government entities and GSE's such as Ginnie Mae, Fannie Mae, or Freddie Mac, institutions must meet certain minimum net-worth requirements. Inability to meet the requirements may result in termination of the service contracts.

Loan Participations

10.08 In certain industries, a typical customer's borrowing needs often exceed its bank's legal lending limits. To accommodate the customer, the bank may participate the loan to other banks. A *loan participation*, as defined in the Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) glossary, is a transaction in which a single lender makes a large loan to a borrower and subsequently transfers undivided interests in the loan to groups of bank or other entities. Transfers by the originating lender may take the legal form of either assignments or participations. The transfers are usually on a nonrecourse basis, and the transferor (originating lender) continues to

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[1] See information on disclosures for asset-backed securities required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act in chapter 4, "Industry Overview—Mortgage Companies."

service the loan. The transferee (participating entity) may or may not have the right to sell or transfer its participation during the term of the loan, depending on the terms of the participation agreement.[2]

Regulatory Matters

10.09 The federal banking agencies limit the aggregate amount of servicing assets, which includes mortgage servicing assets that may be included in regulatory capital.

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

10.11 On May 17, 2002, the Office of the Comptroller of the Currency (OCC), Federal Deposit Insurance Corporation (FDIC), Board of Governors of the Federal Reserve System, and Office of Thrift Supervision (collectively, the federal banking agencies), issued the *Interagency Advisory on the Regulatory Capital Treatment of Accrued Interest Receivables Related to Credit Card Securitizations*. This advisory clarified that accrued interest receivable (AIR) represents a subordinated interest held by the transferor in cash flows of a credit card securitization, and that AIR meets the definition of a recourse exposure for risk-based capital purposes, and as such, requires a "dollar-for-dollar" capital.

10.12 On February 25, 2003, the federal banking agencies issued the *Interagency Advisory on Mortgage Banking*. This guidance focuses on risks associated with valuation and modeling processes, hedging activities, management information systems, and internal audit processes in connection with mortgage banking activities.

10.13 On May 3, 2005, the federal banking agencies and National Credit Union Administration (NCUA) issued *Interagency Advisory on Accounting and*

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[2] Under Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 860, *Transfers and Servicing*, so-called last in, first out (LIFO) participations, in which all principal cash flows collected on the loan are paid first to the party acquiring the participation, do not meet the definition of a participating interest (see FASB ASC 860-10-40-6A for detailed guidance on characteristics of a participating interest). Similarly, so-called first in, first out (FIFO) participants, in which all principal cash flows collected on the loan are paid first to the lead lender, do not meet the definition of a participating interest. As a result, neither LIFO nor FIFO participations transferred on or after the beginning of bank's first annual reporting period that began after November 15, 2009 (for example, January 1, 2010, for a bank with a calendar-year fiscal year), qualify for sale accounting and, instead, must be reported as secured borrowings.

Reporting for Commitments to Originate and Sell Mortgage Loans. This advisory provides guidance related to the origination of mortgage loans that will be held for resale, and the sale of mortgage loans under mandatory delivery and best efforts contracts.

10.14 In September 2010, the FDIC approved a final rule to extend through December 31, 2010, the *Safe Harbor Protection for Treatment by the FDIC as Conservator or Receiver of Financial Assets Transferred by an Insured Depository Institution in Connection With a Securitization or Participation*. Under this safe harbor, all securitizations or participations in process before the end of 2010 were permanently grandfathered under the existing terms of Title 12 U.S. *Code of Federal Regulations* (CFR) Part 360.6. The rule defines the conditions for safe harbor protection for securitizations and participations for which transfers of financial assets are made after September 30, 2010, and clarifies the application of the safe harbor to transactions that comply with the new accounting standards (that is, FASB Statement Nos. 166, *Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140*, and 167, *Amendments to FASB Interpretation No. 46(R)*) for off-balance sheet treatment as well as those that do not comply with those accounting standards. The conditions contained in the final rule will serve to protect the Deposit Insurance Fund and the FDIC's interests as deposit insurer and receiver by aligning the conditions for the safe harbor with better and more sustainable securitization practices by insured depository institutions. For more information on this final ruling, readers are encouraged to visit the FDIC website at www.fdic.gov/news/news/press/2010/pr10216.html.

10.15 See chapter 9, "Credit Losses," for regulatory matters related to loan and lease losses and nontraditional mortgage products and chapter 8, "Loans," for regulatory matters related to commercial and residential mortgages.

10.16 The OCC's *Bank Accounting Advisory Series* (BAAS) expresses the Office of the Chief Accountant's current views on accounting topics of interest to national banks. See further discussion of the BAAS in paragraph 8.80 of this guide. Topic 8, "Capital," and Topic 9, "Income and Expense Recognition," of the BAAS includes interpretations on capital treatment for asset sales and securitizations and accounting for transfers of financial assets and securitizations, respectively. Readers are encouraged to read this publication on the OCC website at www.occ.gov/topics/bank-operations/accounting/index-accounting.html.[*]

Accounting and Financial Reporting

Mortgage Loans and Mortgage-Backed Securities Held for Sale

10.17 FASB ASC 948, *Financial Services—Mortgage Banking*, establishes accounting and reporting standards for mortgage banking entities and entities that engage in certain mortgage banking activities.

[*] Due to a number of accounting rule changes, the October 2010 edition of the Office of the Comptroller of the Currency's *Bank Accounting Advisory Series* has revised Section 9A, "Accounting For Transfers of Financial Assets and Securitizations," in its entirety. The questions and responses in Topic 8A, "Capital Treatment for Asset Sales and Securitizations," have not been updated to reflect the regulatory capital rulings in response to the accounting changes per FASB Statement No. 166, *Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140* (codified in FASB ASC 860) and FASB Statement No. 167, *Amendments to FASB Interpretation No. 46(R)* (codified in FASB ASC 810, *Consolidation*).

10.18 FASB ASC 948-310-35-1 states that mortgage loans held for sale (HFS) should be reported at the lower of cost or fair value, determined as of the balance-sheet date. If a mortgage loan has been the hedged item in a fair value hedge (as addressed in FASB ASC 815, *Derivatives and Hedging*), the loan's cost basis used in lower-of-cost-or-fair value accounting should reflect the effect of the adjustments of its carrying amount made pursuant to FASB ASC 815-25-35-1. After the securitization of a mortgage loan HFS that meets the conditions for a sale addressed in FASB ASC 860-10-40-5, FASB ASC 948-310-40-1 requires that any MBSs received by the transferor as proceeds should be classified in accordance with the provisions of FASB ASC 320, *Investments—Debt and Equity Securities*. However, FASB ASC 948-310-35-3A states that a mortgage banking entity must classify as trading any MBSs received as proceeds that it commits to sell before or during the securitization process. An entity is prohibited from reclassifying loans as investment securities unless the transfer of those loans meets the conditions for sale accounting addressed in FASB ASC 860-10-40-5.

10.19 FASB ASC 948-310-35-2 requires that the amount by which the cost exceeds fair value of mortgage loans HFS should be accounted for as a valuation allowance. Changes in the valuation allowance should be included in the determination of net income of the period in which the change occurs.

10.20 The valuation allowance addressed in paragraph 10.19 is not the same as the allowance for credit losses and thus the change should not be recognized in the provision for credit losses.

10.21 For mortgage banking entities, the primary application of FASB ASC 825, *Financial Instruments*, will be to apply the fair value option to loans HFS. In doing so, accounting may be simplified by negating the need to evaluate for the lower of cost or fair value impairment or the need to achieve fair value accounting through a FASB ASC 815 hedge election. The "Fair Value Option" subsections of FASB ASC 825-10 address circumstances in which entities may choose, at specified election dates, to measure eligible items at fair value (the fair value option). FASB ASC 825-10-15 provides guidance on the scope of the "Fair Value Option" subsections. See chapter 20, "Fair Value," of this guide for a summary of FASB ASC 825.

10.22 The fair value of mortgage loans and MBSs HFS should be determined by the type of loan, as explained in FASB ASC 948-310-35-3. At a minimum, separate determinations of fair value for residential (one- to four-family dwellings) and commercial mortgage loans should be made. Either the aggregate or individual loan basis may be used in determining the lower of cost or fair value for each type of mortgage loan. Fair value for loans subject to investor purchase commitments (committed loans) and loans held on a speculative basis (uncommitted loans) should be determined separately as follows:

a. *Committed loans*. Mortgage loans covered by investor commitments should be based on the fair values of the loans.

b. *Uncommitted loans*. Fair value for uncommitted loans should be based on the market in which the mortgage banking entity normally operates. That determination would include consideration of the following:

  i. Market prices and yields sought by the mortgage banking enterprise's normal market outlets.

  ii. Quoted Ginnie Mae security prices or other public market quotations for long-term mortgage loan rates.

iii. Freddie Mac and Fannie Mae current delivery prices.

c. *Uncommitted mortgage-backed securities*. Fair value for uncommitted MBSs that are collateralized by a mortgage banking entity's own loans ordinarily should be based on fair value of the securities. If the trust holding the loans may be readily terminated and the loans sold directly, fair value for the securities should be based on the fair value of the loans or the securities, depending on the mortgage banking entity's sales intent. Fair value for other uncommitted MBSs should be based on published MBSs yields.

10.23 Paragraphs 2–3 of FASB ASC 820-10-30[†] explain that when an asset is acquired or a liability is assumed in an exchange transaction for that asset or liability, the transaction price represents the price paid to acquire the asset or received to assume the liability (an *entry price*). In contrast, the fair value of the asset or liability represents the price that would be received to sell the asset or paid to transfer the liability (an *exit price*). Conceptually, entry prices and exit prices are different. Entities do not necessarily sell assets at the prices paid to acquire them. Similarly, entities do not necessarily transfer liabilities at the prices received to assume them. In many cases, the transaction price will equal the exit price and, therefore, represent the fair value of the asset or liability at initial recognition. In determining whether a transaction price represents the fair value of the asset or liability at initial recognition, the reporting entity should consider factors specific to the transaction and the asset or liability. For example, a transaction price might not represent the fair value of an asset or liability at initial recognition if any of the following conditions exist:

a. The transaction is between related parties.

b. The transaction occurs under duress or the seller is forced to accept the price in the transaction. For example, that might be the case if the seller is experiencing financial difficulty.

c. The unit of account represented by the transaction price is different from the unit of account for the asset or liability measured at fair value. For example, that might be the case if the asset or liability measured at fair value is only one of the elements in the transaction, the transaction includes unstated rights and privileges that should be separately measured, or the transaction price includes transaction costs.

d. The market in which the transaction occurs is different from the market in which the reporting entity would sell the asset or transfer the liability, that is, the principal market or most advantageous

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[†] In May 2011, FASB issued Accounting Standards Update (ASU) No. 2011-04, *Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*. The amendments in this ASU result in common fair value measurement and disclosure requirements in U.S. generally accepted accounting principles (GAAP) and International Financial Reporting Standards (IFRSs). The amendments alter the wording used to describe many of the requirements in U.S. GAAP for measuring fair value and for disclosing information about fair value measurements. The ASU does not require additional fair value measurements and is not intended to establish valuation standards or affect valuation practices outside of financial reporting.

The amendments in this ASU are effective prospectively (1) for public entities, for interim and annual periods beginning after December 15, 2011 and (2) for nonpublic entities, for annual periods beginning after December 15, 2011. Early application is not permitted for public entities. Early application is permitted for nonpublic entities, but only for interim periods beginning after December 15, 2011. See FASB ASC 820-10-65-8 for further information regarding changes in valuation technique as a result of implementation of respective guidance. Readers should consult the text of ASU No. 2011-04 for further information.

market. For example, those markets might be different if the reporting entity is a securities dealer that transacts in different markets, depending on whether the counterparty is a retail customer (retail market) or another securities dealer (interdealer market).

10.24 As stated in FASB ASC 820-10-35-19,† a fair value measurement is for a particular asset or liability. Therefore, the measurement should consider attributes specific to the asset or liability, for example

a. the condition or location or both of the asset or liability.

b. restrictions, if any, on the sale or use of the asset at the measurement date.

10.25 As stated in FASB ASC 820-10-35-21,† the asset or liability might be either of the following:

a. A standalone asset or liability (for example, a financial instrument or an operating asset)

b. A group of assets, or liabilities, or both (for example, an asset group, a reporting unit, or a business)

10.26 Whether the asset or liability is a standalone asset or liability or a group of assets or liabilities depends on its *unit of account*, as explained in FASB ASC 820-10-35-22.† The *unit of account* for the asset or liability, which is defined in the FASB ASC glossary as that which is being measured by reference to the level at which an asset or liability is aggregated (or disaggregated), should be determined in accordance with the provisions of other accounting principles, except as provided in FASB ASC 820-10-35-44. See chapter 20 of this guide for a summary of FASB ASC 820, *Fair Value Measurement*.

10.27 If a loan is held for resale, loan origination fees and the direct loan origination costs as specified in FASB ASC 310, *Receivables*, should be deferred until the related loan is sold as stated in FASB ASC 948-310-25-3. If a loan is held for investment, such fees and costs should be deferred and recognized as an adjustment of yield as specified in paragraphs 18 and 21–26 of FASB ASC 310-20-35 and 310-20-50-2.

10.28 Notwithstanding the characteristics discussed in FASB ASC 815-10-15-83, loan commitments that relate to the origination of mortgage loans that will be HFS, as discussed in FASB ASC 948-310-25-3, should be accounted for as derivative instruments by the issuer of the loan commitment (that is, the potential lender), as stated in FASB ASC 815-10-15-71.

10.29 FASB ASC 815-15-25-4 explains that an entity that initially recognizes a hybrid financial instrument that under FASB ASC 815-15-25-1 would be required to be separated into a host contract and a derivative instrument may irrevocably elect to initially and subsequently measure that hybrid financial instrument in its entirety at fair value (with changes in fair value recognized in earnings). A financial instrument should be evaluated to determine that it has an embedded derivative requiring bifurcation before the instrument can become a candidate for the fair value election.

10.30 FASB ASC 948-310-30-4 states that mortgage loans transferred from loans HFS to long-term-investment classification should be valued at the lower of cost or fair value on the date of transfer. Also, FASB ASC 942-320-55

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† See footnote † in paragraph 10.23.

addresses a financial institutions' ability to hold mortgage securities to maturity.

10.31 The carrying amount of mortgage loans to be sold to an *affiliated entity* (as defined in the FASB ASC glossary) should be adjusted to the lower of cost or fair value of the loans as of the date management decides that a sale to an affiliated entity will occur, as stated in paragraphs 1–2 of FASB ASC 948-310-30. If a particular class of mortgage loans or all loans are originated exclusively for an affiliated entity, the originator is acting as an agent of the affiliated entity, and the loan transfers should be accounted for at the *originator's acquisition cost*, as defined in the FASB ASC glossary.

Transfers and Servicing of Financial Assets

10.32 FASB ASC 860, *Transfers and Servicing*, establishes accounting and reporting standards for transfers and servicing of financial assets. As stated in FASB ASC 860-10-05-6, this guidance applies to various types of transfers, including securitizations, factoring arrangements, transfers of receivables with recourse, securities lending transactions, repurchase agreements, loan participatios, and banker's acceptances.

10.33 FASB ASC 860-10 provides consistent standards for distinguishing transfers of financial assets that are sales from transfers that are secured borrowings.

10.34 The objective of FASB ASC 860-10-40-4 and related implementation guidance is to determine whether a transferor and its consolidated affiliates included in the financial statements being presented have surrendered control over transferred financial assets or third-party beneficial interests. This determination

a. should first consider whether the transferee would be consolidated by the transferor (for implementation guidance, see FASB ASC 860-10-55-17D).

b. should consider the transferor's continuing involvement in the transferred financial assets.

c. requires the use of judgment that should consider all arrangements or agreements made contemporaneously with, or in contemplation of, the transfer, even if they were not entered into at the time of the transfer.

With respect to item (*b*), all continuing involvement by the transferor, its consolidated affiliates included in the financial statements being presented, or its agents should be considered continuing involvement by the transferor. In a transfer between two subsidiaries of a common parent, the transferor-subsidiary should not consider parent involvements with the transferred financial assets in applying the following paragraph.

10.35 To be eligible for sale accounting, an entire financial asset cannot be divided into components before a transfer unless all of the components meet the definition of a participating interest, according to FASB ASC 860-10-40-4A. The legal form of the asset and what the asset conveys to its holders should be considered in determining what constitutes an entire financial asset (for implementation guidance, see FASB ASC 860-10-55-17E). An entity should not account for a transfer of an entire financial asset or a participating interest in an entire financial asset partially as a sale and partially as a secured borrowing.

10.36 FASB ASC 860-10-40-6A provides detailed guidance on the characteristics of a participating interest.

10.37 According to FASB ASC 860-10-40-4B, if a transfer of a portion of an entire financial asset meets the definition of a participating interest, the transferor should apply the guidance in the following paragraph. If a transfer of a portion of a financial asset does not meet the definition of a participating interest, the transferor and transferee should account for the transfer as a secured borrowing with a pledge of collateral, in accordance with the guidance in FASB ASC 860-30-25-2. However, if the transferor transfers an entire financial asset in portions that do no individually meet the participating interest definition, the following paragraph should be applied to the entire financial asset once all portions have been transferred.

10.38 FASB ASC 860-10-40-5 states that a transfer of an entire financial asset, a group of entire financial assets, or a participating interest in an entire financial asset in which the transferor surrenders control over those financial assets should be accounted for as a sale if and only if all of the following conditions are met:

a. *Isolation of transferred financial assets*. 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. Transferred financial assets are isolated in bankruptcy or other receivership only if the transferred financial assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor or any of its consolidated affiliates included in the financial statements being presented. For multiple step transfers, a bankruptcy-remote entity (as defined in the FASB ASC glossary) is not considered a consolidated affiliate for purposes of performing the isolation analysis. Notwithstanding the isolation analysis, each entity involved in the transfer is subject to the applicable guidance on whether it should be consolidated (see paragraphs 7–14 of FASB ASC 860-10-40 and the guidance beginning in FASB ASC 860-10-55-18). A set-off right (as defined in the FASB ASC glossary) is not an impediment to meeting the isolation condition.

b. *Transferee's rights to pledge or exchange*. This condition is met if both the following conditions are met:

    i. Each transferee (or, if the transferee is an entity whose sole purpose is to engage in securitization or asset-backed financing activities and that entity is constrained from pledging or exchanging the assets it receives, each third-party holder of its beneficial interests) has the right to pledge or exchange the assets (or beneficial interests) it received.

    ii. No condition both constrains the transferee (or third-party holder of its beneficial interests) from taking advantage of its right to pledge or exchange and provides more than a trivial benefit to the transferor (see paragraphs 15–21 of FASB ASC 860-10-40).

    If the transferor, its consolidated affiliates included in the financial statements being presented, and its agents have no continuing involvement with the transferred financial assets, the condition under FASB ASC 860-10-40-5(b) is met.

c. *Effective control*. The transferor, its consolidated affiliates included in

the financial statements being presented, or its agents do not maintain effective control over the transferred assets or third-party beneficial interests related to those transferred assets (see FASB ASC 860-10-40-22A). A transferor's effective control over the transferred financial assets includes, but is not limited to, any of the following:

i. An agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity (see paragraphs 23–27 of FASB ASC 860-10-40).

ii. An agreement, other than through a cleanup call (see paragraphs 28–39 of FASB ASC 860-10-40), that provides the transferor with both the unilateral ability to cause the holder to return specific financial assets and a more-than-trivial benefit attributable to that ability.

iii. An agreement that permits the transferee to require the transferor to repurchase the transferred financial assets at a price that is so favorable to the transferee that it is probable that the transferee will require the transferor to repurchase them (see FASB ASC 860-10-55-42D).

10.39 For guidance on accounting for a transfer that satisfies the conditions in FASB ASC 860-10-40-5, see FASB ASC 860-20 (sales of financial assets), including FASB ASC 860-20-40's derecognition guidance and FASB ASC 860-20-25's guidance on recognition of new assets obtained and new liabilities. For guidance on accounting for a transfer that does not satisfy the conditions of FASB ASC 860-10-40-5, see FASB ASC 860-30 (secured borrowings and collateral).

10.40 Paragraphs 16–18 of FASB ASC 860-10-05 provide background on securities lending transactions and paragraphs 48–50 of FASB ASC 860-10-55 explain the application of the guidance. Application of repurchase agreements and wash sales is discussed in paragraphs 51–56 of FASB ASC 860-10-55[‡] and FASB ASC 860-10-55-57, respectively.

Sale of Financial Assets

10.41 *Sale of a participating interest*. Upon completion of a transfer of a participating interest that satisfies the conditions in FASB ASC 860-10-5 to be accounted for as a sale, FASB ASC 860-20-40-1A states that the transferor (seller) should

a. allocate the previous carrying amount of the entire financial asset between both of the following on the basis of their relative fair value at the date of the transfer,

i. the participating interest sold.

[‡] In April 2011, FASB issued ASU No. 2011-03, *Transfers and Servicing (Topic 860): Reconsideration of Effective Control for Repurchase Agreements*. ASU No. 2011-03 removes from the assessment of effective control (*a*) the criterion requiring the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed terms, even in the event of default by the transferee, and (*b*) the collateral maintenance implementation guidance related to that criterion. Other criteria applicable to the assessment of effective control are not changed by this ASU. The guidance in this ASU is effective for the first interim or annual period beginning on or after December 15, 2011, and should be applied prospectively to transactions or modifications of existing transactions that occur on or after that date. Early adoption is not permitted. Readers should consult the full text of ASU No. 2011-03 for further information.

   ii. the participating interest that continues to be held by the transferor.

b. derecognize the participating interest(s) sold.

c. apply the guidance in FASB ASC 860-20-25-1 and 860-20-30-1 on recognition and measurement of assets obtained and liabilities incurred in the sale.

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

e. report any participating interest(s) that continue to be held by the transferor as the difference between the following amounts measured at the date of the transfer,

   i. the previous carrying amount of the entire financial asset.

   ii. the amount derecognized.

10.42 *Sale of an entire financial asset or group of entire financial assets*. Upon completion of a transfer of an entire financial asset or group of entire financial assets that satisfies the conditions in FASB ASC 860-10-5 to be accounted for as a sale, FASB ASC 860-20-40-1B states that the transferor (seller) should

a. derecognize the transferred financial assets.

b. apply the guidance in FASB ASC 860-20-25-1 and 860-20-30-1 on recognition and measurement of assets obtained and liabilities incurred in the sale.

c. recognize in earnings any gain or loss on the sale.

If the transferred financial assets was accounted for under FASB ASC 320 as available for sale before the transfer, item (*a*) requires that the amount in other comprehensive income be recognized in earnings at the date of the transfer.

10.43 *Transferor recognition and measurement of assets obtained and liabilities incurred in a sale of financial assets*. Upon completion of a transfer of financial assets that satisfies the conditions to be accounted for as a sale in FASB ASC 860-10-50-5, FASB ASC 860-20-25-1 states the transferor (seller) should also recognize any assets obtained or liabilities incurred in the sale, including, but not limited to, any of the following:

a. Cash

b. Servicing assets

c. Servicing liabilities

d. In a sale of an entire financial asset or a group of entire financial assets, any of the following:

   i. The transferor's beneficial interest in the transferred financial assets

   ii. Put or call options held or written (for example, guarantee or recourse obligations)

   iii. Forward commitments (for example, commitments to deliver additional receivables during the revolving periods of some securitizations)

   iv. Swaps (for example, provisions that convert interest rates from fixed to variable)

10.44 According to FASB ASC 860-20-30-1, the transferor should initially measure at fair value any asset obtained (or liability incurred) and recognized under FASB ASC 860-20-25-1.

10.45 *Transferee recognition and measurement of assets obtained and liabilities incurred in a sale of financial assets*. FASB ASC 860-20-25-3 and FASB ASC 860-20-30-2 state that the transferee should recognize and initially measure all assets obtained (including any participating interest[s] obtained) and any liabilities incurred at fair value.

10.46 *Financial assets subject to prepayment*. FASB ASC 860-20-35-2 requires that financial assets, except for instruments that are within the scope of FASB ASC 815-10, that can contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment should be subsequently measured like investments in debt securities classified as available-for-sale or trading under FASB ASC 320. Examples of such financial assets include, but are not limited to, interest-only strips, other beneficial interests, loans, or other receivables.

Servicing Assets and Liabilities

10.47 Servicing rights are significant assets for some institutions. They have value in addition to the servicing fee value because of the servicer's ability to invest the "float" that results from payments that are received from borrowers but are not yet passed on to the investors in the loans. Additionally, intrinsic value components of servicing rights include ancillary income, such as late-payment charges and prepayment charges. Accordingly, servicing rights, either separately or as part of a loan, are generally readily purchased and sold.

10.48 According to FASB ASC 860-50-25-1, an entity should recognize a servicing asset or servicing liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract in any of the following situations:

a. A servicer's transfer of any of the following, if that transfer meets the requirements for sale accounting:

  i. An entire financial asset

  ii. A group of entire financial assets

  iii. A participating interest in an entire financial asset, in which circumstance the transferor should recognize a servicing asset or a servicing liability only related to the participating interest sold

b. An acquisition or assumption of a servicing obligation that does not relate to financial assets of the servicer or its consolidated affiliates included in the financial statements being presented

10.49 A servicer that transfers or securitizes financial assets in a transaction that does not meet the requirements for sale accounting and is accounted for as a secured borrowing with the underlying financial assets remaining on the transferor's balance sheet should not recognize a servicing asset or a servicing liability, as stated in paragraphs 2–3 of FASB ASC 860-50-25. A servicer that recognizes a servicing asset or servicing liability should account for the contract to service financial assets separately from those financial assets.

10.50 FASB ASC 860-50-25-4 states that an entity that transfers its financial assets to an unconsolidated entity in a transfer that qualifies as a sale in which the transferor obtains the resulting securities and classifies them as debt securities held-to-maturity in accordance with FASB ASC 320 may either separately recognize its servicing assets or servicing liabilities or report those servicing assets or servicing liabilities together with the asset being serviced.

10.51 FASB ASC 860-50-30-1 states that an entity should initially measure at fair value, a servicing asset or servicing liability that qualifies for separate recognition regardless of whether explicit consideration was exchanged.

10.52 FASB ASC 860-50-35-1 states that an entity should subsequently measure each class of servicing assets and servicing liabilities using one of the following methods:

a. *Amortization method.* Amortize servicing assets or servicing liabilities in proportion to and over the period of estimated net servicing income (if servicing revenues exceed servicing costs) or net servicing loss (if servicing costs exceed servicing revenues), and assess servicing assets or servicing liabilities for impairment or increased obligation based on fair value at each reporting date.

b. *Fair value measurement method.* Measure servicing assets or servicing liabilities at fair value at each reporting date and report changes in fair value of servicing assets and servicing liabilities in earnings in the period in which the changes occur.

10.53 FASB ASC 860-50-35-2 states that the election described in paragraphs 1 (see paragraph 10.52) and 4–5 (see paragraph 10.54) of FASB ASC 860-50-35 should be made separately for each class of servicing assets and servicing liabilities.

10.54 Paragraphs 4–5 of FASB ASC 860-50-35 state that an entity should apply the same subsequent measurement method to each servicing asset and servicing liability in a class. Classes of servicing assets and servicing liabilities should be identified based on any of the following:

a. The availability of market inputs used in determining the fair value of servicing assets or servicing liabilities.

b. An entity's method for managing the risks of its servicing assets or servicing liabilities.

Once an entity elects the fair value measurement method for a class of servicing assets and servicing liabilities, that election should not be reversed, as stated in FASB ASC 860-50-35-3(a).

10.55 *Transfers of servicing rights*. The criteria in paragraphs 2–4 of FASB ASC 860-50-40 apply to transfers of servicing rights relating to loans previously sold and to transfers of servicing rights relating to loans that are retained by the transferor, as stated in FASB ASC 860-50-40-6.

10.56 FASB ASC 860-50-40-2 states that the following criteria should be considered when evaluating whether a transfer of servicing rights qualifies as a sale:

- Whether the transferor has received written approval from the investor if required.
- Whether the transferee is a currently approved transferor/servicer and is not at risk of losing approved status.

- If the transferor finances a portion of the sales price, whether an adequate nonrefundable down payment has been received (necessary to demonstrate the transferee's commitment to pay the remaining sales price) and whether the note receivable from the transferee provides full recourse to the transferee. Nonrecourse notes or notes with limited recourse (such as the servicing) do not satisfy this criterion.
- Temporary servicing performed by the transferor for a short period of time should be compensated in accordance with a subservicing contract that provides adequate compensation.

10.57 Servicing rights may be purchased by brokers or investment bankers that intend to seek buyers for the rights. Although such purchases cannot be canceled, approval of the transfer of the rights is not requested by the seller until the broker enters into a transaction with the third-party purchaser. Thus, such transactions should generally be characterized as financing transactions and a sale has not occurred until an approval of transfer of rights has been requested, even though other contingencies are resolved.

10.58 FASB ASC 860-50-40-3 states that the following criteria should also be considered when evaluating whether a transfer of servicing rights qualifies as a sale:

a. Title has passed

b. Substantially all risks and rewards of ownership have irrevocably passed to the buyer

c. Any protection provisions retained by the seller are minor and can be reasonably estimated

10.59 FASB ASC 860-50-40-4 explains that if a sale is recognized and minor protection provisions exist, a liability should be accrued for the estimated obligation associated with those provisions. The seller retains only minor protection provisions if both of the following are met:

a. The obligation associated with those provisions is estimated to be no more than 10 percent of the sales price.

b. Risk of prepayment is retained for no longer than 120 days.

10.60 FASB ASC 860-50-40-5 states that a temporary subservicing contract in which the subservicing will be performed by the transferor for a short period of time would not necessarily preclude recognizing a sale at the closing date.

10.61 Paragraphs 7–9 of FASB ASC 860-50-40 provide additional guidance on sales of servicing right with a subservice contract.

10.62 Paragraphs 10–11 of FASB ASC 860-50-40 address a situation in which an entity sells the right to service mortgage loans that are owned by other parties. The related mortgage loans have been previously sold, with servicing retained, in a separate transaction. Because of the ability to invest the float that results from payments received from borrowers but not yet passed to the owners of the mortgages, the mortgage servicing rights can be sold for immediate cash or for a participation in the future interest stream of the loans. If a transfer of mortgage servicing rights qualifies as a sale under the criteria stated in FASB ASC 860-50-40-2 and the sale is for a participation in the future interest income stream, gain recognition is appropriate at the sale date.

10.63 In general, three to six months elapse between entry into a contract to sell servicing rights and actual delivery of the loan portfolio to be serviced. These delays may result from the purchaser's inability to accept immediate delivery, the seller's inability to immediately transfer the servicing records and loan files, difficulties in obtaining necessary investor approval, requirements to give advance notification to mortgagors, or other planning considerations. Issues relating to the transfer of risks and rewards between buyers and sellers of servicing rights may be complex.

10.64 Paragraphs 1–2 of FASB ASC 860-50-45 state that an entity should report recognized servicing assets and servicing liabilities that are subsequently measured using the fair value measurement method in a manner that separates those carrying amounts on the face of the statement of financial position from the carrying amounts for separately recognized servicing assets and servicing liabilities that are subsequently measured using the amortization method. To accomplish that separate reporting, an entity may either (*a*) display separate line items for the amounts that are subsequently measured using the fair value measurement method and amounts that are subsequently measured using the amortization method or (*b*) present the aggregate of those amounts that are subsequently measured at fair value and those amounts that are subsequently measured using the amortization method (see paragraphs 9–11 of FASB ASC 860-50-35) and disclose parenthetically the amount that is subsequently measured at fair value that is included in the aggregate amount.

Secured Borrowings and Collateral

10.65 Paragraphs 2–3 of FASB ASC 860-30-05 state that a debtor may grant a security interest in certain assets to a lender (the secured party) to serve as collateral for its obligation under a borrowing, with or without recourse to other assets of the obligor. An obligor under other kinds of current or potential obligations, for example, interest rate swaps, also may grant a security interest in certain assets to a secured party. If collateral is transferred to the secured party, the custodial arrangement is commonly referred to as a pledge. Secured parties sometimes are permitted to sell or repledge (or otherwise transfer) collateral held under a pledge. The same relationships occur, under different names, in transfers documented as sales that are accounted for as secured borrowings (see FASB ASC 860-30-25-2).

10.66 FASB ASC 860-30-25-2 requires that the transferor and transferee account for the transfer as a secured borrowing with pledge of collateral in either of the following circumstances:

a. If a transfer of an entire financial asset, a group of entire financial assets, or a participating interest in an entire financial asset does not meet the conditions for a sale in FASB ASC 860-10-40-5

b. If a transfer of a portion of an entire financial asset does not meet the definition of a participating interest

The transferor should continue to report the transferred financial asset in its statement of financial position with no change in the asset's measurement (that is, basis of accounting).

10.67 FASB ASC 860-30-25-5 states that the accounting for noncash collateral by the debtor (or obligor) and the secured party depends on whether the secured party has the right to sell or repledge the collateral and on whether the debtor has defaulted. Noncash collateral should be accounted for as follows:

a. If the secured party (transferee) has the right by contract or custom

to sell or repledge the collateral, then FASB ASC 860-30-45-1 requires that the obligor (transferor) should reclassify that asset and report that asset in its statement of financial position separately, (for example, as security pledged to creditors) from other assets not so encumbered.

b. If the secured party (transferee) sells collateral pledged to it, it should recognize the proceeds from the sale and its obligation to return the collateral. The sale of the collateral is a transfer subject to the provisions of FASB ASC 860.

c. If the debtor (transferor) defaults under the terms of the secured contract and is no longer entitled to redeem the pledged asset, it should derecognize the pledged asset as required by FASB ASC 860-30-40-1 and the secured party (transferee) should recognize the collateral as its asset initially measured at fair value (see FASB ASC 860-30-30-1) or, if it has already sold the collateral, derecognize its obligation to return the collateral (see FASB ASC 860-30-40-1).

d. Except as provided in FASB ASC 860-30-40-1, the debtor (transferor) should continue to carry the collateral as its asset, and the secured party (transferee) should not recognize the pledged asset.

Transfers of Loans With Recourse

10.68 Institutions may transfer loans with recourse. This may be accomplished to deliver loans into a particular investor's commitment program, to obtain a better price, or both. For example, a seller may be obligated to make full or partial payment to the purchaser if the debtor fails to pay when payment is due. Similarly, a seller may be obligated to make payments to the purchaser as the result of loan prepayments or because of adjustments resulting from defects (such as failure to perfect a security interest in collateral) of the transferred loans. In some cases (for example, student loans), underwriting exceptions identified subsequent to the transfer of loans may subject the seller to additional recourse risk if the borrower defaults on the loan. Because of the continuing risk of delinquency and foreclosure, the institution's management should carefully evaluate its potential contingent liabilities with respect to such loans.

10.69 FASB ASC 860 provides an overview of transfers of receivables with recourse. A transfer of receivables in their entireties with recourse should be accounted for as a sale, with the proceeds of the sale reduced by the fair value of the recourse obligation, if the conditions in FASB ASC 860-10-40-5 are met, as stated in FASB ASC 860-10-55-46(a). Otherwise, a transfer of receivables with recourse should be accounted for as a secured borrowing. A transfer of a portion of a receivable with recourse, other than that permitted in FASB ASC 860-10-40-6A(c)(4), does not meet the requirements of a participating interest and should be accounted for as a secured borrowing, as stated in FASB ASC 860-10-55-46(b).

Loans Not Previously Held for Sale

10.70 FASB ASC 310-10-35-49 states that once a decision has been made to sell loans not previously classified as HFS, such loans should be transferred into the HFS classification and carried at the lower of cost or fair value. At the time of the transfer into the HFS classification, any amount by which cost

exceeds fair value should be accounted for as a valuation allowance. This guidance applies to both mortgage and nonmortgage loans.

10.71 The following paragraphs discuss whether the adjustments should be recorded by using an allowance method or as a direct write down, depending on the circumstances involved.

10.72 On March 26, 2001, the federal banking agencies and NCUA issued *Interagency Guidance on Certain Loans Held for Sale* to provide instruction to institutions and examiners about the appropriate accounting and reporting treatment for certain loans that are sold directly from the loan portfolio or transferred to a HFS account. This guidance addresses transfers to the HFS account for loans within its scope and states that when a decision is made to sell a loan or portion thereof that was not originated or initially acquired with the intent to sell, the loan should be clearly identified and transferred to the HFS account.

10.73 Accordingly, for institutions subject to this guidance, once the decision has been made to sell loans not previously classified as HFS, such loans should be transferred into the HFS classification. For loans with declines in fair value that are attributable to credit quality, any reduction in the loan's value at the time of the transfer into the HFS classification should be reflected as a write-down of the recorded investment resulting in a new cost basis, with a corresponding reduction in the allowance for loan and lease losses. Thus, this guidance adds to the provisions of a requirement to write down the transferred loan and establish a new cost basis for institutions subject to this guidance.

10.74 In contrast, for loans with declines in fair value that are attributable to interest or foreign exchange rates and clearly are not attributable, in any respect, to credit or transfer risk, any amount by which the recorded investment exceeds fair value at the time of the transfer into the HFS classification should be accounted for as a valuation allowance.

10.75 Variable-rate loans are generally sold at stated rates, with gain or loss measurement based on a premium or discount on the face value of the portfolio to be sold. Fixed-rate loans are generally sold at a discount or premium to provide a specified yield to the investor, and the corresponding gain or loss is based on the difference between the yield of the loans to be sold and the contractual yield to the investor. The yield on a pool of loans is the calculated weighted-average interest rate for that pool.

Consolidation[||]

10.76 A reporting entity that holds a direct or indirect (explicit or implicit) variable interest in a legal entity must determine whether the guidance in the

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[||] FASB Statement No. 166 eliminated the exceptions for qualifying special purpose entities (QSPEs) from the consolidation guidance in FASB ASC 810. In conjunction with release of FASB Statement No. 166, FASB issued FASB Statement No. 167 to improve financial reporting by entity's involved with variable interest entities (VIEs) and to address the potential impacts on certain provisions of FASB Interpretation No. 46(R), *Consolidation of Variable Interest Entities (revised December 2003)—an interpretation of ARB No. 51*, as a result of the QSPE concept. The provisions of FASB Statement Nos. 166 and 167 are found within FASB ASC 860, *Transfers and Servicing,* and FASB ASC 810, respectively.

As a result of this guidance, reporting entity's should now evaluate former QSPEs in consideration of whether the reporting entity has a variable interest in the entity, whether the former QSPE is a VIE, and whether the reporting entity should consolidate the entity or provide

"Variable Interest Entities" subsections of FASB ASC 810-10 applies to that legal entity before considering other consolidation guidance. However, if a reporting entity does not have a direct or indirect (explicit or implicit) variable interest in a legal entity, then the reporting entity is not the primary beneficiary of that legal entity and is not required to provide disclosures for that legal entity under FASB ASC 810-10, "Variable Interest Entities" subsections.

10.77 Per the FASB ASC glossary, a *variable interest* is defined as an investment or other interest that will absorb portions of a variable interest entity's (VIE) expected losses or received portions of the entity's expected residual returns. Variable interests in a VIE are contractual, ownership, or other pecuniary interests in a VIE that change with changes in the fair value of the VIE's net assets exclusive of variable interests. Equity interests with or without voting rights are considered variable interests if the legal entity is a VIE and to the extent that the investment is at risk as described in FASB ASC 810-10-15-14 (see paragraph 10.81). FASB ASC 810-10-25-55 explains how to determine whether a variable interest in specified assets of a legal entity is a variable interest in the entity. Paragraphs 1–41 of FASB ASC 810-10-55 describe various types of variable interest and explain in general how they may affect the determination of the primary beneficiary of a VIE.

10.78 "Pending Content" in paragraphs 37–38 of FASB ASC 810-10-55 provide detailed guidance in determining whether fees paid to a legal entity's decision maker or service provider constitute a variable interest.

10.79 "Pending Content" in paragraphs 9 and 11 of FASB ASC 810-10-05 state that the VIE guidance with FASB ASC 810-10 explains how to identity a VIE and how to determine when a reporting entity includes the assets, liabilities, noncontrolling interests, and results of activities of a VIE in its consolidated financial statements. VIEs are often created for a single specified purpose, for example, to facilitate securitization, leasing, hedging, research and development, reinsurance, or other transactions or arrangements. The distinction between VIEs and other entities is based on the nature and amount of the equity investment and the rights and obligations of the equity investors.

10.80 FASB ASC 810-10-15-12 provides exceptions to consolidation that apply to both VIEs and voting interest entities, whereas "Pending Content" in FASB ASC 810-10-15-17 provides a listing of entities exempt from consolidation under VIE guidance but that may be subject to consolidation under other accounting principles generally accepted in the United States of America (U.S. GAAP).

10.81 *Variable interest entity determination.* According to "Pending Content" in FASB ASC 810-10-15-14, a legal entity should be subject to consolidation under the VIE guidance if, by design, any of the following conditions exist:

a. The total equity investment at risk is not sufficient to permit the legal entity to finance its activities without additional subordinated financial support provided by any parties, including equity holders. For this purpose, the total equity investment at risk has all of the following characteristics:

(footnote continued)

disclosures about its involvement with the former QSPE. Reporting entities should also consider the need to re-evaluate the initial assessments of special purpose entities as VIEs based on the amendments of FASB Statement No. 167.

i. Includes only equity investments in the legal entity that participate significantly in profits and losses even if those investments do not carry voting rights.

ii. Does not include equity interests that the legal entity issued in exchange for subordinated interests in other VIEs.

iii. Does not include amounts provided to the equity investor directly or indirectly by the legal entity or by other parties involved with the legal entity, unless the provider is a parent, subsidiary, or affiliate of the investor that is required to be included in the same set of consolidated financial statements as the investor.

iv. Does not include amounts financed for the equity investor directly by the legal entity or by other parties involved with the legal entity, unless that party is a parent, subsidiary, or affiliate of the investor that is required to be included in the same set of consolidated financial statements as the investor.

Paragraphs 45–47 of FASB ASC 810-10-35 discuss the amount of the total equity investment at risk that is necessary to permit a legal entity to finance its activities without additional subordinated financial support.

b. As a group the holders of the equity investment at risk lack any of the following three characteristics:

i. The power through voting rights or similar rights to direct the activities of a legal entity that most significantly impact the entity's economic performance.

ii. The obligation to absorb the expected losses of the legal entity. The investor or investors do not have that obligation if they are directly or indirectly protected from the expected losses or are guaranteed a return by the legal entity itself or by other parties involved with the legal entity. See paragraphs 55–56 of FASB ASC 810-10-55 for a discussion of expected losses.

iii. The right to receive the expected residual returns of the legal entity. The investors do not have the right if their return is capped by the legal entity's governing documents or arrangements with other variable interest holders or the legal entity.

c. The equity investors as a group also are considered to lack the characteristics in (b)(i) if both of the following conditions are present:

i. The voting rights of some investors are not proportional to their obligations to absorb the expected losses of the legal entity, their rights to receive the expected residual returns of the legal entity, or both.

ii. Substantially all of the legal entity's activities either involve or are conducted on behalf of an investor that has disproportionately few voting rights. This provision is necessary to prevent a primary beneficiary from avoiding consolidation of a VIE by organizing the legal entity with nonsubstantive voting interests.

For purposes of applying this requirement, reporting entities should consider each party's obligations to absorb expected losses and rights to receive expected residual returns related to all of that party's

interests in the legal entity and not only to its equity investment at risk.

10.82 *Reconsideration of VIE status.* A legal entity that previously was not subject to the VIE guidance presented in FASB ASC 810-10 should not become subject to them simply because of losses in excess of its expected losses that reduce the equity investment, according to "Pending Content" in FASB ASC 810-10-35-4. The initial determination of whether a legal entity is a VIE should be reconsidered if any of the following occur:

a. The legal entity's governing documents or contractual arrangements are changed in a manner that changes the characteristics or adequacy of the legal entity's equity investment at risk

b. The equity investment or some part thereof is returned to the equity investors, and other interests become exposed to expected losses of the legal entity

c. The legal entity undertakes additional activities or acquires additional assets, beyond those that were anticipated at the later of the inception of the entity or the latest reconsideration event, that increase the entity's expected losses

d. The legal entity receives an additional equity investment that is at risk, or the legal entity curtails or modifies its activities in a way that decreases its expected losses

e. Changes in facts and circumstances occur such that the holders of the equity investment at risk, as a group, lose the power from voting rights or similar rights of those investments to direct the activities of the entity that most significantly impact the entity's economic performance

10.83 *Primary beneficiary evaluation.* In accordance with "Pending Content" in paragraphs 38–38A of FASB ASC 810-10-25-38, a reporting entity should consolidate a VIE when the reporting entity has a variable interest (or combination of variable interests) that provides the reporting entity with a controlling financial interest on the basis of the provisions in paragraphs 38A–38G of FASB ASC 810-10-25. A reporting entity should be deemed to have a controlling financial interest in a VIE, and thus is the VIE's primary beneficiary, if it has both of the following characteristics:

a. The power to direct the activities of the VIE that most significantly impact the VIE's economic performance

b. The obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE

10.84 For purposes of determining whether a reporting entity is the primary beneficiary of a VIE held by its related parties, FASB ASC 810-10-25-42 states that the reporting entity with a variable interest should treat variable interests in that same VIE held by its related parties as its own interests. FASB ASC 810-10-25-43 provides guidance on related parties and de facto agents. In situation in which a reporting entity concludes that neither it nor one of its related parties has the characteristics in FASB ASC 810-10-25-38A but, as a group, the reporting entity and its related parties (including de facto agents) have those characteristics, then FASB ASC 810-10-25-44 states that the party within the related party group that is most closely associated with the VIE is the primary beneficiary. The determination of which party within the related party group is most closely associated with the VIE requires

judgment and should be based on analysis of all relevant facts and circumstances, including all of the following:

a. The existence of a principal-agency relationship between parties within the related party group

b. The relationship and significance of the activities of the VIE to the various parties within the related party group

c. A party's exposure to the variability associated with anticipated economic performance of the VIE

d. The design of the VIE

10.85 Once a reporting entity has determined itself to be the primary beneficiary of a VIE, the reporting entity must consolidate the VIE. In addition, a reporting entity with a variable interest in a VIE must also provide disclosures about its involvement with the VIE, regardless of whether it is the primary beneficiary of the VIE.

10.86 *Financial Statement Presentation.* "Pending Content" in FASB ASC 810-10-45-25 states that a reporting entity should present each of the following separately on the face of the statement of financial position:

a. Assets of a consolidated VIE that can be used only to settle obligations of the consolidated VIE

b. Liabilities of a consolidated VIE for which creditors (or beneficial interest holders) do not have recourse to the general credit of the primary beneficiary

10.87 *Primary beneficiary of a VIE disclosure requirements.* "Pending Content" in FASB ASC 810-10-50-3 states the primary beneficiary of a VIE that is not a business should disclose the amount of gain or loss recognized on the initial consolidation of the VIE. In addition to other disclosures of FASB ASC 810, *Consolidation*, the primary beneficiary should disclose all of the following (unless the primary beneficiary also holds a majority voting interest):

a. The carrying amounts and classification of the VIE's assets and liabilities in the statement of financial position that are consolidated in accordance with VIE guidance in FASB ASC 810-10, including qualitative information about the relationship(s) between those assets and liabilities

b. Lack of recourse if creditors (or beneficial interest holders) of a consolidated VIE have no recourse to the general credit of the primary beneficiary

c. Terms of arrangements, giving consideration to both explicit arrangements and implicit variable interests that could require the reporting entity to provide financial support to the VIE, including events or circumstances that could expose the reporting entity to a loss

10.88 *Nonprimary beneficiary holder of a significant variable interest in a VIE disclosure requirements.* "Pending Content" in FASB ASC 810-10-50-4 states that in addition to disclosures required by other guidance, a reporting entity that holds a variable interest in a VIE, but is not the VIE's primary beneficiary, should disclose

a. the carrying amounts and classification of the assets and liabilities in the reporting entity's statement of financial position that relate to the reporting entity's variable interest in the VIE.

b. the reporting entity's maximum exposure to loss as a result of its involvement with the VIE, including how the maximum exposure is determined and the significant sources of the reporting entity's exposure to the VIE. If the reporting entity's maximum exposure to loss as a result of its involvement with the VIE cannot be quantified, that fact should be disclosed.

c. a tabular comparison of the carrying amounts of the assets and liabilities, as required by item (*a*), and the reporting entity's maximum exposure to loss, as required by item (*b*). A reporting entity should provide qualitative and quantitative information to allow financial statement users to understand the differences between the two amounts. That discussion should include, but is not limited to, the terms of arrangements, giving consideration to both explicit arrangements and implicit variable interests, that could require the reporting entity to provide financial support (for example, liquidity arrangements and obligations to purchase assets) to the VIE, including events or circumstances that could expose the reporting entity to a loss.

d. information about any liquidity arrangements, guarantees, and/or other commitments by third parties that may affect the fair value or risk of the reporting entity's variable interest in the VIE is encouraged.

e. if applicable, significant factors considered and judgments made in determining that the power to direct the activities of a VIE that most significantly impact the VIE's economic performance is shared in accordance with the guidance in FASB ASC 810-10-25-38D.

10.89 *Primary beneficiaries or other holders of interests in VIEs disclosure requirements.* "Pending Content" in FASB ASC 810-10-50-5A states that a reporting entity that is a primary beneficiary of a VIE or a reporting entity that holds a variable interest in a VIE but is not the entity's primary beneficiary should disclose all of the following:

a. Its methodology for determining whether the reporting entity is the primary beneficiary of a VIE, including, but not limited to, significant judgments and assumptions made. One way to meet this disclosure requirement would be to provide information about the types of involvements a reporting entity considers significant, supplemented with information about how the significant involvements were considered in determining whether the reporting entity is the primary beneficiary.

b. If facts and circumstances change such that the conclusion to consolidate a VIE has changed in the most recent financial statements (for example, the VIE was previously consolidated and is not currently consolidated), the primary factors that caused the change and the effect on the reporting entity's financial statements.

c. Whether the reporting entity has provided financial or other support (explicitly or implicitly) during the periods presented to the VIE that it was not previously contractually required to provide or whether the reporting entity intends to provide that support, including both of the following:

   i. The type and amount of support, including situations in which the reporting entity assisted the VIE in obtaining another type of support.

ii. The primary reasons for providing the support.

d. Qualitative and quantitative information about the reporting entity's involvement (giving consideration to both explicit arrangements and implicit variable interests) with the VIE, including, but not limited to, the nature, purpose, size, and activities of the VIE, including how the VIE is financed. Paragraphs 48–54 of FASB ASC 810-10-25 and example 4 (see FASB ASC 810-10-55-87) provide guidance on how to determine whether a reporting entity has an implicit variable interest in a VIE.

10.90 *Aggregation of Certain Disclosures.* "Pending Content" in FASB ASC 810-10-50-9 states that disclosures about VIEs may be reported in the aggregate for similar entities if separate reporting would not provide more useful information to financial statement users. A reporting entity should disclose how similar entities are aggregated and should distinguish between:

a. VIEs that are not consolidated because the reporting entity is not the primary beneficiary but has a significant variable interest

b. VIEs that are consolidated

In determining whether to aggregate VIEs, the reporting entity should consider quantitative and qualitative information about the different risk and reward characteristics of each VIE and the significance of each VIE to the entity. The disclosures should be presented in a manner that clearly and fully explains to financial statement users the nature and extent of an entity's involvement with VIEs.

10.91 In accordance with "Pending Content" in FASB ASC 810-10-50-10, a reporting entity should determine, in light of the facts and circumstances, how much detail it should provide to satisfy the requirements of the VIE guidance presented in FASB ASC 810-10. A reporting entity should also determine how it aggregates information to display its overall involvements with VIEs with different risk characteristics. The reporting entity must strike a balance between obscuring important information as a result of too much aggregation and overburdening financial statements with excessive detail that may not assist financial statement users to understand the reporting entity's financial position.

VA No-Bids and Private Mortgage Agencies

10.92 Historically, the VA paid lenders 100 percent of the outstanding debt on defaulted loans that the VA guaranteed. In return, the lenders turned the borrowers' houses over to the VA, which would dispose of them. The VA had the option of guaranteeing the lesser of 60 percent of a loan's original balance or $27,500, leaving the property with the lender if that is less costly for the agency. Called a *no-bid option*, this practice was seldom used, especially because inflation pushed up housing prices during the late 1970s and early 1980s. However, as inflation began to slow and the costs of carrying foreclosed houses began to rise, the VA began to invoke the no-bid option.

10.93 On October 1, 2008, the VA issued Circular 26-08-19, *Implementation of Loan Guarantee Provisions of Public Law 110-389*. Section 501 of Public Law 110-389 provides a temporary increase in the maximum guaranty amount for loans closed January 1, 2009, through December 31, 2011. During this period, the "maximum guaranty amount" set forth in this circular should be substituted for the maximum guaranty amount specified at *Veterans' Benefits*, U.S. Code Title 38, Section 3703(a)(1)(C), Title 38 CFR Parts 36.4302(a)(4) and

36.4802(a)(4), and in the VA Lender's Handbook. The guaranty amount for loans remains unchanged where the original principal loan amount is $417,000 or less. If the original principal loan amount is greater than $417,000, the VA will guarantee 25 percent of the original principal loan amount, up to the maximum guaranty amount. The maximum guaranty amount varies depending upon the location of the property. In February 2009, the VA issued changes to Circular 26-08-19 to clarify entitlement calculations for certain veterans with previously used, unrestored entitlement. Readers are encouraged to refer to the U.S. Department of Veterans Affairs website for details regarding the maximum guarantee calculation.

10.94 Institutions may incur losses due to the uncollectibility of receivables from other government programs such as the Federal Housing Administration or Ginnie Mae, from other investors such as Freddie Mac and Fannie Mae, or from insolvent private mortgage insurers.

10.95 With the increased risk of foreclosure losses (including unrecoverable interest advances; foreclosure costs such as attorneys' fees, inspections, and so forth; and the implicit cost to carry the asset until ultimate sale), the evaluation of loss allowances on VA and privately insured mortgage loans has become increasingly difficult. Chapter 11, "Real Estate Investments, Real Estate Owned, and Other Foreclosed Assets," provides guidance on the valuation of foreclosed real estate, and chapter 9, provides guidance on the evaluation of the collectibility of real estate loans.

Financial Statement Presentation

10.96 Loans or trade receivables may be presented on the balance sheet as aggregate amounts, as stated in FASB ASC 310-10-45-2. However, such receivables HFS should be a separate balance sheet category. Nonmortgage loans HFS should be reported at the lower of cost or fair value, as stated in FASB ASC 310-10-35-48.

10.97 FASB ASC 310-10-50-3 states that if major categories of loans or trade receivables are not presented separately in the balance sheet, they should be presented in the notes to the financial statements. FASB ASC 860-20-50-5 states that the aggregate amount of gains or losses on sales of loans or trade receivables (including adjustments to record loans HFS at the lower of cost or fair value) should be presented separately in the financial statements or disclosed in the notes to the financial statements.

10.98 As explained in FASB ASC 230-10-45-21, cash receipts and cash payments resulting from acquisitions and sales of loans should be classified as operating cash flows if those loans are acquired specifically for resale and are carried at market value or at the lower of cost or market value. For example, mortgage loans HFS are required to be reported at the lower of cost or market value in accordance with FASB ASC 948. Receipts from collections or sales of loans made by the entity and of other entities' debt instruments (other than cash equivalents and certain debt instruments that are acquired specifically for resale as discussed in FASB ASC 230-10-45-21) that were purchased by the entity, are cash inflows from investing activities, according to FASB ASC 230-10-45-12(a).

10.99 Many financial institutions currently present gains or losses on sales of loans or trade receivables separately on the face of the income statement. The financial statement disclosure requirements do not prohibit this industry practice.

10.100 FASB ASC 948-310-50-1 requires the an entity to disclose method used in determining the lower of cost or fair value of mortgage loans (that is, aggregate or individual loan basis).

10.101 In addition, see chapter 18, "Derivative Instruments: Futures, Forwards, Options, Swaps, and Other Derivative Instruments," in this guide for accounting and financial reporting of derivative instruments recognized in connection with mortgage banking activities.

10.102 FASB ASC 825-10-45 addresses financial statement presentation if the fair value option is elected for mortgage loans HFS.

Financial Statement Disclosure

10.103 FASB ASC 860 provides disclosure requirements for transfers and servicing of financial assets, including sales of financial assets, secured borrow and collateral, and servicing assets and liabilities. Paragraphs 3–7 of FASB ASC 860-10-50 provide detailed guidance regarding the principal objectives of the disclosure requirements of FASB ASC 860 as well as consideration of disclosure aggregation. The specific disclosures required by FASB ASC 860 are minimum requirements, and an entity may need to supplement the required disclosures depending on factors provided in FASB ASC 860-10-50-4.

10.104 *Secured borrowing and collateral disclosure requirements*. An entity should disclose all of the following for collateral, as stated in FASB ASC 860-30-50-1A:

a. If the entity has entered into repurchase agreements or securities lending transactions, it should disclose its policy for requiring collateral or other security.

b. As of the date of the latest statement of financial position presented, both of the following:

  i. The carrying amount and classification of any assets pledged as collateral that are not reclassified and separately reported in the statement of financial position in accordance with FASB ASC 860-30-25-5(a) and associated liabilities.

  ii. Qualitative information about the relationship(s) between those assets and associated liabilities; for example, if assets are restricted solely to satisfy a specific obligation, a description of the nature of restrictions placed on those assets.

c. If the entity has accepted collateral that it is permitted by contract or custom to sell or repledge, it should disclose all of the following:

  i. The fair value as of the date of each statement of financial position presented of that collateral.

  ii. The fair value as of the date of each statement of financial position presented of the portion of that collateral that it has sold or repledged.

  iii. Information about the sources and uses of that collateral.

10.105 *Servicing assets and servicing liabilities disclosure requirements*. For all servicing assets and servicing liabilities, an entity should disclose all of the following, according to FASB ASC 860-50-50-2:

a. Management's basis for determining its classes of servicing assets and servicing liabilities

b. A description of the risks inherent in servicing assets and servicing liabilities and, if applicable, the instruments used to mitigate the income statement effect of changes in fair value of the servicing assets and servicing liabilities

c. The amount of *contractually specified servicing fees* (which is defined in the FASB ASC glossary), late fees, and ancillary fees earned for each period for which results of operations are presented, including a description of where each amount is reported in the statement of income

d. Quantitative and qualitative information about the assumptions used to estimate fair value (for example, discount rates, anticipated credit losses, and prepayment speeds)

Disclosure of quantitative information about the instruments used to manage the risks inherent in servicing assets and servicing liabilities, including the fair value of those instruments at the beginning and end of the period, is encouraged but not required. An entity that provides such quantitative information is also encouraged, but not required, to disclose quantitative and qualitative information about the assumptions to estimate the fair value of those instruments. FASB ASC 235-10-50 provides guidance on disclosures of accounting policies.

10.106 For servicing assets and servicing liabilities subsequently measured at fair value, FASB ASC 860-50-50-3 states that for each class of servicing assets and servicing liabilities, the activity in the balance of servicing assets and the activity in the balance of servicing liabilities (including a description of where changes in fair value are reported in the statement of income for each period for which results of operations are presented), including, but not limited to, the following:

a. The beginning and ending balances

b. Additions through purchases of servicing assets, assumptions of servicing obligations, and servicing obligations that result from transfers of financial assets

c. Disposals

d Changes in fair value during the period resulting from either changes in valuation inputs or assumptions used in the valuation model or other changes in fair value and a description of those changes

e. Other changes that affect the balance and a description of those changes

10.107 For all entities within the scope of FASB ASC 860-50, all of the following should be disclosed for servicing assets and servicing liabilities measured subsequently under the amortization method in FASB ASC 860-50-35-1(a), according to FASB ASC 860-50-50-4:

a. For each class of servicing assets and servicing liabilities, the activity in the balance of servicing assets and the activity in the balance of servicing liabilities (including a description of where changes in the carrying amount are reported in the statement of income for each period for which results of operations are presented), including, but not limited to, the following:

i. The beginning and ending balances.

ii. Additions through purchases of servicing assets, assumption of servicing obligations, and recognition of servicing obligations that result from transfers of financial assets.

iii. Disposals.

iv. Amortization.

v. Application of valuation allowance to adjust carrying value of servicing assets.

vi. Other-than-temporary impairments.

vii. Other changes that affect the balance and a description of those changes.

b. For each class of servicing assets and servicing liabilities, the fair value of recognized servicing assets and servicing liabilities at the beginning and end of the period.

c. The risk characteristics of the underlying financial assets used to stratify recognized servicing assets for purposes of measuring impairment in accordance with FASB ASC 860-50-35-9. If the predominant risk characteristics and resulting stratums are changed, that fact and the reasons for those changes should be included in the disclosures about the risk characteristics of the underlying financial assets used to stratify the recognized servicing assets in accordance with this paragraph.

d. For each period for which results of operations are presented, the activity by class in any valuation allowance for impairment of recognized servicing assets including all of the following:

i. Beginning and ending balances.

ii. Aggregate additions charged and recoveries credited to operations.

iii. Aggregate write-downs charged against the allowance.

10.108 *Sales of financial assets disclosure requirements*. For securitizations, asset-backed financing arrangements, and similar transfers accounted for as sales when the transferor has continuing involvement with the transferred financial assets, the entity should disclose all of the following for each income statement presented, as stated in FASB ASC 860-20-50-3:

a. The characteristics of the transfer including all of the following:

i. A description of the transferor's continuing involvement with the transferred financial assets.

ii. The nature and initial fair value of both (*a*) the asset obtained as proceeds and (*b*) the liabilities incurred in the transfer.

iii. The gain or loss from sale of transferred financial assets.

b. For the initial fair value measurements in item (*a*)(ii), the level within the fair value hierarchy in FASB ASC 820 in which the fair value measurement fall, segregating fair value measurements using each of the following:

i. Quoted prices in active markets for identical assets or liabilities (level 1).

ii. Significant other observable inputs (level 2).

iii. Significant unobservable inputs (level 3).

c. For the initial fair value measurements in item (a)(ii), the key inputs and assumptions used in measuring the fair value of assets obtained and liabilities incurred as a result of the sale that relate to the

transferor's continuing involvement, including quantitative information about all of the following:

i. Discount rates.

ii. Expected prepayments including the expected weighted-average life of prepayable financial assets. The weighted-average life of prepayable assets in periods (for example, months or years) can be calculated by multiplying the principal collections expected in each future period by the number of periods until that future period, summing those products, and dividing the sum by the initial principal balance.

iii. Anticipated credit losses, including expected static pool losses.

If an entity has aggregated transfers during a period in accordance with the guidance beginning in FASB ASC 860-10-50-5, it may disclose the range of assumptions.

d. For the initial fair value measurements in item (*a*)(ii), the valuation technique(s) used to measure fair value.

e. Cash flows between a transferor and transferee, including all of the following:

i. Proceeds from new transfers.

ii. Proceeds from collections reinvested in revolving-period transfers.

iii. Purchases of previously transferred financial assets.

iv. Servicing fees.

v. Cash flows received from a transferor's interests.

10.109 For securitizations, asset-backed financing arrangements, and similar transfers accounted for as sales when the transferor has continuing involvement with the transferred financial assets, the entity should disclose all of the following for each statement of financial position presented, according to FASB ASC 860-20-50-4:

a. Qualitative and quantitative information about the transferor's continuing involvement with transferred financial assets that provides financial statement users with sufficient information to assess the reasons for the continuing involvement and the risks related to the transferred financial assets to which the transferor continues to be exposed after the transfer and the extent that the transferor's risk profile has changed as a result of the transfer (including, but not limited to, credit risk, interest rate risk, and other risks), including all of the following:

i. The total principal amount outstanding

ii. The amount that has been derecognized

iii. The amount that continues to be recognized in the statement of financial position

iv. Whether the transferor has provided financial or other support during the periods presented that it was not previously contractually required to provide to the transferee or its beneficial interest holders, including—when the transferor assisted the transferee or its beneficial interest holders in obtaining support—

both (*a*) the type and amount of support and (*b*) the primary reasons for providing the support

An entity also is encouraged to disclose information about any liquidity arrangements, guarantees, or other commitments by third parties related to the transferred financial assets that may affect the fair value or risk of the related to transferor's interest.

b. The entity's accounting policies for subsequently measuring assets or liabilities that relate to the continuing involvement with the transferred financial assets.

c. The key inputs and assumptions used in measuring the fair value of assets or liabilities that relate to the transferor's continuing involvement including, at a minimum, but not limited to, quantitative information about all of the following:

   i. Discount rates.

   ii. Expected prepayments including the expected weighted-average life of prepayable financial assets (see FASB ASC 860-20-50-3(c)(ii)).

   iii. Anticipated credit losses, including expected static pool losses, if applicable. Expected static pool losses can be calculated by summing the actual and projected future credit losses and dividing the sum by the original balance of the pool of assets.

If an entity has aggregated transfers during a period in accordance with the guidance beginning in FASB ASC 860-10-50-5, it may disclose the range of assumptions.

d. For the transferor's interest in the transferred financial assets, a sensitivity analysis or stress test showing the hypothetical effect on the fair value of those interests (including any servicing assets or servicing liabilities) of two or more unfavorable variations from the expected levels for each key assumption that is reported under item (*b*) independently from any change in another key assumption.

e. A description of the objectives, methodology, and limitations of the sensitivity analysis or stress test.

f. Information about the asset quality of transferred financial assets and any other financial assets that it manages together with them. This information should be separated between assets that have been derecognized and assets that continue to be recognized in the statement of financial position. This information is intended to provide financial statement users with an understanding of the risks inherent in the transferred financial assets as well as in other financial assets and liabilities that it manages together with transferred financial assets. For example, information for receivables should include, but is not limited to both of the following:

   i. Delinquencies at the end of the period.

   ii. Credit losses, net of recoveries, during the period.

10.110 In addition, see chapter 18 for disclosures required for derivative instruments recognized in connection with mortgage banking activities.

10.111 FASB ASC 820-10-50 and FASB ASC 825-10-50 provide additional guidance related to fair value disclosures.[†]

Auditing

Objectives

10.112 Audit objectives and procedures for loan origination and underwriting are discussed in chapter 8. Audit objectives and procedures for securities, including MBSs, are addressed in chapter 7. The primary audit objectives in this area are to obtain sufficient appropriate evidence that

a. loans HFS exist and are the property of the institution;

b. loans HFS are carried at the lower of cost or fair value, or at fair value if that election has been made;

c. loans HFS are properly classified, described, and disclosed in the financial statements;

d. transfers of financial assets have been properly accounted for as sales or secured borrowings;

e. gains and losses on the transfer of financial assets or servicing rights are properly measured, recorded, and disclosed;

f. assets obtained and liabilities incurred as a result of a transfer of a financial asset accounted for as a sale are properly recognized and measured initially and on an ongoing basis;

g. proper title has passed to the holder of purchased servicing rights;

h. derivatives are properly identified, valued, recorded and disclosed; and

i. the entity has complied with the disclosure objectives for transfers of financial assets in FASB ASC 860 for all transfers of financial assets and other applicable disclosures.

Planning

10.113 In accordance with AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), the auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures (as described in chapter 5, "Audit Considerations and Certain Financial Reporting Matters.") The following procedures related to loan transfers and mortgage banking activities assist the auditor in obtaining the required understanding:

a. Obtain an understanding of the entity's transfer and servicing activities

b. Inquire about the nature and frequency of transfers, the types of loans transferred, and the nature of obligations incurred

c. Inquire about the bookkeeping and reporting systems employed both at the time of transfer and thereafter

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[†] See footnote † in paragraph 10.23.

10.114 The auditor should obtain an understanding of mortgage banking activities in which the institution is engaged. The auditor should inquire about how the mortgage banking activities relate to management's objectives for managing interest-rate risk and enhancing liquidity. The auditor should inquire about the reporting systems used by management to account for mortgage banking activities and should consider whether management has sufficient data to evaluate loan sale transactions, identify loans HFS, and track mortgage loan commitments and applications. Such information is usually needed to manage risks arising from mortgage banking activities.

10.115 Institutions acting as servicers of loans have a fiduciary responsibility to parties under the agreement. Failure to meet these responsibilities may result in contingent liabilities that could have a material effect on an institution's financial statements. Under contracts with third parties such as Ginnie Mae, Freddie Mac, Fannie Mae, and the Department of Housing and Urban Development (HUD), an institution must meet certain minimum net worth requirements. Failure to meet the requirements could result in termination of the servicing contract or the loss of a seller servicer number. In addition, the auditor should consider whether an institution's servicing systems ensure proper controls over investor and escrow accounts (for example, for taxes and insurance or loan principal and interest) and evaluate the potential for contingencies liabilities associated with noncompliance with investor-servicing requirements.

10.116 Contractual agreements with Ginnie Mae, Freddie Mac, Fannie Mae, HUD, or other investors may require engagements related to aspects of the contractual agreement or to the Securities and Exchange Commission Regulation AB or the Uniform Single Attestation Program for mortgage bankers. These agreements may require confirmation work on the actual loans being serviced under specific contracts.

Internal Control Over Financial Reporting and Possible Tests of Controls

10.117 AU section 314 establishes standards and provides guidance on obtaining a sufficient understanding of the entity and its environment, including its internal control. It provides guidance on understanding the components of internal control and explains how an auditor should obtain a sufficient understanding of internal control for the purposes of assessing the risks of material misstatement. Paragraph .40 of AU section 314 requires that, in all audits, the auditor should obtain an understanding of the 5 components of internal control (the control environment, risk assessment, control activities, information and communication systems, and monitoring), sufficient to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. The auditor should obtain a sufficient understanding by performing risk assessment procedures to evaluate the design of controls relevant to an audit of financial statements and to determine whether they have been implemented. Paragraph .102 of AU section 314 states that the auditor should identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions, account balances, and disclosures.

10.118 The discussions of internal control activities in chapters 8 and 9 are also relevant to loan transfers and mortgage banking activities.

10.119 *Policies and procedures.* Examples of typical internal control activities relating to financial reporting of mortgage banking activities include, but are not limited to,

- use of a quality control function to monitor underwriting and documentation practices;
- executive management review of open and pending commitments to buy or sell and strategies to minimize exposure to changing interest rates;
- loans sold with servicing released or retained are properly identified for derecognition;
- periodic reconciliation of cash receipts and payments applied to the servicing (custodial) system;
- periodic reconciliations of custodial accounts (the level of account activity could determine the frequency of reconciliation);
- periodic reconciliation of servicing fees received to servicing fee income recorded in the general ledger;
- periodic evaluation of the recoverability of servicing rights and other capitalized costs; and
- distinguishing loans HFS from those held for investment.

10.120 Examples of typical internal control activities relating to financial reporting of loan transfers include, but are not limited to,

- approval of sales by appropriate officers or committees;
- periodic reconciliations of detailed trial balances to the general ledger balance of loans HFS;
- periodic review of the outstanding loans and locked-in borrower commitments for proper valuation;
- procedures in place to ensure that derivative loan commitments, derivative sales contracts, and loans HFS are properly identified and valued;
- procedures in place to ensure that interest and fee income and gains or losses on sales are properly recorded, and information required for GAAP disclosures is available;
- procedures in place to ensure that assets obtained and liabilities incurred as a result of a transfer of a financial asset accounted for as a sale are properly accounted for initially and on an ongoing basis; and
- procedures in place to ensure that loans HFS are properly identified.

10.121 The auditor should perform tests of controls when the auditor's risk assessment includes an expectation of the operating effectiveness of controls or when substantive procedures alone do not provide sufficient appropriate audit evidence at the relevant assertion level. Tests of controls that may be used to obtain evidence to support such an assessment include

- selecting a sample of borrower remittances and testing allocation of payment amounts to income, principal, escrow, and service fee accounts;
- reviewing custodial account reconciliations and supporting documentation to ensure that all activity is processed and cleared currently;

- selecting a sample of delinquent loans serviced and considering whether collection and follow-up procedures are performed on a timely basis and are in accordance with investor requirements; and
- examining loan documentation. (See chapter 8.)

10.122 The following are tests of controls that may be used by the auditor to ensure that internal controls over financial reporting of loan transfers are operating effectively:

- Examine applicable loan sale and servicing agreements.
- Determine that the appropriate personnel understand the accounting treatment for sales of loans and related financial reporting implications.
- Examine accounting records to determine that verification procedures are effectively performed to ensure interest and fee income and gains or losses on sales of loans are properly recorded.

Substantive Tests

10.123 Regardless of the assessed risks of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions related to transfers of loans and mortgage banking activities.

10.124 The auditor should determine the nature, timing, and extent of substantive tests based on an assessment of the risks of material misstatements. Substantive tests that the auditor may perform include the following:

- Selecting a sample of borrower remittances and testing allocation of payment amounts to income, principal, escrow, and service fee accounts.
- Obtaining and testing the documentation supporting escrow and investor account reconciliations. (Custodial accounts may be off-balance-sheet accounts. Accordingly, the auditor may need to select custodial accounts from records independent of the general ledger. In this case, the auditor may need to perform separate tests of the completeness and accuracy of custodial records.)
- Obtaining and testing supporting documentation for derivatives and related fair value determinations.
- Evaluating the propriety of loan classifications to determine that all loans HFS within the loan portfolio are properly identified. (In evaluating whether loans are HFS or in the loan portfolio, the auditor should consider management policy and practices, for example, previous loan sale activity, types of loans sold, transactions subsequent to year-end, and pending contracts, and whether management has the ability and intent to hold the loans for the foreseeable future or until maturity.)
- Reviewing the documentation and recalculating the amounts supporting the measurement of lower of cost or fair value for loans HFS, or fair value should that election have been made.
- Selecting a sample of loan sales made during the period and reviewing investor contracts to evaluate whether sale-versus-secured borrowing treatment and servicing assets and liabilities have been recognized properly.

- Recalculating a sample of loan sale transactions to test calculation of weighted-average rates and corresponding gains or losses and vouching payments received for those transactions.
- Analytically projecting service fees for comparison with service fee revenues reported in operating income for the period.
- Analytically reviewing gain on sale to the volume of loans sold.
- Analytically reviewing the fair values of derivative loan commitments, derivative sales contracts, and loans HFS against the related notional amount and for directional consistency between the accounts.
- Evaluating the adequacy of valuation allowances for servicing and escrow advances. (Some investors require that contractual interest and principal be remitted to them by the servicer regardless of mortgagor performance. Advances of such amounts are frequently made in anticipation of borrower performance and generally must be tracked on an individual basis to limit exposure to uncollectible advances.)
- For servicing rights, reviewing the assumptions used in the valuation process, considering their current reasonableness, and evaluating the effect of changes in assumptions on impairment.
- Analyzing prepayment data used by management to calculate value of servicing rights at sale date and the systems used to update prepayment data over time for actual prepayment experience, selecting a sample of loan pools sold in prior periods, and comparing the actual current loan balance with estimates.
- Analytically reviewing the amount of initial servicing right and ending servicing right in relation to the related loan balances.
- Evaluating the method of amortizing servicing rights.
- Evaluating the adequacy of the liability for recourse obligations. (Loan sale/servicing agreements generally address recourse provisions and should be reviewed for all substantial investors to ensure that portfolios sold with recourse are included in recourse liability considerations.)
- Confirming selected loan balances serviced for others and related information directly with the borrower.

10.125 Interpretation No. 1, "The Use of Legal Interpretations As Audit Evidence to Support Management's assertion That A Transfer of Financial Assets Has Met the Isolation Criterion in Paragraphs 7–14 of Financial Accounting Standards Board Accounting Standards Codification 860-10-40," of AU section 336, *Using the Work of a Specialist* (AICPA, *Professional Standards*, AU sec. 9336 par. .01–.21), provides guidance to the auditor in obtaining sufficient appropriate audit evidence when an entity has derecognized financial assets in connection with a transfer to another entity.

Chapter 11

Real Estate Investments, Real Estate Owned, and Other Foreclosed Assets

Introduction

11.01 Generally, the largest component of real estate owned (REO) by lenders is assets taken in settlement of troubled loans through surrender or foreclosure. Real estate investments, real estate loans that qualify as investments in real estate, and premises that are no longer used in operations may also be included in REO. Furthermore, institutions may obtain assets other than real estate through foreclosure, and those assets also are addressed in this chapter.

Foreclosed Assets

11.02 Foreclosed assets include all assets received in full or partial satisfaction of a receivable and include real and personal property; equity interests in corporations, partnerships, and joint ventures; and beneficial interests in trusts. Foreclosed assets also include loans that are treated as if the underlying collateral had been foreclosed because the institution has taken possession of the collateral, even though legal foreclosure or repossession proceedings have not taken place.

Real Estate Investments

11.03 Some institutions make direct equity investments in real estate projects.

11.04 Further, in some loans accounted for as real estate investments, institutions have virtually the same risks and rewards as those of owners or joint venture participants. Such arrangements are treated as if the institution actually has an ownership interest in the property. In such arrangements, the lender participates in expected residual profits, which may be in the form of an equity kicker or a higher than usual effective interest rate. At the outset and during the construction and development of the property, the borrower generally has little or no equity in the property and the institution's only source of repayment is the property. The institution generally (*a*) agrees to provide substantially all funds to acquire, develop, and construct the property, (*b*) funds the commitment or origination fees or both, and (*c*) funds interest during the development and construction of the property.

Regulatory Matters

11.05 Certain provisions, not present in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 360, *Property, Plant, and Equipment*, are prevalent practices in the banking industry and are consistent with safe and sound banking practices and the accounting objectives set forth in Section 37(a) of the Federal Deposit Insurance Act. These provisions have been incorporated into the glossary of the Consolidated Reports of Condition and Income instructions. The instructions state

- when a bank receives a long-lived asset, such as real estate, from a borrower in full satisfaction of a loan, the long-lived asset is rebuttably presumed to be held for sale (HFS) and the bank shall account for this asset at its fair value less cost to sell. This fair value (less cost to sell) becomes the "cost" of the foreclosed asset; and
- after foreclosure, each foreclosed real estate asset (including any real estate for which the bank receives physical possession, regardless of whether formal foreclosure proceedings take place) must be carried at the lower of (1) the fair value of the asset minus the estimated costs to sell the asset or (2) the cost of the asset (as defined in the preceding paragraphs). This determination must be made on an asset-by-asset basis.

11.06 Office of Thrift Supervision (OTS) policy does not automatically require general allowances on REO. However, OTS policy states that an association should establish general allowances when the association is likely to experience losses on the disposition of REO in excess of any fair-value estimates, or is likely to incur costs during the holding period for REO that are not reflected in the carrying value. Also, OTS regulatory capital standards require certain real estate assets to be deducted from available regulatory capital.

11.07 Voluntary direct investments in real estate are generally limited for national banks, as described in Title 12 U.S. *Code of Federal Regulations* Part 7.100. State member banks may invest in real estate only with the prior approval of the Federal Reserve Board as described in Regulation H.

Accounting and Financial Reporting

Foreclosed Assets

11.08 FASB ASC 310-40 establishes guidance on the accounting for and the reporting of foreclosed assets.

11.09 FASB ASC 310-10-35-32 requires that, regardless of the measurement method, a creditor should measure impairment based on the fair value of the collateral if the creditor determines that foreclosure is probable. Further, FASB ASC 310-40-40-6 provides that a troubled debt restructuring that is in substance a repossession or foreclosure by the creditor, that is, the creditor receives physical possession of the debtor's assets regardless of whether formal foreclosure proceedings take place, or in which the creditor otherwise obtains one or more of the debtor's assets in place of all or part of the receivable, should be accounted for according to the provisions of FASB ASC 310-40-35-7 and paragraphs 2–4 of FASB ASC 310-40-40 and if appropriate, FASB ASC 310-40-40-8.

11.10 According to FASB ASC 310-40-40-7, in a transaction having all of the characteristics set forth in FASB ASC 310-40-40-6A, the foreclosed property should be recorded at the lower of the net amount of the receivable or fair value of the property. The net receivable assumes that the accrual of interest income on the financing, if any, is appropriate under the circumstances. FASB ASC 310, *Receivables*, would be applied to a foreclosure related to a sale accounted for under the full accrual method, and if appropriate, the repossessed property would be recorded at its fair value. The "Impairment and Disposal of Long-Lived Assets" subsections of FASB ASC 360-10 require a foreclosed asset that

is newly acquired and that is classified as HFS to be recognized at the lower of its carrying value or fair value less cost to sell.

11.11 FASB 310-10-45-3 requires that foreclosed and repossessed assets should be classified as a separate balance sheet amount or included in other assets in the balance sheet, with separate disclosures in the notes to the financial statements. Certain returned or repossessed assets, such as inventory, should not be classified separately if the assets subsequently are to be utilized by the entity in operations.

Accounting and Reporting for Long-Lived Assets to Be Disposed of by Sale

11.12 The "Impairment or Disposal of Long-Lived Assets" subsections of FASB ASC 360-10 provide guidance for measurement of long-lived assets to be disposed of by sale.

11.13 FASB ASC 360-10-45-9 states that a long-lived asset (disposal group) to be sold should be classified as HFS in the period in which all of the following criteria are met:

a. Management, having the authority to approve the action, commits to a plan to sell the asset (disposal group).

b. The asset (disposal group) is available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such assets (disposal groups).

c. An active program to locate a buyer and other actions required to complete the plan to sell the asset (disposal group) have been initiated.

d. The sale of the asset (disposal group) is probable, and transfer of the asset (disposal group) is expected to qualify for recognition as a completed sale, within one year, except as permitted by FASB ASC 360-10-45-11.

e. The asset (disposal group) is being actively marketed for sale at a price that is reasonable in relation to its current fair value. The price at which a long-lived asset (disposal group) is being marketed is indicative of whether the entity currently has the intent and ability to sell the asset (disposal group). A market price that is reasonable in relation to fair value indicates that the asset (disposal group) is available for immediate sale, whereas a market price in excess of fair value indicates that the asset (disposal group) is not available for immediate sale.

f. Actions required to complete the plan indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn.

11.14 FASB ASC 360-10-45-10 states that if, at any time, the preceding criteria are no longer met (except as permitted by FASB ASC 360-10-45-11), a long-lived asset (disposal group) classified as HFS should be reclassified as held and used in accordance with FASB ASC 360-10-35-44.

11.15 FASB ASC 360-10-35-43 states that a long-lived asset (disposal group) classified as HFS should be measured at the lower of its carrying amount or fair value less cost to sell. If the asset (disposal group) is newly acquired, the carrying amount of the asset (disposal group) should be established based on

its fair value less cost to sell at the acquisition date. A long-lived asset should not be depreciated (amortized) while it is classified as HFS. Interest and other expenses attributable to the liabilities of a disposal group classified as HFS should continue to be accrued.

11.16 A valuation allowance for a loan collateralized by a long- lived asset should not be carried over as a separate element of the cost basis for purposes of accounting for the long-lived asset under FASB ASC 360 after foreclosure, as stated in FASB ASC 310-40-40-10.

11.17 In accordance with FASB ASC 360-10-35-40, a loss should be recognized for any initial or subsequent write-down to fair value less cost to sell. A gain should be recognized for any subsequent increase in fair value less cost to sell, but not in excess of the cumulative loss previously recognized (for a write-down to fair value less cost to sell). The loss or gain should adjust only the carrying amount of a long-lived asset, whether classified as HFS individually or as part of a disposal group. A gain or loss not previously recognized that results from the sale of a long-lived asset (disposal group) should be recognized at the date of sale according to FASB ASC 360-10-40-5.

11.18 FASB ASC 360-10-45-5 states that a gain or loss recognized on the sale of a long-lived asset (disposal group) that is not a component of an entity should be included in income from continuing operations before income taxes in the income statement of a business entity. If a subtotal such as income from operations is presented, it should include the amounts of those gains or losses.

11.19 As stated in FASB ASC 205-20-45-10, the assets and liabilities of a disposal group classified as HFS should be presented separately in the asset and liability sections, respectively, of the statement of financial position. Those assets and liabilities should not be offset and presented as a single amount. The major classes of assets and liabilities classified as HFS should be separately disclosed either on the face of the statement of financial position or in the notes to the financial statements (see FASB ASC 205-20-50-1(a)).

11.20 FASB ASC 205-20-50-1 states that the following information should be disclosed in the notes to the financial statements that cover the period in which a long-lived asset (disposal group) either has been sold or is classified as HFS under the requirements of FASB ASC 360-10-45-9:

a. A description of the facts and circumstances leading to the expected disposal, the expected manner and timing of that disposal, and, if not separately presented on the face of the statement, the carrying amount(s) of the major classes of assets and liabilities included as part of a disposal group.

b. The gain or loss recognized in accordance with FASB ASC 360-10-35-40 and FASB ASC 360-10-40-5.

c. If applicable, amounts of revenue and pretax profit or loss reported in discontinued operations.

d. If applicable, the segment in which the long-lived asset (disposal group) is reported under FASB ASC 280, *Segment Reporting*.

Accounting and Reporting for Long-Lived Assets to Be Held and Used

11.21 The "Impairment or Disposal of Long-Lived Assets" subsections of FASB ASC 360-10 provide guidance for recognition and measurement of the impairment of long-lived assets to be held and used.

11.22 Paragraphs 17, 21, and 29 of FASB ASC 360-10-35 require that a long-lived asset (asset group) should be tested for recoverability whenever events or changes in circumstances indicate that its carrying amount may not be recoverable. The carrying amount of a long-lived asset (asset group) is not recoverable if it exceeds the sum of the undiscounted cash flows expected to result from the use and eventual disposition of the asset (asset group). That assessment should be based on the carrying amount of the asset (asset group) at the date it is tested for recoverability, whether in use or under development. Estimates of future cash flows used to test recoverability of a long-lived asset (asset group) should include only the future cash flows (cash inflows less associated cash outflows) that are directly associated with and that are expected to arise as a direct result of the use and eventual disposition of the asset (asset group). Those estimates should exclude interest charges that will be recognized as an expense when incurred.

11.23 FASB ASC 360-10-35-17 states that an impairment loss should be recognized only if the carrying amount of the long-lived asset (asset group) is not recoverable and exceeds its fair value. An impairment loss should be measured as the amount by which the carrying amount of the long-lived asset (asset group) exceeds its fair value. Paragraphs 23–25 of FASB ASC 360-10-35 provide guidance on asset groups.

11.24 When a long-lived asset (asset group) is tested for recoverability, FASB ASC 360-10-35-22 states that it also may be necessary to review depreciation estimates and methods as required by FASB ASC 250, *Accounting Changes and Error Corrections*, or the amortization period as required by FASB ASC 350, *Intangibles—Goodwill and Other*. Paragraphs 17–20 of FASB ASC 250-10-45 and FASB ASC 250-10-50-4 address the accounting for changes in accounting estimates, including changes in the method of depreciation, amortization, and depletion. Paragraphs 1–5 of FASB 350-30-35 address the determination of the useful life of an intangible asset. Any revision to the remaining useful life of a long-lived asset resulting from that review also should be considered in developing estimates of future cash flows used to test the asset (asset group) for recoverability. However, any change in the accounting method for the asset resulting from that review should be made only after applying FASB ASC 360-10.

11.25 If an impairment loss is recognized, the adjusted carrying amount of a long-lived asset should be its new cost basis according to FASB ASC 360-10-35-20. For a depreciable long-lived asset, the new cost basis should be depreciated (amortized) over the remaining useful life of that asset. Restoration of a previously recognized impairment loss is prohibited.

11.26 In accordance with FASB ASC 360-10-45-4, an impairment loss recognized for a long-lived asset (asset group) to be held and used should be included in income from continuing operations before income taxes in the income statement of a business entity. If a subtotal such as income from operations is presented, it should include the amount of that loss.

11.27 As stated in FASB ASC 360-10-50-2, the following information should be disclosed in the notes to the financial statements that include the period in which an impairment loss is recognized:

a. A description of the impaired long-lived asset (asset group) and the facts and circumstances leading to the impairment

b. If not separately presented on the face of the statement, the amount of the impairment loss and the caption in the income statement that includes that loss

c. The method or methods for determining fair value (whether based on a quoted market price, prices for similar assets, or another valuation technique)

d. If applicable, the segment in which the impaired long-lived asset (asset group) is reported under FASB ASC 280

Furthermore, FASB ASC 360-10-50-3 states that the disclosure requirements presented in FASB ASC 205-20-50-1 (see paragraph 11.20) are also applicable to long-lived assets (disposal groups) within the scope of FASB ASC 360-10.

Real Estate Investments

11.28 FASB ASC 970, *Real Estate—General*, provides accounting guidance concerning various forms of real estate investments. FASB ASC contains several subtopics for real estate due to the different accounting treatment for the various subindustries.

11.29 The "Acquisition, Development, and Construction" subsections of FASB ASC 310-10-15 and FASB ASC 310-10-25 address acquisition, development, and construction (ADC) arrangements and provide guidance for determining whether a lender should account for an ADC arrangement as a loan or as an investment in real estate or a joint venture. The FASB ASC glossary defines an *acquisition, development, and construction arrangement* as an arrangement in which a lender, usually a financial institution, participates in expected residual profit from the sale or refinancing of property. FASB ASC 310-10-25-19 outlines certain characteristics that would suggest the risks and rewards of the arrangement are similar to those associated with an investment in real estate or joint venture.

11.30 ADC arrangements accounted for as investments in real estate or joint ventures should be combined and reported in the balance sheet separately from those ADC arrangements accounted for as loans, as stated in FASB ASC 310-10-45-15.

Sale of Real Estate Assets[*]

11.31 FASB ASC 360-20 establishes standards for recognition of profit on all real estate sales transactions, other than retail land sales, without regard to the nature of the seller's business.

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[*] Financial Accounting Standards Board (FASB) Emerging Issues Task Force (EITF) Issue No. 10-E, "Accounting for Deconsolidation of a Subsidiary That Is In-Substance Real Estate," addresses whether the sale of real estate guidance in FASB *Accounting Standards Codification* (ASC) 360-20 applies to all derecognition events involving subsidiaries that are in-substance real estate.

At the June 23, 2011, EITF meeting, the EITF discussed the feedback provided by the EITF Issue No. 10-E Working Group. The EITF decided to address only whether FASB ASC 360-20 would apply to the loss of control of an in-substance real estate entity when that loss

11.32 FASB ASC 360-20-40 presents the real estate derecognition standards primarily from the perspective of the profit recognition upon a sale. This guidance addresses various conditions that may or may not result in derecognition of the real estate asset (and related profit or loss recognition, if any). The six primary methods of accounting for sales transactions are full accrual, installment, percentage-of-completion, reduced profit, cost recovery, and deposit. If a company is selling discrete real estate projects, it may need to consider the "component of an entity" issue such that these may need to be reported as discontinued operations in accordance with paragraphs 1–5 of FASB ASC 205-20-45. Other guidance on accounting for real estate sales that may apply includes FASB ASC 970-360 and FASB ASC 840-40.

Development Costs

11.33 The "Real Estate Project Costs" subsections in FASB ASC 970-10 establish accounting and reporting standards for ADC, selling, and rental costs associated with real estate projects, as stated in FASB ASC 970-10-05-6. Project costs clearly associated with the ADC of a real estate project should be capitalized as a cost of that project, according to FASB ASC 970-360-25-2.

11.34 Payments to obtain an option to acquire real property should be capitalized as incurred, as stated in FASB ASC 970-340-25-3. All other costs related to a property that are incurred before the entity acquires the property, or before the entity obtains an option to acquire it, should be capitalized if all of the following conditions are met and otherwise should be charged to expense as incurred:

a. The costs are directly identifiable with the specific property.

b. The costs would be capitalized if the property were already acquired.

c. Acquisition of the property or of an option to acquire the property is probable (that is, likely to occur). This condition requires that the prospective purchaser is actively seeking to acquire the property and has the ability to finance or obtain financing for the acquisition and that there is no indication that the property is not available for sale.

11.35 Paragraphs 8–12 of FASB ASC 970-340-25 state that costs incurred on real estate for property taxes and insurance should be capitalized as property cost only during periods in which activities necessary to get the property ready for its intended use are in progress. Accounting for costs of

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(footnote continued)

of control is the result of default on the subsidiary's nonrecourse debt in accordance with FASB ASC 810-10. The EITF reached a consensus-for-exposure that a parent should apply the guidance in FASB ASC 360-20 to determine whether in-substance real estate should be derecognized. The EITF decided that a reporting entity should apply the guidance in FASB ASC 360-20 to determine whether to derecognize real estate owned by the in-substance real estate subsidiary. The EITF noted that (*a*) the same derecognition requirements (FASB ASC 360-20) should apply regardless of whether the real estate is owned directly by the reporting entity or indirectly through the reporting entity's in-substance real estate subsidiary; (*b*) FASB ASC 360-10 requires a two-step impairment approach and does not permit the entity to consider the nonrecourse debt when evaluating the real estate asset for impairment; and (*c*) it would not be appropriate for the entity to derecognize the nonrecourse debt before it has been legally released from its obligation.

At the July 13, 2011, meeting, FASB ratified the consensus-for-exposure reached by the EITF in EITF Issue No. 10-E and approved the issuance of a proposed Accounting Standards Update for a 75-day public comment period. Readers are encouraged to visit the FASB website (www.fasb.org) for the latest developments.

amenities should be based on management's plans for the amenities in accordance with the criteria stated in FASB ASC 970-340-25-9. Incremental revenues from incidental operations in excess of incremental costs of incidental operations should be accounted for as a reduction of capitalized project costs.

11.36 The capitalized costs of real estate projects should be assigned to individual components of the project based on specific identification, as stated in FASB ASC 970-360-30-1. If specific identification is not practical, capitalized costs should be allocated as follows:

a. Land costs and all other common costs, including the costs of amenities to be allocated as common costs per paragraphs 9–11 of FASB ASC 970-340-25 (before construction), should be allocated to each land parcel benefited. Allocation should be based on the relative fair value before construction.

b. Construction costs should be allocated to individual units in the phase on the basis of relative sales values of each unit.

If allocation based on relative values is also impractical, costs should be allocated based on area methods (for example, square footage) or other value methods as appropriate under the circumstances.

Allocation of Income and Equity Among Parties to a Joint Venture

11.37 If a real estate investment is made through a joint venture arrangement, a formal agreement generally exists that specifies key terms, such as profit or loss allocations, cash distribution, and capital infusion provisions. The terms of these agreements may affect the institution's investment valuation and, accordingly, are considered in the investment evaluation process.

11.38 According to FASB ASC 970-323-35-16, joint venture agreements may designate different allocations among the investor for any of the following:

a. Profits and losses

b. Specified costs and expenses

c. Distributions of cash from operations

d. Distributions of cash proceeds from liquidation

11.39 FASB ASC 970-323-35-17 states that accounting by the investors for their equity in the venture's earnings under such agreements requires careful consideration of substance over form and consideration of the underlying values, as discussed in FASB ASC 970-323-35-10. Specified profit and loss allocation ratios should not be used to determine an investor's equity in venture earnings if the allocation of cash distributions and liquidating distributions are determined on some other basis.

11.40 If a specified allocation has no substance (for example, all depreciation is to be allocated to one partner but all cash distributions, including proceeds from the sale of real estate, are shared equally by all partners), it should be ignored. The agreement should be analyzed to determine how changes in net assets of the venture will affect cash payments to investors over the venture's life and at liquidation.

11.41 The institution should consider whether it is appropriate to allocate to other partners losses in excess of their capital contributions or whether the institution should record losses in excess of its own investment, including loans and advances. Items that may affect the institution's decision are (*a*) the

financial strength of the partners, (*b*) the type of partners (general versus limited) and the partners' legal requirement to fund losses, (*c*) the fair value of the real estate, and (*d*) the type of losses being incurred (cash or book). Paragraphs 2–11 of FASB ASC 970-323-35 provide guidance on investor accounting for losses in such circumstances.

11.42 FASB ASC 970-810 provides guidance on consolidation matters incremental to the real estate industry. FASB ASC 970-810-25-2 states that a noncontrolling investor in a general partnership should account for its investment by the equity method and should be guided by the provisions of FASB ASC 323, *Investments—Equity Method and Joint Ventures*. A controlling investor should account for its investment under the principles of accounting applicable to investments in subsidiaries. For guidance on determining control held by an investor, see paragraphs 1–2 of FASB ASC 970-810-25. For guidance on determining whether a general partner should consolidate a limited partnership or apply the equity method of accounting to its interests in the limited partnership, see FASB ASC 970-810-25-3.

Auditing

Objectives

11.43 The primary objectives of audit procedures in the real estate investments, REO, and other foreclosed assets area are to obtain sufficient appropriate evidence that

a. the assets exist and are owned by the institution;

b. the assets are properly classified, described, and disclosed in the financial statements;

c. adequate provisions have been made for impairment, if any, of the assets;

d. depreciation expense, where applicable and other revenues and expenses related to real estate assets are properly allocated and reported;

e. sales of assets, including the recognition of gains and losses, have been recognized; and

f. appropriate disclosures have been made.

Planning

11.44 In accordance with AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatements* (AICPA, *Professional Standards*), the auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures as described in chapter 5, "Audit Considerations and Certain Financial Reporting Matters." In obtaining that understanding, the auditor should consider the following factors related to real estate investments, REO, and other foreclosed assets that may indicate higher inherent risk in this area:

- Adverse environmental or economic conditions that may affect real estate markets and the values and liquidity of properties or other assets

- Significant losses on past sales of REO or other foreclosed assets
- Complex real estate assets
- Sales, financed by the institution, of REO or other foreclosed assets
- Lack of experienced real estate staff
- High concentrations of real estate or other assets in a particular geographic area
- Significant fluctuations in the amount and number of foreclosures or in-substance foreclosures
- Inexperienced internal appraisal personnel or the use of low-quality or outdated appraisals

Internal Control Over Financial Reporting and Possible Tests of Controls

11.45 AU section 314 establishes standards and provides guidance on obtaining a sufficient understanding of the entity and its environment, including its internal control. It provides guidance on understanding the components of internal control and explains how an auditor should obtain a sufficient understanding of internal control for the purposes of assessing the risks of material misstatement. Paragraph .40 of AU section 314 requires that, in all audits, the auditor should obtain an understanding of the five components of internal control (control environment, risk assessment, control activities, information and communication systems, and monitoring), sufficient to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. The auditor should obtain a sufficient understanding by performing risk assessment procedures to evaluate the design of controls relevant to an audit of financial statements and to determine whether they have been implemented. Paragraph .102 of AU section 314 states that the auditor should identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions, account balances, and disclosures.

11.46 Inherent risk is often high for foreclosed assets and ADC arrangements because of the high degree of subjectivity involved in determining real estate values and the classification of ADC arrangements. However, with a high level of inherent risk in the real estate area, the auditor would often conclude that for most of the assertions it is more effective or efficient to assess control risk at the maximum and plan a primarily substantive approach, involving a selection of major real estate assets for detailed review.

11.47 To plan the audit, the auditor should obtain a sufficient understanding of internal control over the financial reporting of individually significant real estate investments, REO and other foreclosed assets. The auditor should perform tests of controls when the auditor's risk assessment includes an expectation of the operating effectiveness of controls or when substantive procedures alone do not provide sufficient appropriate audit evidence at the relevant assertion level. Internal controls over financial reporting of real estate investments, REO, and other foreclosed assets may include

- written policies and procedures, including those that address
  - frequency of appraisals and selection and qualifications of appraisers;

- — disbursement of funds and capitalization of costs;
- — evaluation of management companies;
- — review and monitoring of marketing efforts;
- — nature and amount of facilitating financing;
- — revenue recognition;
- — cost to sell; and
- — capitalization of interest.

- proper authorizations for specific transactions.
- periodic reviews of balances, fair values, realizable values, and policies by persons specified in management's written policy.

Substantive Tests

11.48 Regardless of the assessed risks of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions related to real estate investments, REO, and other foreclosed assets.

11.49 *Other REO and real estate investments.* Obtaining audit evidence about the carrying amount of foreclosed assets (fair values) and real estate investments (including loans that qualify as real estate investments) may involve a review of appraisals, feasibility studies, forecasts, sales contracts or lease commitments, and information concerning the track record of the developer. Being aware of the involvement of related parties may contribute to the design of audit procedures used by the auditor. To obtain appropriate audit evidence of progress to completion under a real estate investment or other real estate project, the auditor may also decide to perform an on-site inspection of certain properties.

11.50 Substantive tests of other real estate and real estate investments generally focus on the valuation assertion; however, tests of the other assertions should also be considered. For example, evidence about the completeness assertion may be obtained through the auditor's testing of loans. In addition, the auditor should consider testing the propriety of gains and losses on real estate sales and capitalized interest and other holding costs.

11.51 Estimates of the fair value of real estate assets are necessary to account for such assets. AU section 342, *Auditing Accounting Estimates* (AICPA, *Professional Standards*), provides guidance on auditing accounting estimates (such as estimates of fair values). AU section 342 discusses how an auditor obtains an understanding of how management developed estimates, concentrating on the key factors and assumptions used. It also discusses how the auditor evaluates the reasonableness of those estimates. AU section 328, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*), establishes standards and provides guidance on auditing fair value measurements and disclosures contained in financial statements. In particular, AU section 328 addresses audit considerations relating to the measurement and disclosure of assets, liabilities, and specific components of equity presented or disclosed at fair value in financial statements.[†]

[†] The Auditing Standards Board (ASB) has finalized a new clarified auditing standard, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*. This auditing standard, which will supersede AU section 328, *Auditing Fair Value Measurements and Disclosures*, and AU section 342, *Auditing Accounting Estimates* (AICPA,

11.52 Many fair values will be based on valuations by independent appraisers. In applying audit procedures to real estate, the auditor often relies on representations of independent experts, particularly appraisers and construction consultants, to assist in the assessment of real estate values. AU section 336, *Using the Work of a Specialist* (AICPA, *Professional Standards*), provides guidance in this area. See paragraphs .08–.09 of AU section 336 for evaluating the qualifications and work of a specialist. When an appraisal is used as audit evidence, the auditor may

a. evaluate the professional qualifications of the specialist in determining that the specialist possesses the necessary skill or knowledge in the particular field by considering the following:

   i. The professional certification, license, or other recognition of the competence of the appraiser

   ii. The reputation and standing of the appraiser in the views of peers and others familiar with the appraiser's capability or performance

   iii. The appraiser's experience with the particular type of real estate collateral being valued

   iv. The appraiser's experience with real estate in the specific geographic location of the collateral

b. evaluate the objectivity of the appraiser based on any relationships the appraiser has with the financial institution;

c. obtain an understanding of the methods and assumptions used by the appraiser;

d. test the data provided to the appraiser; and

e. evaluate whether the appraiser's findings support the fair value measurement.

11.53 Independent appraisals may be considered acceptable audit evidence. The quality of appraisals varies, however, and, in some instances, the auditor may have reason to believe certain assumptions underlying appraisals are unrealistic. The auditor should understand and consider the approaches and assumptions used in obtaining the appraised value. Some matters that should be considered by the auditor when evaluating an appraisal are

- a rise or decline in a particular market area not reflected in an appraisal may warrant that additional procedures, or perhaps a new appraisal, be performed;
- if the date of appraisal is substantially earlier than the audit date, a rise or decline in a particular market area between the two dates may warrant a new appraisal or the performance of additional procedures;

(footnote continued)

Professional Standards), addresses the auditor's responsibilities relating to accounting estimates, including fair value accounting estimates and related disclosures. Additionally, it expands on how other clarified auditing standards are to be applied in relation to accounting estimates, and includes requirements and guidance related to misstatements of individual accounting estimates and indicators of possible management bias. This clarified auditing standard has been finalized but not yet issued. See the preface of this guide for further information on the ASB's Clarity Project. The effective date of this clarified standard is for audits of financial statements for periods ending on or after December 15, 2012, unless otherwise established (early implementation is not permitted).

- appraised values should be based on current market conditions and must be discounted for costs to complete and sell, as well as for carrying costs; and
- the estimated selling prices should reflect the expectations of a sale in the reasonably near future—not in an indefinite future period.

11.54 In periods of declining real estate values, management may implement policies and procedures that address the following:

- The age at which an appraisal is considered to be outdated
- A process for obtaining updated appraisals
- A process for discounting aged appraisals to reflect declines in fair value that are not reflected in the aged appraisals

11.55 Because of time and cost considerations, an institution may use various approaches to estimate value without using the services of an independent appraiser. In evaluating internally derived valuation data, the auditor should understand the methods and assumptions used and the qualifications of the individual performing the evaluation and should be aware of inherent subjective determinations in estimating value that may be significant to the valuation process. The auditor should consider the reasonableness of the assumptions and approach used and should test the information underlying the valuation. Further, the auditor may decide to engage an appraiser independent of the institution to test the institution's internally derived valuation. Despite the existence of an appraisal, in certain situations the auditor may wish to physically observe properties for the stage of completion, for deterioration, or for estimating the extent of occupancy.

11.56 The auditor should also evaluate whether significant real estate transactions qualify as sales in conformity with criteria set forth in FASB ASC 360-20-40.

11.57 *Other foreclosed assets.* The procedures discussed previously may be applied to other foreclosed assets to the extent that the auditor deems necessary.

Chapter 12

Other Assets, Other Liabilities, and Other Investments

Introduction

12.01 The following assets are among those frequently grouped as *other assets* or *other investments* in institutions' balance sheets; however, any that are individually material should be presented in the balance sheet as a separate amount:

- Accrued interest receivable (see chapter 7, "Investments in Debt and Equity Securities," for a discussion on securities and chapter 8, "Loans," for a discussion on loans)
- Premises and equipment
- Other real estate, such as foreclosed assets (see chapter 11, "Real Estate Investments, Real Estate Owned, and Other Foreclosed Assets," for a discussion on real estate investments, real estate owned, and other foreclosed assets)
- Servicing assets (SAs) (see chapter 10, "Transfers and Servicing—Including Mortgage Banking," for a discussion of SAs)
- Federal Home Loan Bank (FHLB), Federal Reserve Bank (FRB), or other restricted stocks
- National Credit Union Share Insurance Fund (NCUSIF) deposits or other share insurance deposits
- Mortgage servicing advances
- Identifiable intangible assets, such as core deposit intangibles, and purchased credit-card relationships (PCCRs)
- Indemnification assets arising from contractual indemnities provided in business combinations
- Goodwill
- Customers' liabilities on acceptances
- Deferred tax assets (see chapter 16, "Income Taxes")
- Investments in equity securities that are not readily marketable (which meet definition of a security in the Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 320, *Investments—Debt and Equity Securities*, but are not subject to its provisions because they are not readily marketable), such as stock in the Federal Agricultural Mortgage Corporation or stock in banker's banks.
- Other equity investments, including investments in joint ventures or venture capital investments, and credit union investments in credit union service organizations (CUSOs) and corporate credit unions
- Investments in nonnegotiable certificates of deposits (see chapter 6, "Cash and Cash Equivalents")
- Bank owned life insurance

- Prepaid pension assets

12.02 Other liabilities frequently include the following:

- Accounts payable
- Accrued interest payable (see chapter 13, "Deposits," for discussion of deposits)
- Accrued expenses
- Borrower's taxes and insurance escrows
- Bankers' acceptance liability
- Guarantee liabilities pursuant to FASB ASC 460, *Guarantees*
- Recourse liabilities
- Allowance related to unfunded loan commitments
- Servicing liabilities
- Asset retirement obligations
- Liabilities associated with exit or disposal activities
- Estimated litigation and settlement loss allowance
- Capital lease obligations
- Compensation and benefit-related accruals, such as bonuses, pension liabilities, supplemental executive retirement plans, and postretirement health care benefits including split-dollar life insurance arrangements
- Deferred tax liabilities
- Allowance for unrecognized tax benefits

Premises and Equipment

12.03 Premises and equipment consist primarily of land, buildings, furniture, fixtures, equipment, purchased software, and leasehold improvements used in institution operations. Such assets may be acquired directly or through a special-purpose subsidiary. Institutions may also lease property and equipment to other parties.

FHLB or FRB Stock

12.04 *FHLB stock.* Institutions that are members of the FHLB system are required to maintain a minimum investment in FHLB stock. The minimum is calculated as a percentage of aggregate outstanding mortgages. An additional investment calculated as a percentage of total FHLB advances, letters of credit, and the collateralized portion of interest-rate swaps outstanding may be necessary. FHLB stock is capital stock that is bought from and sold only to the FHLB at $100 par. Both stock and cash dividends may be received on FHLB stock.

12.05 *FRB stock.* Members of the Federal Reserve System are required to maintain stock in the district FRB in a specified ratio to its capital. The stock does not provide the owner with control or financial interest in the FRB, is not transferable, and cannot be used as collateral. A member institution's ownership of FRB stock may be canceled in the event of the institution's insolvency or voluntary liquidation, conversion to nonmember status through merger or

acquisition, or voluntary or involuntary termination of membership in the Federal Reserve System.

Identifiable Intangibles

12.06 Identifiable intangible assets may be acquired individually, as part of a group of assets, or in a business combination in accordance with FASB ASC 805, *Business Combinations*. According to the FASB ASC glossary, *intangible assets* are assets (not including financial assets) that lack physical substance. (The term *intangible assets* is used to refer to intangible assets other than goodwill.) They may include, among others, core deposit intangibles (the value of long-term deposit relationships), and credit-card customer lists (the value of long-term credit-card relationships). They may also include assets arising from contractual indemnities against future losses (based on future expected cash flows), including indemnities provided by the Federal Deposit Insurance Corporation (FDIC) for certain assets identified in loss-sharing agreements.

12.07 Paragraphs 9–15A of FASB ASC 805-20-25 provide guidance on recognizing identifiable intangible assets, including operating leases and reacquired rights, acquired in a business combination. Paragraphs 11–45 of FASB ASC 805-20-55 present examples of identifiable intangible assets acquired in a business combination. See chapter 19, "Business Combinations," in this guide for additional information regarding this topic.

Goodwill

12.08 Goodwill arises in a business combination. *Goodwill* is an asset representing the future economic benefits arising from other assets acquired in a business combination or an acquisition by a not-for-profit entity that are not individually identified and separately recognized, as defined in the FASB ASC glossary.

Customers' Liabilities on Acceptances

12.09 Customer's liabilities on acceptances represent a customer's outstanding debt to the institution that resulted from a banker's acceptance transaction. A banker's acceptance is a short-term negotiable time draft drawn on and accepted by an institution.

Other Miscellaneous Items

12.10 Other items that may be classified as other assets include accounts receivable, accruals for miscellaneous fees, other prepaid expenses, payroll deductions receivable, and suspense accounts. Suspense accounts usually contain amounts related to items recorded and held pending classification and transfer to the proper account and may originate from a variety of sources, such as loan remittances, branch clearing transactions, automated teller machine transactions, and payroll transactions. Suspense accounts are generally recorded within "other liabilities" in the balance sheet but may have debit balances.

Regulatory Matters

12.11 Section 107(4) of the Federal Credit Union Act, as well as many state statutes, allow credit unions to purchase, hold, and dispose of only that

property which is necessary or incidental to their operations. Credit unions are limited by regulatory authorities to a maximum investment in property and equipment. This limitation also includes lease payments. Credit unions may also be prohibited from acquiring real property from certain related parties.

12.12 Banks and savings institutions are generally limited in the type and amount of intangible assets that may be held without deduction from regulatory capital. In addition to these limits, for purposes of calculating tier 1 capital, the amount of SAs and PCCRs that institutions can hold without deduction from tier 1 capital cannot exceed 90 percent of their fair market value and are subject to other limitations.

12.13 The Office of the Comptroller of the Currency (OCC), Board of Governors of the Federal Reserve System, FDIC, and Office of Thrift Supervision issued a joint statement "Clarification of the Risk Weight for Claims on or Guaranteed by the FDIC" on February 26, 2010. Under the agencies' risk-based capital guidelines, direct claims on and claims unconditionally guaranteed by the FDIC, such as FDIC-insured deposits, prepaid assessments of deposit insurance premiums, debt guaranteed under the FDIC's Temporary Liquidity Guarantee Program, and similarly guaranteed debt, may be assigned a zero percent risk weight. Recent loss-sharing agreements entered into by the FDIC with acquirers of assets from failed institutions are considered conditional guarantees for risk-based capital purposes due to contractual conditions that acquirers must meet. The guaranteed portion of assets subject to a loss-sharing agreement may be assigned a 20 percent risk weight. (See OCC Bulletin No. 2010-10 and FDIC Financial Institution Letter-7-2010 for additional information.)

12.14 Both national banks and state member banks are limited as to the amount of their investments in bank premises. National bank limitations are set forth in *Banks and Banking*, *U.S. Code* 12, Section 371d. State member bank limitations are set forth in Title 12 U.S. *Code of Federal Regulations* (CFR) 208.22.

12.15 See paragraphs 10.09 of this guide for information on interagency guidelines on asset securitization.

12.16 The OCC's *Bank Accounting Advisory Series* (BAAS) expresses the Office of the Chief Accountant's current views on accounting topics of interest to national banks. See further discussion of the BAAS in paragraph 8.80 of this guide. Topic 10B, "Intangible Assets," includes interpretations and responses related to intangible assets. Readers are encouraged to read this publication on the OCC website at www.occ.gov/topics/bank-operations/accounting/index-accounting.html.

Accounting and Financial Reporting

Premises and Equipment*

12.17 Financial institutions account for premises and equipment in the same way that commercial enterprises account for property and equipment

* In August 2010, the Financial Accounting Standards Board (FASB) issued an exposure draft, *Leases (Topic 840)*. The proposed guidance was initiated as a joint project between FASB and the International Accounting Standards Board to develop a new approach to lease accounting that would ensure that assets and liabilities arising under leases are recognized in the statement of financial position. Based on comments received in response to the exposure

(fixed assets). Institutions carry premises and equipment at cost less accumulated depreciation, and adjust the carrying amount for permanent impairments of value. Capital additions and improvements to premises should be capitalized, including construction period interest capitalized in accordance with FASB ASC 835-20. A description of the institution's depreciation and capitalization policies should be included in the notes to the financial statements.

12.18 In accordance with paragraphs 1–2 of FASB ASC 942-360-45, premises and equipment are generally shown as a single caption on the balance sheet, net of accumulated depreciation and amortization, the amount of which should be disclosed either on the face of the balance sheet or in the notes to the financial statements. For premises and equipment, net gains or net losses on dispositions should be included in noninterest income or noninterest expense.

12.19 Long-lived assets or asset groups should be tested for recoverability whenever events or changes in circumstances indicate that the carrying amount may not be recoverable as stated in FASB ASC 360-10-35-21. Capital leases should be accounted for in accordance with FASB ASC 840-30 and are subject to the requirements of the "Impairment or Disposal of Long-Lived Assets" subsections of FASB ASC 360-10, for purposes of recognizing and measuring impairment.

12.20 Premises and equipment held for use, including capital leases, need to be tested for recoverability whenever indicators of impairment are present. Paragraph 12.56 provides further guidance on impairment of long-lived assets.

12.21 Consolidation of subsidiaries that own premises and equipment should occur in accordance with FASB ASC 810, *Consolidation*.

12.22 All reporting entities should apply the guidance in FASB ASC 810, as stated in FASB ASC 810-10-15-3, to determine whether and how to consolidate another entity and apply the applicable subsections of FASB ASC 810-10. The "Variable Interest Entity" subsections of FASB ASC 810 clarify the application of the "General" subsections of FASB ASC 810 to certain legal entities in which equity investors do not have sufficient equity at risk for the legal entity to finance its activities without additional subordinated financial support, or according to "Pending Content" in FASB ASC 810-10-05-8, as a group, the holders of the equity investment at risk lack any of the following three characteristics:

a. The power, through voting rights or similar rights, to direct the activities of a legal entity that most significantly impact the entity's economic performance

b. The obligation to absorb the expected losses of the legal entity

c. The right to receive the expected residual returns of the legal entity.

12.23 FASB ASC 840-40 provides guidance on how to account for sale-leaseback transactions and various sale-leaseback matters.

12.24 FASB ASC 350-40 provides guidance on accounting for the cost of computer software developed or obtained for internal use and for determining

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(footnote continued)

draft and decisions reached at the July 20–21, 2011, board meeting, FASB agreed unanimously to re-expose its revised proposals for a leases standard. FASB expects to release a revised proposal during the fourth quarter of 2011. The amendments are expected to result in significant changes to the accounting requirements for both lessees and lessors. Readers are encouraged to visit the FASB website for the latest developments regarding the lease project, including a summary of the proposed model and decisions reached to date.

whether the software is for internal use. According to FASB ASC 350-40-05-2, internal use software is acquired, internally developed, or modified solely to meet the entity's internal needs and during the software's development or modification, no substantive plan exists or is being developed to market the software externally. Accounting for the cost of either internally developed and produced or purchased computer software to be sold, leased, or otherwise marketed is established in FASB ASC 985-20.

12.25 If the individual categories of assets are material, they should be disclosed on the face of the balance sheet or in the notes to the financial statements. The gross amount of assets recorded under capital leases as of the date of each balance sheet presented by major classes according to nature or function should be disclosed, in accordance with FASB ASC 840-30-50-1.

12.26 *Operating leases.* An *operating lease*, from the perspective of a lessor, is a lease that meets the conditions in FASB ASC 840-10-25-43(d) and, from the perspective of a lessee, is any lease other than a capital lease, as defined in the FASB ASC glossary. The capital lease criteria are specified in FASB ASC 840-10-25-1. From the lessor's perspective, the leased assets are recorded on the balance sheet with or near property, plant, and equipment and lease payments are recognized as rental income in the income statement in accordance with FASB ASC 840-20-45-2 and 840-20-25-1, respectively. Long-lived assets of lessors subject to operating leases are also subject to the requirements of "Impairment or Disposal of Long-Lived Assets" subsections of FASB ASC 360-10 for purposes of recognizing and measuring impairment. From the lessee's perspective, rent should be charged to expense by lessees over the lease term as it becomes payable, in accordance with FASB ASC 840-20-25-1. If rental payments are not made on a straight-line basis, rental expense nevertheless should be recognized on a straight-line basis unless another systematic and rational basis is more representative of the time pattern in which use benefit is derived from the leased property, in which case that basis should be used.

FHLB or FRB Stock

12.27 On June 23, 2004, the Federal Housing Finance Board voted to require the 12 FHLBs to enhance their financial disclosures by registering with the Securities and Exchange Commission. Each bank is required to register a class of its equity securities under Section 12(g) of the Securities and Exchange Act of 1934. The banks file quarterly, annual, and supplemental disclosures.

12.28 Although FHLB (or FRB) stock is an equity interest in a FHLB (or FRB), it does not have a readily determinable fair value for purposes of FASB ASC 320 because its ownership is restricted and it lacks a market, as stated in FASB ASC 942-325-05-2. FHLB (or FRB) stock can be sold back only at its par value of $100 per share and only to the FHLBs (or FRBs) or to another member institution. In addition, the equity ownership rights represented by FHLB stock are more limited than would be the case for a public company.

12.29 FHLB and FRB stock should be classified as a restricted investment security, carried at cost, and evaluated for impairment, as stated in FASB ASC 942-325-25-1 and 942-325-35-1. FASB ASC 942-325-35-2 states that both cash and stock dividends received on FHLB stock should be reported as income. See FASB ASC 505, *Equity*, and FASB ASC 852, *Reorganizations*, for guidance concerning stock splits.

12.30 FASB ASC 942-325-35-3 states that FHLB stock is generally viewed as a long-term investment. Accordingly, when evaluating FHLB stock for

impairment, its value should be determined based on the ultimate recoverability of the par value rather than by recognizing temporary declines in value. The determination of whether the decline affects the ultimate recoverability is influenced by criteria such as the following:

- The significance of the decline in net assets of the FHLBs as compared to the capital stock amount for the FHLBs and the length of time this situation has persisted.
- Commitments by the FHLBs to make payments required by law or regulation and the level of such payments in relation to the operating performance of the FHLBs.
- The impact of legislative and regulatory changes on the institutions and, accordingly, on the customer base of the FHLBs.
- The liquidity position of the FHLBs.

12.31 The evaluation of whether a decline is temporary or whether it affects the ultimate recoverability of the FHLB stock is ultimately made by the member institution based on the facts at the time. This consideration is influenced by (*a*) the materiality of the carrying amount to the member institution and (*b*) whether an assessment of the institution's operational needs for the foreseeable future would indicate management intends to dispose of the stock and cause management to dispose of the stock at an amount other than par value.

12.32 When addressing other than temporary impairment, readers may also refer to FASB ASC 320-10-35.

12.33 Classification of FHLB or FRB stock in the balance sheet varies among financial institutions. Some institutions, with more significant investments in FHLB or FRB stock, present their investment as a separate line item in the balance sheet. Others may combine the investment in FHLB or FRB stock with other investments or other assets. Either manner of presentation is acceptable.

12.34 However, investments in FHLB or FRB stock should not be shown with securities accounted for under FASB ASC 320, according to FASB ASC 942-325-45-1.

Goodwill and Other Intangible Assets

12.35 *Identified intangibles other than goodwill*. In accordance with FASB ASC 350-30-25-1, an intangible asset that is acquired either individually or with a group of other assets should be recognized. FASB ASC 350-30-25-2 states that the cost of a group of assets acquired in a transaction other than a business combination or an acquisition by a not-for-profit entity should be allocated to the individual assets acquired based on their relative fair values and should not give rise to goodwill. Paragraphs 12.06–.07 and chapter 19 discuss intangible assets acquired in connection with a business combination.

12.36 Costs of internally developing, maintaining, or restoring intangible assets that are not specifically identifiable, that have indeterminate lives, or that are inherent in a continuing business or nonprofit activity and related to an entity as a whole, should be recognized as an expense when incurred in accordance with FASB ASC 350-30-25-3.

12.37 In accordance with paragraphs 1–4 of FASB 350-30-35, the accounting for a recognized intangible asset is based on its useful life to the reporting

entity. An intangible asset with a finite useful life should be amortized; an intangible asset with an indefinite useful life should not be amortized. The useful life of an intangible asset to an entity is the period over which the asset is expected to contribute directly or indirectly to the future cash flows of that entity. The useful life is not the period of time that it would take that entity to internally develop an intangible asset that would provide similar benefits. However, a reacquired right recognized as an intangible asset is amortized over the remaining contractual period of the contract in which the right was granted. If an entity subsequently reissues (sells) a reacquired right to a third party, the entity includes the related unamortized asset, if any, in determining the gain or loss on the reissuance. The estimate of the useful life of an intangible asset to an entity should be based on an analysis of all pertinent factors, including those described in FASB ASC 350-30-35-3. If no legal, regulatory, contractual, competitive, economic, or other factors limit the useful life of an intangible asset to the reporting entity, the useful life of the asset should be considered to be indefinite. The term indefinite does not mean the same as infinite or indeterminate. The useful life of an intangible asset is indefinite if that life extends beyond the foreseeable horizon—that is, there is no foreseeable limit on the period of time over which it is extended to contribute to the cash flows of the reporting entity.

12.38 As required by FASB ASC 350-30-35-6, if an intangible asset has a finite useful life, but the precise length of that life is not known, that intangible asset should be amortized over the best estimate of its useful life. The method of amortization should reflect the pattern in which the economic benefits of the intangible asset are consumed or otherwise used up. If that pattern cannot be reliably determined, a straight-line amortization method should be used. Accordingly, FASB ASC 350-30-35-7 states that an intangible asset should not be written down or off in the period of acquisition unless it becomes impaired during that period.

12.39 The amount of an intangible asset to be amortized should be the amount initially assigned to that asset less any residual value, according to FASB ASC 350-30-35-8. The residual value of an intangible asset should be assumed to be zero unless at the end of its useful life to the entity the asset is expected to continue to have a useful life to another entity and either of the following conditions is met:

a. The reporting entity has a commitment from a third party to purchase the asset at the end of its useful life.

b. The residual value can be determined by reference to an exchange transaction in an existing market for that asset and that market is expected to exist at the end of the asset's useful life.

12.40 Paragraphs 9–10 and 12 of FASB ASC 350-30-35 state that an entity should evaluate the remaining useful life of an intangible asset that is being amortized each reporting period to determine whether events and circumstances warrant a revision to the remaining period of amortization. If the estimate of an intangible asset's remaining useful life is changed, the remaining carrying amount of the intangible asset should be amortized prospectively over that revised remaining useful life. If an intangible asset that is being amortized is subsequently determined to have an indefinite useful life, the asset should be tested for impairment in accordance with paragraphs 18–20 of FASB ASC 350-30-35. (FASB ASC 360-10-35-21 includes examples of impairment indicators.) That intangible asset should no longer be amortized and should be accounted for in the same manner as other intangible assets that are not subject to amortization.

12.41 FASB ASC 350-30-35-14 states that an intangible asset that is subject to amortization should be reviewed for impairment in accordance with the "Impairment or Disposal of Long-Lived Assets" subsections of FASB ASC 360-10 by applying the recognition and measurement provisions in paragraphs 17–35 of FASB ASC 360-10-35. In accordance with the "Impairment or Disposal of Long-Lived Assets" subsections of FASB ASC 360-10, an impairment loss should be recognized if the carrying amount of an intangible asset is not recoverable and its carrying amount exceeds its fair value. After an impairment loss is recognized, the adjusted carrying amount of the intangible asset should be its new accounting basis. Subsequent reversal of a previously recognized impairment loss is prohibited.

12.42 If an intangible asset is determined to have an indefinite useful life, it should not be amortized until its useful life is determined to be no longer indefinite, as required by paragraphs 15–17 of FASB ASC 350-30-35. An entity should evaluate the remaining useful life of an intangible asset that is not being amortized each reporting period to determine whether events and circumstances continue to support an indefinite useful life. If an intangible asset that is not being amortized is subsequently determined to have a finite useful life, the asset should be tested for impairment in accordance with paragraphs 18–20 of FASB ASC 350-30-35. That intangible asset should then be amortized prospectively over its estimated remaining useful life and accounted for in the same manner as other intangible assets that are subject to amortization.

12.43 In accordance with paragraphs 18–20 of FASB ASC 350-30-35, an intangible asset that is not subject to amortization should be tested for impairment annually, or more frequently if events or changes in circumstances indicate that the asset might be impaired. The impairment test should consist of a comparison of the fair value of an intangible asset with its carrying amount. If the carrying amount of an intangible asset exceeds its fair value, an impairment loss should be recognized in an amount equal to that excess. After an impairment loss is recognized, the adjusted carrying amount of the intangible asset should be its new accounting basis. Subsequent reversal of a previously recognized impairment loss is prohibited.

12.44 *Indemnification assets.* Indemnification assets arise from contractual indemnities provided for in a business combination. According to paragraphs 27–28 of FASB ASC 805-20-25, the acquirer should recognize an indemnification asset at the same time that it recognizes the indemnified item, measured on the same basis as the indemnified item, subject to the need for a valuation allowance for uncollectible amounts. However, the indemnity may relate to an asset or liability that is an exception to the recognition or measurement principal, such as a contingency that is not recognized at the acquisition date because it does not meet the criteria for recognition in paragraphs 18A–19 of FASB ASC 805-20-25 at that date. In such a circumstance, the indemnification asset should be recognized and measured using assumptions consistent with those used to measure the indemnified item, subject to management's assessment of the collectability of the indemnification asset and any contractual limitations on the indemnified amount. FASB ASC 805-20-35-4 states that at each subsequent reporting date, the acquirer should measure an indemnification asset that was recognized in accordance with paragraphs 27–28 of FASB ASC 805-20-25 at the acquisition date on the same basis as the indemnified liability or asset. Further, the measure is subject to any contractual limitations on its amount and, for an indemnification asset that is not subsequently measured at its fair value, management's assessment of the collectability of the indemnification asset.

12.45 *Goodwill.*[†] In accordance with FASB ASC 350-20-35-1,goodwill should not be amortized. Instead, goodwill should be tested for impairment at a level of reporting referred to as a reporting unit. (Paragraphs 33–46 of FASB ASC 350-20-35 provide guidance on determining reporting units.) Impairment is the condition that exists when the carrying amount of goodwill exceeds its implied fair value, as stated in paragraphs 2–3 of FASB ASC 350-20-35. Paragraphs 4–19 of FASB ASC 350-20-35 describe a 2-step impairment test that should be used to identify potential goodwill impairment and measure the amount of a goodwill impairment loss to be recognized (if any).[‡] FASB 350-20 provides detailed guidance on accounting for goodwill.

12.46 *Financial statement presentation.* Paragraphs 1–2 of FASB ASC 350-30-45 state that at a minimum, all intangible assets should be aggregated and presented as a separate line item in the statement of financial position. However, that requirement does not preclude presentation of individual intangible assets or classes of intangible assets as separate line items. The amortization expense and impairment losses for intangible assets should be presented in income statement line items within continuing operations as deemed appropriate for each entity.

12.47 The aggregate amount of goodwill should be presented as a separate line item in the statement of financial position, as provided in paragraphs 1–3 of FASB ASC 350-20-45. The aggregate amount of goodwill impairment losses should be presented as a separate line item in the income statement before the subtotal income from continuing operations (or similar caption) unless a goodwill impairment loss is associated with a discontinued operation. A goodwill impairment loss associated with a discontinued operation should be included (on a net-of-tax basis) within the results of discontinued operations. FASB ASC 350-30-50 and 350-20-50 provide additional disclosure requirements for intangible assets and goodwill, respectively.

Exit or Disposal Activities

12.48 Exit activities include, but are not limited to, the closure of activities in a particular location, the relocation of activities from one location to another, changes in management structure, sale or termination of a line of business, or a fundamental reorganization that affects the nature and focus of operations.

[†] In April 2011, FASB issued proposed Accounting Standards Update (ASU) *Intangibles—Goodwill and Other (Topic 350): Testing Goodwill for Impairment*. The amendments in the proposed ASU are intended to reduce the complexity and costs by allowing an entity to make a qualitative evaluation about the likelihood of goodwill impairment to determine whether it should calculate the fair value of a reporting unit. The amendments in this proposed ASU would be effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. Early adoption would be permitted. FASB expects to issue final guidance during 2011. Readers should be alert for developments.

[‡] In December 2010, FASB issued ASU No. 2010-28, *Intangibles—Goodwill and Other (Topic 350): When to Perform Step 2 of the Goodwill Impairment Test for Reporting Units with Zero or Negative Carrying Amounts*. The amendments in this ASU modify step 1 of the goodwill impairment test for reporting units with zero or negative carrying amounts. For those reporting units, an entity is required to perform step 2 of the goodwill impairment test if it is more likely than not that a goodwill impairment exists. The amended guidance can be found in FASB ASC 350-20-35 and is labeled as "Pending Content" due to the transition and effective date information discussed in FASB ASC 350-10-65-2.

For public entities, the amendments in this ASU are effective for fiscal years, and interim periods within those years, beginning after December 15, 2010. Early adoption is not permitted. For nonpublic entities, the amendments are effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. Nonpublic entities may adopt the amendments using the effective date for public entities. Readers should consult the text of ASU No. 2010-28 for further information.

12.49 FASB ASC 420, *Exit or Disposal Cost Obligations*, discusses recognition of liabilities for the costs associated with exit or disposal activities, including, but not limited to, involuntarily employee termination benefits pursuant to a one-time termination benefit arrangement, costs to terminate a contract that is not a capital lease, and other associated costs, including costs to consolidate or close facilities and relocate employees, according to paragraphs 2–3 of FASB ASC 420-10-05.

Asset Retirement Obligations

12.50 FASB ASC 410-20 establishes accounting standards for recognition and measurement of a liability for an asset retirement obligation and the associated asset retirement costs, as stated in FASB ASC 410-20-05-1.

12.51 An example of an asset retirement obligation might include an obligation to restore space leased for bank operations to its original condition, including the cost of removing vaults, teller lines and drive-through facilities.

12.52 The guidance in FASB ASC 410-20 applies to legal obligations associated with the retirement of a tangible long-lived asset that result from the acquisition, construction, development and (or) the normal operation of a long-lived asset, including any legal obligations that require disposal of a replaced part that is a component of a tangible long-lived asset, according to FASB ASC 410-20-15-2(a). FASB ASC 410-20-25-4 requires that the fair value of a liability for an asset retirement obligation be recognized in the period in which it is incurred if a reasonable estimate of fair value can be made.

12.53 The FASB ASC glossary clarifies the term *conditional asset retirement obligation*, as used in FASB ASC 410-20, as a legal obligation to perform an asset retirement activity in which the timing and (or) method of settlement are conditional on a future event that may or may not be within the control of the entity. In addition, as defined in the FASB ASC glossary, the *asset retirement cost* is the amount capitalized that increases the carrying amount of the long-lived asset when a liability for an asset retirement obligation is recognized.

Customers' Liabilities on Acceptances

12.54 FASB ASC 942-310-35-8 establishes that provisions for uncollectible amounts for customers' acceptance liabilities should be made, if necessary. Customers' liabilities on acceptances should be reported gross, rather than net of the related bankers' acceptance liability in accordance with FASB ASC 942-310-45-1.

Mortgage Servicing Advances

12.55 Mortgage servicers may make payments on a borrower's behalf when escrow amounts, or other similar deposits, are not sufficient. For example, a servicer may pay a borrower's property tax to avoid a tax lien. Such amounts may need to be evaluated as to their significance and collectability by management.

Impairment of Long-Lived Assets

12.56 The "Impairment or Disposal of Long-Lived Assets" subsections of FASB ASC 360-10 establish the financial accounting and reporting for the impairment of long-lived assets to be held and used or to be disposed of,

including (*a*) capital leases of lessees, and (*b*) long-lived assets of lessors subject to operating leases, according to FASB ASC 360-10-15-4(a). See chapter 11 for the requirements of FASB ASC 360-10.

National Credit Union Share Insurance Fund Deposit

12.57 Federally insured credit unions are required, under 12 CFR 741.4c, to maintain on deposit with the NCUSIF during each reporting period an amount equal to 1 percent of the credit union's total insured shares at the close of the preceding reporting period. The amount on deposit is adjusted periodically for changes in the amount of a credit union's insured shares. For example, if the insured shares decline, a pro rata portion of the amount on deposit with the NCUSIF is refunded to the credit union. A credit union, according to 12 CFR 741.4d, is also required to pay to the NCUSIF, on dates the National Credit Union Administration (NCUA) board determines, but not more than twice in any calendar year, an insurance premium in an amount stated as a percentage of insured shares, which will be the same for all insured credit unions. The NCUA board may assess a premium charge only if the NCUSIF's equity ratio is less than 1.3 percent and the premium charge does not exceed the amount necessary to restore the equity ratio to 1.3 percent. If the equity ratio of NCUSIF falls below 1.2 percent, the NCUA board is required to assess a premium in an amount it determines is necessary to restore the equity ratio to, and maintain that ratio at, 1.2 percent.

12.58 FASB ASC 942-325-25-3 states that amounts deposited with the NCUSIF should be accounted for and reported as assets as long as such amounts are fully refundable.

12.59 The refundability of NCUSIF deposits should be reviewed for impairment, as stated in FASB ASC 942-325-35-4(a). When the refundability of a deposit is evaluated, the financial condition of both the credit union and of the NCUSIF should be considered. Deposits may be returned to solvent credit unions for a number of reasons, including the termination of insurance coverage, conversion to insurance coverage from another source, or the transfer of operations of the insurance fund from the NCUA board. However, insolvent or bankrupt credit unions should not be entitled to a return of their deposits. To the extent that NCUSIF deposits are not refundable, they should be charged to expense in the period in which the deposits are made or the assets become impaired.

12.60 FASB ASC 942-325-35-4(b) states that in years in which the equity of the NCUSIF exceeds normal operating levels, the NCUA is required to make distributions to insured credit unions to reduce the equity of the NCUSIF to normal operating levels. Such distributions may be in the form of a waiver of insurance premiums, premium rebates, or cash payments. Distributions in connection with that reduction in the equity of the NCUSIF should be reported in the income statement in the period in which it is determined that a distribution will be made.

12.61 FASB ASC 942-325-35-4(c) also states that the system of savings account insurance established by the recapitalization of the NCUSIF, which provided for reserves of 1 percent of insured deposits, is based on the concept that the necessary deposits create a fund with an earning potential sufficient to provide for the risk of losses in the credit union system. In years during which the earnings of the fund have been adequate to provide insurance protection and cover all expenses and losses incurred by the fund, the NCUA has elected to waive the insurance premiums due from insured credit unions. In those

years, it has been industry practice to net imputed earnings on the insurance deposits against imputed premium expense rather than present them as gross amounts on the statement of income. In years during which the insurance premiums are not waived by the NCUA, the premiums should be expensed in the period to which they relate. To the extent that the NCUA assesses premiums to cover prior operating losses of the insurance fund or to increase the fund balance to normal operating levels, credit unions should expense those premiums when assessed.

12.62 In a letter to federally-insured credit unions (NCUA Letter to Credit Unions No. 09-CU-02, "Corporate Credit Union System Strategy") issued on January 28, 2009, the NCUA announced certain actions it was taking to stabilize the corporate credit union system. The NCUA indicated that the expense of the actions would be passed on proportionately to all federally-insured credit unions through the partial write-off of such credit unions' existing deposits with the NCUSIF, as well as the assessment of an insurance premium sufficient to return the NCUSIF's equity to insured shares ratio to 1.30 percent.

12.63 On May 20, 2009, Helping Families Save Their Homes Act of 2009 ("Helping Families Act") became law. The legislation amended the Federal Credit Union Act providing several provisions favorable to credit unions including, but not limited to the following:

- The Temporary Corporate Credit Union Stabilization Fund was created to mitigate near term corporate credit union stabilization costs with NCUA authority to assess premiums over 7 years.
- The $250,000 share and deposit insurance limit was extended through 2013.
- The NCUSIF was provided authority to assess premiums over 8 years to rebuild the equity ratio, if needed.

See NCUA Letter to Credit Unions No. 09-CU-14, "Corporate Stabilization Fund Implementation," dated June 2009.

Other Investments

12.64 *CUSOs.*[1] Credit unions are allowed under the NCUA regulations to own and operate outside entities that conduct business related to the general services of the credit union. The types of businesses are restricted as to operations within the regulations. These entities may conduct business with other credit unions, credit union members, and nonmembers. In addition, credit unions can own these entities with other credit unions or outside third parties.

12.65 Credit unions are restricted in the amount of money that can be invested in and loaned to the CUSO. Under current regulations, credit unions can lend and invest up to 1 percent of the credit union's unimpaired capital and surplus. The CUSO can be structured as a corporation, a limited liability company, or a limited partnership as long as the credit union is not the general partner. All CUSOs must follow U.S. generally accepted accounting principles (GAAP), have an annual opinion audit, and prepare quarterly financial statements. A wholly owned CUSO is not required to obtain a separate annual financial statement audit if it is included in the annual consolidated financial statement audit of the credit union that is its parent. The recording of the

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[1] See Title 12 U.S. *Code of Federal Regulations* Part 712.

investment in or loan to the CUSO must also be accounted for in accordance with U.S. GAAP.

12.66 The following are the general approved categories of CUSOs within the regulations:

- Checking and currency services
- Clerical, professional and management services
- Business loan origination
- Consumer mortgage loan origination
- Electronic transaction services
- Financial counseling services
- Fixed-asset services
- Insurance brokerage services
- Leasing
- Loan support services
- Record retention, security, and disaster recovery services
- Securities brokerage services
- Shared branching
- Student loan origination
- Travel agency
- Trust and trust-related services
- Real estate brokerage services
- Non-CUSO service providers
- Credit card loan origination
- Payroll processing services

12.67 Under current IRS regulations, federally chartered credit unions do not have to pay taxes on income from flow-through entities. However, state chartered credit unions may be liable for taxes on flow-through income. All CUSOs must follow all relevant IRS and state reporting and filing requirements.

12.68 In accordance with FASB ASC 323, *Investments—Equity Method and Joint Ventures*, the equity method of accounting should be used if the institution has the ability to exercise significant influence over the operating and financial policies of the investee or CUSO. The equity method tends to be most appropriate if an investment enables the investor to influence the operating or financial decisions of the investee, as stated in FASB ASC 323-10-05-5. The investor then has a degree of responsibility for the return on its investment, and it is appropriate to include in the results of operations of the investor its share of the earnings or losses of the investee. Influence tends to be more effective as the investor's percent of ownership in the voting stock of the investee increases. Investments of relatively small percentages of voting stock of an investee tend to be passive in nature and enable the investor to have little or no influence on the operations of the investee.

12.69 An entity separate from the institution may be a variable interest entity that is subject to consolidation in accordance with the "Variable Interest Entities" subsections of FASB ASC 810-10, according to FASB ASC 810-10-15-9.

The "Variable Interest Entities" subsections of FASB ASC 810 clarify the application of the "General" subsections to certain entities in which equity investors do not have sufficient equity at risk for the legal entity to finance its activities without additional subordinated financial support or, according to "Pending Content" in FASB ASC 810-10-05-8, as a group, the holders of the equity investment at risk lack any one of the following three characteristics:

a. The power, through voting rights or similar rights, to direct the activities of a legal entity that most significantly impact the entity's economic performance

b. The obligation to absorb the expected losses of the legal entity

c. The right to receive the expected residual returns of the legal entity.

Contributed Assets

12.70 Many credit unions receive substantial contributions (for example, use of facilities and utilities, telephone services, data processing, mail services, payroll processing services, pension administration services and pension plan contributions, and other materials and supplies) from their sponsoring organizations. Many credit unions also rely on volunteers to provide various services to their members; some credit unions are staffed exclusively by volunteers. In addition, credit unions occasionally receive contributions of assets of material value.

12.71 Contributions received, as provided by FASB ASC 958-605-25-2, should be recognized as revenue or gains in the period received and as assets, decreases of liabilities, or expenses depending on the form of the benefits received. FASB ASC 958-605-25-8 clarifies that, pursuant to FASB ASC 958-605-25-2, an unconditional promise to give should be recognized when it is received. However, to be recognized there must be sufficient evidence in the form of verifiable documentation that a promise was made and received. Contributions of services should be recognized only if the services received (*a*) create or enhance nonfinancial assets or (*b*) require specialized skills, are provided by individuals possessing those skills, and would typically need to be purchased if not provided by donation, as explained in FASB ASC 958-605-25-16.

12.72 Contributions received should be measured at their fair values, according to FASB ASC 958-605-30-2. FASB ASC 820, *Fair Value Measurement*, defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. See chapter 20, "Fair Value," of this guide for a summary of FASB ASC 820.

12.73 The fair value of the asset should be determined based on the assumptions that market participants would use in pricing the asset, as stated in FASB ASC 820-10-35-9.[||] In accordance with FASB ASC 958-605-30-6, unconditional promises to give that are expected to be collected in less than one year may be measured at net realizable value because that amount results in

[||] In May 2011, FASB issued ASU No. 2011-04, *Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*. The amendments in this ASU result in common fair value measurement and disclosure requirements in accounting principles generally accepted in the United States of America (U.S. GAAP) and International Financial Reporting Standards. The amendments alter the wording used to describe many of the requirements in U.S. GAAP for measuring fair value and for disclosing information about fair value measurements. The ASU does not require additional fair value measurements and is not intended to establish valuation standards or affect valuation practices outside of financial reporting.

a reasonable estimate of fair value. Contributions of services that create or enhance nonfinancial assets may be measured by referring to either the fair value of the services received or the fair value of the asset or of the asset enhancement resulting from the services, as stated in FASB ASC 958-605-30-10. A major uncertainty about the existence of value may indicate that an item received or given should not be recognized, according to FASB ASC 958-605-25-4. The future economic benefit or service potential of a tangible item usually can be obtained by exchanging it for cash or by using it to produce goods or services, as stated in FASB ASC 958-605-25-5. FASB ASC 958-605-50-1 sets forth certain disclosure requirements for receipts of contributed services.

Auditing

Objectives

12.74 *Other assets.* The primary objectives of audit procedures applied to other assets are to obtain sufficient appropriate evidence that

a. the assets exist and are owned by the institution;

b. the assets are properly classified, described, and disclosed in the financial statements;

c. intangible assets that should be amortized are being amortized on a consistent basis over the estimated period of benefit;

d. adequate provisions have been made for impairment, if any, of the assets;

e. sales of assets, including the recognition of gains and losses, have been properly recognized; and

f. appropriate disclosures, including the existence of liens, have been made.

12.75 *Other liabilities.* The primary objectives of auditing other liabilities are to obtain reasonable assurance that

- the liabilities represent authorized obligations of the institution; and
- all contingencies and estimated current period expenses that will be paid in future periods that should be accrued during the period have been accrued, classified, and described in accordance with GAAP, and the related disclosures are adequate.

Planning

12.76 In accordance with AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), the auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement of the financial statements whether due to error or

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(footnote continued)

The amendments in this ASU are effective prospectively (1) for public entities, for interim and annual periods beginning after December 15, 2011 and (2) for nonpublic entities, for annual periods beginning after December 15, 2011. Early application is not permitted for public entities. Early application is permitted for nonpublic entities, but only for interim periods beginning after December 15, 2011. See FASB ASC 820-10-65-8 for further information regarding changes in valuation technique as a result of implementation of respective guidance. Readers should consult the text of ASU No. 2011-04 for further information.

fraud, and to design the nature, timing, and extent of further audit procedures (as described in chapter 5, "Audit Considerations and Certain Financial Reporting Matters"). Presented in the following list are examples of factors related to other assets and other liabilities that may indicate higher risks of material misstatement for these areas:

- A current interest rate environment that may adversely affect the values of intangible assets that derive their value from (*a*) loan relationships or (*b*) from the timing and amount of future cash flows
- Loss of depositor relationships
- Prepayments of loans resulting in loss of servicing revenue and relationships
- Operating losses and uncertainty about future taxable income
- Declining real estate values
- Unreconciled balances in suspense accounts
- Litigation or regulatory enforcement actions or both
- Planned branch dispositions
- Operating losses at FHLBs or NCUSIF

Internal Control Over Financial Reporting and Possible Tests of Controls

12.77 AU section 314 establishes standards and provides guidance on obtaining a sufficient understanding of the entity and its environment, including its internal control. It provides guidance on understanding the components of internal control and explains how an auditor should obtain a sufficient understanding of internal control for the purposes of assessing the risks of material misstatement. Paragraph .40 of AU section 314 requires that, in all audits, the auditor should obtain an understanding of the five components of internal control (the control environment, risk assessment, control activities, information and communication systems, and monitoring), sufficient to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. The auditor should obtain a sufficient understanding by performing risk assessment procedures to evaluate the design of controls relevant to an audit of financial statements and to determine whether they have been implemented. Paragraph .102 of AU section 314 states the auditor should identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions, account balances, and disclosures.

12.78 AU section 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*), establishes standards and provides guidance on determining overall responses and designing and performing further audit procedures to respond to the assessed risks of material misstatement at the financial statement and relevant assertion levels in a financial statement audit, and on evaluating the sufficiency and appropriateness of the audit evidence obtained.

12.79 The auditor should perform tests of controls when the auditor's risk assessment includes an expectation of the operating effectiveness of controls or when substantive procedures alone do not provide sufficient appropriate audit

evidence at the relevant assertion level. Typical financial reporting controls may include the following:

- Written policies and procedures that, among other things, specify depreciation and amortization methods and periods for property and equipment
- Proper authorizations for specific transactions, such as approval for property and equipment purchases and sales
- Periodic reviews of balances, fair values, realizable values, and policies by persons specified in management's written policy
- Written policies and procedures aimed at assessing possible impairment of assets on a periodic basis

Substantive Tests

12.80 Regardless of the assessed risks of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions related to other assets and other liabilities.

12.81 *FHLB or FRB stock.* If the institution is a member of the FHLB or Federal Reserve System, the auditor should consider (*a*) confirming stock ownership with the related FHLB or FRB and (*b*) reconciling the dollar amount of the shares with the institution's general ledger. For institutions holding FHLB stock, the auditor should consider the status of the FHLB's redemption of its stock at par value before concluding that income recognition is appropriate for any FHLB stock dividends.

12.82 *Premises and equipment.* Substantive procedures used to test premises and equipment consist primarily of physical inspection, review of documents of title or other documents supporting the acquisition, tests of disposals and other adjustments, and reasonableness tests of depreciation. Similar procedures are often used to test the classification, recording, and disclosure of leased premises and equipment.

12.83 Auditors should be alert for signs that premises and equipment are no longer in use and consider tests to determine whether there are any undisclosed liens on premises and equipment. If those signs are present, the auditor might test whether there is impairment of the premises and equipment that should be recognized. Also, computer hardware and software are particularly vulnerable to obsolescence and their valuation should be reviewed if not in use.

12.84 *Intangible assets and goodwill.* The auditor is responsible for evaluating the reasonableness of accounting estimates made by management in the context of the financial statements taken as a whole. AU section 342, *Auditing Accounting Estimates* (AICPA, *Professional Standards*),[#] provides guidance on auditing accounting estimates (such as estimates of fair values). AU section 342

[#] The Auditing Standards Board (ASB) has finalized a new clarified auditing standard, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*. This auditing standard, which will supersede AU section 328, *Auditing Fair Value Measurements and Disclosures*, and AU section 342, *Auditing Accounting Estimates* (AICPA, *Professional Standards*), addresses the auditor's responsibilities relating to accounting estimates, including fair value accounting estimates and related disclosures. Additionally, it expands on how other clarified auditing standards are to be applied in relation to accounting estimates, and includes requirements and guidance related to misstatements of individual accounting estimates and indicators of possible management bias. This clarified auditing standard has been finalized but not yet issued. See the preface of this guide for further

discusses how an auditor should obtain an understanding of how management developed estimates, concentrating on the key factors and assumptions used, and evaluates the reasonableness of those estimates. In this area, such key factors and assumptions may include the ability of the assets to generate income in the future, the expected lives of loans, expected losses on assets subject to contractual indemnities, or expected withdrawal rates of deposits. The auditor should consider whether the assumptions continue to be reasonable and evaluate the effect of changes in assumptions on the recoverability of the assets. Additionally, the auditor might consider using a specialist to assist in this evaluation.

12.85 *Customers' liabilities on acceptances.* Substantive tests that are performed on loans, such as confirmation and collectibility reviews, are generally used to test customers' liabilities on acceptances. (See chapters 8 and 9, "Credit Losses.")

12.86 *Other liabilities.* Substantive audit procedures relating to interest payable, accrued expenses, and other liability amounts that the auditor might perform include the following:

- Tracing recorded amounts to supporting documentation
- Agreeing rates used in the calculation of recorded amounts of interest payable to board of directors' authorization
- Testing individual calculations of accrued interest (dividends)
- Tracing recorded amounts to subsequent cash disbursements
- Examining evidence supporting the carrying amount of other liabilities, including such items as an actuarial evaluation used to compute accrued pension costs, payroll tax returns, and invoices received from third parties
- Confirming recorded amounts
- Performing a search for unrecorded liabilities
- Circulating attorney letters
- Performing analytical procedures
- Evaluating key assumptions, such as discount rates

12.87 *Suspense accounts.* The auditor should consider reviewing the suspense account for material items remaining in the account at year-end for reclassification entries to the appropriate account. The auditor should also consider reviewing for subsequent entries made to clear suspense account items.

(footnote continued)

information on the ASB's Clarity Project. The effective date of this clarified standard is for audits of financial statements for periods ending on or after December 15, 2012, unless otherwise established (early implementation is not permitted).

Chapter 13

Deposits

Introduction

13.01 Deposits are an important source of funds for banks, credit unions, and savings institutions. Finance and mortgage companies do not take insured deposits. Because a credit union's members are also its owners, credit unions often refer to deposits as *share accounts* and related interest paid as *dividends.* Some credit unions permit nonmembers to deposit funds subject to certain restrictions.

13.02 Deposits are often an institution's most significant liability and interest expense on deposits an institution's most significant expense.

13.03 Deposits are generally classified by whether they bear interest, by their ownership (for example, public, private, interbank, or foreign), and by their type (for example, demand, time, and savings; or transaction and non-transaction). A description of various deposit products follows. These descriptions may not correspond to regulatory designations under Federal Reserve Board Regulation D.

Demand Deposits*

13.04 Demand deposits (often called *transaction accounts* or *DDAs*) are accounts that may bear interest and the depositor is entitled to withdraw at any time without prior notice. Checking and negotiable order of withdrawal accounts are the most common form of demand deposits. Withdrawals are typically made through check writing, automated teller machines (ATMs), debit cards at point-of-sale (POS) terminals, electronic funds transfers (EFTs), or preauthorized payment transactions. Deposits are generally made through direct deposit (such as payroll amounts) or EFTs, or at ATMs or teller windows.

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* Under Regulation D, demand deposit accounts (DDAs) and negotiable order of withdrawal (NOW) accounts are types of transaction accounts. DDAs may not be interest-bearing under federal regulation, whereas NOW accounts may bear interest.

In November 2010, the Federal Deposit Insurance Corporation's (FDIC) Board of Directors issued a final rule to implement Section 343 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) that provides temporary unlimited coverage for noninterest-bearing transaction accounts at all FDIC insured depository institutions (IDIs). The separate coverage for non-interest-bearing transaction accounts became effective on December 31, 2010, and terminates on December 31, 2012. See FDIC Financial Institution Letter (FIL)-76-2010, "Final Rule: Temporary Unlimited Coverage for Noninterest-Bearing Transaction Accounts," for further information.

Effective July 21, 2011, Section 627 of the Dodd-Frank Act permits IDIs to pay interest on DDAs. In response to this provision of the Dodd-Frank Act, the FDIC released FIL-38-2011, "Deposit Insurance Notice Requirement Regarding the Payment of Interest on Demand Deposit Accounts," to remind IDI's that if on or after July 21, 2011, an IDI modifies the terms of a DDA so that the account may pay interest, the IDI must notify the affected customers that the account no longer will be eligible for unlimited deposit insurance coverage as a non-interest-bearing transaction account (issued May 2011).

Savings Deposits

13.05 Savings deposits bear interest and have no stated maturity. Savings deposits include passbook and statement savings accounts and money-market deposit accounts (MMDAs). Withdrawals and deposits are typically made at ATMs or teller windows, by EFTs, or by preauthorized payments. Furthermore, MMDAs generally permit the customer to write checks, although the number of checks that may be written is limited by law.

Time Deposits

13.06 Time deposits, which include certificates of deposit (CDs), individual retirement accounts (IRAs), and open accounts, bear interest for a fixed, stated period of time.

13.07 CDs bear a stipulated maturity and interest rate, payable either periodically or at maturity. CDs may be issued in bearer form (payable to the holder) or registered form (payable only to a specified individual or entity) and may be negotiable or nonnegotiable (always issued in registered form). Negotiable CDs, for which there is an active secondary market, are generally short term and are most commonly sold to corporations, pension funds, and government bodies in large denominations (generally, $100,000 to $1 million). Nonnegotiable CDs, including savings certificates, are generally in smaller denominations. Depositors holding nonnegotiable CDs may recover their funds prior to the stated maturity, however, in doing so they normally pay a penalty.

13.08 Retirement accounts known as IRAs, Keogh accounts (also known as H.R. 10 plans), and self-employed-person accounts are generally maintained as CDs. However, because of the tax benefits for depositors, they typically have longer terms than most CDs. Many retirement accounts provide for automatic renewal on maturity.

13.09 Open accounts are time deposits with specific maturities and fixed interest rates but, unlike savings certificates, amounts may be added to them until maturity. Common types of open accounts are vacation and Christmas club accounts.

13.10 According to Internal Revenue Code regulations, employers that withhold federal taxes from employees' pay are required to deposit those funds periodically with a depository institution. Institutions record such deposits, which are noninterest-bearing, as treasury tax and loan accounts and include such accounts with their deposits. (See chapter 15, "Debt," paragraph 15.18.)

Brokered Deposits

13.11 Brokered deposits are time deposits that are third-party deposits placed by or through the assistance of a deposit broker. Deposit brokers sometimes sell interests in placed deposits to third parties. As discussed in subsequent paragraphs, federal law restricts the acceptance and renewal of brokered deposits by an institution based on its capitalization.

13.12 Brokered deposits are similar to other deposits in that they represent funds placed at the institution by a third party. However, they are fundamentally different in that the funds were acquired through the use of a broker, not through a customer relationship.

13.13 In recent years, a new brokered deposit account type known as the Certificate of Deposit Account Registry System (CDARS) program has become more prevalent. With CDARS, an investor who wishes to buy CDs in excess of the Federal Deposit Insurance Corporation (FDIC) insurance limit is able to do so through one account. The sponsoring financial institution sells the amount in excess of the FDIC insurance limit to other institutions. The investor ultimately has one CDARS account through which their entire CD balance is FDIC insured. Financial institutions can participate in the process through buying deposits, selling deposits, or a reciprocating relationship.

Dormant Accounts

13.14 Institutions generally have a policy on classifying accounts as dormant. Before a savings account is classified as dormant, it must be inactive for a standard period of time, which normally exceeds that of checking accounts. After a much longer specific period of inactivity, as determined by the state in which the institution is located, state regulations may require the inactive deposits be turned over to (escheated to) the state.

Closed Accounts

13.15 When an account is closed, the signature card or electronic file is generally removed from the file of active accounts and placed in a closed-account section.

Other Deposit Services

13.16 Institutions often offer other deposit services such as reserve or overdraft protection programs[1] (which combine a checking account and a preauthorized personal loan), check guarantee services, and consolidated account statements (which combine the account information of several services into one monthly statement).

The Payments Function and Services

13.17 The payments function of a depository institution involves facilitating money payments and transferring funds. The payments function is accomplished through checks and EFTs.

13.18 *Check processing.* The check-clearing process, which is highly automated, involves the exchange of checks and the settlement of balances among institutions locally, regionally, and nationally. Check processing traditionally involved the encoding of checks with magnetic ink character recognition (MICR) symbols to facilitate routing, the proof and transit function, and the flow of checks for collection. A correspondent system and the Federal Reserve perform such clearinghouse functions for depository institutions. More recently, check processing occurs through the digital capture of check images and the electronic transfer and settlement between accounts.

13.19 An institution receives two types of checks: (*a*) on-us checks, drawn on a depositor's account and (*b*) foreign checks, drawn on accounts of other institutions. Such checks may be received from the Federal Reserve, local

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[1] Interagency guidance issued by the Office of the Comptroller of the Currency, the Federal Reserve, the FDIC, the Office of Thrift Supervision, and the National Credit Union Association, addresses the risks and accounting treatment associated with overdraft protection programs.

clearinghouses, other depository institutions, at an ATM or teller window, through the mail, or by other means, such as a loan payment.

13.20 Many physical checks that an institution receives have been dollar-amount encoded by the first institution that handles the check. However, checks received through an institution's own operations must go through its proof department or its correspondent bank. A proof department has the responsibility to

a. prove the individual transaction against its documentation, such as a deposit slip;

b. verify totals for several departments;

c. encode the dollar-amount field;

d. mechanically endorse the back of the check; and

e. sort the items according to destination.

13.21 The flow of physical checks for collection depends primarily on the location of the institution on which the check is drawn. Processing an on-us check for deposit to another account in the same institution is straightforward: The institution debits the check writer's account and credits the check depositor's account. Processing a check drawn on another depository institution, however, can be complex.

13.22 Though some direct collections are made in the banking system, most institutions collect foreign checks through a clearing arrangement (clearinghouse), a correspondent bank, or the Federal Reserve.

13.23 In a clearing arrangement, a group of depository institutions in a given area that receive large numbers of deposited checks drawn on one another meets to exchange and collect payment for the checks. Checks are physically exchanged among participants, and collection is made by crediting or debiting the net amount presented by each institution against all the others.

13.24 When a correspondent institution receives a check drawn on one of its respondent institutions, the check collection process can take several different routes. If the presented check is drawn on an institution that also maintains an account with the correspondent, collection simply involves the correspondent's transfer of deposit credit from one account to another account. If the check is drawn on an institution that does not have an account relationship with the correspondent, the check is credited to the respondent institution's account and then either (*a*) sent to a second correspondent in which the first correspondent and the institution on which the check is drawn both have an account, (*b*) sent to a local clearinghouse, or (*c*) sent to a Federal Reserve bank.

13.25 The Federal Reserve collects checks by internally transferring credit balances from one account to another, in much the same way that individual institutions collect on-us checks. For presenting and paying institutions that have accounts at two different Federal Reserve banks, an extra step is involved in the collection process. Each Federal Reserve bank has an interdistrict settlement account that it maintains on the books of the Interdistrict Settlement Fund established in Washington, D.C., to handle settlements. A check presented to one Federal Reserve bank drawn on a depository institution in another Federal Reserve district will result in a transfer of interdistrict settlement account balances from one Federal Reserve bank to another.

13.26 *EFT systems.* Institutions have responded to the large volume of checks and the high costs of clearing checks by increasingly using EFT systems. EFT systems are computer-based networks designed to move funds to and from accounts and to and from other institutions electronically, thus eliminating paper-based transactions. Banks and savings institutions transact an enormous volume of daily business between themselves and for customers over regional and national EFT systems. The three principal kinds of EFT systems are direct deposit systems, automated clearinghouse (ACH) systems, and ATMs.

13.27 A direct deposit system involves the direct deposit of payments into a customer's account without the use of a definitive check and is widely used for payrolls. The payment information is usually transmitted to the institution from the payer in electronic form and processed through the institution's proof system.

13.28 An ACH is used to transfer funds from one institution's account at a Federal Reserve bank to that of another; conduct transactions in the federal funds market; transfer funds for customers; transfer book entries representing certain securities; and receive, send, and control other specific EFT messages between member banks and other clearinghouses. The largest ACH is Fedwire, operated by the Federal Reserve. The Clearing House Interbank Payments System (CHIPS) is an ACH operated by the New York Clearing House Association and is the focal point for payments in the world's international dollars market. International dollar payments generally do not leave the United States but are held as deposits at money-center and regional banks or the U.S. branches of foreign banks and are transferred between accounts through CHIPS in payment for internationally traded goods and services, international financial transactions, or settlement of debt.

13.29 Institutions also provide a variety of retail EFT services, including ATMs, POS terminals, telephone bill payment, and home computer banking.

13.30 *The Check Clearing for the 21st Century Act (Check 21).* Check 21 requires financial institutions to recognize paper checks constructed from digital images as negotiable instruments (Subpart D of Regulation CC, Expedited Funds Availability). These negotiable instruments, known as *substitute checks*, contain certain information to be considered a legal equivalent of an original check. To be a legal equivalent, substitute checks must

a. be suitable for automated processing;

b. bear a MICR line containing all the information appearing on the original check;

c. meet the technical requirements for substitute checks;

d. bear a legend that states, "This is a legal copy of your check. You can use it the same way you would use the original check;" and

e. be able to be processed in the same manner as the original check with current check processing equipment.

13.31 Check 21 includes necessary warranties, indemnities and disclosures. If a financial institution transfers, presents, or returns a substitute check for consideration (payment), it warrants that

a. the substitute check has met all the requirements to have legal equivalence to the original check, and

b. no party will be asked to pay a check that already has been paid.

Under these warranties, the financial institution will indemnify any person who suffered a loss due to the receipt of a substitute check instead of the original check. If the financial institution transferred a substitute check to a consumer who experienced a loss, it may be responsible for recrediting the consumer. Banks normally have procedures in place for processing recredit amounts for consumer payment. Additionally, upon the implementation of Check 21, certain consumer disclosures explaining Check 21 are required to be sent to consumers.

13.32 With Check 21, financial institutions can convert paper checks into electronic images and deliver Image Replacement Documents in place of the original for payment. Additionally, two banks or a network of multiple banks through mutual agreement can now exchange data taken from the MICR of the original check or an electronic image of the original check, and drastically reduce turnaround time (float).

Regulatory Matters

Limitations on Brokered Deposits

13.33 Restrictions on the acceptance of brokered deposits, particularly for institutions that become undercapitalized, could affect an institution's liquidity. The effect of such restrictions on liquidity may be a condition, when considered with other factors that could indicate substantial doubt about an entity's ability to continue as a going concern. (See chapter 5, "Audit Considerations and Certain Financial Reporting Matters.")

13.34 *Banks and savings institutions.* Section 29 of the Federal Deposit Insurance (FDI) Act (codified in Title 12 U.S. *Code of Federal Regulations* [CFR] Part 337) significantly limits the acceptance or use of brokered deposits, funds which the reporting bank obtains directly or indirectly by or through any deposit broker for deposit into one or more accounts, by depository institutions other than those that are well capitalized (as defined for purposes of prompt corrective regulatory action, as discussed in chapter 1, "Industry Overview—Banks and Savings Institutions"). Adequately capitalized institutions may accept brokered deposits only if they first obtain a waiver from the FDIC. Undercapitalized institutions are prohibited from accepting brokered deposits.

13.35 Also, the federal banking agencies may restrict the use of brokered deposits of institution about which the agencies have concerns, even though the institution may continue to be deemed well capitalized. Such restriction may be evidenced by a memorandum of understanding, board resolution, cease-and-desist order or other regulatory order.

13.36 Section 29 of the FDI Act also limits the interest rates that may be offered by under- or adequately capitalized institutions. Undercapitalized institutions may not solicit any deposits by offering rates significantly higher (as defined) than prevailing rates in the institution's market area or the prevailing rate in the market area from which the deposit is accepted. Adequately capitalized institutions are prohibited from paying interest on brokered deposits above certain levels. The applicable federal banking agency may also restrict the rate paid by well capitalized institutions.

13.37 Effective January 1, 2010, institutions subject to these interest rate restrictions are required to use the "national rate" to determine conformance with the restrictions. The *national rate* is defined as a simple average of rates

paid by insured depository institutions and branches for which data are available. Institutions subject to the restrictions operating in an area where the rates paid on deposits are higher than the "national rate" can use the local market to determine the prevailing rate if they seek and receive approval from the FDIC. See FDIC Financial Institution Letter-69-2009, "Process for Determining If An Institution Subject to Interest-Rate Restrictions is Operating in a High-Rate Area," dated December 4, 2009.

13.38 *Credit unions.* Section 107(6) of the Federal Credit Union Act (codified in 12 CFR 701.32(b)) limits the acceptance and use of nonmember and public unit deposits (as defined), including brokered deposits, to the greater of (*a*) 20 percent of the total deposits of the federal credit union or (*b*) $1.5 million.

Classification of Deposits of Credit Unions

13.39 The Credit Union Membership Access Act (H.R. 1151) (codified in 12 CFR 715) requires all federally insured credit unions with assets of $10 million and over to follow U.S. generally accepted accounting principles (GAAP). Accordingly, all federally insured credit unions with over $10 million in assets are required to file their call report on a U.S. GAAP basis. However, the call report is not structured for U.S. GAAP presentation and disclosure and shows deposits in a separate category, not in equity or liabilities. To the National Credit Union Association (NCUA), the call report deals specifically with recognition and measurement for U.S. GAAP rather than presentation and disclosure.

13.40 As discussed further in paragraph 13.62, supervisory committees of federal credit unions are required to perform a verification of member's accounts.

Accounting and Financial Reporting[2]

13.41 Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 942-405-25-3 states that the institution's liability for deposits originates and should be recognized at the time deposits are received from customers rather than when the institution collects the funds from other institutions. Checks that are deposited by customers and that are in the process of collection and are currently not available for withdrawal (deposit float) should be recorded as assets and liabilities. Deposits should not be recorded based solely on collections.

13.42 Deposit accounts that are overdrawn should be reclassified as loans and should therefore be evaluated for collectibility as part of the evaluation of credit loss allowances.

13.43 Credit unions and corporate credit unions should report unequivocally all member deposit accounts, including member shares, as liabilities in the

[2] In June 2010, the AICPA issued Technical Questions and Answers (TIS) section 2130.38, "Certificates of Deposit and Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 820, *Fair Value Measurements and Disclosures*," TIS section 2130.39, "Balance Sheet Classification of Certificates of Deposit," and TIS section 2130.40, "Certificates of Deposit and FASB ASC 320, *Investments—Debt and Equity Securities*" (AICPA, *Technical Practice Aids*). TIS section 2130.38 addresses whether certificates of deposit (CDs) are within the scope of the disclosure requirements of FASB ASC 820, *Fair Value Measurement*. TIS section 2130.39 addresses where in a classified balance sheet an entity should report a CD. TIS section 2130.40 addresses whether a CD is within the scope of FASB ASC 320, *Investments—Debt and Equity Securities*.

statement of financial condition, as stated in FASB ASC 942-405-25-4. The statement of financial condition should either (*a*) present deposit accounts as the first item in the liabilities and equity section or (*b*) include deposit accounts within a captioned subtotal for total liabilities, according to paragraphs 3–4 of FASB ASC 942-405-45. An unclassified presentation whereby all liabilities and equity are shown together under one subheading and savings accounts are presented as the last item before retained earnings is not an acceptable presentation. The interest paid or accrued on these accounts, commonly referred to as *dividends,* should be reported as an interest expense on the statement of income, and the amount of interest payable to members should be included as a liability in the statement of financial condition.

13.44 FASB ASC 942-405-50-1 states that disclosures about deposit liabilities should include the following:

a. The aggregate amount of time deposit accounts (including CDs) in denominations of $100,000 or more at the balance sheet date

b. Securities, mortgage loans, or other financial instruments that serve as collateral for deposits, that are otherwise not disclosed under FASB ASC 860, *Transfers and Servicing*

c. The aggregate amount of any demand deposits that have been reclassified as loan balances, such as overdrafts, at the balance-sheet date

d. Deposits that are received on terms other than those available in the normal course of business

13.45 Some additional disclosures about deposits should generally include the following:

a. For time deposits having a remaining term of more than one year, the aggregate amount of maturities for each of the five years following the balance sheet date (in conformity with FASB ASC 470-10-50-1)

b. The amount of deposits of related parties at the balance-sheet date (in conformity with FASB ASC 850, *Related Party Disclosures*)

13.46 In conformity with FASB ASC 825, *Financial Instruments*, the fair value of deposits should also be disclosed. FASB ASC 942-470-50-1 states that in estimating the fair value of deposit liabilities, a financial entity should not take into account the value of its long-term relationships with depositors, commonly known as core deposit intangibles, which are separate intangible assets, not financial instruments. For deposits liabilities with no defined maturities, the fair value to be disclosed under FASB ASC 825-10-50-13 and FASB ASC 825-10-60-1 is the amount payable on demand at the reporting date.

Auditing

Objectives

13.47 The primary objectives of auditing procedures for deposit liabilities are to obtain sufficient appropriate evidence that

a. financial statement amounts for deposit liabilities and related transactions include all deposit obligations of the institution and reflect all related transactions for the period; and

b. deposit liabilities and related income statement and balance-sheet

accounts have been properly valued, classified, and disclosed in conformity with GAAP.

Planning

13.48 In accordance with AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), the auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures (as described in chapter 5). The following factors related to deposits may contribute to higher inherent risk:

a. Large number of accounts and volumes of transactions

b. Transactions executed through a variety of means and locations

c. Accounts typically can be opened in numerous locations or through the Internet

d. Recurring and significant difficulties in reconciling exception items

e. A practice of permitting depositors to withdraw funds from their accounts before deposited checks have been collected by the institution

f. Introduction of new deposit products

g. The existence and activity of previously inactive or dormant accounts

h. Significant increases in the number of closed accounts, especially near the end of a reporting period

i. Numerous accounts having instructions not to mail account statements to the depositor (*no-mail* accounts)

13.49 As stated in paragraph .20 of AU section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*), at the account balance, class of transactions, relevant assertion, or disclosure level, audit risk consists of (*a*) the risk (consisting of inherent risk and control risk) that the relevant assertions related to balances, classes, or disclosures contain misstatements (whether caused by error or fraud) that could be material to the financial statements when aggregated with misstatements in other relevant assertions related to balances, classes, or disclosures and (*b*) the risk (detection risk) that the auditor will not detect such misstatements. These components of audit risk may be assessed in quantitative terms, such as percentages, or in nonquantitative terms such as high, medium, or low risk. The way the auditor should consider these component risks and combines them involves professional judgment and depends on the auditor's approach or methodology. For example, if deposit liabilities have a higher inherent risk, considering factors listed in paragraph 13.48 or other factors, and if there is a basis for concluding that control risk is low, the auditor may conclude that the overall risk of material misstatement is low.

Internal Control Over Financial Reporting and Possible Tests of Controls

13.50 AU section 314 establishes standards and provides guidance on obtaining a sufficient understanding of the entity and its environment, including its internal control. It provides guidance on understanding the components

of internal control and explains how an auditor should obtain a sufficient understanding of internal control for the purposes of assessing the risks of material misstatement. Paragraph .40 of AU section 314 requires that, in all audits, the auditor should obtain an understanding of the five components of internal control (control environment, risk assessment, control activities, information and communication, and monitoring), sufficient to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. The auditor should obtain a sufficient understanding by performing risk assessment procedures to evaluate the design of controls relevant to an audit of financial statements and to determine whether they have been implemented. Paragraph .102 of AU section 314 states that the auditor should identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions, account balances, and disclosures.

13.51 AU section 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*), establishes standards and provides guidance on determining overall responses and designing and performing further audit procedures to respond to the assessed risks of material misstatement at the financial statement and relevant assertion levels in a financial statement audit, and on evaluating the sufficiency and appropriateness of the audit evidence obtained.

13.52 Effective internal control (as it relates to financial reporting of deposits) generally should provide reasonable assurance that (*a*) deposits are accepted in accordance with management's established policies, (*b*) misstatements caused by error or fraud in the processing of accounting information for deposits are prevented or detected, and (*c*) deposits are monitored on an ongoing basis to determine whether recorded financial statement amounts necessitate adjustment.

13.53 According to paragraph .70 of AU section 314, the auditor should obtain sufficient knowledge of the control environment to understand the attitudes, awareness, and actions of those charged with governance concerning the entity's internal control and its importance in achieving reliable financial reporting. In understanding the control environment, the auditor should concentrate on the implementation of controls because controls may be established but not acted upon. Control activities that may contribute to a strong control environment may include

- policies and procedures approved by the board of directors and that include position limits for each type of deposit (including brokered deposits) and guidelines for setting the interest rates offered on deposits.
- segregation of duties between persons involved with the proof function, persons having access to cash, persons responsible for opening new accounts and issuing CDs or savings certificates, persons with responsibility for authorizing account adjustments, and persons with responsibility for posting information to the general ledger. (Because many of the potential duty conflicts found in the deposit area also exist for cash, it is usually efficient to coordinate any assessment of segregation of duties in those two areas.)
- reconciliation of subsidiary ledgers for deposit principal, accrued interest, and related accounts to the general ledger on a periodic basis.

- daily performance of a proof and transit operation with rejected or exception items segregated and individually reviewed. (Examples of such items include activity in dormant accounts or customer overdrafts.)
- designation by management of persons such as officers or supervisory employees, to be responsible for reviewing and approving unposted holdover items, overdrafts, return items, and status of inactive or dormant accounts.
- files, ledger cards, canceled checks, deposit tickets, signature cards, and unissued CDs and savings certificates safeguarded from unauthorized access (including dual control over and prenumbering of unissued certificates and official checks).
- periodic depositor account statements mailed regularly. (Returned statements are controlled, with follow-up on a timely basis.)
- supervisory personnel designated by management to be responsible for periodically reviewing activity in employee accounts for unusual transactions.
- EFTs subject to control procedures that
  - segregate duties between employees who handle cash, balance EFT transactions, authorize EFTs, and post EFTs to deposit accounts.
  - require authorization for EFTs exceeding a depositor's available balance.
  - establish and maintain current, written agreements with all depositors making EFT requests, particularly for those customers who initiate EFT requests by telephone, cellular phone, Internet, POS terminal and other means not involving signed authorization. These agreements generally should set forth the scope of the institution's liability and the agreed-upon security procedures for authenticating transactions (such as callbacks or passwords).
  - provide for the review of rejected transactions and the correction and reversal of entries by a supervisor.
  - restrict initiation of EFTs and access to computer terminals or other EFT equipment.
  - require that documentation of EFTs is provided to the parties involved on a timely basis.
  - disclose the name of the debit party to the receiver of funds.
  - provide for written instructions to employees and users concerning the EFT function.
  - provide for the use and confidentiality of authorized caller and other access codes or authentication algorithms, including periodic changes in such codes or algorithms.
  - provide for the maintenance of a current list of personnel authorized to initiate EFTs.
  - establish authorization limits for personnel.
  - provide for holds to be placed on customer accounts by EFT personnel when instructions are received directly from the authorized customer to confirm that available funds are in the

customer's account or that the EFT funds are within authorized limits before the EFT is made.

— provide for the maintenance of card files or authorization letters on file for all customers who initiate EFTs.

- controls and verification procedures over requests for EFTs in place at respondent depository institutions.

13.54 The auditor should perform tests of controls when the auditor's risk assessment includes an expectation of the operating effectiveness of controls or when substantive procedures alone do not provide sufficient appropriate audit evidence at the relevant assertion level, such as typically would be the case with the audit of deposits. Examples of tests of controls might include

- observing or otherwise obtaining evidence about segregation of duties and supervisory review of activity in employee accounts;
- testing the reconciliations of related accounts, including the disposition of reconciling items and review and approval by a person other than the preparer;
- testing controls over origination of and access to signature cards and mailing address files;
- testing controls over the direct mailing of statements to depositors;
- comparing withdrawal slips with the applicable signature cards; and
- testing controls over restrictions on deposits pledged as collateral, inactive or dormant accounts, and mail receipts.

13.55 Tests of control activities related to EFTs might include

- testing compliance with management's established authorization and verification procedures;
- validating sequence numbers on transfers sent and received;
- confirming that acknowledgments are returned for all outgoing messages;
- reviewing management's daily comparison of the total number and dollar amount of EFTs sent and received with summaries received from the Federal Reserve;
- testing the reconciliations of daily reserve or clearing account statements for disposition of reconciling differences and supervisory review and approval;
- testing the procedures for identification and verification of EFTs with respondent institutions; and
- observing control activities that address access.

Substantive Tests

13.56 Regardless of the assessed risks of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions related to deposits.

13.57 Audit procedures for deposits might include testing the reconciliations of related subsidiary and general ledger accounts, confirmation of account balances, and analytical procedures.

13.58 *Subsidiary records and reconciliations.* Procedures might be performed that provide reasonable assurance that the subsidiary ledger information to be confirmed and tested has been recorded properly in the general ledger. The disposition of reconciling items between general and subsidiary ledgers (such as returned items, adjustment items, holdovers, overdrafts, and service charges) might be investigated to determine whether any adjustments to recorded amounts are necessary.

13.59 *Confirmations.* Confirmation is undertaken to obtain evidence from third parties about financial statement assertions made by management, as stated in paragraph .06 of AU section 330, *The Confirmation Process* (AICPA, *Professional Standards*).

13.60 Confirmation of deposits provides evidence about existence and valuation but it may not provide evidence about other assertions. It would be appropriate for the auditor to use the negative form of confirmation request only when the risks of material misstatement is low and the auditor has no reason to believe that the recipients will not consider the requests. According to paragraph .16 of AU section 330, factors such as the form of the confirmation request, prior experience on the audit or similar engagements, the nature of the information being confirmed, and the intended respondent should affect the design of the requests because these factors have a direct effect on the reliability of the evidence obtained through confirmation procedures. Refer to AU section 330 for additional guidance on the confirmation process. Refer to AU section 350, *Audit Sampling* (AICPA, *Professional Standards*), and AU section 312 for guidance on the extent of audit procedures (that is, considerations involved in determining the number of items to confirm). Readers may also refer to the AICPA Audit Guide *Audit Sampling* that provides guidance to help auditors apply audit sampling in accordance with AU section 350. Guidance on the timing of audit procedures is included in AU section 318.

13.61 Accounts for which positive confirmation requests are returned undelivered should be subjected to alternative procedures (such as personal contact with the depositor) to obtain evidence necessary to reduce audit risk to an acceptably low level. (See paragraphs .31–.32 of AU section 330 for additional guidance regarding alternative procedures.) Some depositors may have instructed the institution not to send account statements to the depositor's mailing address. For such no-mail accounts, the auditor might review a written request from the depositor requesting the no-mail status and could use alternative procedures. Alternative procedures for positive confirmation nonreplies and no-mail accounts might include obtaining the respective period deposit account statement and subsequent statements to review for unusual activity and investigating any significant or unusual activity noted.

13.62 *Credit union supervisory committee procedures.* Note that one of the explicit duties of a federally insured credit union's supervisory committee is to periodically perform a verification of the members' accounts. In addition to procedures required under generally accepted auditing standards (GAAS), auditors may be asked to extend their procedures to assist in meeting the supervisory committee's requirements. Section 715.18(b) of the NCUA's Rules and Regulations require that the verification be made using any of the following methods:

- A controlled verification of 100 percent of members' share and loan accounts.
- A sampling method that provides a random selection that is expected to be representative of the population from which the sample was

selected, which will allow the auditor to test sufficient accounts in both number and scope to provide assurance that the general ledger accounts are fairly stated in relation to the financial statements taken as a whole. (According to paragraph .24 of AU section 350, sample items should be selected in such a way that the sample can be expected to be representative of the population.)

- For independent, licensed, certified public accountants, the additional option of sampling members' accounts using nonstatistical sampling methods consistent with applicable GAAS provided the sampling method provides a selection that allows the auditor to test sufficient accounts in both number and scope to provide assurance that the general ledger accounts are fairly stated in relation to the financial statements taken as a whole. (Independent, licensed, certified public accountants will be responsible for documenting their sampling procedures, and providing evidence to NCUA, if requested, that the method used is consistent with applicable GAAS.)

13.63 *Check 21.* The following are some potential audit concerns that may arise related to Check 21:

- The auditor will see fewer original checks as they are replaced by substitute checks. Audit planning may be adjusted based on the financial institution's processes for disseminating and returning checks.
- Detecting check fraud may become more difficult as substitute checks will no longer contain watermarks, fingerprints, ink or original paper with access to pressure points. Because the original check is no longer used for processing, the security of the electronic systems will reduce human access to the financial information and reduce employee fraud or error. Shorter processing time will allow for a quicker identification of check fraud or forgery.
- The financial institution may have purchased equipment that does not have the proper controls in place to prevent computer hacking.

13.64 *Accrued interest payable, interest expense, and service charge income.* Substantive audit procedures should be performed on accrued interest payable, interest expense, and service charge income in connection with other procedures on deposits. Audit procedures for such amounts include reviewing and testing reconciliations of subsidiary ledgers with the general ledger, recalculating interest paid, accrued interest payable, and service charge income, and testing of interest expense and service charge income for the period.

13.65 *Overdraft protection programs.* Audit procedures on overdraft protection programs may include verifying that overdraft balances are properly classified along with the related write-offs of uncollectible balances.

13.66 *Other analytical procedures.* Analytical review procedures can provide substantive evidence about the completeness of deposit-related financial statement amounts and disclosures; however, such procedures in tests of deposit expense are often less precise than substantive tests such as recalculations. Because institutions generally offer a wide variety of deposit products and rates (which change frequently during a financial reporting period), it is normally difficult to develop sufficiently precise expectations to be used in analyzing yields on deposits. Accordingly, analytical procedures in this area should generally be considered only as a supplement to other substantive procedures, except where an expected yield can be known with some precision.

Further guidance is provided in AU section 329, *Analytical Procedures* (AICPA, *Professional Standards*), and AU section 326, *Audit Evidence* (AICPA, *Professional Standards*). Be careful not to view trends entirely from a historical perspective; current environmental and business factors as well as local, regional, and national trends could be considered to determine if the institution's trend appears reasonable. Some analytical review procedures that could be considered include

- compare the percentage of deposit growth during the period with historical percentages,
- compare the average deposit account balances during the period with those of prior periods,
- review the relative composition of deposits from period to period,
- compare the amounts and percentage ratio of dormant accounts to total deposits with those of prior periods, and
- compare deposit interest rates with those prevailing in the institution's marketing area for the same periods.

13.67 The decision about which analytical procedure or procedures to use to achieve a particular audit objective is based on the auditor's judgment on the expected effectiveness and efficiency of the available procedures. The auditor obtains assurance from analytical procedures base upon consistency of the recorded amounts with expectations developed from data derived from other sources. Paragraph .22 of AU section 329 states the auditor should document any additional auditing procedures performed in response to significant unexpected differences arising from the analytical procedures and the results of such additional procedures.

13.68 For significant risks of material misstatement, it is unlikely that audit evidence obtained from substantive analytical procedures alone will be sufficient.

Chapter 14

Federal Funds and Repurchase Agreements

Introduction

14.01 This chapter addresses two types of transactions—federal funds and repurchase agreements (repos)—that can be either investing or financing transactions, depending on which side of the transaction the financial institution participates. Federal funds transactions can be an important tool for managing liquidity. Repos also can provide a cost-effective source of funds and may provide a means for the institution to leverage its securities portfolio for liquidity and funding needs.

Federal Funds Purchased

14.02 Federal funds are funds that commercial banks deposit at Federal Reserve Banks. Banks must meet legal reserve requirements on a daily basis by maintaining a specified total amount of deposits at Federal Reserve Banks and vault cash. A bank with excess reserves on a particular day may lend the excess, at an agreed-rate of interest (the federal funds rate), to another bank needing funds to meet its reserve requirements that day. The federal funds market does not increase or decrease total reserves in the Federal Reserve System, but merely redistributes them to facilitate efficient use of bank reserves and resources. However, by setting reserve requirements, the Federal Reserve may increase or decrease total reserves in the system. No physical transfer of funds takes place; the Federal Reserve Bank charges the seller's reserve balance and credits the buyer's reserve balance. In addition to buying and selling funds to meet their own needs, banks with correspondent banking relationships absorb or provide funds as a service or accommodation to their correspondents. Accordingly, banks may operate on both sides of the federal funds market on the same day.

14.03 Two types of transactions involving federal funds are commonly used. In an unsecured transaction, the selling bank sells federal funds on one day and is repaid with interest at maturity (usually the next day). In a collateralized transaction, other than by a repo, a bank purchasing federal funds places U.S. government securities in a custody account for the seller until the funds are repaid. A borrowing bank records a liability (federal funds *purchased*) and a selling bank records an asset (federal funds *sold*).

Repurchase Agreements

14.04 A *repurchase agreement* (repo), as stated in the Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) glossary, refers to a transaction that is accounted for as a collateralized borrowing in which a seller-borrower of securities sells those securities to a buyer-lender with an agreement to repurchase them at a stated price plus interest at a specified date or in specified circumstances. The payable under a repo refers to the amount of the seller-borrower's obligation recognized for the future repurchase of the securities from the buyer-lender. In certain industries, the terminology is reversed; that is, entities in those industries refer to this type of agreement as a reverse repo. A *reverse repurchase agreement* (reverse repo), per

the FASB ASC glossary, refers to a transaction that is accounted for as a collateralized lending in which a buyer-lender buys securities with an agreement to resell them to the seller-borrower at a stated price plus interest at a specified date or in specified circumstances. The receivable under a reverse repo refers to the amount due from the seller-borrower for the repurchase of the securities from the buyer-lender. In certain industries, the terminology is reversed; that is, entities in those industries refer to this type of agreement as a repo.[1]

14.05 Most repos involve obligations of the federal government or its agencies, but other financial instruments, such as commercial paper, banker's acceptances, and negotiable certificates of deposit, are sometimes used in repos. Repos are similar to the seller-borrower's borrowing funds equal to the sales price of the related securities with the securities as collateral. The difference in the price at which the institution sells its securities and repurchases them represents interest for the use of the funds. Most repo transactions occur with other depository institutions, dealers in securities, state and local governments, and customers (retail repo). Maturities of such agreements are flexible and generally vary from 1 day to 270 days.

14.06 *Dollar-roll repurchase agreements*, as defined in the FASB ASC glossary, are agreements to sell and repurchase similar but not identical securities. The securities sold and repurchased are usually of the same issuer. Dollar-rolls differ from regular repos in that the securities sold and repurchased have all of the following characteristics:

- They are represented by different certificates.
- They are collateralized by different but similar mortgage pools (for example, conforming single-family residential mortgages).
- They generally have different principal amounts.

Fixed coupon and yield maintenance dollar agreements comprise the most common agreement variations. In a fixed coupon agreement, the seller and buyer agree that delivery will be made with securities having the same stated interest rate as the interest rate stated on the securities sold. In a yield maintenance agreement, the parties agree that delivery will be made with securities that will provide the seller a yield that is specified in the agreement. The securities repurchased are generally priced to result in substantially the same yield.

14.07 The dollar roll market consists primarily of agreements that involve mortgage-backed securities (MBSs).

14.08 The seller-borrower retains control over the future economic benefits of the securities sold and assumes no additional market risk.

14.09 In a yield-maintenance agreement, the securities repurchased may have a different stated interest rate from that of the securities sold and are generally priced to result in different yields as specified in the agreement.[2] The

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[1] Broker-dealers and this guide refer to agreements by seller-borrowers to sell and repurchase securities as *repurchase agreements* (repos) and agreements by buyer-lenders to purchase and resell securities as *reverse repurchase agreements* (reverse repos). Savings institutions and credit unions have in the past used the opposite terms, calling a seller-borrower's agreement a *reverse repo* and a buyer-lender's agreement a *repo*.

[2] The price-spread relationship between securities with different contract interest rates does not move in tandem. The existence of yield and price disparities provides opportunities for the buyer-lender to deliver, within the terms of the agreement, certificates providing the greatest benefit to the buyer-lender.

seller-borrower surrenders control over the future economic benefits of the securities sold and assumes additional market risk. Yield-maintenance agreements may contain *par cap*[3] provisions that could significantly alter the economics of the transactions.

14.10 The terms of the agreements often provide criteria to determine whether the securities are similar enough to make the transaction, in substance, a borrowing and lending of funds or whether the securities are so dissimilar that the transaction is a sale and purchase of securities. For agreements involving securities collateralized by dissimilar pools, those transactions are accounted for as sales and purchases of securities.

14.11 *Rollovers and extensions.* Occasionally, securities involved in repos are not delivered on the settlement date of the agreement and the contract may be rolled over or extended upon mutual agreement of the buyer-lender and seller-borrower.

14.12 *Breakage.* Securities repurchased under repos commonly have a principal amount that differs from the principal amount of the security originally sold under the agreement. This is particularly common to dollar rolls, which involve MBSs. That difference is referred to as breakage and occurs because the principal amounts of MBSs generally differ as a result of the monthly amortization of principal balances of mortgages collateralizing the MBSs. The amount of the breakage is a factor in determining whether substantially the same security is reacquired in the repo transaction, that is, whether good delivery (one in accordance with the agreement terms) has been met on repurchase of the MBSs.

14.13 *Business risk.* Business risks associated with repos include the contractual and economic complexities inherent in certain of these transactions and the corresponding risk associated with the degree to which the institution's management understands the terms of the agreements and the economics of the transactions. Misunderstandings may result in incorrect pricing of the agreements or an incorrect assessment of the risks that are being assumed, the return that is anticipated to be earned, or the financing costs that are being incurred. Misunderstandings of the terms may also result in improper accounting treatment of the transaction (that is, as a sale and purchase or as a secured borrowing).

14.14 *Market risk.* The prices of government securities vary inversely with changes in interest rates. Price changes may be small, but they can result in significant changes in the market values of government securities due to the large dollar amounts often involved in government securities transactions. This is generally referred to as *market risk*. Price changes may affect the ability of the seller-borrower under repos to continue the financing without providing additional collateral. Changes in prices also affect the margin in a transaction and may create a need for the seller-borrower to transfer additional securities or return cash.

14.15 The excess of the fair value of the securities transferred by the seller-borrower over the amount of cash transferred by the buyer-lender is called a *haircut*. A haircut represents a margin of safety required by the buyer-lender to guard against a decline in the value of the collateral as a result of rising interest rates during the term of the agreement. Whether an agreement provides for a haircut depends on competition among buyer-lenders and

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[3] A *par cap* provision limits the repurchase price to a stipulated percentage of the face amount of the certificate. Fixed-coupon agreements do not contain par cap provisions.

seller-borrowers and their relative bargaining strengths. Haircuts generally range from a fraction of one percent to four percent or five percent but may be higher in certain instances.

14.16 All of the following factors are considered in determining the haircut for a particular transaction:

a. The term of the agreement

b. The creditworthiness of the institution

c. The type of securities underlying the agreement, the length of time to maturity, and the creditworthiness of the issuer of the securities

d. The volatility of the market value of the underlying securities

e. The differential between the interest rate specified in the agreement and the interest rate on the securities

14.17 *Credit risk.* A repo or reverse repo can be considered a loan of cash by one party and a loan of securities by another. When the agreement is completed, both loans are repaid. Parties to repo and reverse repo transactions are subject to credit risk, that is, the risk that the transaction counterparty will not perform under the terms of the agreement. For example, a seller-borrower is at risk that changes in market prices and resulting economic losses may prevent the buyer-lender from returning the securities at the maturity of the agreement.

14.18 Credit risk also exists to the extent that the issuer of the underlying securities may default. However, such risk may be negligible for securities issued or guaranteed by the U.S. government or its agencies. If the issuer of the underlying securities defaults, both participants in the repo are obligated to complete the transaction. This aspect of credit risk is affected by the extent to which the institution's repo position is concentrated in any one type of underlying security or with any one counterparty.

14.19 The extent of credit risk faced by a seller-borrower also depends on the buyer-lender's business policies and practices for control and use of collateral, the extent of the haircut on securities serving as collateral, the extent to which the buyer-lender offsets transactions (that is, maintains a matched book), and the buyer-lender's extent of capitalization.

14.20 Analyzing credit risk requires an understanding of how securities dealers and other counterparties to repos manage their businesses and of the steps that can be and are taken to reduce their exposure to market risk. Securities dealers are typically highly leveraged, with securities positions that represent large multiples of their net capital and that can quickly be eroded by adverse market changes. Many securities dealers entering into repos frequently employ matched-book transactions. In a matched-book transaction, the securities dealer effects both a repo and a reverse repo with the same underlying securities for the same period of time but usually at slightly different rates. By running a matched book, a dealer can reduce its exposure to market changes, and a seller-borrower may face less credit risk by entering into agreements with a dealer that has a matched book and employs adequate procedures to control credit risk. Even if the dealer runs a matched book, the seller-borrower still faces credit risk associated with the dealer's credit risk, that is, the risk that a customer of the dealer might not be able to complete its agreement with the dealer.

14.21 *Risk of collateral loss.* When an institution transfers the securities sold under an agreement to repurchase, there is a risk that the dealer may not be able to reverse the transaction by selling the securities back at the agreed price. If the institution overcollateralizes the agreement by selling the securities at a relatively large discount from the market price, its rights to the overage may be diminished or lost entirely in the event of the dealer's bankruptcy. In that case, the institution may find that neither the securities nor the funds to replace the securities are available for the dealer to complete the transaction and, as a result, may incur an economic loss. If the institution does not have the legal right of setoff, the potential economic loss extends to the full value of the securities, including accrued interest.

14.22 If the institution has the legal right to set off the securities against the borrowed funds, the potential economic loss is limited to the excess of the fair value of the securities, plus accrued interest, at the date of the sale over the amount borrowed, plus or minus any change in that fair value and accrued interest. However, the accounting loss may be greater or less than the economic loss if the book value of the securities is above or below their fair value. (See paragraph 14.39.)

14.23 Securities purchased under agreements to resell (reverse repos) pose risk to buyer-lenders to the extent that they do not take possession of the securities they agreed to resell.[4] If the buyer-lender or securities dealer through whom the transaction is made does not perfect a security interest in securities purchased (by having signed an agreement and by taking possession, either directly or through a custodian acting as its agent), the potential economic loss extends to the full value of the securities and the risk assumed—namely, credit risk—becomes that of an unsecured lender. Institutions reduce such risk by

- *a.* making sure that definitive collateral is held by the counterparty's custodian as the counterparty's agent with specific identification of the assignee;
- *b.* settling through the Federal Reserve System, where book-entry collateral is transferred directly or by a notation entry;
- *c.* evaluating the creditworthiness of the other party to the agreement; and
- *d.* overcollateralizing the borrowing.

Regulatory Matters

14.24 In 1985, the Federal Financial Institutions Examination Council (FFIEC) issued a policy statement that was adopted by the Office of the Comptroller of the Currency, Federal Reserve Board, and Federal Deposit Insurance Corporation (FDIC). The policy established guidelines for insured depository institution repo activities including guidelines for written repos, policies and procedures, credit risk management, and collateral management. The Office of Thrift Supervision has not separately adopted the policy statement, but refers federal savings associations to the FFIEC policy statement. In

[4] The Gramm-Leach-Bliley Act of 1999 (GLBA) repealed the blanket exemption for banks from the definition of a *broker* set forth in Section 3(a)(4) of the Securities Exchange Act of 1934 (Exchange Act). In place of the blanket exemption, GLBA provided 11 specific exceptions for the definition of *broker*. The statutory exceptions were designed to allow banks to continue to effect securities transactions in connection with certain traditional bank activities. Regulation R, "Exceptions for Banks from the Definition of Broker in the Securities Exchange Act of 1934," defines important terms relating to the broker exceptions in the Exchange Act and provides a number of exemptions.

1998, the FFIEC modified the policy statement to reflect the enactment and inclusion of other laws and regulations applicable to repos and to update the list of written repo provisions with an expanded list of provisions to reflect current market practice.

14.25 On December 18, 2008, the FDIC issued Financial Institution Letter-146-2008,"Recordkeeping Requirements for Qualified Financial Contracts," which required institutions in troubled condition to produce position level and counterparty level data and other information that is relevant to the resolution and disposition of qualified financial contracts (QFCs). QFCs include repos among other contracts and agreements.

Accounting and Financial Reporting

14.26 FASB ASC 860, *Transfers and Servicing*, establishes accounting and reporting standards for transfers and servicing of financial assets. Transfers of financial assets take many forms, including repos. Paragraphs 19–21 of FASB ASC 860-10-05 provide an overview of repos. Paragraphs 51–56 of FASB ASC 860-10-55 provide implementation guidance for accounting for repos.

14.27 FASB ASC 860-10-55-55[*] states that if the criteria in FASB ASC 860-10-40-5 are met, the transferor should account for the repo as a sale of financial assets and a forward repurchase commitment, and the transferee should account for the agreement as a purchase of financial assets and a forward resale commitment. Other transfers that are accompanied by an agreement to repurchase the transferred financial assets that would be accounted for as sales if the conditions in FASB ASC 860-10-40-5 are met include transfers with agreements to repurchase at maturity and transfers with repos in which the transferor has not obtained collateral sufficient to fund substantially all of the cost of purchasing replacement financial assets.

14.28 FASB ASC 860-30 provides guidance on transactions that are accounted for as secured borrowings with a transfer of collateral. According to paragraphs 2–3 of FASB ASC 860-30-05, a debtor (obligor) may grant a security interest in certain assets to a lender (the secured party) to serve as collateral for its obligation under a borrowing, with or without recourse to other assets of the obligor. An obligor under other kinds of current or potential obligations may also grant a security interest in certain assets to a secured party. If collateral is transferred to the secured party, the custodial arrangement is commonly referred to as a pledge. Secured parties sometimes are permitted to sell or repledge (or otherwise transfer) collateral held under a pledge. The same relationships occur, under different names, in transfers documented as sales that are accounted for as secured borrowings. Per FASB ASC 860-30-25-5, the accounting for noncash collateral by the debtor (or obligor) and the secured

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[*] In April 2011, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2011-03, *Transfers and Servicing (Topic 860): Reconsideration of Effective Control for Repurchase Agreements*. ASU No. 2011-03 removes from the assessment of effective control (*a*) the criterion requiring the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed terms, even in the event of default by the transferee, and (*b*) the collateral maintenance implementation guidance related to that criterion. Other criteria applicable to the assessment of effective control are not changed by this ASU. The amended guidance is located in FASB *Accounting Standards Codification* (ASC) 860-10-40 and 860-10-55 and is labeled as "Pending Content" due to the transition and effective date information discussed in FASB ASC 860-10-65-4. The guidance in this ASU is effective for the first interim or annual period beginning on or after December 15, 2011 and should be applied prospectively to transactions or modifications of existing transactions that occur on or after that date. Early adoption is not permitted. Readers should consult the full text of ASU No. 2011-03 for further information.

party depends on whether the secured party has the right to sell or repledge the collateral and on whether the debtor has defaulted.

14.29 FASB ASC 860-10-55-51 notes that, under many agreements to repurchase transferred financial assets before their maturity, the transferor maintains effective control over those financial assets. Repos that do not meet all the criteria in FASB ASC 860-10-40-5 should be treated as secured borrowings.

14.30 FASB ASC 860-10-40-24[*] states that an agreement that both entitles and obligates the transferor to repurchase or redeem transferred financial assets from the transferee maintains the transferor's effective control over those assets under FASB ASC 860-10-40-5(c)(1), if all of the following conditions are met:

a. The financial assets to be repurchased or redeemed are the same or substantially the same as those transferred (see paragraph 14.31).

b. The transferor is able to repurchase or redeem them on substantially the agreed terms, even in the event of default by the transferee. To be able to repurchase or redeem financial assets on substantially the agreed terms, even in the event of default by the transferee, a transferor must at all times during the contract term have obtained cash or other collateral sufficient to fund substantially all of the cost of purchasing replacement financial assets from others.

c. The agreement is to repurchase or redeem them before maturity, at a fixed or determinable price.

d. The agreement is entered into contemporaneously with, or in contemplation of, the transfer.

14.31 FASB ASC 860-10-40-24(a)[*] states that, to be substantially the same, the financial asset that was transferred and the financial asset that is to be repurchased or redeemed need to have all of the following characteristics:

a. The same primary obligor (except for debt guaranteed by a sovereign government, central bank, government-sponsored enterprise or agency thereof, in which case the guarantor and the terms of the guarantee must be the same)

b. Identical form and type to provide the same risks and rights

c. The same maturity (or in the case of mortgage-backed pass-through and pay-through securities, similar remaining weighted-average maturities that result in approximately the same market yield)

d. Identical contractual interest rates

e. Similar assets as collateral

f. The same aggregate unpaid principal amount or principal amounts within accepted good delivery standards for the type of security involved

FASB ASC 860-10-55-35 contains implementation guidance related to these conditions.

14.32 In accordance with FASB ASC 860-10-55-35(a), the exchange of pools of single-family loans would not meet the criteria in item (*a*) in paragraph

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[*] See footnote * in paragraph 14.27.

14.31, because the mortgages making up the pool do not have the same primary obligor and would therefore not be considered substantially the same.

14.33 An example of item (*b*) in paragraph 14.31 would not be met by the Government National Mortgage Association (Ginnie Mae) I securities for Ginnie Mae II securities, loans to foreign debtors that are otherwise the same except for different U.S. foreign tax credit benefits (because such differences in the tax receipts associated with the loans result in instruments that vary in form and type), and commercial paper for redeemable preferred stock, as stated in FASB ASC 860-10-55-35(b).

14.34 In accordance with FASB ASC 860-10-55-35(c), an example of item (*c*) in paragraph 14.31 would be the exchange of a *fast-pay* Ginnie Mae certificate (that is, a certificate with underlying mortgage loans that have a high prepayment record) for a *slow-pay* Ginnie Mae certificate would not meet this criterion, because differences in the expected remaining lives of the certificates result in different market yields.

14.35 Related to item (*f*) in paragraph 14.31, participants in the MBSs market have established parameters for what is considered acceptable delivery. As stated in FASB ASC 860-10-40-24(a)(6),[*] these specific standards are defined by the Bond Market Association (BMA) and can be found in *Uniform Practices for the Clearance and Settlement of Mortgage-Backed Securities and Other Related Securities*, which is published by the BMA.

14.36 *Repurchase financings.* Paragraphs 21A–21B of FASB ASC 860-10-05 provide an overview on transactions involving an initial transfer and a repurchase financing. A repurchase financing involves the transfer of a previously transferred financial asset back to the initial transferor as collateral for a financing between the initial transferee (the borrower) and the initial transferor (the lender). A repurchase financing also typically involves the initial transferor returning the transferred asset, or substantially the same asset (see FASB ASC 860-10-40-24(a)) to the initial transferee when the financing is repaid on a stated date.

14.37 Paragraphs 42–47 of FASB ASC 860-10-40 address accounting for a transfer of a financial asset and a related repurchase financing and state that a transferor and transferee should not separately account for a transfer of a financial asset and a related repurchase financing unless both of the following conditions are met:

a. The two transactions have a valid and distinct business or economic purpose for being entered into separately.

b. The repurchase financing does not result in the initial transferor regaining control over the financial asset.

14.38 Paragraphs 17A–17C of FASB ASC 860-10-55 provide implementation guidance related to repurchase financings.

14.39 *Offsetting.*[†] Financial institutions may operate on both sides of the federal funds and repo markets on the same day. FASB ASC 210-20-05-1 states

[*] See footnote * in paragraph 14.27.

[†] In January 2011, FASB issued the proposed ASU *Balance Sheet Offsetting*. The proposed guidance was initiated as a joint project between FASB and the International Accounting Standards Board (IASB) to provide users of financial statements with information to understand the extent of offsetting in the statement of financial position and improve comparability between International Financial Reporting Standards and accounting principles generally accepted in the United States of America (U.S. GAAP). The proposed guidance as issued would

that it is a general principle of accounting that the offsetting of assets and liabilities in the balance sheet is improper except where a right of setoff exists. The FASB ASC glossary defines *right of setoff* as the debtor's legal right, by contract or otherwise, to discharge all or a portion of the debt owed to another party by applying against the debt an amount that the other party owes to the debtor and FASB ASC 210-20-45-1 specifies conditions that must be met to permit offsetting. According to FASB ASC 942-210-45-3, FASB ASC 210, *Balance Sheet*, permits offsetting in the statement of financial position of only payables and receivables that represent repos and reverse repos and that meet all of the conditions specified therein and does not apply to securities borrowing or lending transactions.

14.40 *Disclosures.* FASB ASC 860 requires certain disclosures about transfers and servicing of financial assets. See chapter 10, "Transfers and Servicing—Including Mortgage Banking," for additional information regarding the particular disclosures.

14.41 FASB ASC 860-30-50-1A(a) requires an entity that has entered into repos or securities lending transactions to disclose its policy for requiring collateral or other security.

14.42 In addition, FASB ASC 825-10-50-20 states that, except as indicated in FASB ASC 825-10-50-22, an entity should disclose all significant concentrations of credit risk arising from all financial instruments, whether from an individual counterparty or groups of counterparties.

14.43 The concentrations-of-credit-risk disclosures apply to debt securities and loans. The carrying amounts of repos and reverse repos maturing within 90 days generally would approximate their fair values.

14.44 When a smaller financial institution sells securities to another larger financial institution, under agreements to repurchase, the agreements may have default provisions that should be considered for disclosure in the financial statements. For example, a common default provision is if the selling financial institution drops below well capitalized under prompt corrective action provisions. The defaulting institution may be required to pay amounts in excess of the outstanding balance plus accrued interest.

(footnote continued)

eliminate the exception in U.S. GAAP that allows offsetting for some derivative and sale and repurchase (and reverse sale and repurchase) contracts when the right of setoff is conditional, there is no intention to set off, or such intention is conditional. The proposed guidance would also enhance disclosures required by U.S. GAAP by requiring improved information about eligible assets and eligible liabilities subject to setoff, and related arrangements (such as collateral arrangements) and the effect of those arrangements on an entity's financial position.

In June 2011, FASB and the IASB discussed alternative approaches for requiring offsetting of financial assets and financial liabilities on the face of the balance sheet. The majority of the FASB board members supported providing an exception from the general offsetting criteria for derivative instruments, which would allow offsetting of fair value amounts recognized for derivatives and fair value amounts recognized for the right to reclaim cash collateral or the obligation to return cash collateral arising from derivative instruments recognized at fair value with the same counterparty under a master netting arrangement. During July 2011, FASB and IASB also discussed revisions to the proposed offsetting disclosures.

Readers are encouraged to visit the FASB website for the latest developments regarding the offsetting project, including a summary of decisions reached to date since the issuance of the proposed guidance. FASB expects to issue final guidance during 2011.

Auditing

Objectives

14.45 The primary objectives of audit procedures applied to federal funds and repo transactions are to obtain sufficient appropriate evidence that

a. the reported amounts include all federal funds purchased or sold and that repos and reverse repos are properly identified, described, and disclosed; include all such agreements; and are stated at appropriate amounts;

b. interest expense or income and the related balance-sheet accounts are properly measured and reported in the proper periods;

c. repos and dollar rolls accounted for as secured borrowings meet the criteria for secured borrowings, including the condition that the assets to be repurchased or redeemed are the same or substantially the same as those transferred;

d. federal funds and repo transactions have been executed in accordance with management's authorizations and are obligations of the institution;

e. assets pledged as collateral for federal funds and repo transactions are properly disclosed in the financial statements;

f. the federal funds sold and securities purchased under reverse repos exist and are either on hand or are held in safekeeping or custody for the bank;

g. the institution has legal title or similar rights of ownership for all recorded securities;

h. recorded amounts include all such assets owned by the institution, and the financial statements include all related transactions during the period;

i. the values at which securities are reported are appropriate;

j. realized and unrealized gains and losses on sales of securities are properly measured, recorded, and disclosed;

k. securities involved in such agreements are properly described and classified in the financial statements and the related note disclosures are adequate; and

l. events of default are appropriately disclosed and any related fees are properly accrued.

Planning

14.46 In accordance with AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), the auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures (as described in chapter 5, "Audit Considerations and Certain Financial Reporting Matters"). The following factors related to federal funds and repos could influence the risks of material misstatement. Federal funds transactions are fairly routine for most institutions, are generally not complex, and many have

matured by the close of the audit; thus, less risk may be associated with this account balance at a specific institution. Normal auditing procedures for borrowed funds could be applied to such obligations. However, certain repo transactions, whether viewed from an accounting, legal, or economic perspective, are extremely complex. Also, the risks involved in repo transactions vary widely, depending on the terms of the agreement, the parties involved, and the legal status of the agreement. The risks faced by an institution entering into a repo are generally reduced if the institution maintains effective controls related to the authorization, processing, and recording of these transactions. The auditing guidance in this chapter focuses on repo transactions.

14.47 The auditor inspects the current-year's interim financial statements, board of directors' reports and minutes, supervisory examination reports or related reports, and pertinent financial information and accounting to obtain an understanding of the level of activity in federal funds and repos, types of transactions entered into, accounting treatment (financing versus a sale and repurchase), and compliance with the institution's established investment and asset/liability management policies.

14.48 When an institution concentrates its repos with one dealer or a small group of dealers the evaluation of credit risk and counterparty risk gains significant importance to the auditor. The auditor might

a. obtain an understanding of the institution's controls over evaluating the reputation and financial strength of the dealer;

b. inspect the latest audited financial statements of the dealer;

c. obtain an understanding of the specific entity within an affiliated group with which the institution is doing business; and

d. obtain an understanding of transactions between that entity and its affiliates.

14.49 The audit procedures applied to federal funds purchased and securities sold under agreements to repurchase are also appropriate for federal funds sold and securities purchased under agreements to resell. It is important for the auditor to be aware that, as a buyer-lender, an institution might not take delivery of the securities that serve as collateral in a repo transaction. If it does take delivery, either directly or indirectly through another party acting as its agent, credit risk is less than may otherwise be the case; the auditor could consider confirming the occurrence and terms of the transaction, and the seller-borrower's obligation to repurchase the securities with the seller-borrower, and might consider counting securities in the institution's possession and confirming securities not in its possession with the custodian.

14.50 Whenever a buyer-lender or its agent does not take delivery of the securities, the auditor should consider confirming not only the occurrence and terms of the transaction and the obligation to repurchase the securities but also that they have not been delivered and are being held on the institution's behalf. It is important to note, when delivery is not made, the transaction has many of the attributes of an unsecured loan. Accordingly, the auditor should consider assessing the reputation and financial strength of the seller-borrower and of its custodian. Based on those assessments, the auditor should consider the desirability of obtaining a report from the custodian's auditor on the custodian's internal accounting controls over securities held in safekeeping, about which

AU section 324,[‡,5] *Service Organizations* (AICPA, *Professional Standards*), provides guidance. The report should cover both the design of the system and compliance tests directed to specific objectives of internal accounting control over the custodial function.

Internal Control Over Financial Reporting and Possible Tests of Controls

14.51 AU section 314 establishes standards and provides guidance on obtaining a sufficient understanding of the entity and its environment, including its internal control. It provides guidance on understanding the components of internal control and explains how an auditor should obtain a sufficient understanding of internal control for the purposes of assessing the risks of material misstatement. Paragraph .40 of AU section 314 requires that, in all audits, the auditor should obtain an understanding of the five components of internal control (the control environment, risk assessment, control activities, information and communication systems, and monitoring), sufficient to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. The auditor should obtain a sufficient understanding by performing risk assessment procedures to evaluate the design of controls relevant to an audit of financial statements and to determine whether they have been implemented. Paragraph .102 of AU section 314 states that the auditor should identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions, account balances, and disclosures.

14.52 The auditor should obtain an understanding of the institution's internal control over financial reporting of federal funds and repo transactions. (Chapter 7, "Investments in Debt and Equity Securities," and 15, "Debt," discuss related control issues for investments and borrowings, respectively.) Examples of controls in this area are as follows:

[‡] The guidance contained in AU section 324, *Service Organizations* (AICPA, *Professional Standards*), has now been split into an attest standard and an auditing standard to better reflect the nature of the work being performed. The Auditing Standards Board (ASB) has finalized a new clarified auditing standard on service organizations, *Audit Considerations Relating to an Entity Using a Service Organization*. This auditing standard will supersede AU section 324 and addresses the user auditor's responsibility for obtaining sufficient appropriate audit evidence in an audit of the financial statements of a user entity that uses one or more service organizations. This clarified auditing standard has been finalized but not yet issued. See the preface of this guide for further information on the ASB's Clarity Project. The effective date of this clarified standard is for audits of financial statements for periods ending on or after December 15, 2012, unless otherwise established (early adoption would not be appropriate).

The related attest standard, Statement on Standards for Attestation Engagements (SSAE) No. 16, *Reporting on Controls at a Service Organization* (AICPA, *Professional Standards*, AT sec. 801), was issued in April 2010. It addresses examination engagements undertaken by a service auditor to report on controls at organizations that provide services to user entities when those controls are likely to be relevant to user entities' internal control over financial reporting. SSAE No. 16 supersedes the guidance for service auditors in AU section 324 and is effective for service auditors' reports for periods ending on or after June 15, 2011. Early implementation is permitted.

[5] The AICPA Audit Guide *Service Organizations: Applying SAS No. 70, as Amended* has been revised by a task force of the ASB to reflect the requirements and guidance in SSAE No. 16. The revised Audit Guide, *Service Organizations: Applying SSAE No. 16, Reporting on Controls at a Service Organization*, is currently available to readers. Also, the newly released Audit Guide *Reporting on Controls at a Service Organization Relevant to Security, Availability, Processing Integrity, Confidentiality, or Privacy* addresses reporting on a service provider's controls over subject matter other than financial reporting.

- The institution has formal, written policies that specify the types of securities that can be sold or repurchased under repos.
- Formal policies and procedures are in place to provide that repo transactions are executed in accordance with written contracts that describe the rights and obligations of the parties.
- Master agreements used by the institution should be entered into by authorized personnel and should specify the terms of the transactions and the intent of the parties.
- Only board-approved securities dealers and other institutions are allowed to enter into transactions with the institution.
- The institution has policies and procedures to provide that only authorized individuals enter into and approve such transactions and that those individuals are aware of the inherent risks and returns of such agreements. The institution's board of directors sets limits on the amount and terms of agreements with particular securities dealers and other institutions.
- The institution has policies and procedures for monitoring the reputation, financial stability, and creditworthiness of securities dealers and other institutions with which the institution may enter into an agreement as a basis for evaluating their ability to fulfill their obligation to return the collateral to the institution.
- The institution has procedures for monitoring communications with securities dealers and other institutions and for reviewing confirmations from securities dealers to detect unrecorded or inappropriately recorded transactions and to determine the reasonableness of interest rates.
- Initial transactions and rollover agreements are reviewed by a responsible official who determines whether the transactions represent sales or financing transactions.
- Written policies mandate frequent evaluation of the market value, including accrued interest, of the agreements and necessary collateral levels.
- The subsidiary ledgers containing information on securities collateralizing agreements are periodically reconciled to the general ledger.
- Policies and procedures exist to monitor the use of hedging techniques, if any, to reduce market risk.
- Review of the default provisions to ensure that any required disclosures are included in the financial statements.

14.53 The auditor should perform tests of controls when the auditor's risk assessment includes an expectation of the operating effectiveness of controls or when substantive procedures alone do not provide sufficient appropriate audit evidence at the relevant assertion level. Examples of tests of controls the auditor may perform include the following:

- Obtain and review the institution's written investment and asset/liability management policies (or other applicable policies relating to the management of federal funds and repo transactions), and consider whether such policies have been reviewed and approved by the institution's board of directors.

- Obtain the institution's approved list of counterparties to agreements, and compare the list with those dealers with whom borrowing transactions were entered into during the current year. Ascertain that counterparty limits set by the board of directors have not been exceeded.
- Review selected transactions to consider whether all significant terms were specified and documented and whether the amounts and terms were consistent with those established by the institution's formal investment and asset/liability management policies.
- Review supporting documentation for transactions, and consider whether only authorized individuals entered into or otherwise executed those transactions on behalf of the institution.
- Test whether the institution has properly followed procedures for recording the difference between the selling price and repurchase price as interest expense and whether interest expense is properly recorded on other borrowings, such as federal funds purchased.[6]
- Review the latest audited financial statements of the counterparties and other available reports, such as reports on internal control or special-purpose reports by the dealer's accountant, to determine whether the dealer has net capital in excess of statutory requirements.

14.54 If there is reason to question the creditworthiness of the counterparty, the auditor might consult with legal counsel regarding whether, in the event of the counterparty's inability to return (sell back) the collateral securities, the institution has the right to set off the loan liability against the collateral.

Substantive Tests

14.55 According to paragraph .51 of AU section 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*), regardless of the assessed risks of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure. This reflects the fact that the auditor's assessment of risk is judgmental and may not be sufficiently precise to identify all risks of material misstatement.

14.56 *Inspection of repo or other documentation of borrowing.* Repos and other source documents may be inspected by the auditor and relevant details may be agreed upon concerning the respective recording of the liability in the subsidiary records. The auditor should test that securities collateralizing the borrowing are adequately identified to ensure proper disclosure and that the amounts and description should agree to the respective subsidiary ledger. The auditor should also identify any default provisions and determine whether any events of default have occurred and whether any liabilities require accrual as a result of the event of default.

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[6] These procedures also could be performed to provide substantive evidence.

14.57 *Confirmation*.[7] The auditor could consider confirming the amount and all significant terms of federal funds and repos with the respective securities dealers, customers, and institutions. Details of any rollovers or extensions of repos should be agreed to brokers' advices. Confirming the repo transactions provides evidence of the occurrence of the transactions, their terms, and the treatment of the underlying securities, for example, evidence that the securities were delivered to the counterparty. Confirmation does not provide evidence about the existence, location, or transferability of the securities or about the counterparty's ability to complete the transactions. It is usually impracticable to confirm the location of the securities delivered to the counterparty as collateral. The counterparty often is not able to determine the exact location of the securities delivered because they are fungible with other securities of the same issue under the dealer's control and are commingled with those securities. In addition, the counterparty may have appropriately used the securities for collateral in another repo or dollar roll in which the counterparty sold the securities to be repurchased at a later date. The seller-borrower and its auditor need not necessarily be concerned, however, about the location of securities transferred to the counterparty as collateral because their location does not necessarily affect the risk that the counterparty may not complete the transactions.

14.58 The auditor should consider the need to assess the counterparty's ability to complete the transaction by other procedures, such as testing the subsequent completion of the transaction, reviewing audited financial statements of the counterparty, considering the regulatory requirements applicable to the counterparty, and, if necessary, obtaining a special-purpose report from the counterparty's auditor.

14.59 *Review of related-party transactions.* The auditor might consider reviewing borrowing transactions involving related parties that have been accounted for as sales transactions to determine whether there are potential unrecorded financing transactions. A review of transaction activity may indicate that an event accounted for as two separate transactions (a sale and subsequent purchase) is in fact a repo that should be accounted for as a financing. The auditor might consider the possibility of related party transactions that are improperly accounted for, possibly to avoid recognizing losses on sales.

14.60 *Assess collateral risk.* The auditor may assess the collateral risk through consideration of the counterparty's reputation, financial position, and market presence. The auditor may consider reviewing the current market values, including accrued interest, of securities serving as collateral and consider whether the collateral is sufficient or excessive in relation to the requirements of the agreement. The auditor might assess whether those securities repurchased under repos meet the substantially-the-same criteria for financing transactions or whether a gain or loss should have been recorded under a sales transaction. The auditor may test whether collateral held is properly recognized on the balance sheet in accordance with FASB ASC 860. Under FASB ASC 860-30-25-5(c), if the obligor (transferor) defaults under the terms of the secured contract and is no longer entitled to redeem the pledged asset, it should

[7] For additional guidance, refer to Interpretation No. 1, "Auditing Interests in Trusts Held by a Third-Party Trustee and Reported at Fair Value," of AU section 328, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*, AU sec. 9328 par. .01–.04), and Interpretation No. 1, "Auditing Investments in Securities Where a Readily Determinable Fair Value Does Not Exist," of AU section 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*, AU sec. 9332 par. .01–.04), respectively.

derecognize the pledged asset as required by FASB ASC 860-30-40-1 and the secured party (transferee) should recognize the collateral as its asset.

14.61 *Analytical procedures.* Chapters 7 and 15 discuss analytical procedures that may also be applied in this area.

14.62 *Tests of fair value disclosures.*Paragraph .09 of AU section 328, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*),[||] states the auditor should obtain an understanding of the entity's process for determining fair value measurements and disclosures and of the relevant controls sufficient to develop an effective audit approach. AU section 328 addresses audit considerations relating to the measurement and disclosure of assets, specific components of liabilities, and equity presented or disclosed at fair value in financial statements. AU section 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*),[#] provides guidance to auditors in planning and performing auditing procedures for assertions about derivative instruments, hedging activities, and investments in securities that are made in an entity's financial statements.

14.63 *Other procedures.* Other audit procedures related to repos that the auditor may consider performing are as follows:

- Read the board of directors' minutes to determine whether financing transactions have been authorized.
- Test whether approved securities dealers are used, and whether financing arrangements comply with the institution's established policies.
- Recompute gains or losses on reverse repos that are not accounted for as secured borrowings on a test basis.

[||] The ASB has finalized a new clarified auditing standard, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*. This auditing standard, which will supersede AU section 328, *Auditing Fair Value Measurements and Disclosures*, and AU section 342, *Auditing Accounting Estimates* (AICPA, *Professional Standards*), addresses the auditor's responsibilities relating to accounting estimates, including fair value accounting estimates and related disclosures. Additionally, it expands on how other clarified auditing standards are to be applied in relation to accounting estimates, and includes requirements and guidance related to misstatements of individual accounting estimates and indicators of possible management bias. This clarified auditing standard has been finalized but not yet issued. See the preface of this guide for further information on the ASB's Clarity Project. The expected date of this clarified standard is for audits of financial statements for periods ending on or after December 15, 2012, unless otherwise established (early implementation is not permitted).

[#] The ASB has finalized a new clarified auditing standard, *Audit Evidence—Specific Considerations for Selected Items*. This clarified auditing standard will supersede AU section 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*), and addresses specific considerations by the auditor in obtaining sufficient appropriate audit evidence regarding certain aspects of investments in securities and derivatives, among other things. This clarified auditing standard has been finalized but not yet issued. See the preface of this guide for further information on the ASB's Clarity Project. The effective date of this clarified standard is for audits of financial statements for periods ending on or after December 15, 2012, unless otherwise established (early implementation is not permitted).

Chapter 15
Debt

Introduction

15.01 Depository institutions use long- and short-term borrowings to provide funds that supplement deposits and to carry out their overall asset/liability management strategy. Finance and mortgage companies cannot take deposits, and therefore, rely almost exclusively on borrowings to fund loans and operations.

15.02 Debt-to-equity ratios of finance companies generally are higher than those of manufacturing companies because finance company assets consist more of liquid receivables than of inventories and fixed assets. Debt-to-equity ratios of at least four- or five-to-one are not uncommon for finance companies. However, finance companies' leverage has traditionally been much lower than the leverage of depository institutions.

15.03 Debt may be classified as senior, senior subordinated, and junior subordinated. The classifications describe declining priorities, which become especially significant when solvency becomes questionable.

15.04 Company policy and credit rating goals cause companies to establish diverse target amounts for each priority category of debt. Moreover, debt agreements usually contain restrictions on the amount of debt that may be incurred in each category. For example, a common restriction in debt securities issued to the general public prohibits pledging assets to secure new or existing debt. Other common restrictions may limit dividend payments and the amount of additional senior debt that can be incurred. If an issuer has other restrictions in its current typical public issue, lenders commonly demand the same restrictions in a private placement.

15.05 The creditworthiness of an institution's debt may be assessed by a rating agency based on analysis of ratios and other factors.[1] Ratings directly affect the institution's cost of borrowing and, thus, its ability to borrow. Institutional investors, such as other financial institutions, insurance companies, trusts, mutual funds, and pension and profit-sharing plans, rely heavily on credit ratings when making investment decisions. Some are prohibited by law or formal agreement from investing in debt below a specified minimum level. For example, some states prohibit licensed domestic insurance companies from investing in corporate obligations that do not meet specified fixed-charge coverage ratios. Similarly, many government agency pension funds are prohibited by law from investing in securities that do not have an investment grade rating.

Long-Term Debt

15.06 The most common long-term debt funding sources are debentures and notes. Institutions also may have long-term mortgages, obligations and commitments under capital leases, and mandatorily redeemable preferred

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[1] For example, many debt agreements consider the debt in default if the issuer fails to pay interest. Accordingly, credit risk may be assessed (in part) through analysis of fixed-charge coverage, which is the ratio of pretax earnings (before interest expense) to interest expense.

stock, that have many of the characteristics of debt. Such obligations are similar to those of other kinds of enterprises. Funds are also borrowed through Eurodollar certificates, collateralized mortgage obligations (CMOs) and real estate mortgage investment conduits (REMICs), mortgage-backed bonds (MBBs), mortgage-revenue bonds, and Federal Home Loan Bank (FHLB) advances.

15.07 The terms of an institution's long-term debt obligations vary widely. They may be secured or unsecured. The debt may be senior or subordinated to other debt. The debt may be convertible into shares of common stock. Convertible debentures are convertible into stock at a specified price at the option of the holder. In most cases, convertible debt securities are also callable at the option of the issuer, generally beginning a few years after issuance. Interest rates may be fixed or floating.

15.08 Credit unions may borrow from individuals (whether or not they are members of the credit union) by issuing promissory notes or *certificates of indebtedness*. Certificates of indebtedness are generally uninsured. Their issuance is governed by Section 701.38 of the National Credit Union Administration (NCUA) *Rules and Regulations*. Credit unions can have access to the NCUA maintained Central Liquidity Facility for short term borrowing by either being a member directly, or indirectly through an agent (usually a corporate credit union). Other notes issued by credit unions are generally payable to corporate credit unions or other financial institutions, or a Federal Reserve Bank.

15.09 Institutions and their subsidiaries sometimes finance expansion using traditional real estate mortgages.

Short-Term Debt

15.10 *Repurchase agreements.* Repurchase agreements are discussed in chapter 14, "Federal Funds and Repurchase Agreements."

15.11 *Federal funds purchased.* Federal funds purchased are discussed in chapter 14.

15.12 *Commercial paper.* Commercial paper is an unsecured promissory note that provides creditworthy institutions, typically, finance companies or holding companies of banks and savings institutions, with short-term funds. Commercial paper is generally short-term (at most 270 days, but usually much less) and negotiable.

15.13 Institutions that rely heavily on commercial paper generally sell and redeem it continuously. They may sell more commercial paper than needed on certain days simply to maintain a market for customers who wish to invest beyond the institution's current needs. Sales of commercial paper may also increase when large amounts of commercial paper or long-term debt mature. Proceeds in excess of current needs are often invested by entering into repurchase agreements or by buying Eurodollar deposits, or commercial paper issued by others.

15.14 *Lines of credit.* Institutions often obtain funds through lines of credit from banks and savings institutions.

15.15 Institutions may obtain lines of credit as a source of funds or to provide creditors with assurance that commercial paper and other shorter term debt will be repaid. Further, rating agencies generally will not rate a finance company's commercial paper if it is not supported by a line of credit.

15.16 Institutions may pay commitment fees, maintain compensating balances, or do both to have lines of credit available. Interest rates on borrowings under lines of credit are usually based on a spread over the lender's prime rate based on the lender's assessment of credit risk.

15.17 *Borrowing from Federal Reserve discount windows and Federal Home Loan Bank system.* Member depository institutions may borrow from their regional Federal Reserve Bank in the form of discounts (often called *rediscounts*) and advances, which are primarily used to cover shortages in the required reserve account and also in times of liquidity problems. A discounting transaction is technically a note to the Federal Reserve with recourse secured by a member institution's eligible loans. In an advancing transaction, a member institution executes a promissory note, which is collateralized generally by government securities to the Federal Reserve. Most discount-window transactions are in the form of advances. Interest charged in those transactions is referred to as *discount*. The rates are set biweekly by the individual reserve banks. Such loans usually have short maturities. Members of the FHLB System can obtain advances of varying maturities from their district FHLBs. FHLB advances often are secured through pledges of loans or securities. Paragraph 15.72 discusses the performance of agreed-upon procedures relating to collateral for FHLB advances.

15.18 *Treasury tax and loan note accounts.* Employers that withhold federal taxes from employees' pay are required to deposit those funds periodically with a bank or savings institution. Institutions record such deposits, that are noninterest-bearing, as treasury tax and loan accounts and include such accounts with their deposits. However, on the day after receipt, such funds must be remitted to the Federal Reserve Bank or converted into an open-ended, interest-bearing note, commonly referred to as a *treasury tax and loan note account*.

15.19 *Banker's acceptances.* Paragraphs 24–26 of the Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 860-10-05 state that banker's acceptances provide a way for a bank to finance a customer's purchase of goods from a vendor for periods usually not exceeding 6 months. Under an agreement among the bank, the customer, and the vendor, the bank agrees to pay the customer's liability to the vendor upon presentation of specified documents that provide evidence of delivery and acceptance of the purchased goods. The principal document is a draft or bill of exchange drawn by the customer that the bank stamps to signify its acceptance of the liability to make payment on the draft on its due date. Once the bank accepts a draft, the customer is liable to repay the bank at the time the draft matures. The bank recognizes a receivable from the customer and a liability for the acceptance it has issued to the vendor. The accepted draft becomes a negotiable financial instrument. The vendor typically sells the accepted draft at a discount either to the accepting bank or in the marketplace. A risk participation is a contract between the accepting bank and a participating bank that the participating bank agrees, in exchange for a fee, to reimburse the accepting bank in the event that the accepting bank's customer fails to honor its liability to the accepting bank in connection with the banker's acceptance. The participating bank becomes a guarantor of the credit of the accepting bank's customer.

15.20 Banker's acceptances are similar to other short-term borrowed funds in that they can be effectively used for short-term liquidity needs by avoiding disbursing funds for short-term loans to bank customers. Readers may also refer to FASB ASC 460, *Guarantees*, for guidance, because banker's acceptances contains an obligation to stand ready to perform over the term of

the guarantee in the event that the specified triggering events or conditions occur, which may require the recognition of an obligation at fair value.

15.21 *Mortgage-backed bonds.* MBBs are any borrowings (other than those from an FHLB) collateralized in whole or in part by one or more real estate loans. MBBs typically have the following characteristics:

a. Fixed maturities or payments of principal and interest

b. The use of mortgage loans or mortgage-backed securities (MBSs) owned by the issuer as collateral

c. Stated or fixed interest rates with interest payable monthly or semiannually (there may also be call provisions)

d. Principal payments made through periodic sinking-fund payments or at final maturity

e. Mortgage collateral in which the purchaser does not have an ownership interest

f. Collateral values usually ranging from 110 percent to 200 percent of the amount of the debt issue, so that the collateral exceeds the principal value during its entire outstanding life (overcollateralization)

15.22 The total mortgage collateral pool is generally overcollateralized to the extent necessary to provide assurance that the investor can sell the mortgage loans without loss in the secondary market in case of MBB issuer default.

15.23 *Preferred stock and other obligations of finance subsidiaries.* Finance subsidiaries, as defined in federal banking regulations, are a means by which institutions can issue preferred stock and other securities at rates lower than those the institutions would otherwise have to pay if they issued the securities directly. Thus, finance subsidiaries afford banking institutions the opportunity to obtain less costly funds.

15.24 *Finance subsidiaries*, as defined in the FASB ASC glossary, are subsidiaries with no assets, operations, revenues, or cash flows other than those related to the issuance, administration, and repayment of the security being registered and any other securities guaranteed by its parent entity.

15.25 In a structured financing (the simplest form of a finance subsidiary), the parent institution transfers certain assets to a special-purpose finance subsidiary to collateralize or otherwise support the securities issued by the finance subsidiary. In return for the assets, the subsidiary remits the net proceeds of the offering to the parent for use in operations. Where debt is issued at the subsidiary level, the trustee for the debt perfects a security interest in the transferred collateral. If preferred stock is issued, no security interest is perfected. However, because the finance subsidiary is chartered for the limited purpose of issuing the securities and can neither incur debt nor engage in any other business (that is, a bankruptcy remote entity), the preferred stock is, in fact, insulated from other encumbrances and is, therefore, backed by the collateral in a manner approximating a security interest. The result is to provide greater protection for preferred stockholders than any of them would have had if the parent institution had been the issuer.

15.26 The economic value of this financing technique is made possible by a variety of factors. Because of the requirements established by the rating agencies, preferred stock offerings are significantly overcollateralized by a

combination of mortgage securities, short-term money-market instruments, treasuries, and other securities. This degree of collateralization, combined with the protection afforded by the structure, enables the rating agencies to issue triple-A ratings. Additionally, because qualified corporate taxpayers holding preferred stock are eligible for a deduction of a specified percentage of dividends received, the dividends paid by the issuer can be low by market standards, making the transaction a low-cost "borrowing" for the parent.

15.27 *Collateralized mortgage obligations.* As introduced in paragraph 7.31 of this guide, CMOs are multiclass, pay-through bonds collateralized by MBSs or mortgage loans and are generally structured so that all, or substantially all, of the collections of principal and interest from the underlying collateral are paid to the holders of the bonds. Typically, the bonds are issued with two or more maturity classes; the actual maturity of each bond class varies depending upon the timing of the cash receipts from the underlying collateral. CMOs are usually issued by a minimally capitalized special-purpose corporation (issuer) established by one or more sponsors (frequently the original owners of the mortgages). The assets collateralizing the obligations are acquired by the special-purpose corporation and then pledged to an independent trustee until the issuer's obligation under the bond indenture has been fully satisfied. The investor agrees to look solely to those trusteed assets and the issuer's initial capital (collectively referred to as *segregated assets*) for repayment of the obligations. Therefore, the sponsor and its other affiliates no longer have any financial obligations for the instrument, although one of those entities may retain the responsibility for servicing the underlying mortgage loans.

15.28 For the sponsor of the CMO, cash is immediately generated; there is no waiting for the collection of the amounts when the respective mortgage payments come due. Credit enhancement of CMOs is generally achieved by using collateral that carries a third-party guarantee; otherwise, CMOs are overcollateralized to mitigate the risk of default. The excess collateral generally reverts to the sponsor at the maturity of the CMOs. The sponsor of the CMO issuer may retain any residual (see chapter 7, "Investments in Debt and Equity Securities"), or an unrelated third party may acquire the residual as an investment.

15.29 For both the issuer and investor, cash flows may not materialize as scheduled. For example, prepayments of the underlying mortgages at a greater-than-anticipated rate can reduce the yield to maturity expected by the investor.

15.30 *Real estate mortgage investment conduits.* REMICs are vehicles for issuing multiclass mortgage-backed obligations that require compliance with a number of technical requirements of the Internal Revenue Code (IRC). REMICs refer to the taxable entity (rather than to the security structure like a CMO and other types of mortgage-backed borrowings). Failure to comply with the requirements could result in imposition of a corporate income tax on the gross income of the REMIC. REMIC certificates of ownership are qualifying real property loans and qualified assets under the IRC.

15.31 To qualify for REMIC status as defined by the IRC, all of the assets continuously held by the REMIC must consist of qualified mortgages and permitted investments. In general, the term, *qualified mortgages* refers to mortgages that are principally collateralized by an interest in real property and are transferred to the REMIC at the time of its formation or purchased by the REMIC within three months of its formation. Qualified mortgage also refers to a regular interest in another REMIC. The term *permitted investments* includes cash-flow investments, qualified reserve assets, and foreclosed property.

15.32 All of the interests in the REMIC normally consists of either regular interests or residual interests. A regular interest is an interest that unconditionally entitles the holder to receive specified principal and interest payments under terms that are fixed at the time of the REMIC's formation. A residual interest is any interest in a REMIC that is not a regular interest. Only one class of residual interest may exist with respect to a REMIC. In other words, the rights of all of the holders of interest that do not qualify as regular interests must be exactly the same.

Regulatory Matters

15.33 Institutions regulated by the Office of Thrift Supervision (OTS) must notify the OTS before borrowing money, unless the institution meets regulatory capital requirements and any applicable minimum capital directive.[*] Regulations may also prohibit growth above a certain level without prior regulatory approval. Further, savings institutions generally must obtain written approval (prior to issuance) for subordinated debt to qualify as regulatory capital.

15.34 The Federal Reserve Act limits the availability of borrowings through the Federal Reserve discount window for certain borrowings.

Accounting and Financial Reporting

15.35 Significant categories of borrowings should be presented as separate line items in the liability section of the balance sheet, or as a single line item with appropriate note disclosure of components as stated in FASB ASC 942-470-45-1. Institutions may, alternatively, present debt based on the debt's priority (that is, senior or subordinated) if they also provide separate disclosure of significant categories of borrowings. FASB ASC 860-30-45-1 explains that if the secured party (transferee) has the right by contract or custom to sell or repledge the collateral, then the obligor (transferor) should reclassify that asset and report that asset in its statement of financial position separately (for example, as security pledged to creditors) from other assets not so encumbered.

15.36 Paragraphs 2–3 of FASB ASC 860-30-45 establish that liabilities incurred by either the secured party or obligor in securities borrowings or resale transactions should be separately classified, but it does not specify the classification or the terminology to be used to describe such liabilities, nor does it prescribe the terminology to be used for assets for which the transferee has the right to repledge the collateral, as discussed in paragraph 15.35.

15.37 FASB ASC 942-470-50-3 states that for debt, the notes to the financial statements should describe the principal terms of the respective agreements including, but not limited to, the title or nature of the agreement, or both; the interest rate (and whether it is fixed or floating); the payment terms and maturity date(s); collateral; conversion or redemption features; whether it is senior or subordinated; and restrictive covenants (such as dividend restrictions), if any.

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[*] Under Title III of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), the Office of Thrift Supervision (OTS) will be abolished and authority will be transferred to the Office of the Comptroller of the Currency, the Federal Reserve System, and the Federal Deposit Insurance Corporation. The transfer of authorities is effective July 21, 2011, and abolishment of the OTS will be effective 90 days after the transfer date. See chapter 1, "Industry Overview—Banks and Savings Institutions," for further information regarding the transfer of power and additional Dodd-Frank Act provisions.

15.38 Accounting and reporting requirements for long-term obligations are the same for financial institutions as for other entities, as stated in FASB ASC 942-470-50-2. If the financial institution has an unclassified balance sheet, there is no need to separate balances into current and long-term portions. (See FASB ASC 440-10-50 for disclosure requirements of future payments on long-term borrowings.)

15.39 In accordance with FASB ASC 470-10-50-1, institutions should disclose the combined aggregate amount of maturities and sinking-fund requirements for all long-term borrowings for each of the five years following the date of the latest balance sheet presented.

15.40 According to FASB ASC 835-30-45-3, issue costs should be reported in the balance sheet as deferred charges. FASB ASC 470-10-35-2 states that debt issue costs should be amortized over the same period used in the interest cost determination.

15.41 Debt instruments with redemption features should be carefully analyzed to determine the appropriate period over which these items should be amortized.

15.42 FASB ASC 480, *Distinguishing Liabilities from Equity*,[†] establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. "Pending Content" in paragraphs 4–5 of FASB ASC 480-10-25, as well as paragraphs 8 and 14 of FASB ASC 480-10-25, require an issuer to classify the following instruments as liabilities (or assets in some circumstances):

a. A mandatorily redeemable financial instrument, unless the redemption is required to occur only upon the liquidation or termination of the reporting entity. A financial instrument that embodies a conditional obligation to redeem the instrument by transferring assets upon an event not certain to occur becomes mandatorily redeemable if that event occurs, the condition is resolved, or the event becomes certain to occur.

b. Any financial instrument, other than an outstanding share, that, at inception, embodies an obligation to repurchase the issuer's equity shares, or is indexed to such an obligation, and that requires or may require the issuer to settle the obligation by transferring assets.

c. A financial instrument that embodies an unconditional obligation, or a financial instrument other than an outstanding share that embodies a conditional obligation, that the issuer must or may settle by issuing a variable number of its equity shares if, at inception, the monetary value of the obligation is based solely or predominantly on any of the following:

[†] For certain mandatorily redeemable financial instruments of certain nonpublic entities, the "Pending Content" in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 480-10-25 has been indefinitely deferred. For certain mandatorily redeemable noncontrolling interests that were deferred for both public and nonpublic entities, FASB plans to reconsider implementation issues and, perhaps, classification or measurement guidance for those noncontrolling interests during the deferral period, in conjunction with FASB's ongoing projects. During the deferral period for certain mandatorily redeemable noncontrolling interests, all public entities as well as nonpublic entities that are Securities and Exchange Commission registrants are required to follow the disclosure requirements in paragraphs 1–3 of FASB ASC 480-10-50 as well as disclosures required by other applicable guidance. For additional effective date information see the transition and open effective date information discussed in FASB ASC 480-10-65-1.

i. A fixed monetary amount known at inception (for example, a payable settleable with a variable number of the issuer's equity shares).

ii. Variations in something other than the fair value of the issuer's equity shares (for example, a financial instrument indexed to the S&P 500 and settleable with a variable number of the issuer's equity shares).

iii. Variations inversely related to changes in the fair value of the issuer's equity shares (for example, a written put option that could be net share settled).

15.43 As stated in FASB ASC 480-10-25-10, examples of financial instruments that meet the criteria in FASB ASC 480-10-25-8 include forward purchase contracts or written put options on the issuer's equity shares that are to be physically settled or net cash settled.

15.44 *Convertible instruments*. Accounting for debt obligations that are convertible into other instruments such as equity securities can be very complex. Such instruments may require bifurcation of embedded derivatives, bifurcation between liability and equity, and impact earnings per share calculations.

15.45 *Redeemable preferred stock.* As noted in paragraph 15.42, "Pending Content" in FASB ASC 480-10-25-4 states that a mandatorily redeemable financial instrument should be classified as a liability unless the redemption is required to occur only upon the liquidation or termination of the reporting entity. "Pending Content" in FASB ASC 480-10-45-1 states that items within the scope of FASB ASC 480-10 should be presented as liabilities (or assets in some circumstances). Those items should not be presented between the liabilities section and equity section of the statement of financial position.

15.46 Redeemable preferred stock that is conditionally redeemable (for example, stock that is puttable by the holder at a specified date) is not in the scope of FASB ASC 480. For Securities and Exchange Commission (SEC) registrants, according to SEC Accounting Series Release No. 268, *Presentation in Financial Statements of "Redeemable Preferred Stocks"* (codified in the SEC Codification of Financial Reporting Policies), mezzanine presentation applies for conditionally redeemable stock that is not in the scope of FASB ASC 480. (Also see paragraphs 17.17–.25 of this guide for a discussion of preferred stock and regulatory capital).

15.47 *Banker's acceptances.* FASB ASC 860-10-55-65 addresses banker's acceptances and risk participations in them. An accepting bank that obtains a risk participation should not derecognize the liability for the banker's acceptance because the accepting bank is still primarily liable to the holder of the banker's acceptance even though it benefits from a guarantee of reimbursement by a participating bank. The accepting bank should not derecognize the receivable from the customer because it has not transferred the receivable. The accepting bank should, however, record the guarantee purchased, and the participating bank should record a liability for the guarantee issued. Certain disclosures are required to be made by a guarantor in its interim and annual financial statements about its obligations under guarantees, as stated in FASB ASC 460-10-05-2. FASB ASC 460 also addresses the recognition of a liability by a guarantor at the inception of a guarantee for the obligations the guarantor has undertaken in issuing that guarantee.

15.48 *Mortgage-backed bonds.* FASB ASC 942-470-45-2 states that transfers of mortgages accounted for under FASB ASC 860, *Transfers and Servicing*, as secured borrowings of the issuing institution should be classified as debt on the institution's balance sheet. Such MBBs should be classified separately from advances, other notes payable, and subordinated debt.

15.49 Any discounts or premiums associated with the issuance of MBBs ordinarily should be reported in a contra liability (debit) or liability (credit) account, consistent with FASB ASC 835-30-45-1A and FASB Statement of Financial Accounting Concepts No. 6, *Elements of Financial Statements* (paragraphs 235–239). Bond issue costs or expenses (legal, accounting, printing, and other expenses) generally should be deferred and amortized to operations using the constant effective yield method over the life of the bonds.

15.50 *Extinguishments of liabilities.* FASB ASC 405-20 provides accounting and reporting standards for extinguishments of liabilities. FASB ASC 405-20-40-1 states that a debtor should derecognize a liability if and only if it has been extinguished. A liability has been extinguished if either of the following conditions is met:

a. The debtor pays the creditor and is relieved of its obligation for the liability. Paying the creditor includes delivery of cash, other financial assets, goods or services, or reacquisition by the debtor of its outstanding debt securities whether the securities are canceled or held as so-called treasury bonds.

b. The debtor is legally released from being the primary obligor under the liability, either judicially or by the creditor. FASB ASC 405-20-40-2 provides related guidance.

15.51 *Gain or loss on extinguishments*. Most gains or losses on extinguishments are recorded as ordinary items. However, FASB ASC 470-50-45-1 indicates that gains and losses from extinguishment of debt that meet the criteria in FASB ASC 225-20 (unusual nature and infrequency of occurrence) are not precluded from being classified as extraordinary items unless they result from the application of Line-of-Credit or Revolving Debt agreements under FASB ASC 470-50-40-21(c).

15.52 *Modifications or exchanges of debt*. FASB ASC 470-50 provides accounting and reporting standards for assessing modification or exchanges of debt arrangements in determining whether or not the modifications or exchanges will result in extinguishment or modification of accounting. FASB ASC 470-60 provides accounting and reporting guidance for determining when a modification is considered a troubled debt restructuring.

15.53 *Foreign currency debt.* Entities with debt payable in a foreign currency may experience fluctuations in the reporting currency value of the debt due to changes in exchange rates. In some instances, entities enter into a currency swap contract to receive a foreign currency and pay the reporting currency. FASB ASC 815-10-45-2 states that none of the provisions in FASB ASC 815-10 support netting a hedging derivative's asset (or liability) position against the hedged liability (or asset) position in the balance sheet. Readers may refer to FASB ASC 815, *Derivatives and Hedging*, for further guidance.

15.54 *Dual currency bonds.* The guidance in paragraphs 35–36 of FASB ASC 815-20-55 related to foreign-currency-denominated interest payments also applies to dual-currency bonds that provide for repayment of principal in the functional currency and periodic fixed-rate interest payments denominated in a foreign currency, as stated in FASB ASC 815-20-55-37. FASB ASC 830-20

applies to dual-currency bonds and requires the present value of the interest payments denominated in a foreign currency to be remeasured and the transaction gain or loss recognized in earnings.

15.55 *Real estate mortgage investment conduits*. As discussed earlier, REMIC is simply a label that covers various forms of underlying securities. These securities may resemble either CMOs or pass-through certificates that represent a transfer of the underlying receivables. Institutions may enter into REMIC transactions to raise immediate cash utilizing mortgage agreements as collateral. FASB ASC 860 provides accounting and reporting standards for transfers of financial assets, including transfers associated with REMICs and CMOs. FASB ASC 810, *Consolidation*, provides guidance on the consolidation of these entities which are typically variable interest entities.

15.56 *Lease financing*.[‡] Accounting for leases by lessees and lessors is established by FASB ASC 840, *Leases*.

15.57 *Lending of customers' securities*. Banks and savings institutions sometimes lend customers' securities. FASB ASC 860-30 discusses application of the guidance to securities lending transactions. Any contingencies related to the lending of securities normally should be accounted for in conformity with FASB ASC 450, *Contingencies*.

15.58 *Fair value measurements*. FASB ASC 820, *Fair Value Measurement*, defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. See chapter 20, "Fair Value," for a summary of FASB ASC 820. Some institutions have elected to apply fair value accounting to financing agreements under FASB ASC 825, *Financial Instruments*.

15.59 *Consolidation*. Reporting entities should apply the guidance in FASB ASC 810 to determine whether and how to consolidate another entity and apply the subsections of FASB ASC 810, including variable interest entities, as stated in FASB ASC 810-10-15-3.[2]

Auditing

Objectives

15.60 The primary audit objectives in this area are to obtain sufficient appropriate evidence that

a. short- and long-term borrowings recorded as of the date of the financial statements include all such liabilities of the institution and

[‡] In August 2010, FASB issued an exposure draft, *Leases (Topic 840)*. The proposed guidance was initiated as a joint project between FASB and the International Accounting Standards Board to develop a new approach to lease accounting that would ensure that assets and liabilities arising under leases are recognized in the statement of financial position. Based on comments received in response to the exposure draft and decisions reached at the July 20-21, 2011, board meeting, FASB agreed unanimously to re-expose its revised proposals for a leases standard. FASB expects to release a revised proposal during the 4th quarter of 2011. The amendments are expected to result in significant changes to the accounting requirements for both lessees and lessors. Readers are encouraged to visit the FASB website for the latest developments regarding the lease project, including a summary of the proposed model and decisions reached to date.

[2] For additional assistance, refer to Technical Question and Answer section 1400.29, "Consolidated Versus Combined Financial Statements Under FASB ASC 810, *Consolidation*" (AICPA, *Technical Practice Aids*). FASB is expected to issue and exposure draft proposing amendments to FASB ASC 810, *Consolidation*. Readers should remain alert for developments.

that they have been properly valued, classified, described and disclosed, and reflect all transactions for the period;

b. financing subsidiaries are consolidated with the parent institution as required by FASB ASC 810;

c. interest expense and the related balance-sheet accounts (accrued interest payable, unamortized premiums or discounts, and issuance costs) are properly measured and recorded, and amortization has been properly computed;

d. collateral for borrowings is properly identified and disclosed;

e. borrowings have been authorized in accordance with management's written policies and are obligations of the institution; and

f. the effects on reported amounts and disclosures of any noncompliance with debt covenants are properly identified, described, and disclosed.

Planning

15.61 In accordance with AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), the auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures (as described in chapter 5, "Audit Considerations and Certain Financial Reporting Matters"). Factors related to other borrowings that could influence the risks of material misstatement may include accounting for borrowings, regulatory considerations, the existence of restrictive covenants, and the existence and adequacy of collateral, if applicable. The auditor might also review board of directors' reports, the current-year's interim financial statements, and other documents that may include information about whether any significant new debt has been incurred or issued and whether any significant debt has been repaid or refinanced. The auditor may also inquire as a means to obtain audit evidence about the nature of the entity, for example, the existence of financing subsidiaries.

Internal Control Over Financial Reporting and Possible Tests of Controls

15.62 AU section 314 establishes standards and provides guidance on obtaining a sufficient understanding of the entity and its environment, including its internal control. It provides guidance on understanding the components of internal control and explains how an auditor should obtain a sufficient understanding of internal control for the purposes of assessing the risks of material misstatement. Paragraph .40 of AU section 314 requires that, in all audits, the auditor should obtain an understanding of the five components of internal control (the control environment, risk assessment, control activities, information and communication systems, and monitoring), sufficient to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. The auditor should obtain a sufficient understanding by performing risk assessment procedures to evaluate the design of controls relevant to an audit of financial statements and to determine whether they have been implemented. Paragraph .102 of AU section 314 states that the auditor should

identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions, account balances, and disclosures.

15.63 According to paragraph .23 of AU section 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*), the auditor should perform tests of controls when the auditor's risk assessment includes an expectation of the operating effectiveness of controls or when substantive procedures alone do not provide sufficient appropriate audit evidence at the relevant assertion level. Controls relating to the financial reporting of debt include, but are not limited to, the following:

- Debt transactions are reviewed and approved by the board of directors or its designated committee and documented in the minutes.
- Debt agreements are reviewed by the appropriate accounting and legal personnel to ensure that borrowings meet generally accepted accounting principles (GAAP) criteria for classification as a liability.
- Adjustments to liability accounts are reviewed and approved by a responsible official.
- The institution is named as issuer or borrower in the respective credit or financing agreements.
- All off-balance-sheet obligations (such as operating leases and guarantees) have been identified, described, and disclosed.
- The subsidiary ledgers for long- and short-term borrowings and collateral are periodically reconciled with the general ledger.
- Reports or statements from outside trustees or transfer agents are periodically reconciled to the institution's records.
- Through periodic confirmation with the trustee or transfer agent, the institution ascertains that collateral on borrowings remains sufficient.
- Borrowings (such as CMOs and REMICs) are reviewed to ensure that they meet the GAAP criteria for treatment as financing transactions and consolidation.
- Periodic tests of covenant compliance are performed and reviewed by responsible personnel.

15.64 Paragraphs .06–.21 of AU section 324,[||,3] *Service Organizations* (AICPA, *Professional Standards*), provide guidance on the user auditor's consideration of the effect of a service organization on the user organization's

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[||] The guidance contained in AU section 324, *Service Organizations* (AICPA, *Professional Standards*), has now been split into an attest standard and an auditing standard to better reflect the nature of the work being performed. The Auditing Standards Board (ASB) has finalized a new clarified auditing standard on service organizations, *Audit Considerations Relating to an Entity Using a Service Organization*. This auditing standard will supersede AU section 324 and addresses the user auditor's responsibility for obtaining sufficient appropriate audit evidence in an audit of the financial statements of a user entity that uses one or more service organizations. This clarified auditing standard has been finalized but not yet issued. See the preface of this guide for further information on the ASB's Clarity Project. The effective date of this clarified standard is for audits of financial statements for periods ending on or after December 15, 2012, unless otherwise established (early adoption would not be appropriate).

The related attest standard, Statement on Standards for Attestation Engagements (SSAE) No. 16, *Reporting on Controls at a Service Organization* (AICPA, *Professional Standards*, AT sec. 801), was issued in April 2010. It addresses examination engagements undertaken by a service auditor to report on controls at organizations that provide services to user

internal control and availability of audit evidence. The auditor should consider this guidance when planning and performing the audit of the financial statements of an institution that obtains services from another service organizations that are part of its information system (for example, processing CMO or REMIC cash flows by a trustee).

> *Considerations for Audits Performed in Accordance with Public Company Accounting Oversight Board (PCAOB) Standards*
>
> Paragraph .01 of AU section 324, *Service Organizations* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards), states that when performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs B17–B27 of appendix B, "Special Topics," of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards), regarding the use of service organizations.

Substantive Tests

15.65 According to paragraph .51 of AU section 318, regardless of the assessed risks of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure. This reflects the fact that the auditor's assessment of risk is judgmental and may not be sufficiently precise to identify all risks of material misstatement.

15.66 *Review of documentation.* The auditor might review documentation such as legal agreements and notes supporting long-term debt and agree pertinent information to subsidiary ledgers. The auditor might review the following information:

a. Type of debt

b. Interest rate and dates interest is payable

c. Maturity of the debt

d. Underlying collateral of the debt, if any

e. Subordination of the debt

f. Evidence of regulatory approval

g. Presence of restrictive covenants

h. Unusual features

i. Embedded derivatives

(footnote continued)

entities when those controls are likely to be relevant to user entities' internal control over financial reporting. SSAE No. 16 supersedes the guidance for service auditors in AU section 324 and is effective for service auditors' reports for periods ending on or after June 15, 2011. Early implementation is permitted.

[3] Audit Guide *Service Organizations: Applying SAS No. 70, as Amended*, has been revised by a task force of the ASB to reflect the requirements and guidance in SSAE No. 16. The revised Audit Guide, *Service Organizations: Applying SSAE No. 16*, Reporting on Controls at a Service Organization, is currently available to readers. Also, the newly released Audit Guide *Reporting on Controls at a Service Organization Relevant to Security, Availability, Processing Integrity, Confidentiality, or Privacy* addresses reporting on a service provider's controls over subject matter other than financial reporting.

15.67 *Confirmation.* The auditor should consider confirming pertinent information with the trustee or transfer agent, including all terms, unpaid balance, accrued interest payable, principal and interest payments made during the year, collateral description, annual trust accounts activity, and the occurrence of any violations of the terms of the agreement. If collateral is not under the control of the institution and is held by a trustee or transfer agent, the auditor should consider confirming its existence, completeness, and valuation with the trustee or transfer agent. If collateral is deemed deficient with respect to the terms of the debt agreement or is not under the control of the institution, the auditor might consider the need for disclosure.

15.68 *Tests of valuation.* The auditor should consider testing borrowings that were issued at a premium or discount to determine whether amortization has been properly computed and recorded. The auditor should also evaluate the propriety of amortization of costs incurred in connection with a debt issuance. The auditor should consider assessing the sufficiency of the value of assets collateralizing any borrowings by confirmation.

15.69 *Analytical procedures.* Analytical procedures can provide substantive evidence about the completeness of debt related financial statement amounts and disclosures; however, such procedures in tests of debt expense are often less precise than substantive tests such as recalculations. Because institutions generally issue a wide variety of debt with rates that vary with each issuance, it is normally difficult to develop expectations to be used in analyzing yields on debt. According to paragraph .10 of AU section 329, *Analytical Procedures* (AICPA, *Professional Standards*), for some assertions, analytical procedures are effective in providing the appropriate level of assurance. For other assertions, however, analytical procedures may not be as effective or efficient as tests of details in providing the desired level of assurance. Further guidance is provided in AU section 329 and AU section 326, *Audit Evidence* (AICPA, *Professional Standards*). Paragraph .16 of AU section 329 states that the auditor obtains assurance from analytical procedures based upon the consistency of the recorded amounts with expectations developed from data derived from other sources. The reliability of the data used to develop the expectations should be appropriate for the desired level of assurance from the analytical procedure. The following are some of the analytical review procedures that could be considered:

- Compare interest expense by major category of debt as a percentage of the average amount of the respective debt outstanding during the year with stated rates on the debt instruments (yield test).
- Evaluate the reasonableness of balance-sheet accruals and other related balance-sheet accounts (accrued interest payable, deferred issuance costs, and premiums and discounts) by comparison to prior-year balances.

15.70 AU section 329 states the auditor's reliance on substantive tests to achieve an audit objective related to a particular assertion may be derived from tests of details, from analytical procedures, or from a combination of both. The decision about which procedure or procedures to use to achieve a particular audit objective is based on the auditor's judgment on the expected effectiveness and efficiency of the available procedures. The auditor considers the level of assurance, if any, he wants from substantive testing for a particular audit objective and decides, among other things, which procedure, or combination of procedures, can provide that level of assurance.

Considerations for Audits Performed in Accordance with PCAOB Standards

Paragraph .09 of AU section 329, *Analytical Procedures* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards), states for significant risks of material misstatement in an integrated audit, it is unlikely that audit evidence obtained from substantive analytical procedures alone will be sufficient.

15.71 *Other procedures.* Other audit procedures the auditor may consider, related to debt and the extinguishment of debt, are as follows:

- Review debt covenants and test whether the institution has complied with such covenants. Determine whether disclosures are appropriate.
- Read minutes of meetings of the board of directors to determine whether financing transactions have been authorized in accordance with the institution's written policies.
- Compare recorded interest expense and accrued interest payable to recorded debt for completeness of debt liabilities.
- Obtain a detailed supporting schedule of prior-year and current-year account balances. Agree the prior-year balance to prior-year working papers and the current-year balance to the general ledger. Review activity for reasonableness.
- For CMOs and REMICs, obtain and review compliance and verification letters prepared by the trustee's auditors. (Such letters are prepared on an annual basis and provide for the verification of the principal balance of the collateral and bonds, the cash flows associated with the issue, and compliance with the respective terms of the underlying agreements.)
- Examine canceled notes for borrowings that have been paid in full.
- Read lease agreements, identifying those that should be capitalized, and determine whether they were recorded using effective rates of interest.
- For financing transactions resulting from failed sales under FASB ASC 860, revisit agreement terms to validate that financing treatment is still appropriate (that is, a call option may have expired resulting in a reconsideration event under FASB ASC 860 that may change the nature of the transfer from a financing to a true sale).

15.72 If applicable, the auditor may be engaged to perform agreed-upon procedures relating to collateral for FHLB advances by reference to the security agreement signed by the institution's management that indicates compliance. The procedures depend upon the nature of the agreement (blanket lien, specific lien without delivery, or specific lien with delivery of the collateral). The respective district FHLB provides guidance on procedures to be performed. In light of the professional standards, the auditor considers whether and how to perform all that is requested by the FHLB.

15.73 The terms of some debt agreements may mandate 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 AU section 623, *Special Reports* (AICPA, *Professional Standards*).

15.74 *Finance company credit questionnaires.* Finance companies provide creditors with financial and operating information through standard credit questionnaires developed jointly by industry and Risk Management Association (an association of lending officers). Some finance companies include credit questionnaires as information in addition to the finance company's basic financial statements. The auditor's responsibility depends on the services requested by the finance company.

15.75 Paragraph .04 of AU section 551A, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*),[#] says an auditor who submits a document containing audited financial statements to the client or to others has a responsibility to report on all the information (such as a credit questionnaire) included in the document. However, AU section 551A states that when the auditor's report is included in a client-prepared document and the auditor is not engaged to report on information accompanying the basic financial statements, his responsibility with respect to such information is described in (*a*) AU section 550A, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*), and (*b*) other sections covering particular types of information or circumstances, such as AU section 558A, *Required Supplementary Information* (AICPA, *Professional Standards*).

[#] In February 2010, the ASB issued Statement on Auditing Standards (SAS) No. 119, *Supplementary Information in Relation to the Financial Statements as a Whole* (AICPA, *Professional Standards*, AU sec. 551). This standard, along with SAS No. 118, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, AU sec. 551), supersede the requirements and guidance in AU section 551. This SAS is effective for audits of financial statements for periods beginning on or after December 15, 2010. Early application is permitted.

SAS No. 119 addresses the auditor's responsibility when engaged to report on whether supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole. The information covered by this SAS is presented outside the basic financial statements and is not considered necessary for the financial statements to be fairly presented in accordance with the applicable financial reporting framework. This SAS also may be applied, with the report wording adapted as necessary, when an auditor has been engaged to report on whether required supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole.

Chapter 16

Income Taxes

Introduction[1]

16.01 Depository institutions generally are subject to the same tax rules that apply to other corporations, including those that are members of a consolidated group. Generally, credit unions are exempt from federal income taxes. Banks and savings institutions are permitted to elect subchapter S status under Internal Revenue Code (IRC) Section 1362, provided certain requirements are met. Among these requirements are a 100-shareholder limitation (including family attribution), one class of stock restriction, and prohibition on the use of the reserve method of accounting for bad debts for tax. If elected, S corporation status essentially converts the financial institution to a pass-through entity for tax purposes so that most of the corporate level tax on income is avoided.

16.02 The IRC contains many provisions specific to taxable depository institutions. Finance and mortgage companies generally are subject to the same tax rules that apply to other corporations. The purpose of this chapter is to highlight certain federal tax matters and related accounting matters specific to the industry and to provide related auditing guidance.

Banks and Savings Institutions

16.03 *Definition of a bank for tax purposes.* IRC Section 581 defines a bank for tax purposes and provides special rules governing bank taxation.

16.04 *Definition of a savings institution for tax purposes.* Savings institutions are considered to be mutual savings banks (IRC Section 591), domestic building and loan associations (IRC Section 7701[a][19]), or cooperative banks (IRC Section 7701[a][32]). The failure of an institution to qualify as a savings institution may affect the financial accounting standards that apply.

16.05 *Securities gains and losses.* IRC Section 582 provides banks special treatment for certain asset dispositions. Gains and losses on bonds, debentures, notes, certificates, and other evidences of indebtedness held by banks generally are treated under IRC Section 582 as ordinary (rather than capital) gains and losses. Equity securities and other investments generally are not afforded IRC Section 582 ordinary treatment. IRC Section 582 generally is not applicable to nonbank subsidiaries, including, for example, passive investment companies established for state planning purposes.

16.06 *Tax bad-debt deductions.* IRC Section 585 provides that a bank or savings institution with $500 million or less in assets is allowed a tax bad-debt deduction for reasonable additions to the bad-debt reserve. This asset test generally is based upon the average adjusted tax basis of all assets. If the institution is a member of a controlled group (as defined), all assets of the group

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[1] This chapter is not intended to provide comprehensive discussion of all possible tax matters an accountant might encounter in the preparation or audit of the financial statements of a financial institution. Further, state tax matters are beyond the scope of the introductory section of this chapter. Consulting this chapter cannot take the place of a careful reading of the related laws, regulations, rulings, and related documents, where appropriate.

are taken into account. The annual addition to the reserve generally cannot exceed the greater of the amount computed using actual experience percentages or the base year fill-up method (as defined).

16.07 A bank or savings institution with assets exceeding $500 million generally is allowed to claim a tax bad-debt deduction only under the general rule of IRC Section 166, that generally permits taxpayers to deduct any debt that becomes worthless, in whole or in part, during the taxable year that is determined to be worthless (the *specific charge-off* method[2]).

16.08 According to regulations, a bank or savings institution also may be required to recapture a portion of its bad-debt reserves if it makes distributions to shareholders that exceed earnings and profits accumulated after 1951. Additionally, if a savings institution makes a distribution in redemption of stock or in partial or complete liquidation, notwithstanding the existence of earnings and profits, a portion of the reserve may have to be recaptured. Exceptions to this rule exist for certain tax-free reorganizations and certain distributions to the Federal Deposit Insurance Corporation (FDIC) in redemption of an interest if such interest was originally received in exchange for assistance provided (see IRC Section 597[c]).

16.09 *Net operating losses.* For taxable years beginning after August 5, 1997, net operating losses (NOLs) of banks and savings institutions generally are carried back 2 years and then forward 20 years under the provisions of IRC Section 172. For taxable years prior to 1994, banks and savings institutions also had various special provisions in the IRC that determined the appropriate carryback and carryforward periods. On November 6, 2009, legislation was passed that extended the period that NOLs sustained in 2008 or 2009 may be carried. As a result, the NOLs incurred in either year (but not both) may be carried back to the fifth taxable year preceding the taxable year that the NOL was suffered. The new law states that not more than 50 percent of the taxable income earned in the fifth preceding tax year may be offset by the NOL carryback. In addition, the election to carry back NOLs up to 5 years is not available to companies receiving assistance under the Troubled Asset Relief Program[*] if the federal government acquired stock (or a right to acquire stock) in the company before the date of enactment of the new law, or if the federal government provides funds to the company (in exchange for a stock interest) after the date of enactment of the new law.

Other

16.10 *Alternative minimum tax.* Beginning in 1987, corporations must compute their federal tax liability under both the regular tax and alternative minimum tax (AMT) systems and pay the higher amount. The AMT system is a separate but parallel tax system that regular taxable income is increased or decreased by certain AMT adjustments and preference items to arrive at AMT income. A rate of tax generally lower than the regular tax rate is applied to AMT income. The AMT adjustments and preference items most common for banks include tax-exempt interest income on private activity bonds issued after August 7, 1986 (reduced by any related interest expense disallowance), and accelerated depreciation and cost recovery. An adjustment is also required for the adjusted current earnings amount (defined), that frequently includes additional modifications for all tax-exempt interest income, the dividends

[2] Finance companies and mortgage companies also use the specific charge-off method.

[*] The Troubled Asset Relief Program expired in October 2010.

received deduction, and the increase in the cash surrender value of life insurance over the premiums paid. Further, only 90 percent of AMT income may be offset by a NOL. Any excess of tax computed under the AMT system over the regular system generally is eligible to reduce future regular tax (a minimum tax credit).

16.11 *Mark to market.* IRC Section 475 generally requires any company that is a *dealer* in securities to mark its securities to market. A dealer is broadly defined as any taxpayer that regularly purchases securities from, or sells securities to, customers in the ordinary course of business. The definition of *securities* in the IRC differs from and is generally more expansive than the definition of *securities* in the Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) glossary. For purposes of IRC Section 475 nonsecuritized loans are, in some circumstances, considered securities. Further, institutions generally may not exempt any security held for investment if it is identified as such at the date of acquisition. A window (sometimes as much as 30 days) has generally been allowed for identification of certain loans.

16.12 *Interest expense relating to tax-exempt income.* IRC Section 291 generally provides that 20 percent of the allocable interest expense attributable to tax-exempt obligations acquired by a financial institution after 1982 and before August 8, 1986, is not deductible. For tax-exempt obligations acquired after August 7, 1986, IRC Section 265 generally requires that all of the interest expense attributable to the obligation be nondeductible. An exception exists for certain "qualified small issuer" obligations (as defined), that are subject to IRC Section 291. To be a qualified small issuer, the issuer must either be a state or local government or issue bonds on behalf of a state or local government. The issuer also must reasonably expect to issue not more than $10 million of tax-exempt obligations (other than certain private activity bonds) within a year. The American Recovery and Reinvestment Act of 2009 that was passed by Congress and signed into law on February 17, 2009, increases the $10 million limit to $30 million for tax-exempt obligations issued in 2009 and 2010 to finance new projects and to refund prior obligations.

Credit Union

16.13 Federal credit unions are exempt from federal and state income tax. State chartered credit unions may be subject to state income tax. Credit union service organizations, that are subsidiaries of federal or state credit unions, may be subject to unrelated business income tax for federal income tax purposes.

Regulatory Matters

16.14 The Federal Financial Institutions Examination Council requires, for regulatory reporting purposes, that income taxes be accounted for in conformity with U.S. generally accepted accounting principles (GAAP). However, income taxes receive special treatment in regulatory capital calculations as the federal banking regulatory agencies limit the amount of deferred tax assets that may be included in regulatory capital.

16.15 The Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the FDIC, and the Office of Thrift Supervision (collectively, the federal banking agencies) amended their regulatory capital rules to permit banks, bank holding companies, and savings

associations to reduce the amount of goodwill that a banking organization must deduct from tier 1 capital by the amount of any deferred tax liability associated with that goodwill. The final rule, *Minimum Capital Ratios; Capital Adequacy Guidelines; Capital Maintenance; Capital: Deduction of Goodwill Net of Associated Deferred Tax Liability*, was effective January 29, 2009. See the FDIC's Financial Institution Letter-144-2008, "Regulatory Capital Standards Deduction of Goodwill Net of Associated Deferred Tax Liability," and Title 12 U.S. *Code of Federal Regulations* Part 325.5 for additional information. Readers are encouraged to monitor the banking agencies' websites for further developments on this topic.

16.16 Regulatory capital standards limit the amount of deferred tax assets, as determined under U.S. GAAP, that can be included in tier 1 capital. Generally, deferred tax assets that are dependent upon future taxable income are limited to the lesser of (*a*) the amount of such deferred tax assets that the bank expects to realize within 1 year of the calendar quarter-end date, based on its projected future taxable income for that year, or (*b*) 10 percent of the amount of the bank's tier 1 capital. Deferred tax assets that are dependent upon future taxable income are (*a*) deferred tax assets arising from deductible temporary differences that exceed the amount of taxes previously paid that a bank could recover through loss carrybacks if the bank's temporary differences (both deductible and taxable) fully reverse at the report date, and (*b*) deferred tax assets arising from operating loss and tax credit carryforwards. When determining the regulatory capital limit for deferred tax assets, a bank may, but is not required to, adjust the amount of its deferred tax assets for any deferred tax assets and liabilities arising from available-for-sale debt securities for purposes of the calculating regulatory capital. A bank must follow a consistent approach with respect to such adjustments.

16.17 In 1998, the federal banking agencies adopted a statement of policy, *Interagency Policy Statement on Income Tax Allocation in a Holding Company Structure*. The policy statement, that does not materially change any of the guidance previously issued by the agencies, generally, requires that intercorporate tax settlements between an institution and its parent company be no less favorable to the institution than if it had filed its income tax return as a separate entity. Taxes should not be paid to the parent before the payment would have been due to the taxing authority and if the subsidiary incurs a tax loss, it should receive a refund from the parent. Adjustments for statutory tax considerations that arise in a consolidated return are permitted if they are made on an equitable basis, consistently applied to all affiliates. These rules generally require that deferred taxes of the institution may not be paid or transferred to, or forgiven by, its holding company. The agencies recommend that members of a consolidated group have a written comprehensive tax agreement to address intercorporate tax policies and procedures.

16.18 IRS regulations permit an institution to obtain evidence, from its primary regulator, stating that the institution maintains and applies loan review and loss classification standards consistent with the agency's regulations regarding loan charge-offs. Each of the federal banking regulatory agencies has implementation guidance on this express determination letter process.

Accounting and Financial Reporting

16.19 FASB ASC 740, *Income Taxes*, addresses financial accounting and reporting for the effects of income taxes that result from an entity's activities during the current and preceding years, as stated in FASB ASC 740-10-05-1.

The objectives of accounting for income taxes, as stated in FASB ASC 740-10-10-1, are to recognize (*a*) the amount of income taxes payable or refundable for the current year and (*b*) deferred tax liabilities and assets for future tax consequences of events that have been recognized in an institution's financial statements or tax returns.

16.20 The guidance requires an asset-and-liability approach for financial accounting and reporting for income taxes and, therefore, has a balance-sheet orientation.

16.21 Two basic principles are related to accounting for income taxes, each of which considers uncertainty through the application of recognition and measurement criteria, according to FASB ASC 740-10-05-5:

- A current income tax liability or asset is recognized for the estimated taxes payable or refundable on tax returns for the current year.
- A deferred tax liability or asset is recognized for the estimated future tax effects attributable to temporary differences and carryforwards.

16.22 The following basic requirements, as provided in FASB ASC 740-10-30-2, are applied to the measurement of current and deferred income taxes at the date of the financial statements:

- The measurement of current and deferred tax liabilities and assets is based on provisions of the enacted tax law; the effects of future changes in tax laws or rates are not anticipated.
- The measurement of deferred tax assets is reduced, if necessary, by the amount of any tax benefits that, based on available evidence, are not expected to be realized.

Deferred Tax Assets and Liabilities

16.23 Subject to certain specific exceptions identified in FASB ASC 740-10-25-3, FASB ASC 740-10-55-7 establishes that a deferred tax liability is recognized for all taxable temporary differences. Deferred tax assets are to be recognized for all deductible temporary differences and operating loss and tax credit carryforwards. In accordance with the definition in the FASB ASC glossary, a *deferred tax asset* is reduced by a *valuation allowance* (as defined in the FASB ASC glossary) if, based on the weight of available evidence, it is more likely than not that some portion or all of the deferred tax assets will not be realized. (The term *more likely than not* means a likelihood of more than 50 percent as established in FASB ASC 740-10-25-6.)

16.24 An example of a deferred tax liability includes book and tax bases differences that will result in future taxable amounts. An example of a deferred tax asset includes book and tax bases differences of assets and liabilities that will result in future deductible amounts.

16.25 FASB ASC 740-10-45-20 requires that the effect of a change in the beginning-of-the-year balance of a valuation allowance that results from a change in circumstances that causes a change in judgment about the realizability of the related deferred tax asset in future years ordinarily should be included in income from continuing operations.

16.26 FASB ASC 740 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements and prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken

in a tax return. This topic also provides guidance on derecognition, classification, interest and penalties, accounting for interim periods, disclosure and transition. The scope of FASB ASC 740 includes domestic and foreign entities in preparing financial statements in accordance with U.S. GAAP.[3] FASB ASC 740 also provides guidance on how an enterprise should determine whether a tax position is effectively settled for the purpose of recognizing previously unrecognized tax benefits. It also uses the terms *effectively settled* and *settlement* in the context of income taxes.

Temporary Differences

16.27 A *temporary difference*, as defined in the FASB ASC glossary, is a difference between the tax basis of an asset or liability computed pursuant to the requirements in FASB ASC 740-10 for tax positions, and its reported amount in the financial statements that will result in taxable or deductible amounts in future years when the reported amount of the asset or liability is recovered or settled, respectively. FASB ASC 740-10-25-20 cites eight examples of temporary differences.

16.28 Other examples of temporary differences common to financial institutions may include the following:

- *Bad-debt reserves* for institutions that deduct bad-debt reserves under IRC Section 585 (that excludes the base year amount discussed at paragraph 16.31) and bad-debt reserves for financial statement purposes in excess of the bad-debt reserve for tax purposes. (For larger institutions that are covered under IRC Section 166, there is no bad-debt reserve for tax purposes and, therefore, the entire allowance for credit losses in the financial statements is a temporary difference.)
- *Unrealized gains or losses on securities* under FASB ASC 320, *Investments—Debt and Equity Securities* may differ from amounts recognized under IRC Section 475.
- *Other real estate owned and other assets* may reflect postacquisition impairment write-downs in the financial statements; those write-downs are generally not recognized for tax purposes until the asset is sold or disposed of for a bank. (For a savings institution, assets acquired before 1996 will generally be treated as a loan until sold.)
- *Accrued deferred compensation* is not deductible for tax purposes until paid.
- *Accrued loss contingencies* are generally not deductible for tax purposes until paid.
- *Depreciation of property, plant, and equipment* and the amortization of intangible assets may be different for financial statement and tax purposes.
- *Accrual of retirement liabilities* is often made in the financial statements in different periods from those that the expense is recognized for tax purposes.

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[3] The AICPA issued a nonauthoritative practice guide titled *Practice Guide on Accounting for Uncertain Tax Positions Under FASB Interpretation No. 48*, that is available on the AICPA website at www.aicpa.org/InterestAreas/FRC/AccountingFinancialReporting/Downloadable Documents/FIN48final.pdf.

- *Other basis differences* in assets and liabilities are caused by the following:
  - *Gains and losses on sales* of loans, foreclosed assets, or property, plant, and equipment recognized in financial reporting periods different from tax periods.
  - *Amortization of imputed interest income* from transactions involving loans recognized in different periods for financial reporting and tax purposes.
  - *Accretion of discount on securities* recorded currently for financial reporting purposes, but subject to tax at maturity or sale, or accreted differently for tax purposes.
  - *Commitment fees* included in taxable income when collected but deferred to a period when earned for financial reporting purposes.
  - *Loan fee income* recognized on a cash basis for tax purposes while recognized as a yield adjustment for financial reporting purposes.
  - *Federal Home Loan Bank stock dividends* recognized as current financial reporting income but deferred for tax purposes.
  - The timing of the recognition of *income or loss for hedges and swaps* that differ for financial reporting and tax purposes.

Financial Statement Presentation and Disclosure

16.29 FASB ASC 740-10-50 provides guidance on the financial statement disclosure requirements relating to income taxes applicable to all entities.

16.30 As established in FASB ASC 740-30-50-2, all of the following information should be disclosed whenever a deferred tax liability is not recognized because of the exceptions to comprehensive recognition of deferred taxes related to subsidiaries and corporate joint ventures:

- A description of the types of temporary differences that a deferred tax liability has not been recognized and the types of events that would cause those temporary differences to become taxable
- The cumulative amount of each type of temporary difference
- The amount of unrecognized deferred tax liability for temporary differences related to investments in foreign subsidiaries and foreign corporate joint ventures that are essentially permanent in duration if determination of that liability is practicable or a statement that determination is not practicable
- The amount of the deferred tax liability for other temporary differences that is not recognized in accordance with the provisions of FASB ASC 740-30-25-18

16.31 As described in FASB ASC 740-10-25-3, a deferred tax liability should not be recognized for certain types of temporary differences unless it becomes apparent that those temporary differences will reverse in the foreseeable future. These types of temporary difference include bad debt reserves for tax purposes of U.S. savings and loan associations (and other qualified thrift lenders) that arose in tax years beginning before December 31, 1987 (that is, the base-year amount). See paragraphs 1–3 of FASB ASC 942-740-25 for the specific requirements related to this exception.

16.32 These bad-debt reserves may be included as an example of a temporary difference related to banks or savings institutions that a deferred tax liability is not recognized when the indefinite reversal criteria of paragraphs 17–19 of FASB ASC 740-30-25 are met.

16.33 FASB ASC 740-10-50-10 requires that institutions disclose the amount of income tax expense or benefit allocated to continuing operations and the amounts separately allocated to other items (in accordance with the intra period tax allocation provisions of paragraphs 2–14 of FASB ASC 740-20-45 and 852-740-45-3) for each year that those items are presented.

16.34 As stated in FASB 740-20-45-11(b), the tax effects of gains and losses included in comprehensive income but excluded from net income (such as translation adjustments under FASB ASC 830, *Foreign Currency Matter*s, and changes in the unrealized holding gains and losses of securities classified as available-for-sale under FASB ASC 320) occurring during the year should be charged or credited directly to other comprehensive income or to a related component of shareholders' equity.

Auditing

Objectives

16.35 The objectives of auditing income taxes are to obtain sufficient appropriate evidence that

a. the provision for income taxes and the reported income tax liability or receivable are properly measured, valued, classified, and described in accordance with GAAP;

b. deferred income tax liabilities and assets accurately reflect the future tax consequences of events that have been recognized in the institution's financial statements or tax returns (temporary differences and carryovers); and

c. a valuation allowance has been established for deferred tax assets when it is more likely than not that they will not be realized.

Planning

16.36 In accordance with AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), the auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures (as described in chapter 5, "Audit Considerations and Certain Financial Reporting Matters"). Changes in specific tax laws from year to year could affect financial institutions, as well as general corporations. It is necessary for the auditor to be aware of such changes.

Internal Control Over Financial Reporting and Possible Tests of Controls

16.37 AU section 314 establishes standards and provides guidance on obtaining a sufficient understanding of the entity and its environment, including its internal control. It provides guidance on understanding the components

of internal control and explains how an auditor should obtain a sufficient understanding of internal control for the purposes of assessing the risks of material misstatement. Paragraph .40 of AU section 314 requires that, in all audits, the auditor should obtain an understanding of the five components of internal control (the control environment, risk assessment, control activities, information and communication systems, and monitoring), sufficient to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. The auditor should obtain a sufficient understanding by performing risk assessment procedures to evaluate the design of controls relevant to an audit of financial statements and to determine whether they have been implemented. Paragraph .102 of AU section 314 states that the auditor should identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions, account balances, and disclosures.

16.38 Paragraph .25 of AU section 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*), establishes standards and provides guidance on determining overall responses and designing and performing further audit procedures to respond to the assessed risks of material misstatement at the financial statement and relevant assertion levels in a financial statement audit, and on evaluating the sufficiency and appropriateness of the audit evidence obtained.

16.39

Considerations for Audits Performed in Accordance with Public Company Accounting Oversight Board (PCAOB) Standards

In addition, when performing an integrated audit of financial statements and internal control over financial reporting, in accordance with PCAOB standards, refer to Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), for a discussion on the extent of test of controls. For purposes of evaluating the effectiveness of internal control over financial reporting, the auditor's understanding of control activities encompasses a broader range of accounts and disclosures than what is normally obtained in a financial statement audit.

Substantive Tests

16.40 Regardless of the assessed risks of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions related to income taxes.

16.41 Substantive audit procedures may include the following:

- Review the tax status and consolidated return requirements of subsidiaries.
- Review the status of current-year acquisitions of other companies and their preacquisition tax liabilities and exposures.
- Obtain a schedule reconciling net income per books with taxable income for federal, state, and foreign income taxes. Agree amounts to

general ledger and supporting documents as appropriate. Consider the reasonableness of the current tax account balances.

- Test the rollforward of tax balance-sheet accounts. Consider vouching significant tax payments and credits.
- Review reconciliation of prior-year tax accrual to the actual filed tax return and determine the propriety of adjustments made in this regard and consider the impact on the current year's tax accrual.
- Consider the deductibility of transactions such as profit-sharing, bonus, contributions, or stock option transactions.
- Ascertain whether changes in income tax laws and rates have been properly reflected in the tax calculations and account balances.
- Review the allocation, apportionment, and sourcing of income and expense applicable to state tax jurisdictions with significant income or franchise taxes.
- Review classification and description of accounts to identify possible tax reporting differences such as reserves for anticipated losses or expenses.
- Review schedule of NOL and other tax credit carryforwards and their utilization.
- Review and determine the need for and appropriateness of any valuation allowance for deferred tax assets. It is important for auditors to note that institutions often may have a significant deferred tax asset resulting from the loan loss reserve. This asset should be evaluated based upon the likelihood of realization, taking into account the timing of the bad-debt deduction, and the special NOL carryovers and carryback tax rules, if applicable.
- Review tax planning strategies and assumptions utilized in the calculation of deferred income taxes under FASB ASC 470, *Debt*.
- Evaluate tax contingencies and consider the appropriate accounting treatment and disclosure requirements for these items under FASB ASC 450, *Contingencies*. Review recent Revenue Agent Reports, if any, and consider current treatment of items challenged by the taxing authorities in prior years for impact on tax contingencies. (The auditor might review Coordinated Issue Papers issued by the IRS for banks and savings institutions to determine their impact on tax contingencies.)
- Evaluate the adequacy of the financial statement disclosures.
- For separate financial statements of affiliates, review terms of all tax-sharing agreements between affiliated entities to determine proper disclosure and accounting treatment. The auditor should be cognizant of and consider whether the institution is in compliance with the regulatory reporting for banks and savings institutions related to intercompany tax allocations, as discussed in the "Income Taxes of a Bank Subsidiary of a Holding Company" section of the glossary of the Federal Financial Institutions Examination Council Consolidated Reports of Condition and Income Instructions, and the *Interagency Policy Statement on Income Tax Allocation in a Holding Company Structure*.

Chapter 17

Equity and Disclosures Regarding Capital Matters

Introduction

17.01 Chapters 1, "Industry Overview—Banks and Savings Institutions," and 2, "Industry Overview—Credit Unions," discuss the regulatory capital requirements for banks and savings institutions and credit unions, respectively. Chapter 4, "Industry Overview—Mortgage Companies," discusses similar capital requirements for mortgage companies. This chapter discusses the related financial statement disclosures and auditing guidance. Chapter 3, "Regulatory Considerations,"of the AICPA Audit and Accounting Guide *Brokers and Dealers in Securities*, discusses similar capital requirements for broker-dealers. Finance companies unaffiliated with banking organizations are not subject to regulatory capital requirements. Finance companies affiliated with banking organizations are subject to consolidated regulatory capital requirements and prudential supervision by the Board of Governors of the Federal Reserve System (FRB).

Banks and Savings Institutions

Introduction

17.02 Banks are organized with capital stock and shareholders. Savings institutions operate under a capital stock structure, like banks, or a cooperative form of ownership, like credit unions. Savings institutions operating under the cooperative form are referred to as "mutual institutions." Although mutual institutions may be incorporated, they issue no capital stock and have no stockholders. The equity section of a mutual institution's statement of financial condition generally consists only of retained earnings and the accumulated other comprehensive income under the Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 220, *Comprehensive Income*. The equity section for banks and stock savings institutions additionally include common stock and additional paid-in capital.

Equity

17.03 *Common stock.* Common stock consists of stock certificates issued to investors (stockholders) as evidence of their ownership interest. As defined in the FASB ASC glossary, *common stock* is stock that is subordinate to all other stock of the issuer.

17.04 *Preferred stock.* Preferred stock has certain privileges over common stock, such as a first claim on dividends. Typically, preferred stock conveys no voting rights, or only limited voting rights, to the holders. The rights of preferred stockholders are described in the articles of incorporation. As defined in the FASB ASC glossary, *preferred stock* is a security that has preferential rights compared to common stock.

17.05 Preferred stock may have certain characteristics or features that qualify it for different components of regulatory capital consistent with the applicable functional regulations and guidelines, for example, cumulative versus noncumulative dividends and perpetual versus limited life.

17.06 *Additional paid-in capital.* Amounts paid in the excess of par are additional paid-in capital. Absent such a stated par value, the bank or savings institution will assign a nominal par value to capital stock. Adjustments for treasury stock transactions, stock based compensation and capital contributions may also be included in additional paid-in capital.

17.07 *Retained earnings.* Retained earnings include undivided earnings and other appropriations as designated by management or regulatory authorities. Undivided earnings include the transfer of net income, declaration of dividends and transfers to additional paid-in capital.

17.08 *Accumulated other comprehensive income.*[*] In accordance with FASB ASC 220-10-45-14, the total of other comprehensive income for a period should be transferred to a component of equity that is displayed separately from retained earnings and additional paid-in capital in a statement of financial position at the end of each accounting period.

17.09 According to FASB ASC 220-10-55-2, other comprehensive income includes, but is not limited to, the following:

- Unrealized holding gains and losses on available for sale securities (see FASB ASC 320-10-45-1).
- Amounts recognized in other comprehensive income for debt securities classified as available-for-sale and held-to-maturity related to an other-than-temporary impairment recognized in accordance with FASB ASC 320-10-35 if a portion of the impairment was not recognized in earnings.
- Gains and losses (effective portion) on derivative instruments that are designated as, and qualify as, cash flow hedges (see FASB ASC

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[*] In June 2011, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2011-05, *Comprehensive Income (Topic 220): Presentation of Comprehensive Income*. Under the amendments in this ASU, an entity has the option to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In both choices, an entity is required to present each component of net income along with total net income, each component of other comprehensive income along with a total for other comprehensive income, and a total amount for comprehensive income. In a single continuous statement, the entity is required to present the components of net income and total net income, the components of other comprehensive income and a total for other comprehensive income, along with the total of comprehensive income in that statement. In the two-statement approach, an entity is required to present components of net income and total net income in that statement of net income. The statement of other comprehensive income should immediately follow that statement of net income and include the components of other comprehensive income and a total for other comprehensive income along with a total for comprehensive income. This ASU eliminates the option to present the components of other comprehensive income as part of the statement of changes in stockholders' equity. An entity is now also required to present on the face of the financial statements reclassification adjustments for items that are reclassified from other comprehensive income to net income in that statement(s) where the components of net income and the components of other comprehensive income are presented.

The amendments in this ASU should be applied retrospectively. For public entities, the amendments are effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. For nonpublic entities, the amendments are effective for fiscal years ending after December 15, 2012, and interim and annual periods thereafter. Early adoption is permitted. Readers should consult the text of ASU No. 2011-05 for further information.

815-20-35-1(c)). As stated in FASB ASC 815-30-35-3, the ineffective portion of the gain or loss on a derivative instrument designated as a cash flow hedge is reported in earnings.

17.10 *Noncontrolling interest in consolidated subsidiaries*. A noncontrolling interest is the portion of equity in a bank's subsidiary not attributable, directly or indirectly, to the parent bank. For regulatory capital purposes, generally, banks may include such noncontrolling interests in equity capital accounts (both common and noncumulative perpetual preferred stocks) of consolidated subsidiaries unless such accounts would not otherwise qualify for inclusion in tier 1 capital. For example, a bank may not include noncontrolling interests representing cumulative preferred stock in consolidated subsidiaries since such preferred stock, if issued directly by the bank, would not eligible for inclusion in tier 1 capital. Noncontrolling interests in consolidated asset-backed commercial paper conduits are excluded for regulatory capital purposes if the consolidated program assets are excluded from risk-weighted assets. Although a noncontrolling interest in a consolidated subsidiary is generally includable in tier 1 capital, a bank's primary federal regulator may determine that it is not includable if it fails to provide meaningful capital support, fails to contribute to the subsidiary's ability to absorb losses, or presents other safety and soundness concerns.

Holding Company Equity and Regulatory Capital[1]

17.11 *Trust preferred securities.* According to FASB ASC 942-810-55-1, trust preferred securities have been issued by banks for a number of years due to favorable regulatory capital treatment. Various trust preferred structures have been developed involving minor differences in terms. Under the typical structure, a bank holding company first organizes a business trust or other special purpose entity. This trust issues two classes of securities: common securities, all of which are purchased and held by the bank holding company, and trust preferred securities, which are sold to investors. The trust's only assets are deeply subordinated debentures of the corporate issuer, which the trust purchases with the proceeds from the sale of its common and preferred securities. The bank holding company makes periodic interest payments on the subordinated debentures to the business trust, which uses these payments to pay periodic dividends on the trust preferred securities to the investors. The subordinated debentures have a stated maturity and may include an embedded

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[1] In 1988, the Basel Committee on Banking Supervision introduced a capital measurement system commonly referred to as the *Basel Capital Accord*. This system provided for the implementation of a credit risk measurement framework with a minimum capital standard of 8 percent by the end of 1992. Since 1988, this framework has been progressively introduced not only in member countries but also in virtually all other countries with internationally active banks. The committee issued a capital adequacy framework which consists of three pillars: minimum capital requirements; supervisory review of an institution's internal assessment process and capital adequacy; and effective use of disclosure to strengthen market discipline as a complement to supervisory efforts.

In June 2011, the Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation issued *Risk-Based Capital Standards: Advanced Capital Adequacy Framework—Basel II; Establishment of a Risk-Based Capital Floor*. The final ruling was effective July 28, 2011, and amends the advanced risk-based capital adequacy standards in a manner that is consistent with certain provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), and the general risk-based capital rules to provide limited flexibility consistent with Section 171(b) of the Dodd-Frank Act for recognizing the relative risk of certain assets generally not held by depository institutions. See further discussion of this final ruling in paragraphs 1.59–.62 of this guide.

call option. Most trust preferred securities are subject to a mandatory redemption upon the repayment of the debentures.

17.12 Under the provisions of FASB ASC 810, *Consolidation*, a bank or a holding company that sponsored a structure described in the preceding paragraph should not consolidate the trust because the trust is a variable interest entity (VIE) and the bank or holding company is not the primary beneficiary of that VIE, as provided by FASB ASC 942-810-55-2.

17.13 The trust's common equity investment is not at risk because the investment was financed by the trust through the purchase of the debentures.

17.14 According to FASB ASC 942-810-45-1, in the typical trust preferred arrangement, the bank holds no variable interest in the trust, and therefore, cannot be the trust's primary beneficiary. If the bank does not consolidate the trust, the bank or holding company should report its debt issued to the trust and an equity-method investment in the common stock of the trust.

17.15 FASB ASC 810-10-55-31 states that some assets and liabilities of a VIE have embedded derivatives. For the purpose of identifying variable interests, an embedded derivative that is clearly and closely related economically to its asset or liability host is not to be evaluated separately.

17.16 Under this guidance, an embedded call option is not a variable interest in the trust.

17.17 *Regulatory capital treatment of trust preferred securities*. On October 21, 1996, the FRB approved the use of certain cumulative preferred stock instruments in tier 1 capital for bank holding companies. Similar interpretive guidance and approvals for qualification as tier 1 capital for national banks and state chartered nonmember banks and thrifts also have been provided, on an institution-specific preapproval basis, by the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision. The Capital and Dividends Booklet of the Comptroller's Licensing Manual provides additional information regarding the guidance issued by the OCC.

17.18 On March 1, 2005, the FRB issued *Risk-Based Capital Standards: Trust Preferred Securities and the Definition of Capital* (Title 12 U.S. *Code of Federal Regulations* Parts 208 and 225 [Regulations H and Y]). This rule allows the continued limited inclusion of trust preferred securities in the tier 1 capital of bank holding companies. Under this rule, trust preferred securities and other restricted core capital elements are subject to stricter quantitative limits. Prior to the rule, the amount of trust preferred securities, together with other cumulative preferred stock that a bank holding company could include in tier 1 capital was limited to 25 percent of tier 1 capital. This rule limits restricted core capital elements to 25 percent of all core capital elements, net of goodwill less any associated deferred tax liability. Internationally active bank holding companies, defined as those with consolidated assets greater than or equal to $250 billion or on a consolidated basis reports on-balance sheet foreign exposure greater than or equal to $10 billion, will be subject to a 15 percent limit (excluding mandatory convertible preferred securities). They may include qualifying mandatory convertible preferred securities up to the generally applicable 25 percent limit. Amounts of restricted core capital elements in excess of these limits generally may be included in tier 2 capital. The rule originally provided a 5 year transition period, which ended March 31, 2009, for application of the quantitative limits.

17.19 The requirement for trust preferred securities to include a call option was eliminated and standards for the junior subordinated debt underlying trust preferred securities eligible for tier 1 capital treatment were clarified. The rule also addressed supervisory concerns, competitive equity considerations, and the accounting for trust preferred securities. The rule also strengthened the definition of regulatory capital by incorporating long standing board policies regarding the acceptable terms of capital instruments included in banking organizations' tier 1 or tier 2 capitals.

17.20 Section 171 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) addresses deductions from regulatory capital and includes the following provisions:

- Trust-preferred securities issued by banks and thrift holding companies after May 19, 2010, will no longer count as tier 1 capital. Trust-preferred securities may otherwise qualify to be treated as tier 2 capital.
- Trust-preferred securities issued before May 19, 2010, by bank and thrift holding companies with $15 billion or more in assets will continue to be treated as tier 1 (subject to existing limitations, see paragraphs 17.17–.18) capital until January 2013. Then, the tier 1 capital treatment will be phased out over a 3-year period.
- Bank and thrift holding companies with assets of less than $15 billion as of December 31, 2009, may continue to include trust-preferred securities that were issued before May 19, 2010, as tier 1 capital (subject to existing limitations, see paragraphs 17.17–.18).
- These provisions of the Dodd-Frank Act do not apply to small bank holding companies (holding companies with less than $500 million in assets). See further discussion of small banking holding companies in paragraph 17.25.

17.21 *Mandatory redeemable preferred stock*. Banks may issue mandatorily redeemable preferred stock as part of their capital structure.

17.22 "Pending Content" in FASB ASC 480-10-25-4 states that a mandatorily redeemable financial instrument should be classified as a liability unless the redemption is required to occur only upon the liquidation or termination of the reporting entity. "Pending Content" in FASB ASC 480-10-45-1 states that items within the scope of FASB ASC 480-10 should be presented as liabilities (or assets in some circumstances). Those items should not be presented between the liabilities section and the equity section of the statement of financial position.[†]

17.23 FASB ASC 480, *Distinguishing Liabilities from Equity*, does not address redeemable preferred stock that is conditionally redeemable (for example, stock that is putable by the holder at a specified date.) Mezzanine presentation would continue to apply for conditionally redeemable stock that is

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[†] For certain mandatorily redeemable financial instruments of certain nonpublic entities, the "Pending Content" in FASB *Accounting Standards Codification* (ASC) 480-10-25 has been indefinitely deferred. For certain mandatorily redeemable noncontrolling interests that were deferred for both public and nonpublic entities, FASB plans to reconsider implementation issues and, perhaps, classification or measurement guidance for those noncontrolling interests during the deferral period, in conjunction with FASB's ongoing projects. During the deferral period for certain mandatorily redeemable noncontrolling interests, all public entities as well as nonpublic entities that are Securities and Exchange Commission registrants are required to follow the disclosure requirements in paragraphs 1–3 of FASB ASC 480-10-50 as well as disclosures required by other applicable guidance.

not in the scope of FASB ASC 480. If mandatorily redeemable shares are subject to the deferral under FASB ASC 480-10-65-1, the guidance in the Securities and Exchange Commission Regulation S-X, Section No. 210.5–02.28, is applicable. This regulation states that mandatory redeemable preferred stock is not to be included in amounts reported as stockholders' equity. Although nonpublic companies are not required to follow Regulation S-X, it would be appropriate for them to do so in most cases.

17.24 *Perpetual preferred stock issued to the U.S. Treasury.* On June 1, 2009, the FRB adopted a final rule (*Federal Register* Vol. 74, No. 103 [1 June 2009], pp. 26081–26084) to allow bank holding companies that have issued senior perpetual preferred stock to the U.S. Department of the Treasury under the capital purchase and other programs established by the Secretary of the Treasury under the Emergency Economic Stabilization Act of 2008, to include such capital instruments in tier 1 capital for purposes of the FRB's risk-based and leverage capital guidelines for bank holding companies. The final rule became effective on July 1, 2009.

17.25 *Bank holding companies under $500 million in assets*. The FRB adopted a Small Bank Holding Company Policy that provides flexibility for qualifying bank holding companies to be exempt from the minimum regulatory capital requirements and a surveillance program to assist in the assessment of the capital adequacy of small bank holding companies regulated by the FRB. The bank holding company capital adequacy guidelines apply on a consolidated basis to bank holding companies with consolidated assets of $500 million or more. For bank holding companies with less than $500 million in consolidated assets, the guidelines will be applied on a bank only basis unless the parent is engaged in a nonbank activity involving significant leverage or the parent company has a significant amount of outstanding debt that is held by the general public.

Disclosures for Banks and Savings Institutions

17.26 Noncompliance with regulatory capital requirements could materially affect the economic resources of a bank or savings institution and claims to those resources, as stated in FASB ASC 942-505-50-1. Accordingly, at a minimum, the entity should disclose the following in the footnotes to the financial statements:

a. A description of regulatory capital requirements for both of the following:
   i. Those for capital adequacy purposes
   ii. Those established by the prompt corrective action provisions of Section 38 of the Federal Deposit Insurance Act (FDI Act)

b. The actual or possible material effects of noncompliance with such requirements

c. Whether the entity is in compliance with the regulatory capital requirements, including, as of each balance sheet date presented, the following with respect to quantitative measures:
   i. The entity's required and actual ratios and amounts of tier 1 leverage, tier 1 risk-based, and total risk-based capital, (for savings institutions) tangible capital, and (for certain banks and bank holding companies) tier 3 capital for market risk
   ii. Factors that may significantly affect capital adequacy such as

potentially volatile components of capital, qualitative factors, and regulatory mandates

d. As of each balance sheet date presented, the prompt corrective action category in which the entity was classified as of its most recent notification

e. As of the most recent balance sheet date, whether management believes any conditions or events since notification have changed the institution's category

Noncompliance with regulatory capital requirements may, when considered with other factors, raise substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time.

17.27 As stated in FASB ASC 942-505-50-1C, a bank or savings institution is (under federal regulations) deemed to be within a given capital category as of the most recent date of any of the following:

a. The date the institution filed a regulatory financial report

b. The date a final regulatory examination report is delivered to the institution

c. The date the institution's primary regulator provides written notice of the entity's capital category or that the institution's capital category has changed

17.28 According to FASB ASC 942-505-50-1A, disclosures should also be presented for any state-imposed capital requirements that are more stringent than or significantly different from federal requirements.

17.29 For "adequately capitalized" or "undercapitalized" institutions, the disclosure in paragraph 17.26*c* should present the minimum amounts and ratios the institution must have to be categorized as *adequately capitalized* under the prompt corrective action framework and should include the effect of any supervisory action that has been imposed, as stated in FASB ASC 942-505-50-1B. The amounts disclosed under that paragraph may be presented in either narrative or tabular form. The percentages disclosed should be those applicable to the entity. Entities with capital adequacy, asset quality, management, earnings, and liquidity ratings of 1 that are not anticipating or experiencing significant growth and have well-diversified risk are required to maintain a minimum leverage ratio of 3.0 percent. An additional 100 to 200 basis points are required for all but these most highly rated entities. Also, if the institution has been advised that it must meet capital adequacy levels that exceed the statutory minimums, those higher levels should be disclosed. Such institution-specific requirements also should be the basis for management's assertion in paragraph 17.26*c* about whether the institution is in compliance.

17.30 Paragraphs 1D–1E of FASB ASC 942-505-50 state that if, as of the most recent balance sheet date presented, the entity is (*a*) not in compliance with capital adequacy requirements, (*b*) considered less than adequately capitalized under the prompt corrective action provisions, or (*c*) both, the possible material effects of such conditions and events on amounts and disclosures in the financial statements should be disclosed.

17.31 The institution should consider also making such disclosures when one or more of the institution's actual ratios is nearing noncompliance or when capital adequacy restrictions are imposed by regulation. Capital ratios higher than those in the prompt corrective action provisions may be required by the federal banking agencies, either informally through a board resolution or

memorandum of understanding or formally though a consent order or formal agreement. Elevated capital levels may be considered for disclosure based on the nature of the agreement and the potential impact on operations.

17.32 Additional information that might be disclosed in situations where there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time may include

- pertinent conditions and events giving rise to the assessment of substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time;
- possible effects of such conditions and events;
- management's evaluation of the significance of those conditions and events and any mitigating factors;
- possible discontinuance of operations;
- management's plans (including relevant prospective financial information); and
- information about the recoverability or classification of recorded asset amounts or the amounts or classification of liabilities.

17.33 FASB ASC 942-505-50-1F states that other regulatory limitations may exist despite compliance with minimum regulatory capital requirements. To the extent such limitations could materially affect the economic resources of the institution and claims to those resources, they should similarly be disclosed in the footnotes to the financial statements.

Disclosure for Holding Companies

17.34 FASB ASC 942-505-50-1G states that the disclosures required by paragraphs 1–1F of FASB ASC 942-505-50 should be presented for all significant subsidiaries of a holding company. Bank holding companies should also present the disclosures required by paragraphs 1–1F of FASB ASC 942-505-50 as they apply to the holding company, except for the prompt corrective action disclosure required by FASB ASC 942-505-50-1(d). Savings institution holding companies are not subject to regulatory capital requirements separate from those of their subsidiaries. Bank holding companies are not subject to the prompt corrective action provisions of the FDI Act.

17.35 A bank holding company that is a financial holding company (FHC) should disclose the applicable regulatory requirements for maintaining its status as a FHC, including that each of its insured deposit taking subsidiaries must be *well capitalized*, *well managed*, and have at least a *satisfactory* Community Reinvestment Act rating. If the FRB were to find that any depository institution subsidiary owned or controlled by the bank holding company ceases to be well capitalized or well managed and such noncompliance is not subsequently corrected, the FRB could require the banking organization to cease its FHC related activities or divest its banking subsidiaries. Paragraph 1.19 of this guide and Section 3901.0.2, "Holding Company Fails to Continue Meeting Financial Holding Company Capital and Management Requirements," of the FRB's Bank Holding Company Supervision Manual provide additional guidance.

17.36 If a bank holding company is an FHC, the significant subsidiaries include all U.S. insured deposit taking subsidiaries.

Illustrative Disclosures for Banks and Savings Institutions (The example disclosures that follow are for illustrative purposes only)

17.37 *Well capitalized.* Following is an illustrative disclosure for an institution that is in compliance with capital adequacy requirements and considers itself *well capitalized* under the prompt corrective action framework. Comparative disclosures should be included for each balance sheet presented.

> The Bank is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory—and possibly additional discretionary—actions by regulators that, if undertaken, could have a direct material effect on the Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of the Bank's assets, liabilities, and certain off-balance-sheet items as calculated under U.S. GAAP, regulatory reporting requirements, and regulatory capital standards. The Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.
>
> Quantitative measures established by regulatory capital standards to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the following table) of total and tier 1 capital (as defined) to risk-weighted assets (as defined), and of tier 1 capital (as defined) to average assets (as defined).[2] Management believes, as of December 31, 200X, that the Bank meets all capital adequacy requirements to which it is subject.
>
> As of December 31, 200X, and December 31, 200W, the most recent notification from [*institution's primary regulator*] categorized the Bank as [*well capitalized*] under the regulatory framework for prompt corrective action. To be categorized as [*well capitalized*] the Bank must maintain minimum total risk-based, tier 1 risk-based, tier 1 leverage ratios as set forth in the table.[3] There are no conditions or events since that notification that management believes have changed the institution's category.

17.38 *Adequately capitalized.* Following is an illustrative paragraph to be added to the disclosures illustrated in paragraph 17.37 when an institution considers itself *adequately capitalized*:

> Under the framework, the Bank's capital levels do not allow the Bank to accept brokered deposits without prior approval from regulators [*describe the possible effects of this restriction*].

17.39 *Undercapitalized.* Following are illustrative paragraphs to be added to the disclosures illustrated in paragraphs 17.37–.38 when an institution considers itself *undercapitalized*. For a discussion about the auditor's consideration of noncompliance, see discussion beginning in paragraph 5.172 of this guide.

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[2] See paragraph 17.29.

[3] Paragraphs 1.63–.73 of this guide describe the prompt corrective action ratios. For some institutions, the calculation of required amounts and ratios under the prompt corrective action framework may differ from calculations under the capital adequacy requirements. The disclosure should provide the relevant amounts and ratios accordingly.

The Bank may not issue dividends or make other capital distributions, and may not accept brokered or high rate deposits, as defined, due to the level of its risk-based capital. [*Describe the possible effects of these restrictions*.]

Under the regulatory framework for prompt corrective action, the Bank's capital status may preclude the Bank from access to borrowings from the Federal Reserve System through the discount window. [*Describe the possible effects of these restrictions*.] Also, as required by the framework, the Bank has a capital plan that has been filed with and accepted by the FDIC. The plan outlines the Bank's steps for attaining the required levels of regulatory capital. Management believes, at this time, that the Bank will meet all the provisions of the capital plan and all the regulatory capital requirements by December 31, 200Y (or earlier if stated in the capital plan). [*The disclosure should continue with discussion of management plans such as reducing the size of the institution by converting noncash assets and reducing liabilities, issuing additional equity securities, or other plans for financial restructuring*.]

17.40 *Banks*. Following is an illustrative table for presentation in financial statements for a bank's actual capital amounts and ratios as of the balance sheet date. All disclosures required by paragraphs 1–1F of FASB ASC 942-505-50 should be presented.

	Actual		*For Capital Adequacy Purposes*[1]		*To Be Well Capitalized Under Prompt Corrective Action Provisions*[2]	
	Amount	*Ratio*	*Amount*	*Ratio*	*Amount*	*Ratio*
Total Capital (to Risk Weighted Assets)	$X,XXX,XXX	X.X%	$X,XXX,XXX	8.0%	$X,XXX,XXX	10.0%
Tier 1 Capital[3] (to Risk Weighted Assets)	$X,XXX,XXX	X.X%	$X,XXX,XXX	4.0%	$X,XXX,XXX	6.0%
Tier 1 Capital (to Average Assets)	$X,XXX,XXX	X.X%	$X,XXX,XXX	4.0%	$X,XXX,XXX	5.0%

[1] See paragraph 17.29.

[2] For *adequately capitalized* or *undercapitalized* institutions, this column should present the minimum amounts and ratios the institution must have to be categorized as adequately capitalized under the prompt corrective action framework and should include the effect of any prompt corrective action capital directive.

[3] See paragraph 17.29.

17.41 *Savings institutions*. Following is an illustrative table for presentation in financial statements for a savings institution's actual capital amounts and ratios as of the balance sheet date. All disclosures required by paragraphs 1–1F of FASB ASC 942-505-50 should be presented.

	Actual		*For Capital Adequacy Purposes*[1]		*To Be Well Capitalized Under Prompt Corrective Action Provisions*[2]	
	Amount	*Ratio*	*Amount*	*Ratio*	*Amount*	*Ratio*
Total Capital (to Risk Weighted Assets)	$X,XXX,XXX	X.X%	$X,XXX,XXX	8.0%	$X,XXX,XXX	10.0%
Core Capital (to Adjusted Tangible Assets)	$X,XXX,XXX	X.X%	$X,XXX,XXX	4.0%	$X,XXX,XXX	5.0%
Tangible Capital (to Tangible Assets)	$X,XXX,XXX	X.X%	$X,XXX,XXX	1.5%	N/A	
Tier 1 Capital (to Risk Weighted Assets)	$X,XXX,XXX	X.X%	N/A		$X,XXX,XXX	6.0%

[1] See footnote 2 in this chapter.

[2] For *adequately capitalized* or *undercapitalized* institutions, this column should present the minimum amounts and ratios the institution must have to be categorized as adequately capitalized under the prompt corrective action framework and should include the effect of any prompt corrective action capital directive.

17.42 *Holding companies.* Following is an illustrative table for presentation in consolidated financial statements for a bank (or savings and loan association) holding company and each significant subsidiary as of the balance sheet date. Tier 3 capital market risk requirements are required to be disclosed only for certain banks and bank holding companies. All disclosures required by paragraphs 1–1F of FASB ASC 942-505-50 should be presented except FASB ASC 942-505-50-1(d) disclosures related to prompt corrective action.

	Actual		*For Capital Adequacy Purposes*[1]		*To Be Well Capitalized Under Prompt Corrective Action Provisions*[2]	
	Amount	*Ratio*	*Amount*	*Ratio*	*Amount*	*Ratio*
Tier 1 Capital (to Risk Weighted Assets):						
Consolidated	**$X,XXX,XXX**	**X.X%**	**$X,XXX,XXX**	**X.X%**	**N/A**	
Subsidiary Bank A	$X,XXX,XXX	X.X%	$X,XXX,XXX	X.X%	$X,XXX,XXX	X.X%
Subsidiary Bank B	$X,XXX,XXX	X.X%	$X,XXX,XXX	X.X%	$X,XXX,XXX	X.X%
Subsidiary Bank C	$X,XXX,XXX	X.X%	$X,XXX,XXX	X.X%	$X,XXX,XXX	X.X%
Tier 1 Capital (to Risk Weighted Assets):						
Consolidated	**$X,XXX,XXX**	**X.X%**	**$X,XXX,XXX**	**X.X%**	**N/A**	
Subsidiary Bank A	$X,XXX,XXX	X.X%	$X,XXX,XXX	X.X%	$X,XXX,XXX	X.X%
Subsidiary Bank B	$X,XXX,XXX	X.X%	$X,XXX,XXX	X.X%	$X,XXX,XXX	X.X%

(continued)

	Actual		For Capital Adequacy Purposes[1]		To Be Well Capitalized Under Prompt Corrective Action Provisions[2]	
	Amount	*Ratio*	*Amount*	*Ratio*	*Amount*	*Ratio*
Tier 1 Capital (to Risk Weighted Assets):						
Subsidiary Bank C	$X,XXX,XXX	X.X%	$X,XXX,XXX	X.X%	$X,XXX,XXX	X.X%
Tier 1 Capital (to Average Assets):						
Consolidated	**$X,XXX,XXX**	**X.X%**	**$X,XXX,XXX**	**X.X%**	**N/A**	
Subsidiary Bank A	$X,XXX,XXX	X.X%	$X,XXX,XXX	X.X%	$X,XXX,XXX	X.X%
Subsidiary Bank B	$X,XXX,XXX	X.X%	$X,XXX,XXX	X.X%	$X,XXX,XXX	X.X%
Subsidiary Bank C	$X,XXX,XXX	X.X%	$X,XXX,XXX	X.X%	$X,XXX,XXX	X.X%

[1] See footnote 2 in this chapter.

[2] For *adequately capitalized* or *undercapitalized* institutions, this column should present the minimum amounts and ratios the institution must have to be categorized as adequately capitalized under the prompt corrective action framework and should include the effect of any prompt corrective action capital directive.

Credit Unions

Introduction

17.43 Credit unions operate under a cooperative form of ownership. Members, in effect, "own" the credit union, although their interests in the credit union (that is, their shares) have the characteristics of deposits. Although the equity section of a credit union's statement of financial condition generally consists of retained earnings and accumulated other comprehensive income, U.S. generally accepted accounting principles (GAAP) requires other items to be classified as equity. As U.S. GAAP evolves, other items may also be included in members' equity. Retained earnings includes statutory reserves, undivided earnings, and other appropriations as designated by management or regulatory authorities. Although credit unions may be incorporated, no stock is issued. Retained earnings is generally shown as a single line item in the statement of financial condition. The components of retained earnings may be presented in the body of the statement of financial condition, the notes to the financial statements, or the statement of retained earnings. All appropriations and other restrictions of retained earnings should be disclosed.

Members' Equity

17.44 *Regular reserve (statutory reserve).* The Federal Credit Union Act and certain states require that a regular (or statutory) reserve be established and maintained to provide an equity base for credit unions. The regular (or statutory) reserve account represents that required appropriation of retained earnings. The regular (or statutory) reserve is established through a charge to undivided earnings and a credit to the reserve account. For federal credit unions, the amount required to be transferred is defined in Sections 702.201 and 702.303 of the National Credit Union Administration (NCUA) *Rules and*

Regulations. The prompt corrective action rules describe the mandatory and discretionary prompt corrective actions that a credit union is subject to in cases where the credit union's capital level is below the *well capitalized* level, or the credit union fails to meet its required risk-based net worth requirement (RBNWR), or the credit union is subject to regulatory restrictions because of activities that are judged by the NCUA to be unsafe and unsound. In cases relating to inadequate capital with respect to the net worth requirement or the risk-based net worth requirement, a credit union is generally required to increase its net worth by the equivalent of at least 0.1 percent of assets each quarter until the credit union is classified as *well capitalized*.

17.45 Certain states may have adopted similar regulations that apply to state chartered credit unions. The statutes for each state should be consulted for applicable requirements.

17.46 Management generally should not consider the regular reserve as a substitute for or supplement to the allowance for loan losses. Loan losses and the provision for loan losses generally should not be charged directly to the regular reserve.

17.47 *Undivided earnings.* Undivided earnings represent unappropriated accumulated earnings or losses of the credit union since its inception. The undivided earnings may also be increased or decreased as a result of transfers to or from appropriated accounts such as the regular reserve.

17.48 *Appropriated undivided earnings.* The board of directors of a credit union may restrict or appropriate portions of undivided earnings for specific purposes in accordance with paragraphs 3–4 of FASB ASC 505-10-45. Examples may include appropriations for loss contingencies and for major expenditures. The amount of such appropriations is normally transferred from undivided earnings, pending resolution of its purpose. Amounts appropriated may be returned to undivided earnings when they are no longer deemed necessary.

17.49 Federally insured state chartered credit unions are required under terms of the insurance agreement to establish an investment valuation reserve, displayed as an equity classification, for held-to-maturity nonconforming investments. Nonconforming investments are those investments permissible under state law for a state chartered credit union, but which are impermissible for federally chartered credit unions.

17.50 *Other components of equity.* U.S. GAAP provides guidance for other items that should be classified as equity (for example, equity acquired in a combination arising from a mutual to mutual acquisition in which no purchase price is paid).

17.51 In accordance with FASB ASC 220-10-45-14, the total of other comprehensive income for a period should be transferred to a component of equity that is displayed separately from retained earnings and additional paid-in capital in a statement of financial position at the end of an accounting period. See FASB ASC 220-10-55-2 and paragraph 17.09 for examples of items required to be reported as other comprehensive income.[*]

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[*] See footnote * in paragraph 17.08.

New Credit Unions and Low Income Designated Credit Unions

17.52 The prompt corrective action regulations for credit unions designated as *new* are different than for other natural person credit unions. According to regulations, to be designated as *new* a credit union must have been in existence for less than 10 years and have $10 million or less in total assets. For credit unions designated as *low income* by the NCUA, the net worth calculation includes certain uninsured, secondary capital accounts (as defined in the regulations).[4,‡]

Disclosures for Natural Person Credit Unions

17.53 FASB ASC 942-505-50-1H states noncompliance with regulatory capital requirements could materially affect the economic resources of a credit union and claims to those resources. Accordingly, at a minimum, a credit union within the scope of FASB ASC 942-10-15-2 should disclose all of the following in the footnotes to the financial statements:

a. A description of regulatory capital requirements (*a*) for capital adequacy purposes and (*b*) for prompt corrective action

b. The actual or possible material effects of noncompliance with such requirements

c. Whether the entity is in compliance with the regulatory capital requirements, including, as of each balance sheet date presented, the following with respect to quantitative measures:

- i. Whether the institution meets the definition of a complex credit union as defined by the NCUA
- ii. The institution's required and actual capital ratios and required and actual capital amounts
- iii. Factors that may significantly affect capital adequacy such as potentially volatile components of capital, qualitative factors, and regulatory mandates

d. As of each balance sheet date presented, the prompt corrective action category in which the institution was classified

e. If, as of the most recent balance sheet date or date financial statements are issued or are available to be issued (as discussed in FASB ASC 855-10-25), the institution is not in compliance with capital adequacy requirements, the possible material effects of such conditions on amounts and disclosures in the financial statements

f. Whether subsequent to the balance sheet date and before the financial statements are issued or are available to be issued (as discussed in FASB ASC 855-10-25), management believes any events or changes have occurred to change the institution's prompt corrective action category

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[4] Prompt corrective action regulations can be found at Title 12 U.S. *Code of Federal Regulations* (CFR) Part 702.301–.307. Additional regulations for "low-income" credit unions can be found at 12 CFR Part 701.34.

[‡] On December 23, 2010, the National Credit Union Administration (NCUA) issued a final rule amending the definition of "low-income members." Readers may find the amended definition at 12 CFR Part 701.34(a)(1).

Noncompliance with regulatory capital requirements may, when considered with other factors, raise substantial doubt about a credit union's ability to continue as a going concern for a reasonable period of time.

17.54 The institution should consider also making such disclosures, as discussed in the preceding paragraph, when the institution's actual ratio is nearing noncompliance.

17.55 Additional information that might be disclosed in situations where there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time may include the following:

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

17.56 Disclosures should also be presented for any state-imposed capital requirements that are more stringent than or significantly different from federal requirements, according to FASB ASC 942-505-50-2.

17.57 The NCUA board adopted prompt corrective action rules in response to the Credit Union Membership Access Act requirement that the NCUA adopt a system to restore the net worth of inadequately capitalized federally insured credit unions. In conjunction with the adopted Prompt Corrective Action Rule, the NCUA board also issued a rule, which defines a *complex* credit union and establishes RBNWRs. Readers should refer to the NCUA *Rules and Regulations* for the risk-based net worth and prompt corrective action requirements.

Illustrative Disclosures for Natural Person Credit Unions

17.58 *Well capitalized.* The example disclosures that follow are for illustrative purposes only. Following is an illustrative disclosure for an institution that is in compliance with capital adequacy requirements and considers itself *well capitalized* under the prompt corrective action framework. Comparative disclosures should be included for each balance sheet presented.

> The Credit Union is subject to various regulatory capital requirements administered by the NCUA. Failure to meet minimum capital requirements can initiate certain mandatory—and possibly additional discretionary—actions by regulators that, if undertaken, could have a direct material effect on the Credit Union's financial statements. Under capital adequacy regulations and the regulatory framework for prompt corrective action, the Credit Union must meet specific capital regulations that involve quantitative measures of the Credit Union's assets, liabilities, and certain off-balance-sheet items as calculated under regulatory reporting requirements. The Credit Union's capital amounts and net worth classification are also subject

to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Credit Union to maintain minimum amounts and ratios (set forth in the following table) of net worth (as defined) to total assets (as defined). Credit unions are also required to calculate a RBNWR which establishes whether or not the Credit Union will be considered "complex" under the regulatory framework. The Credit Union's RBNW ratio as of December 31, 200X was ___ percent. The minimum ratio to be considered complex under the regulatory framework is 6 percent. Management believes, as of December 31, 200X, that the Credit Union meets all capital adequacy requirements to which it is subject.

As of December 31, 200X, the most recent call reporting period, the NCUA categorized the Credit Union as "*well capitalized*" under the regulatory framework for prompt corrective action. To be categorized as "*well capitalized*" the Credit Union must maintain a minimum net worth ratio of 7 percent of assets.[5] There are no conditions or events since that notification that management believes have changed the institution's category.

The Credit Union's actual capital amounts and ratios are also presented in the table.

	Actual		*To Be Adequately Capitalized Under Prompt Corrective Action Provisions*[1]		*To Be Well Capitalized Under Prompt Corrective Action Provisions*	
	Amount	*Ratio*	*Amount*	*Ratio*	*Amount*	*Ratio*
Net worth	$2,000,000	7.5%	$1,600,000	6.0%	$1,800,000	7.0%
Risk-Based Net Worth Requirement	$1,700,000	6.5%	N/A	N/A	N/A	N/A

[1] For *adequately capitalized* or *undercapitalized* institutions, this column should present the minimum amounts and ratios the institution must have to be categorized as adequately capitalized under the prompt corrective action framework and should include the effect of any mandatory or discretionary supervisory actions.

Because the RBNWR, 6.5 percent, is less than the net worth ratio, 7.5 percent, the Credit Union retains its original category. Further, in performing its calculation of total assets, the Credit Union used the [*select one: average of the quarter-end balances of the four most recent quarters, monthly average over the quarter, daily average over the quarter, or quarter-end balance*] option, as permitted by regulation.

17.59 *Adequately capitalized.* Following is an illustrative paragraph to be added in place of the third illustrative paragraph in paragraph 17.58 for an institution that is in compliance with capital adequacy requirements and considers itself *adequately capitalized* under the prompt corrective action framework:

[5] Paragraphs 2.31–.45 of this guide describe the prompt corrective action net worth ratios. For some institutions, the calculation of required amounts and net worth ratios under the prompt corrective action framework may differ from calculations under the capital adequacy requirements. The disclosure should provide the relevant amounts and ratios accordingly.

As of December 31, 200X, and December 31, 200W, the most recent call reporting period, the NCUA categorized the Credit Union as "adequately capitalized" under the regulatory framework for prompt corrective action. To be categorized as "adequately capitalized" the Credit Union must maintain a minimum net worth ratio of 6 percent of assets and, if applicable, must maintain adequate net worth to meet the Credit Union's RBNWR of X percent as set forth in the table.[6] As an "adequately capitalized" credit union, the NCUA's prompt corrective action regulations require that the Credit Union increase its net worth quarterly by an amount equivalent to at least 0.1 percent of its total assets for the current quarter, and must transfer that amount (or more by choice) from undivided earnings to its regular reserve account until it is "well capitalized," while continuing to meet its RBNWR. There are no conditions or events since that filing date that management believes have changed the institution's category.

17.60 *Undercapitalized.* Following are illustrative paragraphs to be added to the disclosures illustrated in paragraph 17.58 when a credit union considers itself *undercapitalized* [for existing credit unions].

The Credit Union may not increase assets and must restrict member business loans due to its net worth. [*Describe the possible effects of these restrictions*.] Under the regulatory framework for prompt corrective action, the Credit Union's net worth classification requires that a net worth restoration plan has been filed with and accepted by the NCUA. The plan outlines the Credit Union's steps for attaining the "adequately capitalized" level of net worth. Management believes, at this time, that the Credit Union will meet implement the steps and meet all the targets of the plan and all the regulatory net worth requirements by December 31, 200X (or earlier if stated in the restoration plan). [*The disclosure should continue with discussion of any discretionary actions required by the NCUA*.]

17.61 *New credit unions.* Following are illustrative paragraphs to be added to the disclosures illustrated in paragraph 17.58 when a new credit union considers itself *moderately, marginally, minimally, or undercapitalized* [for new credit unions].

The Credit Union must restrict member business loans due to its net worth. [*Describe the possible effects of these restrictions*.] Under the regulatory framework for prompt corrective action, a revised business plan has been filed, as required, with and accepted by the NCUA. The plan outlines the Credit Union's steps for attaining the required levels of net worth. Management believes, at this time, that the Credit Union will implement the steps and meet all the targets of the plan and all the regulatory net worth requirements by December 31, 200Y (or earlier if stated in the revised business plan). [*The disclosure should continue with discussion of any discretionary actions required by the NCUA*.]

[6] For some institutions, the calculation of required amounts and net worth ratios under the prompt corrective action framework may differ from calculations under the capital adequacy requirements. The disclosure should provide the relevant amounts and ratios accordingly.

Corporate Credit Unions

Introduction

17.62 Corporate credit unions operate under a cooperative form of ownership similar to natural person credit unions. Corporate credit unions are established to serve the financial needs of natural person credit unions that join the corporate. Although, the equity section of a corporate credit union's statement of financial condition generally consists of paid-in capital, retained earnings and accumulated other comprehensive income, U.S. GAAP requires other items to be classified as equity.[7] As U.S. GAAP evolves, other items may also be included in members' equity. Retained earnings include all forms of retained earnings such as regular or statutory reserves and undivided earnings. Although some corporate credit unions may be incorporated under state laws, no stock is issued.

Equity[||]

17.63 *Membership capital.*[#] Corporate credit unions are different from natural person credit unions in that they have specific membership capital

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[7] See paragraph 17.56.

[||] In October 2010, the NCUA issued final amendments to its rule governing corporate credit unions contained in 12 CFR 704. The major revisions involve corporate credit union capital, investments, asset-liability management, governance, and credit union service organization (CUSO) activities. The amendments establish a new capital scheme, including risk-based capital requirements; impose new prompt corrective action requirements; place various new limits on corporate investments; impose new asset-liability management controls; amend some corporate governance provisions; and limit a corporate CUSO to categories of services preapproved by NCUA. The amendments are effective January 18, 2011, and have been incorporated into this guide, with the exception of amendments to 12 CFR 702.105(a), 703.14(b), 704.2, 704.3, 704.4, and subpart M of 12 CFR 747, which are not effective until October 20, 2011 (and have not been incorporated into this guide). A brief summary of the amendments that are not effective until October 20, 2011, follows:

- 12 CFR 702.105(a) and 703.14(b) provide conforming amendments altering references to paid-in-capital and membership capital to perpetual capital and nonperpetual capital, respectively. See further discussion in footnotes # and **.
- 12 CFR 704.2 is amended for new and revised definitions.
- 12 CFR 704.3 establishes the capital requirements for corporate credit unions covering basic capital requirements, nonperpetual capital account requirements, perpetual contributed capital (PCC) requirements, procedures for establishing different minimum capital requirements, reservations of authority to the NCUA board, and explains the treatment of certain former capital accounts under the old corporate rule (that is, membership capital accounts) that are not converted to the new forms of capital (that is, either nonperpetual or PCC accounts). Some elements of this section have applicability dates that are delayed beyond October 20, 2011. See discussion in footnote ‡‡.
- 12 CFR 704.4 establishes prompt corrective action requirements. See discussion in footnote ||||.

For further details on the amendments included in this final ruling, readers are encouraged to view the final ruling at www.ncua.gov/Resources/RegulationsOpinionsLaws/final/FederalRegisterCorpCUFinalRule.pdf. Additionally, the NCUA's Corporate System Resolution–28, "Letter to Credit Unions: Corporate Rule part 704 10-CU-20 Attachment," provides a summary of the final ruling and is located at www.ncua.gov/Letters/2010/CU/10-CU-20enclosure.pdf.

[#] Effective October 20, 2011, membership capital accounts will be replaced with nonperpetual capital accounts (NCAs). NCAs are funds contributed by members or nonmembers that (*a*) are term certificates with an original minimum term of five years or that have an indefinite term with a minimum withdrawal notice of five years; (*b*) are available to cover losses that exceed retained earnings and PCC; (*c*) are not insured by the National Credit Union Share Insurance Fund (NCUSIF) or other share or deposit insurers; and (*d*) cannot be pledged against borrowings. See discussion of the final ruling at footnote ||.

accounts. Membership capital is comprised of funds contributed by the natural person credit unions, which are available to cover losses that exceed retained earnings and paid in capital. In the event of liquidation, membership capital is payable only after satisfaction of all other liabilities including uninsured deposits. These funds are not insured and cannot be pledged. In general these funds have a minimum withdrawal notice of three years. Corporate credit unions may use either a term certificate for this account or an adjusted balance account, which is generally based on the assets of the member credit union.

17.64 *Paid-in-capital.*[**] Paid in capital is defined as the accounts or other interests that are available to cover losses that exceed reserves and undivided earnings. The National Credit Union Share Insurance Fund or any other insurer does not insure these funds. These funds are callable only at the discretion of the corporate credit union and only if the corporate credit union meets the minimum capital and net economic value[8] requirements after the funds are called. Paid in capital includes both member and nonmember paid-in-capital.[9]

17.65 *Reserves and undivided earnings.* Reserves and undivided earnings represent unappropriated accumulated earnings or losses of the corporate credit union since its inception. The accounting treatment of transactions in undivided earnings of a credit union is similar to that of transactions in retained earnings of corporate enterprises. Corporate credit unions are normally required to maintain a minimum capital ratio of 4 percent.[††] To comply with this regulation, corporate credit unions calculate their capital ratio monthly. The capital ratio is the total corporate credit union's capital divided by the moving daily average net assets. The moving daily average net assets is calculated by the average of daily average net assets for the 1 month being measured and the previous 11 months.[‡‡]

(footnote continued)

Membership capital accounts that are not converted to NCAs or PCC by October 21, 2011, must be put on notice by the corporate credit union and, to the extent not needed to cover operational losses, returned to the member at the end of the notice period.

[**] Effective October 20, 2011, paid in capital will be renamed PCC. PCC means accounts or other interests of a corporate credit union that (*a*) are perpetual, noncumulative dividend accounts; (*b*) are available to cover losses that exceed retained earnings; (*c*) are not insured by the NCUSIF or other share or deposit insurers; and (*d*) cannot be pledged against borrowings. See discussion of the final ruling in footnote ||.

[8] Per Part 704.2, "Definitions," of the NCUA *Rules and Regulations*, "Net economic value (NEV) means the fair value of assets minus the fair value of liabilities. All fair value calculations must include the value for forward settlements and embedded options. The amortized portion of membership capital and paid-in capital, which do not qualify as capital, are treated as liabilities for purposes of this calculation. The NEV ratio is calculated by dividing NEV by the fair value of assets."

[9] Auditors may need to be familiar with Part 704 of the NCUA Rules and Regulations to help assess the propriety and adequacy of financial statement disclosures.

[††] On April 29, 2010, the NCUA board considered the matter of a waiver, permitting an alternative capital level for purposes of regulatory compliance with the provisions of NCUA's corporate rule, 12 CFR 704. The board elected to allow corporate credit unions to use their capital levels, as reported on their November 30, 2008, call report for purposes of determining regulatory compliance with the capital ratio and earnings retention requirements. This waiver will terminate on October 20, 2011. Readers can access a copy of this waiver on the NCUA website at www.ncua.gov/Resources/CorporateStabilization/10-0429NCUArevisedboardorder permittingalternativecapitallevel.pdf.

[‡‡] Effective October 20, 2011, the one existing total capital ratio is replaced with a new leverage ratio, tier 1 risk-based capital ratio, and a total-risk based capital ratio by the corporate credit union final rule (see discussion of the final ruling in footnote ||). The leverage ratio, prior to October 21, 2013, means the ratio of total capital to moving daily average net assets. The leverage ratio, on or after October 21, 2013, means the ratio of *adjusted core capital* (as defined in the final ruling) to moving daily average net assets. The tier 1 risk-based capital

17.66 When significant circumstances or events warrant, the Office of Corporate Credit Unions (OCCU) Director may require a different minimum capital ratio for an individual corporate credit union based on its circumstances.

17.67 A corporate credit union generally must also maintain a minimum retained earnings ratio. According to NCUA regulations, a retail corporate credit union must increase retained earnings if the prior month end retained earnings ratio is less than 2 percent.[††,‡‡]

17.68 If the prior month end retained earnings ratio is less than 2 percent and the core capital ratio is less than 3 percent, the earnings retention factor is .15 percent per annum; or if the prior month-end retained earnings ratio is less than 2 percent and the core capital ratio is equal to or greater than 3 percent, the earnings retention factor is .10 percent per annum. The core capital ratio is computed by dividing a corporate credit union's core capital (retained earnings and paid-in-capital) by its moving daily average net assets.[††,‡‡]

17.69 The monthly earnings retention amount is determined by multiplying the earnings retention factor by the prior month end moving daily average net assets. The quarterly earnings retention amount is determined by multiplying the earnings retention factor by the moving daily average net assets for each of the prior three month-ends.

17.70 *Other components of equity.* U.S. GAAP provides guidance for other items that should be classified as equity.

17.71 In accordance with FASB ASC 220 10-45-14, the total of other comprehensive income for a period should be transferred to a component of equity that is displayed separately from retained earnings and additional paid-in capital in a statement of financial position at the end of an accounting period. See FASB ASC 220-10-55-2 and paragraph 17.09 for examples of items required to be reported as other comprehensive income.[*]

Disclosures for Corporate Credit Unions

17.72 Under current regulation, corporate credit unions are subject to regulatory capital requirements and not prompt corrective action.[||||] In applying the disclosure requirements of FASB ASC 942-505-50, those prompt corrective action disclosures are not applicable for corporate credit unions.

(footnote continued)

ratio will mean the ratio of tier 1 capital (adjusted core capital) to the moving monthly average net risk-weighted assets. The total risk-based capital ratio will mean the ratio of total capital to moving monthly average net risk-weighted assets. The moving monthly average net risk-weighted assets will mean the average of the net risk-weighted assets for the month being measured and the previous 11 months.

The final rule establishes a minimum of 4 percent for the leverage ratio, 4 percent for the tier 1 risk-based capital ratio, and 8 percent for the total risk-based capital ratio. The final rule also requires that a corporate credit union attempt to build retained earnings to a level of 0.45 percent of its moving daily average net assets by October 21, 2013, and submit a retained earnings accumulation plan to the NCUA if it fails to do so.

[††] See footnote †† in paragraph 17.65.

[‡‡] See footnote ‡‡ in paragraph 17.65.

[*] See footnote * in paragraph 17.08.

[||||] Effective October 20, 2011, the corporate credit union final ruling (see discussion of the final ruling in footnote ||) establishes prompt corrective action requirements. The purpose of this section is to define, for corporate credit unions that are not adequately capitalized, the capital measures and capital levels that are used for determining appropriate supervisory actions. It also establishes procedures for submission and review of capital restoration plans

17.73 FASB ASC 942-505-50-1H states that noncompliance with regulatory capital requirements could materially affect the economic resources of a credit union and claims to those resources. Accordingly, at a minimum, a corporate credit union within the scope of FASB ASC 942-10-15-2 should disclose all of the following in the notes to the financial statements:

a. A description of regulatory capital requirements (*a*) for capital adequacy purposes and (*b*) for prompt corrective action

b. The actual or possible material effects of noncompliance with such requirements

c. Whether the entity is in compliance with the regulatory capital requirements, including, as of each balance sheet date presented, all of the following with respect to quantitative measures:

  i. Whether the institutions meets the definition of a complex credit union as defined by the NCUA

  ii. The institution's required and actual capital ratios and required and actual capital amounts

  iii. Factors that may significantly affect capital adequacy such as potentially volatile components of capital, qualitative factors, and regulatory mandates

d. As of each balance sheet date presented, the prompt corrective action category in which the institution was classified

e. If, as of the most recent balance sheet date or date financial statements are issued or are available to be issued (as discussed in FASB ASC 855-10-25), the institution is not in compliance with capital adequacy requirements, the possible material effects of such conditions on amounts and disclosures in the financial statements

f. Whether subsequent to the balance sheet date and prior financial statements are issued or are available to be issued (as discussed in FASB ASC 855-10-25), management believes any events or changes have occurred to change the institution's prompt corrective action category

17.74 FASB ASC 942-505-50-1H also states that noncompliance with regulatory capital requirements may, when considered with other factors, raise substantial doubt about the credit union's ability to continue as a going concern for a reasonable period of time.

17.75 Disclosures should also be presented for any state-imposed capital requirements that are more stringent than or significantly differ from federal requirements, according to FASB ASC 942-505-50-2.

17.76 Additional information that might be disclosed in situations where there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time may include the following:

- Pertinent conditions and events giving rise to the assessment of substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time
- Possible effects of such conditions and events

(footnote continued)

and for issuance and review of capital directives, orders, and other supervisory directives. Readers should review prompt corrective action disclosures to address their applicability for fiscal years ending on or after October 20, 2011.

- Management's evaluation of the significance of those conditions and events and any mitigating factors
- Possible discontinuance of operations
- Management's plans (including relevant prospective financial information)
- Information about the recoverability or classification of recorded asset amounts or the amounts or classification of liabilities

Illustrative Disclosures for Corporate Credit Unions

17.77 The example disclosures that follow are for illustrative purposes only. Comparative disclosures should be included for each balance sheet presented.

> The Corporate Credit Union is subject to various regulatory capital requirements administered by the NCUA. Failure to meet minimum capital requirements can initiate certain additional actions by regulators that, if undertaken, could have a direct material effect on the Corporate's financial statements.

Part 704 of NCUA *Rules and Regulations* establishes a minimum capital ratio of 4 percent. A corporate credit union must maintain a minimum retained earnings ratio, or be subject to the earnings retention requirements of Section 704.3(i). The OCCU Director may approve a decrease to the earnings retention amount if it is determined a lesser amount is necessary to avoid a significant adverse impact upon a corporate credit union.[††]

Retained Earnings Ratio	*Core Capital Ratio*	*Earnings Retention Requirement*
<2%	<3%	.15% per annum
<2%	= or >3%	.10% per annum

The corporate's capital ratios are as follows:

	200X
Actual:	
Capital	$ XXX
Capital Ratio	XXX%
Retained Earnings	$ XXX
Retained Earnings Ratio	XXX%
Core Earnings Ratio	XXX%
Required:	
Capital	$ XXX
Capital Ratio	4%
Retained Earnings	$ XXX
Retained Earnings Ratio	2%

The corporate's retained earnings ratio was X.X% and X.X% as of December 31, 200X. The corporate met the earnings retention requirements in accordance with regulatory provisions.

[††] See footnote †† in paragraph 17.65.

Mortgage Companies and Mortgage Banking Activities

Introduction

17.78 Mortgage companies are organized with capital stock and shareholders. Mortgage banking activities primarily consist of two separate but interrelated activities: (1) the origination or acquisition of mortgage loans for the purpose of selling those loans to permanent investors in the secondary market, and (2) the subsequent long term servicing of those loans. Mortgage loans are acquired for sale to permanent investors from a variety of sources, including in-house origination and purchases from third party correspondents. Certain common requirements are discussed in chapter 4. For example, to participate in the Federal Housing Administration mortgage insurance program, a mortgage lender must obtain, U.S. Department of Housing and Urban Development (HUD) approval by meeting various requirements prescribed by HUD, including maintaining minimum net worth requirements. Net worth requirements vary depending on the program. To obtain approval to sell and service mortgage loans for Federal National Mortgage Association (Fannie Mae) or Federal Home Loan Mortgage Corporation (Freddie Mac), a mortgage lender must meet various federal requirements including maintaining an acceptable net worth.

Disclosure for Mortgage Companies and Mortgage Banking Activities

17.79 FASB ASC 948-10-50-3 states that noncompliance with minimum net worth (capital) requirements imposed by secondary market investors or state imposed regulatory mandates could materially affect the economic resources of a mortgage banking entity and claims to those resources. To the extent an entity is subject to such requirements, the entity should disclose all of the following in the notes to the financial statements:

a. A description of the minimum net worth requirements related to the following:
   i. Secondary market investors
   ii. State imposed regulatory mandates

b. The actual or possible material effects of noncompliance with those requirements

c. Whether the entity is in compliance with the regulatory capital requirements, including, as of each balance sheet date presented, the following with respect to quantitative measures:
   i. The entity's required and actual net worth amounts
   ii. Factors that may significantly affect adequacy of net worth such as potentially volatile components of capital, qualitative factors, or regulatory mandates

d. If, as of the most recent balance sheet date, the entity is not in compliance with capital adequacy requirements, the possible material effects of such conditions on amounts and disclosures in the notes to the financial statements

17.80 Further, FASB ASC 948-10-50-4 states that noncompliance with minimum net worth requirements may, when considered with other factors, raise substantial doubt about an entity's ability to continue as a going concern

for a reasonable period of time. Additional information that might be disclosed in these situations may include the following:

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

17.81 FASB ASC 948-10-50-5 states that servicers with net worth requirements from multiple sources should disclose, in the notes to the financial statements, the net worth requirement of the following:

a. Significant servicing covenants with secondary market investors with commonly defined servicing requirements (common secondary market investors include the U.S. HUD, Fannie Mae, Government National Mortgage Association, and Freddie Mac

b. Any other secondary market investor where violation of the requirement would have a significant adverse effect on the business

c. The most restrictive third-party agreement if not previously included

Illustrative Disclosures for Mortgage Companies and Mortgage Banking Activities

17.82 The disclosures that follow are for illustrative purposes only, and represent a mortgage company that is in compliance with capital adequacy requirements. Comparative disclosures should be included for each balance sheet presented.

The Company is subject to various capital requirements in connection with seller-servicer agreements that the Company has entered into with secondary market investors. Failure to maintain minimum capital requirements could result in the Company's inability to originate and service loans for the respective investor and, therefore, could have a direct material effect on the Company's financial statements. Management believes, as of December 31, 200X and 200W, that the Company met all capital requirements to which it is subject.

The Company's actual capital amounts and the minimum amounts required for capital adequacy purposes, by investor, are as follows:

	Actual Capital	*Minimum Capital Requirement*
As of December 31, 200X:		
HUD	$X,XXX,XXX	$XXX,XXX
FHLMC	$X,XXX,XXX	$ XX,XXX
FNMA	$X,XXX,XXX	$ XX,XXX

Regulatory Capital Matters for All Entities

Regulatory Capital Disclosures for Branches of Foreign Institutions

17.83 The disclosure requirements related to capital adequacy and prompt corrective action do not apply to branches of foreign organizations because such branches do not have capital.

17.84 Paragraphs 3–4 of FASB ASC 942-505-50 state that branches of foreign financial institutions, although they do not have regulatory capital requirements, may be required to maintain capital-equivalent deposits and, depending on facts and circumstances, supervisory mandated reserves. These requirements carry regulatory uncertainty of a nature similar to that posed by the regulatory capital rules in that failure to meet such mandates can result in supervisory action and ultimately going-concern questions. Accordingly, branches should disclose such requirements. Quantitative disclosure should be made, highlighting mandated deposit or reserve requirements and actual balances in those reserve or deposit accounts at the balance sheet date(s) reported. Further, if an uncertainty exists related to a parent that creates a higher than normal risk as to the viability of a branch or subsidiary, then that matter should be adequately disclosed in the notes to the financial statements of the branch or subsidiary. If factors do not exist that indicate a higher than normal amount of risk or uncertainty regarding parent capital and other regulatory matters, then disclosures of capital and supervisory issues of the parent would not be required.

Regulatory Capital Disclosures for Trust Operations

17.85 Trust banks are required by certain federal regulators to hold capital as a percentage of discretionary and nondiscretionary assets under management. The percentages vary for each category. The percentages are not standardized as with other capital requirements and are communicated on an entity by entity basis in the application to obtain a trust charter or by other supervisory processes. Depending on the type of charter, these entities may be subject to risk-based standards as well. Because these are not published requirements, these guidelines are applied on a discretionary basis by the agencies and may not be uniformly applied to all entities.

17.86 FASB ASC 942-505-50-5 states that if an institution is subject to capital requirements based on trust assets under management, a discussion of the existence of these requirements, ramifications of failure to meet them, and a measurement of the entity's position relative to imposed requirements should be disclosed in the notes to the financial statements.

Auditing

Banks, Savings Institutions, and Credit Unions

Objectives

17.87 In addition to testing of disclosures, as discussed subsequently, the auditor should consider the implications of capital noncompliance, as discussed beginning in paragraph 5.172 and in chapter 23, "Reporting Considerations," of this guide.

17.88 In addition to the normal objectives sought in auditing equity (for example balances are presented in accordance with GAAP), the auditor's objective in this area is to obtain reasonable assurance that the financial statements include proper and understandable description and disclosure of regulatory matters (as discussed earlier in this chapter) in the context of the financial statements taken as a whole. Similarly, the audit objective for regulatory capital matters relates primarily to disclosure.[10] Capital amounts are determined under U.S. GAAP, regulatory reporting requirements, and regulatory capital standards.

17.89 An auditor's report on financial statements containing the required regulatory capital disclosures does not constitute an opinion on the fair presentation of the institution's regulatory reports (in part or taken as a whole) in conformity with underlying instructions for such reports. Nor does the opinion indicate that the auditor has confirmed with any regulatory agency that the agency has examined or otherwise evaluated or opined on the fair presentation of such reports.

Planning

17.90 As stated in AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), the importance of the auditor's risk assessment as a basis for further audit procedures is discussed in the explanation of audit risk in AU section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*). AU section 326, *Audit Evidence* (AICPA, *Professional Standards*), provides guidance on how the auditor uses relevant assertions in sufficient detail to form a basis for the assessment of risks of material misstatement and to design and performance of further audit procedures.[11] Chapter 5, "Audit Considerations and Certain Financial Reporting Matters," describes these risks. Auditors should obtain an understanding of capital regulations sufficient to understand application and classification decisions made by management. The auditor should obtain audit evidence about the changes in regulatory reporting instructions and related capital requirements since the preceding audit.

17.91 Paragraphs 5.183–.188 of this guide discuss the auditor's responsibility relative to review of supervisory reports and coordination with examiners.

17.92 While planning and carrying out procedures in other audit areas, the auditor should consider the regulatory reporting requirements and regulatory capital standards that affect the risk weighting of assets resulting from the institution's transactions. This information will help the auditor assess (*a*) the regulatory interpretations and reporting requirements that provide guidance consistent with U.S. GAAP in greater detail, (*b*) U.S. GAAP equity amounts adjusted in calculating regulatory capital amounts (for example, tier 1 capital and tier 2 capital), and (*c*) U.S. GAAP asset amounts and off-balance sheet amounts risk weighted for regulatory capital purposes. The information will also be useful for performing any procedures applied to such adjustments

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[10] Notwithstanding the disclosure objective, regulatory matters may also affect preparation of the auditor's report, as discussed in chapter 23, "Reporting Considerations," of this guide.

[11] See paragraph .22 of AU section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*), for the definition of and more guidance about the risk of material misstatement.

(including consideration of the relative risk weightings assigned to certain amounts or transactions).

17.93 In accordance with paragraph .24 of AU section 314, the auditor should obtain an understanding of relevant industry, regulatory, and other external factors. In this regard, some components of regulatory capital ratios, including related amounts, asset measures, and risk weightings, may be difficult to determine due to (*a*) the complexity and subjectivity of capital standards and related regulatory reporting requirements or (*b*) the complexity of the institution's transactions. The number and variety of adjustments between U.S. GAAP and regulatory capital amounts affecting the institution also will affect inherent risk in this area.

17.94 Management's regulatory financial reporting classification and risk weighting decisions involve a high degree of subjective analysis by management and might be challenged by examiners. Accordingly, such decisions that could have a material impact on regulatory disclosures should be carefully considered by the auditor.

17.95 The following are examples of factors related to regulatory matters that may indicate higher risks of material misstatement:

- A high volume or high degree of complexity of off balance sheet transactions
- Actual or borderline noncompliance with minimum capital requirements
- A poor regulatory rating
- Past disagreements between management and regulators about classifications, risk weightings, other regulatory reporting requirements, or application of regulatory capital standards in general
- Frequent corrections to filed regulatory reports
- Regulatory restrictions or other regulatory actions taken related to capital compliance (for example, the federal banking agencies may issue informal enforcement actions such as a memorandum of understanding or commitment letter)
- Unusual, material, or frequent related party transactions
- Capital calculations, including management's classification or risk weighting decisions, that are not well documented

Internal Control Over Financial Reporting

17.96 AU section 314 establishes standards and provides guidance about implementing the second standard of field work. AU section 314 states that the auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. Paragraph .40 of AU section 314 states that the auditor should obtain an understanding of the five components of internal control (control environment, risk assessment, control activities, information and communication systems, and monitoring) sufficient to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. The auditor should obtain a sufficient understanding by performing risk assessment procedures to evaluate the design of controls

relevant to an audit of financial statements and to determine whether they have been implemented. Paragraph .102 of AU section 314 states that the auditor should identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions, account balances, and disclosures.

17.97 Effective internal control over financial reporting in this area should provide reasonable assurance that errors or fraud in financial statement disclosures about regulatory matters are prevented or detected. In part, these controls may overlap with controls the institution has established for compliance with capital requirements. Institutions' systems for gathering the necessary information and preparing regulatory financial reports vary in sophistication. Examples of factors that may contribute to effective internal control in this area include the following:

- Responsibilities for capital planning, monitoring compliance with capital laws and regulations, and preparation of call reports have been assigned to competent individuals in the institution.
- Regulatory financial reporting is subject to risk assessment and supervisory control procedures and is overseen by officers of the institution who review the details supporting classifications and risk weightings.
- Capital amounts reported to regulators are reconciled to underlying detailed schedules and subsidiary ledgers with reconciling items supported by appropriate computations and documentation and with appropriate supervisory review and oversight.
- Procedures are in place for collection and reporting by branches, divisions, and subsidiaries of amounts necessary for regulatory capital calculations.
- Management obtains competent outside advice, as warranted, on significant classification or risk weighting questions before and after major transactions are executed.
- Regulatory capital analyses, calculations, and supporting documentation are well prepared and readily accessible.
- The regulatory financial reporting process (including classifications and risk weightings) is reviewed by the internal audit function.

17.98

Considerations for Audits Performed in Accordance with Public Company Accounting Oversight Board (PCAOB) Standards

Refer to PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), for guidance about integration of audits, scoping decisions when an institution has multiple locations or business units, use of service organizations, and benchmarking of automated controls.

Substantive Procedures

17.99 According to paragraph .51 of AU section 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*), regardless of the assessed risks of material misstatement, the auditor should design and perform substantive

procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure.

17.100 The extent to which the auditor applies tests to specific transactions or amounts will depend on the auditor's assessment of the risks of material misstatement and the materiality of the accounts. Where the risks of material misstatement are assessed at lower levels, the auditor may consider testing a reconciliation of differences between U.S. GAAP as applied in the financial statements versus U.S. GAAP as applied in regulatory reports (if management chose to use an option available under U.S. GAAP for financial statement purposes that is different than the regulatory interpretation of U.S. GAAP for regulatory reporting purposes) before year-end, reviewing classifications made for risk weighting purposes, reviewing examination findings, and testing material differences, risk weighting classifications, and ratio calculations in preparation for any substantive tests to be applied to disclosures of year-end amounts and ratios.

17.101 Satisfaction that regular reserve transfers are in compliance with regulatory requirements is necessary when conducting a credit union engagement. To gain such satisfaction, the auditor should obtain an understanding about of the applicable federal and state laws and regulations. Other entries, including direct charges and credits in accordance with regulatory requirements, should be tested for propriety. Other appropriations of net "retained earnings" should be traced to authorization by the board of directors. Certain changes to the regular reserve are subject to regulatory approval and the auditor should be familiar with these requirements.

17.102 Paragraphs 5.183–.188 of this guide discuss the auditor's responsibility relative to review of supervisory reports and coordination with examiners. Such review and coordination should involve consideration of the adequacy of the financial statement disclosures in this area.

17.103 Paragraph .55 of AU section 318 states that substantive procedures include tests of details and substantive analytical procedures. Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. Tests of details are ordinarily more appropriate to obtain audit evidence regarding certain relevant assertions about account balances, including existence and valuation. The auditor's determination as to the substantive procedures that are most responsive to the planned level of detection risk is affected by whether the auditor has obtained audit evidence about the operating effectiveness of controls.

17.104 Such procedures might include the following:

- Obtain and test management's schedules supporting calculation of the institution's actual and required regulatory capital ratios, including regulatory capital amounts (ratio numerators) and related asset bases (ratio denominators).
- Review and evaluate management's analyses of significant nonrecurring transactions and their impact on regulatory capital.
- Inquire about, and discuss with officers having responsibility for regulatory financial reporting, the existence and nature of any differences between U.S. GAAP as applied in the financial statements versus U.S. GAAP as applied in regulatory reports (if management chose to use an option available under U.S. GAAP for financial statement purposes that is different than the regulatory interpretation of U.S. GAAP for regulatory reporting purposes). Review copies

of prior year regulatory reports (and, as necessary, client's supporting working papers), and obtain management's analysis of classification issues concerning preparation of call reports, including risk weighting classifications assigned. In assessing the completeness of any reconciliation, consider the potential for U.S. GAAP to have been applied differently for any other of the institution's transactions in the financial statements versus regulatory reports.

- Obtain any reconciliation of amounts supporting the institution's regulatory capital ratio calculations to amounts in the institution's financial statements prepared in conformity with U.S. GAAP.[12]
  - Test management's supporting schedules and reconciliations for completeness and mathematical accuracy.
  - Agree U.S. GAAP amounts to general or subsidiary ledgers, or both, and obtain supporting schedules for non-U.S. GAAP amounts.
- Review the nature and amount of material non-U.S. GAAP amounts for propriety and consistency with prior years.
- Consider current treatment of items that resulted in past corrections or changes to regulatory financial reports.
- Consider whether significant changes in instructions for preparation of call reports have been applied to material transactions.
- Inquire about, and discuss with officers having responsibility for call reporting, any significant reclassification of transactions since the last filed regulatory report.

Mortgage Companies and Activities

Objectives

17.105 The auditor's objective in this area includes the normal objectives sought in auditing equity (for example, balances are presented in accordance with GAAP), including obtaining reasonable assurance that the financial statements include proper description and disclosure of capital matters in the context of the financial statements taken as a whole. Capital noncompliance is an important consideration for auditors when conducting a mortgage company engagement.

Planning

17.106 Paragraphs .02 and .08 of AU section 311, *Planning and Supervision* (AICPA, *Professional Standards*), state that the nature, timing, and extent of planning vary with the size and complexity of the entity, and with the auditor's experience with the entity and understanding of the entity and its environment, including its internal control. The auditor should establish an understanding with the client regarding the services to be performed for each engagement and should document the understanding through a written communication with the client. Such an understanding reduces the risk that either the auditor or the client may misinterpret the needs or expectations of the other party. For example, it might be necessary for an auditor to obtain an understanding about the capital requirements that the entity is subject to as a result of seller-servicer agreements entered into with investors, as well as capital

[12] See the Office of Thrift Supervision letter to CEOs dated September 11, 1992.

requirements that may be imposed as a result of other business transactions such as borrowing arrangements. In connection with these requirements, it is important that the auditors understand the elements that constitute capital, as defined in the various agreements.

17.107 In accordance with paragraph .29 of AU section 314, the auditor should obtain an understanding of the entity's objectives and strategies, and the related business risks that may result in material misstatement of the financial statements. Business risks result from significant conditions, events, circumstances, actions, or inactions that could adversely affect the entity's ability to achieve its objectives and execute its strategies, or through the setting of inappropriate objectives and strategies.

17.108 The following are examples of factors related to capital matters that may indicate higher risks of material misstatement:

- Actual or borderline noncompliance with minimum capital requirements
- Communications or restrictions from investors regarding capital compliance issues
- Capital requirements and calculations that are not well documented

Internal Control Over Financial Reporting

17.109 According to paragraph .23 of AU section 318, the auditor should perform tests of controls when the auditor's risk assessment includes an expectation of the operating effectiveness of controls or when substantive procedures alone do not provide sufficient appropriate audit evidence at the relevant assertion level.

17.110 Examples of factors that may contribute to effective internal control in this area follow:

- Responsibilities for capital planning and monitoring compliance with capital requirements have been assigned to competent officials in the company.
- Capital analyses, calculations and supporting documentation are well prepared and readily accessible.

Substantive Procedures

17.111 According to paragraph .51 of AU section 318, regardless of the assessed risks of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure.

17.112 The extent to which the auditor applies tests to specific transactions or amounts will depend on the auditor's assessment of inherent and control risks and the materiality of the accounts.

17.113 Paragraph .55 of AU section 318 states that substantive procedures include tests of details and substantive analytical procedures. Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. Tests of details are ordinarily more appropriate to obtain audit evidence regarding certain relevant assertions about account balances, including existence and valuation. The auditor's determination as to the substantive procedures that are most responsive to the

planned level of detection risk is affected by whether the auditor has obtained audit evidence about the operating effectiveness of controls.

17.114 Such procedures might include the following:

- Obtain and read new seller-servicer agreements entered into during the period, or amendments to existing agreements, for capital requirements in effect
- Obtain and test management's schedules supporting calculation of the entity's actual and required capital amounts
- Review and evaluate management's analyses of significant nonrecurring transactions and their impact on capital
- Obtain any reconciliation of amounts supporting the entity's capital calculations to amounts in the entity's financial statements prepared in conformity with U.S. GAAP
- Test management's supporting schedules and reconciliations for completeness and mathematical accuracy
- Agree GAAP amounts to general or subsidiary ledgers, or both

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Chapter 18

Derivative Instruments: Futures, Forwards, Options, Swaps, and Other Derivative Instruments

Introduction

18.01 The following section provides a discussion about the economic uses of derivative instruments and hedging activities. Refer to Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 815, *Derivatives and Hedging*, for accounting guidance on these topics.

18.02 The derivative instruments addressed in this chapter, which include futures forward, swap, and option contracts, as well as other financial contracts with similar characteristics, have become important financial management tools for banks and savings institutions. These instruments collectively are referred to in this chapter as derivative instruments, which are defined for accounting purposes in paragraphs 83–139 of FASB ASC 815-10-15. This chapter provides background information on basic contracts, risks, and other general considerations to provide a context for related accounting and auditing guidance.

18.03 This chapter focuses on end uses of derivatives, rather than on the broader range of activities that includes the marketing of derivatives to others. Some banks and savings institutions, primarily large commercial banks, act as market makers or dealers in derivatives that are not traded under uniform rules through an organized exchange. The primary goals of those activities are to make a market and earn income on the difference between the bid and offer prices. Although the volume of transactions often causes individual exposures to offset each other, such activities may be subject to different permutations of risks and different accounting, auditing, and regulatory considerations.

18.04 Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*, provides practical guidance for auditing derivative instruments and hedging activities for all types of audit engagements. Chapter 3, "General Accounting Considerations for Derivatives and Securities," of this guide provides general accounting considerations for derivative instruments and background information to help auditors understand and implement the auditing guidance contained in AU section 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*).[*]

[*] The Auditing Standards Board (ASB) has finalized a new clarified auditing standard, *Audit Evidence—Specific Considerations for Selected Items*. This clarified auditing standard will supersede AU section 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*), and addresses specific considerations by the auditor in obtaining sufficient appropriate audit evidence regarding certain aspects of investments in securities and derivatives, among other things. This clarified auditing standard has been finalized but not yet issued. See the preface of this guide for further information on the the ASB's Clarity Project. The effective date of this clarified standard is for audits of financial statements for periods ending on or after December 15, 2012, unless otherwise established (early implementation is not permitted).

Risks Inherent in Derivatives

18.05 Risks inherent in derivatives such as credit risk, market risk, legal risk, and control risk are the same as risks inherent in more familiar financial instruments. However, derivatives often possess special features such as

- little or no cash outflows or inflows necessary at inception;
- no principal balance or other fixed amount to be paid or received; and
- potential risks and rewards substantially greater than the amounts recognized in the statement of financial position.

Also, many derivatives values are more volatile than those of other financial instruments potentially alternating between positive and negative values in a short period of time.

18.06 Given these features, a derivative's risks can be difficult to segregate because the interaction of such risks may be complex. This complexity is increased (*a*) when two or more basic derivatives are used in combination, (*b*) by the difficulty of valuing complex derivatives, and (*c*) by the volatile nature of markets for some derivatives. The economic interaction between an institution's position in derivatives and that institution's other on- or off-balance-sheet positions (whether assets or liabilities) is an important determinant of the total risk associated with an institution's derivatives use. Risk assessment, therefore, involves consideration of the specific instrument and its interaction with other on- and off-balance-sheet portfolios and activities. No list of risk characteristics exists that can cover all those complex interactions, but a discussion of the basic risk characteristics associated with derivatives follows.

18.07 *Nonperformance risk* of derivative instruments is the possibility that either the bank or the dealer will be unable to perform their contractual obligations under the derivative instrument. For example, if a derivative instrument is in an unrealized gain position to the bank, and the dealer entered bankruptcy, it is unlikely that the bank would be able to collect the unrealized value of the derivative from the bankrupt dealer. Conversely, if the derivative instrument is in an unrealized loss position to the bank, and the bank experienced financial difficulties, it is possible that the dealer would not recover the unrealized value of the contract.

18.08 Entities often quantify this risk of loss based upon the derivative's replacement cost—that is, the current market value of an identical contract. Master netting agreements and collateral maintenance provisions are some of the ways that banks and other derivative counterparties seek to reduce nonperformance risk. The requirement that participants settle or collateralize changes in the value of their positions daily or only when above established thresholds mitigate the credit risk of many derivatives traded under uniform rules through an organized exchange (exchange-traded derivatives) or through credit support annex amendments to their International Swaps and Derivatives Association master contracts.

18.09 *Settlement risk* is the related exposure that a counterparty may fail to perform under a contract after the institution has delivered funds or assets according to its obligations under the contract. Settlement risk relates almost solely to over-the-counter (OTC) contracts (that is, nonexchange-traded). Institutions can reduce settlement risk through master netting agreements, which allows the parties to set off all their related payable and receivable positions at settlement.

18.10 *Counterparty risk* connotes the exposure to the aggregate credit risk posed by all transactions with one counterparty.

18.11 *Market risk* relates broadly to economic losses due to adverse changes in the fair value of the derivative. Related risks include price risk, basis risk, and liquidity risk. *Price risk* relates to changes in the level of prices due to changes in (*a*) interest rates, (*b*) foreign exchange rates, or (*c*) other factors that relate to market volatilities of the rate, index, or price underlying the derivative. *Basis risk* relates to the differing effect market forces have on the performance or value of two or more distinct underlyings, possibly in instruments used in combination (see the discussion of hedging that follows). *Liquidity risk* relates to changes in the ability to sell, dispose of, or close out the derivative, thus affecting its value. This may be due to a lack of sufficient contracts or willing counterparties. *Valuation or model risk* is the risk associated with the imperfection and subjectivity of models and the related assumptions used to value derivatives.

18.12 *Legal risk* relates to losses due to a legal or regulatory action that invalidates or otherwise precludes performance by the institution or its counterparty under the terms of the contract or related netting arrangements. Such risk could arise, for example, from insufficient documentation for the contract, an inability to enforce a netting arrangement in bankruptcy, adverse changes in tax laws, or statutes that prohibit entities (such as certain state and local governmental entities) from investing in certain types of financial instruments.

18.13 *Control risk* relates to losses that result from the failure (or absence) of internal controls to prevent or detect problems (such as human error, fraud, or system failure) that hinder an institution from achieving its operational, financial reporting, or compliance objectives. Such failure could result, for example, in an institution failing to understand a contract's economic characteristics. Lack of adequate control also could affect whether published financial information about derivatives was prepared reliably by a failure to prevent or detect misstatements caused by error or fraud in financial reporting. Finally, the institution may be negatively affected if controls fail to prevent or detect instances of noncompliance with related contracts, laws, or regulations. Failure to understand derivatives used may lead to inadequate design of controls over their use.

Types of Derivatives

18.14 Paragraphs 83–139 of FASB ASC 815-10-15 define the term *derivative instrument*.

18.15 A key feature of derivatives, as defined in this chapter, is that resulting cash flows are decided by reference to the following:

a. Rates, indexes (which measure changes in specified markets), or other independently observable factors

b. The value of underlying positions in the following:

   i. Financial instruments such as government securities, equity instruments (such as common stock), or foreign currencies

   ii. Commodities such as corn, gold bullion, or oil

   iii. Other derivatives

18.16 Derivatives can generally be described as either *forward-based* or *option-based*, or there can be combinations of the two. A traditional forward

contract obligates one party to buy and a counterparty to sell an underlying financial instrument, foreign currency, or commodity at a future date at an agreed-upon price. Thus, a *forward-based derivative* (examples are futures, forward, and swap contracts) is a two-sided contract in that each party potentially has a favorable or unfavorable outcome resulting from changes in the value of the underlying position or the amount of the underlying reference factor. A traditional option contract provides one party that pays a premium (the option holder) with a right, but not an obligation, to buy (call options) or sell (put options) an underlying financial instrument, foreign currency, or commodity at an agreed-upon price on or before a predetermined date. The counterparty (the option writer) is obligated to sell (buy) the underlying position if the option holder exercises the right. Thus, *an option-based derivative* (examples are option contracts, interest rate caps, interest-rate floors, and swaptions) is one-sided in the sense that, in the event the right is exercised, only the holder can have a favorable outcome (or the loss is limited to any premium paid) and the writer can have only an unfavorable outcome reduced by any premium received. If market conditions would result in an unfavorable outcome for the holder, the holder will allow the right to expire unexercised. The expiration of the option contract results in a neutral outcome for both parties (except for any premium paid to the writer by the holder). Although there are a variety of derivatives, they generally are variants or combinations of these two types of contracts.

18.17 Derivatives also are either exchange-traded or OTC. Institutions and dealers trade futures, certain option, and other standardized contracts under uniform rules through an organized exchange. Most of the risk inherent in such exchange-traded derivatives relates to market risk rather than to credit risk. OTC derivatives are privately traded instruments (primarily swap, option, and forward contracts) customized to meet specific needs and for which the counterparty is not an organized exchange. As a result, although OTC derivatives are more flexible, they potentially involve higher credit and liquidity risk. The degree of risk depends on factors such as (*a*) the financial strength of the counterparty, (*b*) the sufficiency of any collateral held, and (*c*) the liquidity of the specific instrument. The advantages of OTC derivatives are that they can be customized and may be easier to use.

18.18 A description of the basic contracts and variations follows.

18.19 *Forward contracts* are contracts negotiated between two parties to purchase and sell a specific quantity of a financial instrument, foreign currency, or commodity at a price specified at origination of the contract, with delivery and settlement at a specified future date. Forward contracts are not traded on exchanges and, accordingly, may be less liquid and generally involve more credit and liquidity risk than futures contracts.

18.20 *Forward-rate agreements*, which are widely used to manage interest rate risk (IRR), are forward contracts that specify a reference interest rate and an agreed-upon interest rate (one to be paid and one to be received) on an assumed deposit of a specified maturity at a specified future date (the settlement date). The term of the assumed deposit may begin at a subsequent date; for example, the contract period may be for 6 months, commencing in 3 months. At the settlement date, the seller of the forward-rate agreement pays the buyer if interest calculated at the reference rate is higher than that calculated at the agreed-upon rate; conversely, the buyer pays the seller if interest calculated at the agreed-upon rate is higher than that calculated at the reference rate. Treasury rate locks are a type of forward-rate agreement where the settlement is based upon the price movements of a particular reference U.S. Treasury

issuance rather than to a deposit. Examples of such reference instruments would be the current on-the-run 10-year U.S. Treasury security or possibly to the Committee on Uniform Security Identification Procedures identifier of a particular U.S. Treasury issuance.

18.21 *Futures contracts* are forward-based contracts to make or take delivery of a specified financial instrument, foreign currency, or commodity at a specified future date or during a specified period at a specified price or yield. Futures are standardized contracts traded on an organized exchange. The deliverable financial instruments underlying interest-rate futures contracts are specified investment-grade financial instruments, such as U.S. Treasury securities or mortgage-backed securities (MBSs). *Foreign-currency futures contracts* involve specified deliverable amounts of a particular foreign currency. The deliverable products under *commodities futures contracts* are specified amounts and grades of commodities, such as oil, gold bullion, or coffee.

18.22 Active markets exist for most financial and commodities futures contracts. Active markets provide a mechanism by which entities may transfer their exposures to price risk to other parties. Those parties may, in turn, be trying to manage their own financial risks or achieve gains through speculation. Recognized exchanges, such as the International Monetary Market (a division of the Chicago Mercantile Exchange) or the Chicago Board of Trade, establish conditions governing transactions in futures contracts. U.S. Treasury bond (interest-rate) futures contracts are the most widely traded financial futures contracts. To ensure an orderly market, the exchanges specify maximum daily price fluctuations for each type of contract. If the change in price from the previous day's close reaches a specified limit, no trades at a higher or lower price are allowed. Consequently, trading in the contract is stopped until buy orders and sell orders can be matched either within the daily price limits or on the next business day. Such limits may affect liquidity and thereby hinder the effectiveness of futures contracts used as hedges.

18.23 Brokers require both buyers and sellers of futures contracts to deposit assets (such as cash, government securities, or letters of credit) with a broker. Such assets represent the initial margin (which is a good-faith deposit) at the time the contract is initiated. The brokers mark open positions to market daily and either call for additional assets to be maintained on deposit when losses are experienced (a margin call) or credit customers' accounts when gains are experienced. This daily margin adjustment is called *variation margin*. Variation margin payments generally must be settled daily in cash or acceptable collateral, thus reducing credit risk. The broker returns the initial margin when the futures contract is closed out or the counterparty delivers the underlying financial instrument according to the terms of the contract.

18.24 Delivery of the commodity or financial instrument underlying futures contracts occurs infrequently, as contracts usually are closed out before maturity. This close-out process involves the participants entering a futures contract that is equal and opposite to a currently held futures contract. This provides the participant with equal and opposite positions and obligations and eliminates any subsequent market movements from affecting the net asset or obligation during the remaining lives of the futures contracts.

18.25 *Swap contracts* are forward-based contracts in which two parties agree to swap streams of payments over a specified period. The payment streams are based on an agreed-upon (or notional) principal amount. The term *notional* is used because swap contracts generally involve no exchange of

principal at either inception or maturity. Rather, the notional amount serves as a basis for calculation of the payment streams to be exchanged.

18.26 *Interest-rate swaps* are the most prevalent type of swap contract. One party generally agrees to make periodic payments, which are fixed at the outset of the swap contract. The counterparty agrees to make variable payments based on a market interest rate (index rate). Swap contracts allow institutions to achieve net payments similar to those that would be achieved if the institution actually changed the interest rate of designated assets or liabilities (the underlying cash position) from floating to fixed rate or vice versa.

18.27 Interest-rate swap contracts are considered a flexible means of managing IRR. Because swap contracts are customized for institutions, terms may be longer than futures contracts, which generally have delivery dates from three months to three years. Swap contract documentation usually is standardized and transactions can be concluded quickly, making it possible to rapidly take action against anticipated interest-rate movements.

18.28 Interest-rate swap contracts normally run to maturity. However, there may be circumstances that eliminate an institution's need for the swap contract before maturity. Accordingly, an institution may cancel contracts, sell its position, or enter an offsetting swap contract.

18.29 Swap contracts are not exchange-traded but negotiated between two parties. Therefore, they are not as liquid as futures contracts. They also lack the credit risk protection provided by regulated exchanges. The failure by a counterparty to make payments under a swap contract usually results in an economic loss to an institution only if the underlying prices (for example, interest rates or foreign exchange rates) have moved in an adverse direction; that is, in the direction that the swap contract was intended to protect against. The economic loss corresponds to the cost to replace the swap contract. That cost would be the present value of any discounted net cash inflows that the swap contract would have generated over its term.

18.30 In some swap contracts, the timing of payments varies. For example, in an interest-rate swap contract, one party might pay interest quarterly while the counterparty pays interest semiannually. An added element of credit risk exists for the quarterly payer because of the risk that the semiannual payer may default. Here, the economic loss equals the lost quarterly payment and the cost of replacing the swap contract.

18.31 Many entities enter legally enforceable master netting agreements that may reduce total credit risk. Upon default by an applicable counterparty, the agreements provide that entities may set off (for settlement purposes) all their related payable and receivable derivative contract positions.

18.32 *Foreign-currency swaps* (sometimes called *cross-currency exchange agreements*) are used to fix (for example, in U.S. dollar terms) the value of foreign exchange transactions that will occur in the future. Foreign-currency swap contracts are also used to transfer a stream of cash flows denominated in a particular currency or currencies into another currency or currencies. Basic features of foreign-currency swap contracts include the following:

- The principal amount is usually exchanged at the initiation of the swap contract.
- Periodic interest payments are made based on the outstanding principal amounts at the respective interest rates agreed to at inception.

- The principal amount is usually re-exchanged at the maturity date of the swap contract.

18.33 In *fixed-rate-currency swaps*, two counterparties exchange fixed-rate interest in one currency for fixed-rate interest in another currency. Currency coupon or cross-currency interest-rate swap contracts combine the features of an interest-rate swap contract and a fixed-rate-currency swap contract. That is, the counterparties exchange fixed-rate interest in one currency for floating-rate interest in another currency.

18.34 *Basis swaps* are a variation on interest-rate swap contracts where both rates are variable but are tied to different index rates. For example, one party's rate may be indexed to three-month London Interbank Offered Rate (LIBOR) while the other party's rate is indexed to six-month LIBOR.

18.35 *Equity swaps* are contracts in which the counterparties exchange a series of cash payments based on (*a*) an equity index and (*b*) a fixed or floating interest rate on a notional principal amount. Equity swap contracts typically are tied to a stock index, but sometimes they relate to a particular stock or a defined basket of stocks. One party (the equity payer) pays the counterparty (the equity receiver) an amount equal to the increase in the stock index at regular intervals specified in the contract. Conversely, the equity receiver must pay the equity payer if the stock index declines. The counterparties generally make quarterly payments. Whatever the index performance, the party designated as the equity receiver may also receive an amount representing dividends paid by the companies making up the index during the period.

18.36 The equity payer, on a floating-rate equity swap contract, typically receives LIBOR (plus or minus a notional spread) on the notional principal amount defined in the equity swap contract. This notional principal amount is based on the underlying equity index value at the contract's inception. The notional principal amount is adjusted at each payment date to reflect the settlement of the equity gain or loss. The floating rate is also reset on the periodic payment dates. A fixed-rate equity swap contract is essentially the same, except that the interest rate is fixed for the term of the contract.

18.37 *Commodity swaps* are contracts in which the counterparties agree to exchange cash flows based on the difference between an agreed-upon, fixed price and a price that varies with changes in a specified commodity index, as applied to an agreed-upon quantity of the underlying commodity.

18.38 In *mortgage swaps*, two counterparties exchange contractual payments designed to replicate the net cash flows of a portfolio of MBSs financed by short-term floating-rate funds. For example, mortgage swaps enable an institution to finance mortgage securities at a rate tied to a floating-rate index below LIBOR on a guaranteed, multiyear basis. Mortgage swaps have been described as being similar to an amortizing interest-rate swap (rather than one with a fixed notional principal amount) with a long-term forward commitment to purchase MBSs. In a typical mortgage swap transaction, an investor contracts with a third party to receive cash flows based on a generic class of MBSs over a specified period in exchange for the payment of interest at a rate typically based on LIBOR. The payments are made as if there were an underlying notional pool of mortgage securities. Payments are exchanged on a monthly basis. The cash flows received by the investor are derived not only from the fixed coupon on the generic class of securities but also, to the extent that the coupon is above or below par, from the benefit or loss implicit to the discount or premium. The notional amount of the mortgage swap is adjusted monthly,

based on the amortization and prepayment experience of the generic class of MBSs.

18.39 The contract may require the investor either to take physical delivery of mortgages at a predetermined price (for example, a percentage of the par amount of mortgages remaining in the pool) when the contract expires or to settle in cash for the difference between the predetermined price of the mortgages and their current market value as determined by the dealer.

18.40 *Overnight index swaps* are swap contracts where the floating rate is based upon the geometric average of the overnight rates for the period. The overnight index swap rate is an interest rate representative of the amount of interest paid on funds deposited for one day, such as posted collateral. It is becoming more common to see overnight index swap rates used in the pricing of swaps where collateral is required to be posted to reduce counterparty nonperformance risks.

18.41 *Option contracts* are traded on an exchange or OTC (that is, they are negotiated between two parties). Option contracts allow, but do not require, the holder (or purchaser) to buy (call) or sell (put) a specific or standard commodity, or financial or equity instrument, at a specified price during a specified period (an American option), at a specified date (a European option), or dates (a Bermudian option). Furthermore, certain option contracts may involve cash settlements based on changes in specified indexes, such as stock indexes. Again, the principal difference between option contracts and either futures or forward contracts are that an option contract does not require the holder to exercise the option, whereas performance under a futures or forward contract is mandatory.

18.42 At the inception of an option contract, the holder typically pays a fee, which is called a *premium*, to the writer (or seller) of the option. The premium includes 2 components of value: the intrinsic value and the time value. The *intrinsic value* of a call option is the excess, if any, of the market price of the item underlying the option contract over the price specified in the option contract (the strike price or the exercise price). The intrinsic value of a put is the excess, if any, of the option contract's strike price over the market price of the item underlying the option contract. The intrinsic value of an option cannot be less than zero. The other component of the premium's value is the time value. The *time value* reflects the probability that the price of the underlying item will move above the strike price (for a call) or below the strike price (for a put) during the exercise period. For example, suppose an entity owned a call option that granted it the right to purchase a given stock at $50 per share. If the price of the underlying stock is $50, then the intrinsic value of the option is $0. If the price of the stock rises to $55 per share, then the intrinsic value is $5 because the entity can purchase for $50 an asset that has a market value of $55. If the market value of the shares drops to $45 per share, then the option will not be exercised; it has an intrinsic value of $0.

18.43 The advantage of option contracts held is that they can be used to either mitigate downside price risk or to permit upside profit potential. This is because the loss on a purchased option contract is limited to the amount paid for the option contract. Profit on written option contracts is limited to the premium received but the loss potential is unlimited because the writer is obligated to settle at the strike price if the option is exercised.

18.44 Option contracts are frequently processed through a clearinghouse that guarantees the writer's performance under the contract. This reduces credit risk, much like organized exchanges reduce credit risk for futures

contracts. Thus, such option contracts are primarily subject to market risk. However, for option contracts that are not processed through the clearinghouse, the holder may have significant credit and liquidity risks.

18.45 Different option contracts can be combined to transfer risks from one entity to another. Examples of such option-based derivatives are caps, floors, collars, and swaptions.

18.46 *Interest-rate caps* are contracts in which the cap writer, in return for a premium, agrees to limit, or cap, the cap holder's risk associated with an increase in interest rates for a certain period of time. If rates go above a specified interest-rate level (the strike price or the cap rate), the cap holder is entitled to receive cash payments equal to the excess of the market rate over the strike rate multiplied by the notional principal amount. Issuers of floating-rate liabilities often purchase caps to protect against rising interest rates while retaining the ability to benefit from a decline in rates.

18.47 Because a cap is an option-based contract, the cap holder has the right but not the obligation to exercise the option. If rates move down, the cap holder has lost only the premium paid. Because caps are not exchange-traded, however, they expose the cap holder to credit risk because the cap writer could fail to fulfill its obligations to the cap holder.

18.48 A cap writer has virtually unlimited risk resulting from increases in interest rates above the cap rate. However, the cap writer's premium may potentially provide an attractive return.

18.49 *Interest-rate floors* are similar to interest-rate caps. Interest-rate floors are contracts in which the floor writer, in return for a premium, agrees to limit the risk associated with a decline in interest rates based on a notional amount for a certain period of time. If rates fall below an agreed rate, the floor holder will receive cash payments from the floor writer equal to the difference between the market rate and an agreed rate multiplied by the notional principal amount. Floor contracts allow floating-rate lenders to limit the risk associated with a decline in interest rates while benefiting from an increase in rates. As with interest-rate caps, the floor holder is exposed to credit risk because the floor writer could fail to fulfill its obligations.

18.50 *Interest-rate collars* combine a cap and a floor (one held and one written). Interest-rate collars enable an institution with a floating-rate contract to lock into a predetermined interest-rate range.

18.51 *Swaptions* are option contracts to enter into an interest-rate swap contract at some future date or to cancel an existing swap contract in the future. As such, a swaption contract may act as a floor or a cap for an existing swap contract or be used as an option to enter, close out, or extend a swap contract in the future.

18.52 Various contracts may need to be evaluated as possible derivatives including warrants, the embedded conversion feature in convertible debt, and other embedded derivatives that may or may not require bifurcation. Warrants generally meet the definition of a derivative and should be accounted for as such unless they meet the exception criteria in paragraphs 74–75 of FASB ASC 815-10-15 (see also FASB ASC 815-40 for additional information). Features embedded in contracts or agreements may require separate accounting as a derivative, and complex pricing structures may increase the complexity of the assumptions used in estimating the fair value of a derivative. Warrants and embedded derivatives are less likely to be identified by management as

requiring derivative treatment, which increases the inherent risk for certain assertions. For example, an option to convert the principal outstanding under a loan agreement into equity securities is less likely to be identified for valuation and disclosure considerations if it is a clause in a loan agreement than if it is a freestanding agreement. Similarly, a structured note may include a provision for payments related to changes in a stock index or commodities prices that requires separate accounting. Certain embedded interest structures also require separate accounting. For additional information on evaluating embedded derivatives for bifurcation see FASB ASC 815-15-25.

18.53 *Credit derivatives* are derivatives based on an index, basket of reference entities, or single name reference entity where settlement is determined by the credit performance of the reference entity. The writer of a credit derivative receives a premium (either paid up front or over the life of the contract) as compensation for an obligation to make a payment should a defined credit event occur on the underlying referenced obligation(s). Credit events may include bankruptcy, failure to pay, or repudiation. These instruments may be used by banks to reduce or modify the credit exposure of their loan or investment portfolios.

Uses of Derivatives to Alter Risk

18.54 Financial market participants have created a large variety of derivatives. Not only are there basic contracts, but there are variants tailored to add, subtract, multiply, or divide the related risk and reward characteristics and thereby satisfy specific risk objectives of the parties to the transactions. Such innovation has been driven by the users' desire to cope with (or attempt to take advantage of) market volatility in foreign exchange rates, interest rates, and other market prices; deregulation; tax law changes; and other broad economic or business factors. An institution may attempt to alter such risks (*a*) at a general level (that is, the overall risk exposures faced by the institution), (*b*) at the level of specific portfolios of assets or liabilities, or (*c*) narrowly to a specific asset, liability, or anticipated transaction. Uses of derivatives to alter risks range from uses that help mitigate or control volatile risk exposures (activities that include the idea of taking defensive action against risk through hedging) to uses that increase exposures to risk and, by that, the potential rewards (the idea of offensive action, often considered as trading or speculation).

18.55 *Speculation.* Speculation involves the objective of profiting by entering into an exposed position. That is, assuming risk in exchange for the opportunity to profit from anticipated market movements. A speculator believes that the cash market price of an underlying commodity, financial instrument, or index will change so that the derivative produces net cash inflows or can be closed out in the future at a profit. By simultaneously buying the relatively cheaper item and selling the relatively more expensive item, speculation serves a key function in the financial markets by eliminating price differences and works to keep markets and their prices efficient. See discussion of the Volcker Rule prohibiting banks from propriety trading in paragraphs 1.38 and 18.76 of this guide.

18.56 *Risk management.* Some institutions use derivatives to increase or decrease risks associated with existing or anticipated on- or off-balance sheet transactions. Institutions often manage financial risks both generally (through management of the overall mix of financial assets and liabilities) and specifically (through hedges of specific risks or transactions). Risk managers typically

look at the mix of the institution's interest-based assets and liabilities and attempt to naturally hedge those instruments where offset is possible. Any excess or shortfalls in the natural hedges may then be offset by looking to derivatives and other financial instruments to achieve the degree of offset necessary to insulate the institution from movements in market interest rates.

18.57 Some entities continually analyze and manage financial assets and liabilities based on their payment streams and interest rates, the timing of their maturities, and their sensitivity to actual or potential changes in market prices or interest rates. Such activities fall under the broad definition of *asset/liability management*. Some institutions purchase derivatives to help manage and select their total exposure to IRR. Institutions also purchase derivatives to convert the cash flow pattern and market risk profile of assets and liabilities. Those instruments can be used in the institution's asset/liability management activities to synthetically alter the interest income and expense flows of certain assets or liabilities. For example, an institution can convert the cash flow pattern and market risk profile of floating-rate debt to those of fixed-rate debt by entering an interest-rate swap contract. (Note that synthetic instrument accounting is prohibited by FASB ASC 815-10-25-4).

18.58 *Hedging* connotes a risk alteration activity to protect against the risk of adverse price or interest-rate movements on certain of an institution's assets, liabilities, or anticipated transactions. A *hedge* is a defensive strategy. It is used to avoid or reduce risk by creating a relationship by which losses on certain positions (assets, liabilities, or anticipated transactions) are expected to be counterbalanced in whole or in part by gains on separate positions in another market. For example, an institution may want to attempt to fix the value of an asset, the sales price of some portion of its future production, the rate of exchange for payments to its suppliers, or the interest rates of an anticipated issuance of debt.

18.59 The use of various financial instruments to reduce certain risks results in the hedger assuming a different set of risks. Effective control and management of risks through hedging, usually depends on a thorough understanding of the market risks associated with the financial instrument that is part of the hedging program.

18.60 *Basis risk* is an important risk encountered with most hedging contracts. As introduced above, basis is the difference between the cash market price of the instrument or other position being hedged and the price of the related hedging contract. The institution is subject to the risk that the basis will change while the hedging contract is open (that is, the price correlation will not be perfect). Changes in basis can occur continually and may be significant. Changes in basis can occur even if the position underlying the hedging contract is the same as the position being hedged. However, entities often enter a hedging contract, such as a futures contract, on a position that is different from the position being hedged. Such *cross-hedging* increases the basis risk.

18.61 As cash market prices change, the prices of related hedging contracts change, but not necessarily to the same degree. *Correlation* is the degree to which hedging contract prices reflect the price movement in the cash market. The higher the correlation between changes in the cash market price and the hedging contract's price, the higher the precision with which the hedging contract will offset the price changes of the position being hedged (that is, less basis risk).

18.62 Gains or losses on the hedge position will not exactly offset the exposed cash market positions when the basis changes. The institution might enter a hedge when (*a*) it is perceived that the risk of a change in basis is lower than the risk associated with the cash market price exposure or (*b*) there is the ability to monitor the basis and to adjust the hedge position in response to basis changes.

18.63 Basis changes in response to many factors. Among them are (*a*) economic conditions, (*b*) supply and demand for the position being hedged, (*c*) liquidity of the cash market and the futures market for the instrument, (*d*) the credit rating of the cash instrument, and (*e*) the maturity of the instrument being hedged as compared with the instrument represented in the hedging contract. A discussion of how these factors affect basis is beyond the scope of this chapter. However, convergence—a significant contributor to a change in the basis over time—warrants mention.

18.64 *Convergence* is the shrinking of the basis between the hedging contract's price and the cash market price as the contract delivery date approaches. The hedging contract's price includes an element related to the time value up to the expiration of the contract. Convergence results from the delivery feature of hedging contracts that encourages the price of an expiring contract to equal the price of the deliverable cash market instrument on the day that the contract expires. As the delivery day approaches, prices generally fluctuate less and less from the cash market prices because the effect of expectations related to time is diminishing.

18.65 *The correlation factor* represents the potential effectiveness of hedging a cash market instrument with a contract where the deliverable financial instrument differs from the cash market instrument. The correlation factor generally is determined by regression analysis or another method of technical analysis of market behavior. When a high degree of positive correlation has historically existed between the hedging instrument price and the cash market price of the instrument being hedged, the risk of price variance associated with a cross-hedge is expected to be lower than the risk of not being hedged. Institutions usually employ the correlation factor to analyze cross-hedging risk at the inception of the hedge, while actual changes in the relative values of the hedge instrument and the hedged item usually are employed throughout the hedge period to measure correlation.

Variations on Basic Derivatives

18.66 Some derivatives combine two or more basic contracts and thereby the risk and reward characteristics of several different products. Written options and other variations embedded in certain derivative and nonderivative contracts can magnify interest-rate and other risks assumed by the institution as end user. Included may be variations affecting the term, notional amount, interest rate, or specified payments. These variations have the potential to produce higher cash inflows or outflows than similar instruments that do not contain the option feature. This follows the general rule that the greater the potential return, the higher the risk.

18.67 Some swap contracts involve the institution's writing of options that the counterparty issuer may exercise if certain changes occur in the index rate or under other specified circumstances. As with most option contracts (and allowing for the effect of the premium paid for the contract) the holder of the option (here, the counterparty) has a potentially favorable (or neutral) outcome,

while the writer of the option (here, the institution) has a potentially unfavorable (or neutral) outcome if the option is exercised. For example, the counterparty will exercise an option to sell securities to the institution at a specified price only when that price exceeds the current market prices. Accordingly, the institution must analyze such contracts carefully to understand the nature of the derivative and how it will work under various interest-rate and other conditions.

18.68 *Other variations.* Other variations built into derivatives may necessitate certain actions be taken by the institution or may result in changes in terms if specified events or conditions occur. For example, such variations might involve

- increases or decreases in the notional amount based on certain changes in interest rates;
- increases or decreases in interest rates based on a multiplier;
- additional payments as a result of specified conditions; and
- a settlement payment based upon the expiration of a contract.

18.69 Some swap contracts magnify changes in the specified index rate by tying floating payments to an exponent of the index rate over a specified denominator. The risks of this variation, a contract with embedded leverage terms, are similar to the risks posed by written options. Consider a contract that specifies the floating rate as 3-month LIBOR squared and divided by 5 percent. Assume that 3-month LIBOR is 5 percent at inception. If 3-month LIBOR were to climb 5 basis points to 5.05 percent, the increase would be magnified. The floating rate would increase 10 basis points to approximately 5.10 percent (5.05 percent squared and divided by 5 percent). Thus, at this level of interest rates, an increase of 1 basis point in the index rate for the contract would result in an increase of 2 basis points in the contractual rate—in other words, 1 basis point on twice the stated notional amount.

18.70 Finally, the notional principal amount of certain swap contracts changes with changes in the rate to which the floating payments are indexed. These are called index amortizing swaps. For example, the notional principal amount may decrease when interest rates decline. Thus, the floating-rate payer would lose some of the benefit of declining interest rates but would not get a corresponding benefit if interest rates increase.

Regulatory Matters[1]

18.71 Banking Circular 277, "Risk Management of Financial Derivatives," issued by the Office of the Comptroller of the Currency (OCC), addresses banks' risk management of derivatives and sets forth best practices and procedures for managing risk. OCC Bulletin 94-31, "Risk Management of Financial Derivatives Q & A's," answers commonly asked questions about Banking Circular 277. The Board of Governors of the Federal Reserve System (FRB) issued detailed guidance to its examiners for evaluating derivatives with respect to management oversight, measurements and monitoring procedures, and internal controls in Supervisory and Regulatory Letters 96-17, "Supervisory Guidance for Credit Derivatives," 97-18, "Application of Market Risk Capital Requirements

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[1] Chapter 7, "Investments in Debt and Equity Securities," discusses the regulatory matters affecting the permissibility of certain investments.

to Credit Derivatives," 99-1, "Interim Regulatory Reporting and Capital Guidance on FAS 133, *Accounting for Derivative Instruments and Hedging Activities*" and 02-10, "Derivative Contracts Hedging Trust Preferred Stock." The Federal Deposit Insurance Corporation (FDIC) issued guidance for its examiners in FDIC Financial Institution Letter-62-96, "Credit Derivatives" and 45-98, "Investment Activities." The Office of the Thrift Supervision (OTS) issued Thrift Bulletin 13a, "Management of Interest Rate Risk, Investment Securities, and Derivatives Activities," which provides guidance to management and boards of directors on management of IRR, including the management of investment and derivative activities. "Derivatives: Practice and Principles and related Appendices," published by the Global Derivatives Study Group in 1993, also recommends a set of sound risk management practices for dealers and end-users of derivatives.

18.72 Intercompany transactions and performance of services between two or more U.S. Bank legal vehicles and all their affiliates must be conducted in compliance with the applicable statutory and regulatory requirements of Sections 23A–23B of the Federal Reserve Act (*Banks and Banking*, U.S. Code 12, Section 371c and 371c–1) and Regulation W (Title 12 U.S. *Code of Federal Regulations* [CFR] Part 223) of the Federal Reserve. Derivative transactions are subject to the market terms requirement of Section 23B. Accordingly, each institution would price, and require collateral in, derivative transactions with affiliates in a way that is at least as favorable to the institution as the way the institution would price, or require collateral in, a derivative transaction with comparable unaffiliated counterparties. Credit derivatives that are the functional equivalent of a guarantee are also subjected to Section 23A and, the FRB suggests that other derivative transactions that are the functional equivalent of a loan might be subject to the requirements of Section 23A, depending on facts and circumstances. Regulation W also requires the bank to have policies and procedures in place to manage the credit exposure arising from derivatives with affiliates in a safe and sound manner (see 12 CFR 223.33(b)).

18.73 The Federal Financial Institutions Examination Council *Advisory on Interest Rate Risk Management* was issued on January 6, 2010. The advisory reminds institutions of the supervisory expectations regarding sound practices for managing IRR. Using derivative instruments to mitigate IRR exposures may be appropriate for institutions with the knowledge and expertise in these instruments. Hedging with interest rate derivatives is a potentially complex activity that can have unintended consequences, including compounding losses, if used incorrectly. Each institution using derivatives should establish an effective process for managing IRR. Federal credit unions may only enter into derivative transactions upon receiving prior approval from the National Credit Union Administration.

18.74 On March 22, 2010, the OCC, FRB, FDIC, OTS (collectively, the federal banking agencies) and the National Credit Union Administration issued *Interagency Policy Statement on Funding and Liquidity Risk Management*. The policy statement summarizes the principles of sound liquidity risk management that the agencies have issued in the past and, when appropriate, supplements them with the "Principles for Sound Liquidity Risk Management and Supervision" issued by the Basel Committee on Banking Supervision in September 2008. This policy statement emphasizes supervisory expectations for all depository institutions including banks, thrifts, and credit unions.

18.75 Policies on funding and liquidity risk management should clearly articulate a liquidity risk tolerance that is appropriate for the business strategy of the institution considering its complexity, business mix, liquidity risk profile,

and its role in the financial system. Policies should also contain provisions for documenting and periodically reviewing assumptions used in liquidity projections. Policy guidelines should employ both quantitative targets and qualitative guidelines. For example, these measurements, limits, and guidelines may be specified in terms of the measures and conditions mentioned in the policy statement, as applicable to derivatives (for example, contingent liability exposures such as unfunded loan commitments, lines of credit supporting asset sales or securitizations, and collateral requirements for derivative transactions and various types of secured lending; or exposures of material activities, such as securitization, derivatives, trading, transaction processing, and international activities, to broad systemic and adverse financial market events. This is most applicable to institutions with complex and sophisticated liquidity risk profiles).

18.76 In February 2011, the FRB adopted a final rule, *Conformance Period for Entities Engaged in Prohibited Proprietary Trading or Private Equity Fund or Hedge Fund Activities*. This rule was adopted to implement the conformance period during which banking entities and nonbank financial companies supervised by the FRB must bring their activities and investments into compliance with the prohibitions and restrictions on proprietary trading and relationships with hedge funds and private equity funds imposed by section 619 (commonly referred to as the Volcker Rule) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (see additional discussion in chapter 1, "Industry Overview—Banks and Savings Institutions"). This rule became effective on April 1, 2011. The final rule has been incorporated into Regulation Y (12 CFR Part 225).

18.77 In June 2011, the federal banking agencies issued *Interagency Supervisory Guidance on Counterparty Credit Risk*. The guidance clarifies supervisory expectations and sound practices for an effective counterparty credit risk management framework. The guidance emphasizes that banks should use appropriate reporting metrics and limits systems, have well-developed and comprehensive stress testing, and maintain systems that facilitate measurement and aggregation of counterparty credit risk throughout the organization. The guidance applies to banks with significant derivatives portfolios. It does not apply to banks with limited derivatives exposure, particularly noncomplex exposures that are typical for community banks, such as embedded caps and floors on assets or liabilities, forward agreements to sell mortgages, or isolated interest rate swaps. Banks using derivatives that are more complex or those with significant noncomplex derivatives exposure should refer to the guidance for applicable risk management principles and practices.

Accounting and Financial Reporting[†]

18.78 FASB ASC 815-10-05-4 requires that an entity recognize derivative instruments, including certain derivative instruments embedded in other contracts as assets or liabilities, in the statement of financial position and measure

[†] In May 2010, the Financial Accounting Standards Board (FASB) issued a proposed Accounting Standards Update (ASU), *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities—Financial Instruments (Topic 825) and Derivatives and Hedging (Topic 815)*. The main objective of this proposal is to provide financial statement users with a more timely and representative depiction of an entity's involvement in financial instruments while reducing the complexity in accounting for those instruments. It develops a consistent framework for classifying financial instruments, removes the threshold for recognizing credit impairments creating a single credit impairment model for both loans and debt securities, and makes changes to the requirements to qualify for hedge accounting.

them at fair value. If certain conditions are met, an entity may elect, under FASB ASC 815, to designate a derivative instrument in any one of the following ways:

a. A hedge of the exposure to changes in the fair value of a recognized asset or liability, or an unrecognized firm commitment, that are attributable to a particular risk (referred to as a fair value hedge)

b. A hedge of the exposure to variability in the cash flows of a recognized asset or liability, or of a forecasted transaction, that is attributable to a particular risk (referred to as a cash flow hedge)

c. A hedge of the foreign currency exposure of a net investment in a foreign operation, an unrecognized firm commitment (a foreign currency fair value hedge), an available-for-sale security (a foreign currency fair value hedge), or a forecasted transaction (a foreign currency cash flow hedge)

18.79 FASB ASC 820-10-20 defines *fair value* as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. FASB ASC 820-10-35-5 states that a fair value measurement assumes that the transaction to sell the asset or transfer the liability either occurs in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability. The FASB ASC glossary defines the *principal market* as the market in which the reporting entity would sell the asset or transfer the liability with the greatest volume and level of activity for the asset or liability. The principal market (and thus, market participants) should be considered from the perspective of the reporting entity, thereby allowing for differences between and among entities with different activities. If the market in which the transaction occurs is different from the market in which the reporting entity would sell the asset or transfer the liability, that is, the principal or most advantageous market, the transaction price might not represent the fair value of an asset or liability at initial recognition as stated in FASB ASC 820-10-30-3(d). Under FASB ASC 820-10-35-53, when relevant observable inputs are not otherwise available, the use of unobservable data to measure fair value is permitted. See chapter 20, "Fair Value," of this guide and FASB ASC 820, *Fair Value Measurement*, for additional information.[‡]

(footnote continued)

On February 9, 2011, FASB issued a discussion paper, *Invitation to Comment—Selected Issues about Hedge Accounting*, to solicit input on the International Accounting Standards Board's (IASB's) exposure draft, *Hedge Accounting*, in order to improve, simplify, and converge the financial reporting requirements for hedging activities.

Readers are encouraged to visit the FASB website for the latest developments regarding the accounting for financial instruments project, including a summary of decisions reached to date since the issuance of the proposed guidance.

[‡] In May 2011, FASB issued ASU No. 2011-04, *Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*. The amendments in this ASU result in common fair value measurement and disclosure requirements in accounting principles generally accepted in the United States of America (U.S. GAAP) and International Financial Reporting Standards. The amendments alter the wording used to describe many of the requirements in U.S. GAAP for measuring fair value and for disclosing information about fair value measurements. The ASU does not require additional fair value measurements and is not intended to establish valuation standards or affect valuation practices outside of financial reporting.

The amendments in this ASU are effective prospectively (1) for public entities, for interim and annual periods beginning after December 15, 2011, and (2) for nonpublic entities, for annual periods beginning after December 15, 2011. Early application is not permitted for public entities. Early application is permitted for nonpublic entities, but only for interim periods

18.80 The specific criteria for qualifying for hedge accounting vary depending on the type of hedge. (FASB ASC 815-20-25 sets forth criteria that must be met for designated hedging instruments and hedged items or transactions to qualify for fair value hedge accounting, cash flow hedge accounting, and accounting for a hedge of a net investment in a foreign operation.) FASB ASC 815-20-25-3 prescribes requirements for designation and documentation of the hedge at inception for cash flow and fair value hedges. One aspect of qualification should include an assessment of the expectation of effective offsetting changes in fair values or cash flows during the term of the hedge for the risk being hedged, as stated in FASB ASC 815-10-10-1(d). To meet the documentation requirement applicable to fair value, cash flow, and net investment hedges, at the inception of the hedge, management must designate the derivative as a hedge and contemporaneously formally document the hedging relationship, including identification of all of the following as stated in FASB ASC 815-20-25-3(b):

- The hedging relationship.
- The entity's risk management objective and strategy for undertaking the hedge, including identification of all of the following:
  - The hedging instrument.
  - The hedged item or transaction.
  - The nature of the risk being hedged.
  - The method that will be used on an ongoing basis to retrospectively and prospectively assess the hedging instrument's effectiveness in offsetting the exposure to changes in the hedged item's fair value (if a fair value hedge) or hedged transaction's variability in cash flows (if a cash flow hedge) attributable to the hedged risk. There should be a reasonable basis for how the entity plans to assess the hedging instrument's effectiveness.
  - The method that will be used to measure hedge ineffectiveness (including those situations in which the change in fair value method as described in paragraphs 31–32 of FASB ASC 815-30-35 will be used).
  - If the entity is hedging foreign currency risk on an after-tax basis, that the assessment of the effectiveness, including the calculation of ineffectiveness, will be on an after-tax basis (rather than on a pretax basis).

18.81 Paragraphs 3(c)–(d) of FASB ASC 815-20-25 also include additional documentation requirements applicable specifically to either fair value hedges or cash flows hedges. Paragraphs 4–72 of FASB ASC 815-20-25 address eligibility criteria for hedged items and transactions.

18.82 FASB ASC 815-10-35-2 states that the accounting for changes in the fair value (that is, gains and losses) of a derivative instrument depends on whether it has been designated and qualifies as part of a hedging relationship and, if so, the reason for holding it.

18.83 Companies typically receive periodic fair value reporting from the counterparty. These fair values may or may not conform to the requirements of

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(footnote continued)

beginning after December 15, 2011. See FASB ASC 820-10-65-8 for further information regarding changes in valuation technique as a result of implementation of respective guidance. Readers should consult the text of ASU No. 2011-04 for further information.

FASB ASC 820. As such, additional consideration of these values may be warranted. See chapter 20 for additional information regarding fair value measurements and disclosures.

18.84 *Guarantees.* According to FASB ASC 460-10-25-1, a guarantee that is accounted for as a derivative instrument at fair value under FASB ASC 815 is not subject to the recognition provisions of FASB ASC 460, *Guarantees*. The contingent aspect of the guarantee should be accounted for in accordance with FASB ASC 450-20 unless the guarantee is accounted for as a derivative under FASB ASC 815, according to FASB ASC 460-10-35-4.

18.85 The loss contingency disclosures required by FASB ASC 460-10-50 apply to all guarantees, including a guarantee accounted for as derivative instruments at fair value under FASB ASC 815 (however, this guidance does not apply to guarantees or indemnifications excluded from the scope of FASB ASC 450, *Contingencies*, as described in FASB ASC 460-10-15-7(a)). According to FASB ASC 460-10-50-5(c), the disclosure requirements of FASB ASC 460-10-50 do not eliminate or affect the disclosure requirements in the disclosure sections of FASB ASC 815, which apply to guarantees that are accounted for as derivatives.

18.86 *Offsetting.*[||] Paragraphs 1–2 of FASB ASC 210-20-05 state that it is a general principle of accounting that the offsetting of assets and liabilities in the balance sheet is improper except where a right of setoff exists. The general principle that the offsetting of assets and liabilities is improper except where a right of setoff exists is usually thought of in the context of unconditional receivables from and payables to another party. The general principle also applies to conditional amounts recognized for contracts under which the amounts to be received or paid or items to be exchanged in the future depend on future interest rates, future exchange rates, future commodity prices, or other factors. The FASB ASC glossary defines *right of setoff* as a debtor's legal right, by contract or otherwise, to discharge all or a portion of the debt owed to another party by applying against the debt an amount that the other party owes to the debtor. FASB ASC 210-20-45-1 specifies what conditions must be met to have that right. FASB ASC 210-20-45-9 states that the phrase *enforceable at law* encompasses the idea that the right of setoff should be upheld in bankruptcy.

[||] In January 2011, FASB issued the proposed ASU *Balance Sheet Offsetting*. The proposed guidance was initiated as a joint project between FASB and the IASB to provide users of financial statements with information to understand the extent of offsetting in the statement of financial position and improve comparability between International Financial Reporting Standards and U.S. GAAP. The proposed guidance as issued would eliminate the exception in U.S. GAAP that allows offsetting for some derivative and sale and repurchase (and reverse sale and repurchase) contracts when the right of setoff is conditional, there is no intention to set off, or such intention is conditional. The proposed guidance would also enhance disclosures required by U.S. GAAP by requiring improved information about eligible assets and eligible liabilities subject to setoff, and related arrangements (such as collateral arrangements) and the effect of those arrangements on an entity's financial position.

In June 2011, FASB and the IASB discussed alternative approaches for requiring offsetting of financial assets and financial liabilities on the face of the balance sheet. The majority of FASB board members supported providing an exception from the general offsetting criteria for derivative instruments, which would allow offsetting of fair value amounts recognized for derivatives and fair value amounts recognized for the right to reclaim cash collateral or the obligation to return cash collateral arising from derivative instruments recognized at fair value with the same counterparty under a master netting arrangement. During July 2011, FASB and IASB also discussed revisions to the proposed offsetting disclosures.

Readers are encouraged to visit the FASB website for the latest developments regarding the offsetting project, including a summary of decisions reached to date since the issuance of the proposed guidance. FASB expects to issue final guidance during 2011.

18.87 Paragraphs 1–7 of FASB ASC 815-10-45 address offsetting certain amounts related to derivative instruments. For purposes of this guidance, derivative instruments include those that meet the definition of a derivative instrument but are not included in the scope of FASB ASC 815-10. None of the provisions in FASB ASC 815-10 support netting a hedging derivative's asset (or liability) position against the hedged liability (or asset) position in the balance sheet. Unless the conditions in FASB ASC 210-20-45-1 are met, the fair value of derivative instruments in a loss position should not be offset against the fair value of derivative instruments in a gain position. Similarly, amounts recognized as accrued receivables should not be offset against amounts recognized as accrued payables unless a right of setoff exists. Without regard to the condition in FASB ASC 210-20-45-1(c), a reporting entity may offset fair value amounts recognized for derivative instruments and fair value amounts recognized for the right to reclaim cash collateral (a receivable) or the obligation to return cash collateral (a payable) arising from derivative instrument(s) recognized at fair value executed with the same counterparty under the same master netting arrangement.

18.88 FASB ASC 230-10-45-27 states that cash flows from a derivative instrument that is accounted for as a fair value hedge or cash flow hedge may be classified in the same category as the cash flows from the items being hedged provided that the derivative instrument does not include an other-than-insignificant financing element at inception, other than a financing element inherently included in an at-the-market derivative instrument with no prepayments (that is, the forward points in an at-the-money forward contract) and that the accounting policy is disclosed. If the derivative instrument includes an other-than insignificant financing element at inception, all cash inflows and outflows of the derivative instrument should be considered cash flows from financing activities by the borrower. If for any reason hedge accounting for an instrument that hedged an identifiable transaction or event is discontinued, then any cash flows after the date of discontinuance should be classified consistent with the nature of the instrument.

18.89 *Securities and Exchange Commission (SEC) Market Risk Disclosure Rules*.[2] Item 305 of Regulation S-K requires entities filing with the SEC to disclose certain information about market risk. In general, the rule

a. requires quantitative and qualitative disclosures about market risk inherent in derivatives and other financial instruments outside the financial statements; and

b. provides a reminder to registrants to supplement existing disclosures about financial instruments, commodity positions, firm commitments, and other forecasted transactions with related disclosures about derivatives.

18.90 *SEC Management's Discussion and Analysis (MD&A) Requirements*.[3] Item 303 of Regulation S-K requires institutions to discuss, in their MD&A, any known trends or any known demands, commitments, events or uncertainties that the institution reasonably expects to have a material favorable or unfavorable impact on their results of operations, liquidity, and capital resources.

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[2] Refer to the Securities and Exchange Commission website for the complete disclosure requirements under Regulation S-K (http://ecfr.gpoaccess.gov/cgi/t/text/text-idx?c=ecfr&sid=d1265013c475a5159730851d382ae335&tpl=/ecfrbrowse/Title17/17cfr229_main_02.tpl).

[3] See footnote 2.

18.91 *Written loan commitments.* In accordance with FASB ASC 815-10, loan commitments that relate to the origination of mortgage loans that will be held for sale, as discussed in FASB ASC 948-310-25-3, are required to be accounted for, by the issuer of the loan commitment, as derivative instruments at fair value. Recording a written loan commitment at its initial fair value may result in the recognition in an initial asset and gain, or an initial liability and loss.

18.92 Consistent with the guidance in FASB ASC 860-50 and FASB ASC 825-10, the SEC's *Codification of Staff Accounting Bulletins* topic 5DD, "Written Loan Commitments Recorded at Fair Value Through Earnings," states the expected net future cash flows related to the associated servicing of a loan should be included in the measurement of all written loan commitments that are accounted for at fair value through earnings. The expected net future cash flows should be determined in the same manner that the fair value of a recognized servicing asset or liability is measured under FASB ASC 860-50. However, as discussed in paragraphs 1–2 of FASB ASC 860-50-30, a separate and distinct servicing asset or liability is not recognized for accounting purposes until the servicing rights have been contractually separated from the underlying loan by sale or securitization of the loan with servicing retained.

18.93 The preceding guidance should be applied irrespective of whether the resulting loan is intended to be sold servicing released or servicing retained.

Financial Statement Disclosures

18.94 According to FASB ASC 815-10-50-1, an entity with derivative instruments (or nonderivative instruments that are designated and qualify as hedging instruments pursuant to paragraphs 58 and 66 of FASB ASC 815-20-25) should disclose information to enable users of the financial statements to understand all of the following:

- How and why an entity uses derivative instruments (or such nonderivative instruments)
- How derivative instruments (or such nonderivative instruments) and related hedged items are accounted for under FASB ASC 815
- How derivative instruments (or such nonderivative instruments) and related hedged items affect an entity's financial position, financial performance, and cash flows

18.95 Paragraphs 4A–4F of FASB ASC 815-10-50 require certain quantitative disclosures about fair value amounts of and gains and losses on derivative instruments.

18.96 Paragraphs 4J–4L of FASB ASC 815-10-50 require certain disclosures about credit derivatives and hybrid instruments (for example, a credit-linked note) that have embedded credit derivatives with the objective of providing insight into their potential effect on the entity's financial position, financial performance, and cash flows. These disclosures, however, do not apply to an embedded derivative feature related to the transfer of credit risk that is only in the form of subordination of one financial instrument to another as described in FASB ASC 815-15-15-9.

18.97 FASB ASC 815-10-50-5 provides additional information to consider related to qualitative disclosures. Qualitative disclosures about an entity's objectives and strategies for using derivative instruments (and nonderivative instruments that are designated and qualify as hedging instruments pursuant

to FASB ASC 815-20-25-58 and FASB ASC 815-20-25-66) may be more meaningful if such objectives and strategies are described in the context of an entity's overall risk exposures relating to IRR, foreign exchange risk, commodity price risk, credit risk, and equity price risk. Those additional qualitative disclosures, if made, should include a discussion of those exposures even though the entity does not manage some of those exposures by using derivative instruments. An entity is encouraged, but not required, to provide such additional qualitative disclosures about those risks and how they are managed.

18.98 As stated in FASB ASC 825-10-50-20, except as indicated in FASB ASC 825-10-50-22, an entity should disclose all significant concentrations of credit risk arising from all financial instruments, whether from an individual counterparty or groups of counterparties. Throughout paragraphs 20–21 of FASB ASC 825-10-50, the term *financial instruments* includes derivative instruments accounted for under FASB ASC 815. Group concentrations of credit risk exist if a number of counterparties are engaged in similar activities and have similar economic characteristics that would cause their ability to meet contractual obligations to be similarly affected by changes in economic or other conditions.

Auditing Considerations

18.99 AU section 332[*] provides guidance on auditing procedures for assertions about derivative instruments, hedging activities, and investments in securities that are made in an entity's financial statements. In addition, the companion Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* provides practical guidance for implementation on all types of audit engagements. See chapter 12 of this audit guide for a case study of separately accounting for a derivative embedded in a bond. The suggested auditing procedures contained in the guide do not increase or otherwise modify the auditor's responsibilities described in AU section 332. Rather, the suggested procedures in the guide are intended to clarify and illustrate the application of the requirements of AU section 332. In addition, AU section 328, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*),[#] addresses audit considerations relating to the measurement and disclosure of assets, liabilities, and specific components of equity presented or disclosed at fair value in financial statements.[4]

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[*] See footnote * in paragraph 18.04.

[#] The ASB has finalized a new clarified auditing standard, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*. This auditing standard, which will supersede AU section 328, *Auditing Fair Value Measurements and Disclosures*, and AU section 342, *Auditing Accounting Estimates* (AICPA, *Professional Standards*), addresses the auditor's responsibilities relating to accounting estimates including fair value accounting estimates and related disclosures. Additionally, it expands on how other clarified auditing standards are to be applied in relation to accounting estimates, and includes requirements and guidance related to misstatements of individual accounting estimates and indicators of possible management bias. This clarified auditing standard has been finalized but not yet issued. See the preface of this guide for further information on the ASB's Clarity Project. The expected date of this clarified standard is for audits of financial statements for periods ending on or after December 15, 2012, unless otherwise established (early implementation is not permitted).

[4] For additional guidance refer to Interpretation No. 1, "Auditing Interests in Trusts Held by a Third-Party Trustee and Reported at Fair Value," of AU section 328 (AICPA, *Professional Standards*, AU sec. 9328 par. .01) and Interpretation No. 1, "Auditing Investments in Securities Where a Readily Determinable Fair Value Does Not Exist" of AU section 332 (AICPA, *Professional Standards*, AU sec. 9332 par. .01), respectively.

18.100

Considerations for Audits Performed in Accordance with Public Company Accounting Oversight Board (PCAOB) Standards[5]

PCAOB Staff Audit Practice Alert No. 2, *Matters Related to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400 par. .02), provides guidance on auditors' responsibilities for auditing fair value measurements of financial instruments and when using the work of specialists under the existing standards of the PCAOB. This alert is focused on specific matters that are likely to increase audit risk related to the fair value of financial instruments in a rapidly changing economic environment. This practice alert highlights certain requirements in the auditing standards related to fair value measurements and disclosures in the financial statements and certain aspects of generally accepted accounting principles that are particularly relevant to the current economic environment.

PCAOB Staff Audit Practice Alert No. 3, *Audit Considerations in the Current Economic Environment* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400 par. .03), assists auditors in identifying matters related to the current economic environment that might affect audit risk and require additional emphasis. This practice alert is organized into six sections: (*a*) overall audit considerations; (*b*) auditing fair value measurements; (*c*) auditing accounting estimates; (*d*) auditing the adequacy of disclosures; (*e*) auditor's consideration of a company's ability to continue as a going concern; and (*f*) additional audit considerations for selected financial reporting areas.

PCAOB Staff Audit Practice Alert No. 4, *Auditor Considerations Regarding Fair Value Measurements, Disclosures, and Other-Than-Temporary Impairments* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400 par. .04), informs auditors about potential implications of the recent guidance on reviews of interim financial information and annual audits. This alert addresses the following topics: (*a*) reviews of interim financial information (reviews); (*b*) audits of financial statements, including integrated audits; (*c*) disclosures; and (*d*) auditor reporting considerations.

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[5] Public Company Accounting Oversight Board Staff Audit Practice Alerts are not rules of the board and do not reflect any board determination or judgment about the conduct of any particular firm, auditor, or any other person.

Chapter 19
Business Combinations

Introduction

19.01 Business combinations may involve one enterprise acquiring the equity interests or net assets of another enterprise or both enterprises transferring their equity interests or net assets to a newly formed enterprise. Business combinations involving depository institutions are common and result from voluntary decisions as well as regulatory mandates. Most business combination issues are the same for depository institutions as for other business enterprises. This chapter addresses only significant issues that are unique to depository institutions.

Regulatory Matters

19.02 The Office of Thrift Supervision (OTS) requires the auditors for both the purchasing and selling institutions to opine on whether the transaction has been accounted for in conformity with U.S. generally accepted accounting principles (GAAP) as part of its application approval process.

19.03 Staff Accounting Bulletin (SAB) No. 112, which was issued by the Securities and Exchange Commission (SEC) in June 2009, amends or rescinds portions of the SEC's interpretative guidance regarding business combinations (codified in the SEC *Codification of Staff Accounting Bulletins*, topic 2, "Business Combinations"). This guidance was amended to make the SEC's interpretative guidance consistent with accounting guidance in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 805, *Business Combinations*, and FASB ASC 810, *Consolidations*. Among other changes, SEC *Codification of Staff Accounting Bulletins* topic 2(A)(5), which provided guidance on assigning acquisition costs to loans receivable acquired in a business combination, was removed. FASB ASC 805 provides new guidance that requires acquired receivables, including loans, to be measured at their acquisition date fair value and precludes the acquirer from recognizing a separate valuation allowance at the acquisition date for assets acquired in a business combination. In addition, SAB No. 112 amended SEC *Codification of Staff Accounting Bulletins* topic 2(A)(6), "Debt Issue Costs," to conform to the requirement in FASB ASC 805-10-25-23 that acquisition-related costs be accounted for as expenses in the period in which the costs are incurred and services are received, except for costs incurred to issue debt or equity securities which are recognized in accordance with other applicable U.S. GAAP. The full text of SAB No. 112 is located on the SEC website at www.sec.gov/interps/account/sab112.htm.

19.04 In certain circumstances, an acquired bank or savings institution uses the acquiring institution's basis of accounting in preparing the acquired institution's financial statements. These circumstances are addressed for SEC registrants in the SEC *Codification of Staff Accounting Bulletins* topic 5(J), "New Basis of Accounting Required in Certain Circumstances." As stated in FASB ASC 805-50-25-3, push down accounting is not required for entities that are not SEC registrants. While not required, push down accounting may be permitted for non-SEC registrants.

19.05 However, the Federal Financial Institutional Examination Council (FFIEC) *requires* push down accounting for Reports of Condition and Income (also known as call reports) if a direct or indirect change in control of at least 95 percent of the voting stock of the bank has occurred and the bank does not have an outstanding issue of publicly traded debt or preferred stock. According to the FFIEC, push down accounting is also required if the bank's separate financial statements are presented on a push down basis in reports filed with the SEC. Push down accounting *may* also be used when a direct or indirect change in control of at least 80 percent, but less than 95 percent of the voting stock of the bank has occurred. In all cases, the bank's primary supervisory authority reserves the right to determine whether or not a bank must use push down accounting for purposes of call reports. On March 17, 2009, the OTS issued Thrift Financial Report (TFR) Question and Answer No. 260, "Push Down Accounting," for TFR Schedule SC—Statement of Condition, which aligned the OTS's push down accounting requirements with those of the SEC and the other banking regulators.

19.06 In October 2010, the Office of the Comptroller of the Currency (OCC) issued several questions and answers related to push down accounting in the *Bank Accounting Advisory Series*. This publication is updated periodically to express the Office of the Chief Accountant's current views on accounting topics of interest to national banks. Readers are encouraged to read this publication on the OCC website at www.occ.gov/topics/bank-operations/accounting/index-accounting.html.

19.07 SEC *Codification of Staff Accounting Bulletins* topic 11(N), "Disclosures of The Impact of Assistance From Federal Financial Institution Regulatory Agencies," discusses accounting for transfers of nonperforming assets by financial institutions and disclosure of the impact of financial assistance from regulators. SEC *Codification of Staff Accounting Bulletins* topic 11(N) states the SEC staff's belief that users of financial statements must be able to assess the impact of credit and other risks on a company following a regulatory assisted acquisition, transfer, or other reorganization on a basis comparable with that disclosed by other institutions, that is, as if the assistance did not exist. In that regard, the SEC staff believes that the amount of regulatory assistance should be separately disclosed and should be separately identified in the statistical information furnished pursuant to Industry Guide 3, *Statistical Disclosures by Bank Holding Companies*, to the extent that it affects such information. Further, the nature, extent, and impact of such assistance should be fully disclosed in management's discussion and analysis.

19.08 On June 7, 2010 the OCC, Board of Governors of the Federal Reserve System (FRB), Federal Deposit Insurance Corporation (FDIC), National Credit Union Administration (NCUA), and OTS issued *Interagency Supervisory Guidance on Bargain Purchases and FDIC- and NCUA-Assisted Acquisitions* to address supervisory considerations related to bargain purchase gains and the impact such gains have on the application (licensing) approval process. This guidance also highlights the accounting and reporting requirements unique to business combinations resulting in bargain purchase gains and FDIC- and NCUA-assisted acquisitions of failed institutions. Although this guidance principally focuses on bargain purchase gains, it is also relevant to business combinations in general. The full text of this guidance is located on the FRB website at www.federalreserve.gov/boarddocs/srletters/2010/SR1012a1.pdf.

Accounting and Financial Reporting

19.09 Accounting for business combinations involving financial institutions is similar to that for other entities. According to paragraphs 2–3 of FASB ASC 805-10-15, the guidance in FASB ASC 805 applies to all entities and to all transactions that meet the definition of a business combination. Certain specific qualifications and exceptions are listed in FASB ASC 805-10-15-4.

19.10 According to the FASB ASC glossary, a *business* is an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants, and a *business combination* is a transaction or other event in which an acquirer obtains control of one or more businesses. Per FASB ASC 805-10-25-1, an entity should determine whether a transaction or other event is a business combination which requires that the assets acquired and liabilities assumed constitute a business, and each business combination should be accounted for by applying the acquisition method. If the assets acquired are not a business, the reporting entity should account for the transaction or other event as an asset acquisition.

19.11 The acquisition method requires all of the following steps:

a. Identifying the acquirer (see FASB ASC 805-10)

b. Determining the acquisition date (see FASB ASC 805-10)

c. Recognizing and measuring the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree (see FASB ASC 805-20)

d. Recognizing and measuring goodwill or a gain from a bargain purchase (see FASB ASC 805-30)

19.12 Regarding subpoints (*a*) and (*b*) in the preceding paragraph, paragraphs 4 and 6 of FASB ASC 805-10-25 state that for each business combination, one of the combining entities should be identified as the acquirer. The acquirer should identify the acquisition date, which is the date on which it obtains control of the acquiree.

19.13 Regarding subpoint (*c*) in paragraph 19.11 and as stated in FASB ASC 805-20-25-1, as of the acquisition date, the acquirer should recognize, separately from goodwill, the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree. Recognition of identifiable assets acquired and liabilities assumed is subject to the conditions specified in paragraphs 2–3 of FASB ASC 805-20-25. Under the acquisition method, the acquirer should measure the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree at their acquisition-date fair values, as stated in paragraphs 1–2 of FASB ASC 805-20-30, with exceptions to the measurement principle identified and their accounting treatment addressed in paragraphs 10–23 of FASB ASC 805-20-30.

19.14 FASB ASC 805-20-30-4 states that the acquirer should not recognize a separate valuation allowance as of the acquisition date for assets acquired in a business combination that are measured at their acquisition-date fair values because the effects of uncertainty about future cash flows are included in the fair value measure. For example, the acquirer does not recognize a separate valuation allowance for the contractual cash flows that are deemed to be uncollectible at the acquisition date.

19.15 Regarding subpoint (*d*) in paragaph 19.11 and as stated in FASB ASC 805-30-30-1, the acquirer should recognize goodwill as of the acquisition date, measured as the excess of (*a*) over (*b*):

a. The aggregate of the following:

   i. The consideration transferred measured in accordance with FASB ASC 805-30-30, which generally requires acquisition-date fair value (see FASB ASC 805-30-30-7)

   ii. The fair value of any noncontrolling interest in the acquiree

   iii. In a business combination achieved in stages, the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree

b. The net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed measured in accordance with FASB ASC 805

19.16 FASB ASC 350, *Intangibles—Goodwill and Other*, provides guidance on financial accounting and reporting related to goodwill and other intangibles, other than the accounting at acquisition for goodwill and other intangibles acquired in a business combination. Acquisition guidance for intangible assets acquired in a business combination is provided in FASB ASC 805-20 and guidance on recognition and initial measurement of goodwill acquired in a business combination is provided in FASB ASC 805-30. See chapter 12, "Other Assets, Other Liabilities, and Other Investments," for a discussion of the requirements of FASB ASC 350.

19.17 The consideration transferred in a business combination should be measured at fair value, which should be calculated as the sum of the acquisition-date fair values of the assets transferred by the acquirer, the liabilities incurred by the acquirer to former owners of the acquiree, and the equity interests issued by the acquirer, as stated in FASB ASC 805-30-30-7.

19.18 For assets and liabilities acquired, such as loans and deposits, for which there is not an active market, determining fair values usually involves estimating cash flows and discounting those cash flows at prevailing risk adjusted market rates of interest. Demand deposits are valued at their face amount plus any accrued interest.

Purchase of a Loan or Group of Loans

19.19 FASB ASC 310-20-30-5 explains that the initial investment in a purchased loan or group of loans should include the amount paid to the seller plus any fees paid or less any fees received. FASB ASC 310-20-25-22 explains that the initial investment frequently differs from the related loan's principal amount at the date of purchase. This difference should be recognized as an adjustment of yield over the life of the loan, in accordance with FASB ASC 310-20-35-15.

19.20 FASB ASC 310-20-30-5 further explains that, in applying the provisions of FASB ASC 310-20 to loans purchased as a group, the purchaser may allocate the initial investment to the individual loans or may account for the initial investment in the aggregate. Per FASB ASC 310-20-35-16, the cash flows provided by the underlying loan contracts should be used to apply the interest method, except as set forth in FASB ASC 310-20-35-26. If prepayments are not anticipated pursuant to that paragraph and prepayments occur or a portion of the purchased loans is sold, a proportionate amount of the related deferred fees

and purchase premium or discount should be recognized in income so that the effective interest rate on the remaining portion of loans continues unchanged.

19.21 Loan receivables may be acquired with a fair value (if acquired through a business combination) or relative fair value (if acquired through an asset purchase) lower than the contractual amounts due (principal amount) that are not required to be accounted for in accordance with the guidance in FASB ASC 310-30, which is addressed in the subsequent paragraphs. The discount relating to such acquired loan receivables must be accounted for subsequently through accretion. In a letter to the SEC on December 18, 2009, the AICPA addressed accounting in subsequent periods for discount accretion associated with such loan receivables. The letter confirmed the understanding that the SEC Staff would not object to an accounting policy based on contractual cash flows or an accounting policy based on expected cash flows. Readers may access this letter on the AICPA website (see www.aicpa.org/interestareas/frc/industryinsights/downloadabledocuments/confirmation-letter-on-day-2.pdf).

Loans and Debt Securities Acquired With Deteriorated Credit Quality

19.22 FASB ASC 310-30 provides recognition, measurement, and disclosure guidance regarding loans acquired with evidence of deterioration of credit quality since origination acquired by completion of a transfer for which it is probable, at acquisition, that the investor will be unable to collect all contractually required payments receivable, which is stated in FASB ASC 310-30-05-1. A loan may be acquired at a discount because of a change in credit quality or rate or both, according to FASB ASC 310-30-30-2. When a loan is acquired at a discount that relates, at least in part, to the loan's credit quality, the effective interest rate is the discount rate that equates the present value of the investor's estimate of the loan's future cash flows with the purchase price of the loan.

Special Considerations in Applying the Acquisition Method to Combinations of Mutual Entities

19.23 As stated in FASB ASC 805-30-55-3, when two mutual entities combine, the fair value of the equity or member interests in the acquiree (or the fair value of the acquiree) may be more reliably measurable than the fair value of the member interests transferred by the acquirer. In that situation, paragraphs 2–3 of FASB ASC 805-30-30 require the acquirer to determine the amount of goodwill by using the acquisition-date fair value of the acquiree's equity interests instead of the acquisition-date fair value of the acquirer's equity interests transferred as consideration. In addition, the acquirer in a combination of mutual entities should recognize the acquiree's net assets as a direct addition to capital or equity in its statement of financial position, not as an addition to retained earnings, which is consistent with the way in which other types of entities apply the acquisition method.

19.24 Although similar in many ways to other businesses, mutual entities have distinct characteristics that arise primarily because their members are both customers and owners, according to FASB ASC 805-30-55-4. Members of mutual entities generally expect to receive benefits for their membership, often in the form of reduced fees charged for goods and services or patronage dividends. The portion of patronage dividends allocated to each member is often based on the amount of business the member did with the mutual entity during the year.

19.25 FASB ASC 805-30-55-5 states that a fair value measurement of a mutual entity should include the assumptions that market participants would make about future member benefits as well as any other relevant assumptions market participants would make about the mutual entity. For example, an estimated cash flow model may be used to determine the fair value of a mutual entity. The cash flows used as inputs to the model should be based on the expected cash flows of the mutual entity, which are likely to reflect reductions for member benefits, such as reduced fees charged for goods and services.

Impairment and Disposal Accounting for Certain Acquired Long Term Customer Relationship Intangible Assets

19.26 The impairment and disposal provisions of FASB ASC 360-10 apply to long term customer-relationship intangible assets, except for servicing assets, recognized in the acquisition of a financial institution. Examples of long term customer relationship intangible assets may include depositor and borrower relationship intangible assets, and credit cardholder intangible assets. See chapter 11, "Real Estate Investments, Real Estate Owned, and other Foreclosed Assets," for impairment guidance on intangibles addressed in FASB ASC 360-10.

19.27 Servicing assets are tested for impairment under paragraphs 9–14 of FASB ASC 860-50-35. See chapter 10, "Transfers and Servicing—Including Mortgage Banking," of this guide for further discussion over servicing assets and the related requirements set forth in FASB ASC 860, *Transfers and Servicing*.

Branch Acquisitions

19.28 Depository institutions may acquire branch office locations. Such transactions typically involve the assumption of deposit liabilities by the acquiring institution in exchange for the receipt of a lesser amount of cash, or other assets, such as loans.

19.29 In accordance with FASB ASC 805, an entity should determine whether a transaction or other event is a business combination by applying the definition of a business combination. If the assets acquired are not a business, the reporting entity should account for the transaction or the other event as an asset acquisition, as stated in FASB ASC 805-10-25-1. As discussed in FASB ASC 350-30-25-2 and consistent with FASB ASC 805-50-30-3, the cost of a group of assets acquired in a transaction other than a business combination should be allocated to the individual assets acquired based on their relative fair values and should not give rise to goodwill.

19.30 The "Acquisition of Assets Rather than a Business" subsections of FASB ASC 805-50 address a transaction in which the assets acquired and liabilities assumed do not constitute a business, such a transaction is accounted for as an asset acquisition.

Auditing

Objectives and Planning

19.31 The primary objective of audit procedures for business combinations is to obtain reasonable assurance that the transaction is properly accounted for

in accordance with GAAP. Supervisory management personnel need to review and adequately support accounting entries made to record the transaction initially and those required in subsequent years including values assigned to the assets and liabilities of the acquired entity. Moreover, subsequent to the acquisition date management should review assumptions used in assigning values to assets and liabilities for continuing validity. In accordance with paragraph .102 of AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), the auditor should identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions, account balances, and disclosures.

Substantive Tests

19.32 According to paragraph .51 of AU section 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*), regardless of the assessed risks of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure. This reflects the fact that the auditor's assessment of risk is judgmental and may not be sufficiently precise to identify all risks of material misstatement.

19.33 The auditor should perform tests to obtain assurance regarding the fair values assigned to an acquired depository institution's or branch's assets and liabilities, which are generally supported by independent third party appraisals. AU section 336, *Using the Work of a Specialist* (AICPA, *Professional Standards*), provides guidance to the auditor who uses the work of a specialist in performing an audit in accordance with generally accepted auditing standards. Specialists to whom AU section 336 applies include, but are not limited to, actuaries, appraisers, engineers, environmental consultants, and geologists. The auditor should evaluate the relationship of the specialist to the client, including circumstances that might impair the specialist's objectivity.

19.34 The appropriateness and reasonableness of methods and assumptions used and their application are the responsibility of the specialist. The auditor should (*a*) obtain an understanding of the methods and assumptions used by the specialist (particular attention should be focused on assumptions concerning the assessment of credit risk, loan prepayment factors, and the interest rate assigned in relation to current market conditions), (*b*) make appropriate tests of data provided to the specialist, taking into account the auditor's assessment of control risk, and (*c*) evaluate whether the specialist's findings support the related assertions in the financial statements. Ordinarily, the auditor would use the work of the specialist unless the auditor's procedures lead him or her to believe the findings are unreasonable in the circumstances, as stated in paragraph .12 of AU section 336. If the auditor believes the findings are unreasonable, he or she should apply additional procedures, which may include obtaining the opinion of another specialist.

19.35 In applying procedures to a branch purchase, the auditor should be satisfied with the documentation supporting the fair values assigned to the deposit liabilities assumed and the assets acquired.

Chapter 20

Fair Value[*]

Introduction

20.01 The following section provides a discussion about fair value measurements and disclosures and the fair value option. The Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 820, *Fair Value Measurement* defines *fair value*, establishes a framework for measuring fair value, and requires certain disclosures about fair value measurements. FASB ASC 825, *Financial Instruments*, creates a fair value option that an entity may irrevocably elect fair value as the initial and subsequent measure for many financial instruments and certain other items. The following paragraphs summarize FASB ASC 820 and 825, but are not intended as a substitute for reviewing this guidance in its entirety.

Accounting and Financial Reporting[1]

Definition of Fair Value

20.02 FASB ASC 820-10-20 defines *fair value* as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. FASB ASC 820-10-35-5 states that a fair value measurement assumes that the transaction to sell the asset or transfer the liability either occurs in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability. The FASB ASC glossary defines the *principal market* as the market in which the reporting entity would sell the asset or transfer the liability with the greatest volume and level of activity for the asset or liability. The principal market (and thus, market participants) should be

[*] In May 2011, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2011-04, *Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*. The amendments in this ASU result in common fair value measurement and disclosure requirements in accounting principles generally accepted in the United States of America (U.S. GAAP) and International Financial Reporting Standards (IFRSs). The amendments alter the wording used to describe many of the requirements in U.S. GAAP for measuring fair value and for disclosing information about fair value measurements. The ASU does not require additional fair value measurements and is not intended to establish valuation standards or affect valuation practices outside of financial reporting.

The amendments in this ASU are effective prospectively (1) for public entities, for interim and annual periods beginning after December 15, 2011 and (2) for nonpublic entities, for annual periods beginning after December 15, 2011. Early application is not permitted for public entities. Early application is permitted for nonpublic entities, but only for interim periods beginning after December 15, 2011. See FASB *Accounting Standards Codification* (ASC) 820-10-65-8 for further information regarding changes in valuation technique as a result of implementation of respective guidance. Readers should consult the text of ASU No. 2011-04 for further information.

[1] The *Bank Accounting Advisory Series* (BAAS) expresses the Office of the Chief Accountant's current views on accounting topics of interest to national banks. See further discussion of the BAAS in paragraph 8.80 of this guide. Due to a number of accounting rule changes, the October 2010 edition of the BAAS has revised Section 11D, "Fair Value Accounting," in its entirety. Readers are encouraged to read this publication on the Office of the Comptroller of the Currency website at www.occ.gov/topics/bank-operations/accounting/index-accounting.html.

considered from the perspective of the reporting entity, thereby allowing for differences between and among entities with different activities.

20.03 FASB ASC 820-10-35-3 and 820-10-30-2 provide that the hypothetical transaction to sell the asset or transfer the liability is considered from the perspective of a market participant that holds the asset or owes the liability. Therefore, the objective of a fair value measurement focuses on the price that would be received to sell the asset or paid to transfer the liability (an exit price), not the price that would be paid to acquire the asset or received to assume the liability (an entry price). Conceptually, entry prices and exit prices are different. However, FASB ASC 820-10-30-3 explains that, in many cases, at initial recognition a transaction price (entry price) will equal the exit price and, therefore, will represent the fair value of the asset or liability. In determining whether a transaction price represents the fair value of the asset or liability at initial recognition, the reporting entity should consider facts specific to the transaction and the asset or liability.

20.04 Paragraphs 7–8 of FASB ASC 820-10-35 explain that the price should not be adjusted for transaction costs. However, if location is an attribute of the asset or liability (as might be the case for a commodity), the price in the principal (or most advantageous) market used to measure the fair value of the asset or liability should be adjusted for the costs, if any, that would be incurred to transport the asset or liability to (or from) its principal (or most advantageous) market.

Application of Fair Value Measurement to Assets

20.05 FASB ASC 820-10-35-10 provides that a fair value measurement of an asset assumes the highest and best use of the asset by market participants, considering the use of the asset that is physically possible, legally permissible, and financially feasible at the measurement date. Highest and best use is determined based on the use of the asset by market participants, even if the intended use of the asset by the reporting entity is different.

20.06 FASB ASC 820-10-35-10 provides that the highest and best use for an asset is established by one of two valuation premises: value in-use or value in-exchange. The highest and best use of the asset is in-use if the asset would provide maximum value to market participants principally through its use in combination with other assets as a group (as installed or otherwise configured for use). For example, value in-use might be appropriate for certain nonfinancial assets. The highest and best use of the asset is in-exchange if the asset would provide maximum value to market participants principally on a standalone basis. For example, value in-exchange might be appropriate for a financial asset. According to paragraphs 12–13 of FASB ASC 820-10-35, an asset's value in-use should be based on the price that would be received in a current transaction to sell the asset assuming that the asset would be used with other assets as a group and that those other assets would be available to market participants. An asset's value in-exchange is determined based on the price that would be received in a current transaction to sell the asset standalone.

Application of Fair Value Measurement to Liabilities

20.07 According to paragraphs 16–16A of FASB ASC 820-10-35, a fair value measurement assumes that both (1) the liability is transferred to a market participant at the measurement date (the liability to the counterparty continues; it is not settled), and (2) the nonperformance risk relating to that

liability is the same before and after its transfer. Further, it is also assumed that a liability is exchanged in an orderly transaction between market participants. Certain liabilities, such as debt obligations, are traded in the marketplace as assets. However, many liabilities are rarely transferred in the marketplace due to contractual or other legal restrictions.

20.08 FASB ASC 820-10-35-16B states that if a quoted price in an active market for an identical liability is available, it represents a level 1 measurement. If that is not available, a reporting entity should measure fair value using one or more of the following techniques:

- A valuation technique that uses the quoted price of the identical liability when traded as an asset or the quoted prices for similar liabilities or similar liabilities when traded as assets
- Another valuation technique that is consistent with the principles of FASB ASC 820, such as an income or market approach

20.09 According to FASB ASC 820-10-35-16D, when measuring the fair value of a liability using the quoted price of the liability when traded as an asset, the reporting entity should adjust the quoted price for factors specific to the asset that are not applicable to the fair value measurement of the liability. For example, the quoted price for the asset may relate to a similar, but not identical liability traded as an asset or the unit of account for the asset may not be the same as for the liability.

20.10 FASB ASC 820-10-35-16G explains that when measuring the fair value of a liability using a valuation technique, the reporting entity should ensure the fair value measurement is consistent with FASB ASC 820. For example, when using a technique based on the amount at the measurement date that the reporting entity would receive to enter into the identical liability, the inputs should reflect the assumptions that market participants would use (or the reporting entity's own assumption about the assumptions that market participants would use) in the principal or most advantageous market for issuance of a liability with the same contractual terms.

20.11 When estimating the fair value of a liability, FASB ASC 820-10-35-16E states that the reporting entity should not include a separate input or adjustment to other inputs relating to the existence of a restriction that prevents the transfer of the liability because the effect of that restriction is already either implicitly or explicitly included in the other inputs to the fair value measurement.

20.12 Paragraphs 17–18 of FASB ASC 820-10-35 provide that a fair value measurement of a liability should reflect its nonperformance risk (the risk that the obligation will not be fulfilled). Because nonperformance risk includes the reporting entity's credit risk, the reporting entity should consider the effect of its credit risk (credit standing) on the fair value of the liability in all periods that the liability is measured at fair value.

Valuation Techniques

20.13 Paragraphs 24–35 of FASB ASC 820-10-35 describe the valuation techniques that should be used to measure fair value. Valuation techniques consistent with the market approach, income approach, and cost approach should be used to measure fair value, as follows:

- The market approach uses prices and other relevant information generated by market transactions involving identical or comparable

assets or liabilities. Valuation techniques consistent with the market approach include matrix pricing and often use market multiples derived from a set of comparables.

- The income approach uses valuation techniques to convert future amounts (for example, cash flows or earnings) to a single present amount (discounted). The measurement is based on the value indicated by current market expectations about those future amounts. Valuation techniques consistent with the income approach include present value techniques, option-pricing models, and the multi period excess earnings method.
- The cost approach is based on the amount that currently would be required to replace the service capacity of an asset (often referred to as *current replacement cost*). Fair value is determined based on the cost to a market participant (buyer) to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence.

20.14 FASB ASC 820-10-35-24 states that valuation techniques that are appropriate in the circumstances and for which sufficient data are available should be used to measure fair value. In some cases, a single valuation technique will be appropriate (for example, when valuing an asset or liability using quoted prices in an active market for identical assets or liabilities). In other cases, multiple valuation techniques will be appropriate (for example, as might be the case when valuing a reporting unit) and the respective indications of fair value should be evaluated and weighted, as appropriate, considering the reasonableness of the range indicated by those results, Example 3 (paragraphs 35–41) of FASB ASC 820-10-55 illustrates the use of multiple valuation techniques. A fair value measurement is the point within that range that is most representative of fair value in the circumstances.

20.15 As explained by paragraphs 25–26 of FASB ASC 820-10-35, valuation techniques used to measure fair value should be consistently applied. However, a change in a valuation technique or its application is appropriate if the change results in a measurement that is equally or more representative of fair value in the circumstances. Such a change would be accounted for as a change in accounting estimate in accordance with the provisions of FASB ASC 250, *Accounting Changes and Error Corrections*.

Present Value Techniques

20.16 Paragraphs 4–20 of FASB ASC 820-10-55 provide guidance on present value techniques. Those paragraphs neither prescribe the use of one specific present value technique nor limit the use of present value techniques to the three techniques discussed therein. They say that a fair value measurement of an asset or liability using present value techniques should capture the following elements from the perspective of market participants as of the measurement date: an estimate of future cash flows, expectations about possible variations in the amount or timing (or both) of the cash flows, the time value of money, the price for bearing the uncertainty inherent in the cash flows (risk premium), other case-specific factors that would be considered by market participants, and in the case of a liability, the nonperformance risk relating to that liability, including the reporting entity's (obligor's) own credit risk.

20.17 FASB ASC 820-10-55-6 provides the general principles that govern any present value technique, as follows:

- Cash flows and discount rates should reflect assumptions that market participants would use in pricing the asset or liability.
- Cash flows and discount rates should consider only factors attributed to the asset (or liability) being measured.
- To avoid double counting or omitting the effects of risk factors, discount rates should reflect assumptions that are consistent with those inherent in the cash flows. For example, a discount rate that reflects expectations about future defaults is appropriate if using the contractual cash flows of a loan, but is not appropriate if the cash flows themselves are adjusted to reflect possible defaults.
- Assumptions about cash flows and discount rates should be internally consistent. For example, nominal cash flows (that include the effects of inflation) should be discounted at a rate that includes the effects of inflation.
- Discount rates should be consistent with the underlying economic factors of the currency that the cash flows are denominated.

20.18 FASB ASC 820-10-55-9 describes how present value techniques differ in how they adjust for risk and in the type of cash flows they use. For example, the discount rate adjustment technique (also called the *traditional present value technique*) uses a risk-adjusted discount rate and contractual, promised, or most likely cash flows. In contrast, method 1 of the expected present value techniques uses a risk-free rate and risk-adjusted expected cash flows. Method 2 of the expected present value technique uses a risk-adjusted discount rate (which is different from the rate used in the discount rate adjustment technique) and expected cash flows. In the expected present value technique, the probability-weighted average of all possible cash flows is referred to as the *expected cash flows*. The traditional present value technique and two methods of expected present value techniques are discussed more fully in FASB ASC 820-10-55.

20.19 For an illustration of situations that the price in a transaction involving a derivative instrument might (and might not) represent fair value of the derivative instrument, see example 5 (paragraphs 46–50) of FASB ASC 820-10-55.

The Fair Value Hierarchy

20.20 Because fair value is a market-based measurement, as stated by FASB ASC 820-10-35-9, a fair value measurement should be determined based on the assumptions that market participants would use in pricing the asset or liability (referred to as *inputs*). Paragraphs 37–58 of FASB ASC 820-10-35 establish a fair value hierarchy that distinguishes between (1) market participant assumptions developed based on market data obtained from sources independent of the reporting entity (observable inputs) and (2) the reporting entity's own assumptions about market participant assumptions developed based on the best information available in the circumstances (unobservable inputs). Valuation techniques used to measure fair value should maximize the use of observable inputs and minimize the use of unobservable inputs.

20.21 The fair value hierarchy in FASB ASC 820-10-35 prioritizes the inputs to valuation techniques used to measure fair value into three broad levels. The three levels are discussed in

- *Level 1.* FASB ASC 820-10-35-40, which states that level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date. An *active market*, as defined by the FASB ASC glossary, is a market in which transactions for the asset or liability occur with sufficient frequency and volume to provide pricing information on an ongoing basis. FASB ASC 820-10-35-44 affirms the requirement that the fair value of a position in a single financial instrument (including a block) that trades in an active market should be measured as the product of the quoted price for the individual instrument times the quantity held (within level 1 of the fair value hierarchy). The quoted price should not be adjusted because of the size of the position relative to trading volume (blockage factor). The use of a blockage factor is prohibited, even if a market's normal daily trading volume is not sufficient to absorb the quantity held and placing orders to sell the position in a single transaction might affect the quoted price.
- *Level 2.* Paragraphs 47–51 of FASB ASC 820-10-35, which explain that level 2 inputs are inputs other than quoted prices included within level 1 that are observable for the asset or liability, either directly or indirectly. If the asset or liability has a specified (contractual) term, a level 2 input must be observable for substantially the full term of the asset or liability. Adjustments to level 2 inputs will vary depending on factors specific to the asset or liability. Those factors include the condition and location of the asset or liability, the extent to which the inputs relate to items that are comparable to the asset or liability (including those factors discussed in FASB ASC 820-10-35-16D), and the volume and level of activity in the markets within which the inputs are observed. An adjustment that is significant to the fair value measurement in its entirety might render the measurement a level 3 measurement, depending on the level in the fair value hierarchy that the inputs used to determine the adjustment fall. As discussed in FASB ASC 820-10-35-48, level 2 inputs include the following:
  - Quoted prices for similar assets or liabilities in active markets
  - Quoted prices for identical or similar assets or liabilities in markets that are not active
  - Inputs other than quoted prices that are observable for the asset or liability (for example, interest rates and yield curves observable at commonly quoted intervals, volatilities, prepayment speeds, loss severities, credit risks, and default rates)
  - Inputs that are derived principally from or corroborated by observable market data by correlation or other means (market-corroborated inputs).
- *Level 3.* Paragraphs 52–55 of FASB ASC 820-10-35, which state that level 3 inputs are unobservable inputs for the asset or liability. Unobservable inputs should be used to measure fair value to the extent that relevant observable inputs are not available, thereby allowing for situations that there is little, if any, market activity for the asset or liability at the measurement date. Unobservable inputs should be developed based on the best information available in the circumstances, which might include the entity's own data. In developing unobservable inputs, the reporting entity need not undertake

all possible efforts to obtain information about market participant assumptions. Unobservable inputs should reflect the reporting entity's own assumptions about the assumptions that market participants would use in pricing the asset or liability (including assumptions about risk). Assumptions about risk include the risk inherent in the inputs to the valuation technique. A measurement (for example, a mark-to-model measurement) that does not include an adjustment for risk would not represent a fair value measurement if market participants would include one in pricing the related asset or liability. The reporting entity should not ignore information about market participant assumptions that is reasonably available without undue cost and effort. Therefore, the entity's own data used to develop unobservable inputs should be adjusted if information is readily available without undue cost and effort that indicates that market participants would use different assumptions. FASB ASC 820-10-55-22 discusses level 3 inputs for particular assets and liabilities.

As explained in FASB ASC 820-10-35-37, in some cases, the inputs used to measure fair value might fall in different levels of the fair value hierarchy. The level in the fair value hierarchy that the fair value measurement in its entirety falls should be determined based on the lowest level input that is significant to the fair value measurement in its entirety.

20.22 As discussed in FASB ASC 820-10-35-38, the availability of inputs relevant to the asset or liability and the relative reliability of the inputs might affect the selection of appropriate valuation techniques. However, the fair value hierarchy prioritizes the inputs to valuation techniques, not the valuation techniques. For example, a fair value measurement using a present value technique might fall within level 2 or level 3, depending on the inputs that are significant to the measurement in its entirety and the level in the fair value hierarchy that those inputs fall.

20.23 As stated by FASB ASC 820-10-35-15, the effect on a fair value measurement of a restriction on the sale or use of an asset by a reporting entity will differ depending on whether the restriction would be considered by market participants in pricing the asset. Example 6 (paragraphs 51–55) of FASB ASC 820-10-55 explains that restrictions that are an attribute of an asset, and therefore would transfer to a market participant, are the only restrictions reflected in fair value.

Fair Value Measurements of Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)

20.24 Paragraphs 58–62 of FASB ASC 820-10-35 contain guidance intended to improve financial reporting by permitting the use of a practical expedient, with appropriate disclosures, when measuring the fair value of an alternative investment that does not have a readily determinable fair value.

20.25 According to FASB ASC 820-10-15-4, this guidance only applies to an investment that meets both of the following criteria:

a. The investment does not have a readily determinable fair value.[2]

[2] FASB ASC 820-10-15-15 notes that the FASB ASC glossary definition of *readily determinable fair value* indicates that an equity security would have a readily determinable fair value if any one of the three conditions is met. One of those conditions is that sales prices or bid-and-asked quotations are currently available on a securities exchange registered with the Securities and Exchange Commission or in the over-the-counter market, provided that those

b. The investment is in an entity that has all of the attributes specified in FASB ASC 946-10-15-2[3] or, if one or more of the attributes specified in FASB ASC 946-10-15-2 are not present, is in an entity for which it is industry practice to issue financial statements using guidance that is consistent with the measurement principles in FASB ASC 946, *Financial Services—Investment Companies*.

Examples of investments that this guidance applies may include hedge funds, private equity funds, real estate funds, venture capital funds, offshore fund vehicles, and funds of funds.

20.26 FASB ASC 820-10-35-60 explains that if the net asset value per share of the investment obtained from the investee is not as of the reporting entity's measurement date or is not calculated in a manner consistent with the measurement principles of FASB ASC 946, the reporting entity should consider whether an adjustment to the most recent net asset value per share is necessary.

20.27 FASB ASC 820-10-35-58 states that classification within the fair value hierarchy of a fair value measurement of an investment that is within the scope and measured at net asset value per share requires judgment. This guidance provides considerations for determining the level within the fair value hierarchy that a fair value measurement of an investment at net asset value per share (or its equivalent) should be categorized.

20.28 FASB ASC 820-10-35-61 states that the decision about whether to apply the practical expedient should be made on an investment-by-investment basis and should be applied consistently to the fair value measurement of a reporting entity's entire position in a particular investment, unless it is probable at the measurement date that a reporting entity will sell a portion of an investment at an amount different from net asset value per share (or its equivalent) as described in FASB ASC 820-10-35-62. In those situations, the reporting entity should account for the portion of the investment that is being sold in accordance with other provisions in FASB ASC 820-10 and should not apply the practical expedient discussed in FASB ASC 820-10-35-59.[4]

(footnote continued)

prices or quotations for the over-the-counter market are publicly reported by the National Association of the Securities Dealers Automated Quotations systems or by Pink Sheets LLC. The definition notes that restricted stock meets that definition if the restriction terminates within one year. If an investment otherwise would have a readily determinable fair value, except that the investment has a restriction of greater than one year, the reporting entity should not apply the guidance in paragraphs 59–62 of FASB ASC 820-10-35 and in FASB ASC 820-10-50-6A to the investment.

[3] FASB ASC 946-10-15-2 limits the scope of FASB ASC 946, *Financial Services—Investment Companies,* to investment companies that have the following attributes:

a. Investment activity

b. Unit ownership

c. Pooling of funds

d. Reporting entity

[4] Technical Questions and Answers (TIS) sections 2220.18–.27 (AICPA, *Technical Practice Aids*) discuss implementation guidance regarding the practical expedient.

Fair Value Determination When the Volume or Level of Activity Has Significantly Decreased

20.29 Paragraphs 51A–51H of FASB ASC 820-10-35 clarify the application of FASB ASC 820 in determining fair value when the volume and level of activity for the asset or liability has significantly decreased. Guidance is also included in identifying transactions that are not orderly. In addition, paragraphs 59A–59I of FASB ASC 820-10-55 include illustrations on the application of this guidance.

20.30 This guidance does not apply to quoted prices for an identical asset or liability in an active market (level 1 inputs). For example, although the volume and level of activity for an asset or liability may significantly decrease, transactions for the asset or liability may still occur with sufficient frequency and volume to provide pricing information on an ongoing basis.

20.31 Consistent with FASB ASC 820-10-35-51D, when determining fair value when the volume and level of activity for the asset or liability has significantly decreased, the objective of a fair value measurement remains the same. FASB ASC 820-10-35-51A lists a number of factors that may be evaluated to determine whether there has been a significant decrease in the volume and level of activity for the asset or liability (or similar assets or liabilities) when compared with normal market activity. According to FASB ASC 820-10-35-51B, if, after evaluating the factors, the conclusion is reached that there has been a significant decrease in the volume and level of activity for the asset or liability in relation to normal market conditions, transactions or quoted prices may not be determinative of fair value. Further analysis of the transactions or quoted prices is needed, and a significant adjustment to the transactions or quoted prices may be necessary to estimate fair value in accordance with FASB ASC 820-10. According to FASB ASC 820-10-35-51C, the objective is to determine the point within the range of fair value estimates that is most representative of fair value under the current market conditions. A wide range of fair value estimates may be an indication that further analysis is needed.

20.32 FASB ASC 820-10-35-51D states that determining the price that willing market participants would transact at the measurement date under current market conditions if there has been a significant decrease in the volume and level of activity for the asset or liability depends on the facts and circumstances and requires the use of significant judgment. The reporting entity's intention to hold the asset or liability is not relevant however, because fair value is a market-based measurement, not an entity-specific measurement.

20.33 According to FASB ASC 820-10-35-51E, an entity should evaluate the circumstances to determine whether the transaction is orderly based on the weight of the evidence. Circumstances that may indicate that a transaction is not orderly and guidance that should be considered in the determination are found at paragraphs 51E–51F of FASB ASC 820-10-35. Even if there has been a significant decrease in the volume and level of activity for the asset or liability, it is not appropriate to conclude that all transactions are not orderly (that is, distressed or forced). In making the determination as to whether a transaction is orderly, an entity does not need to undertake all possible efforts, but should not ignore information that is available without undue cost and effort. The reporting entity would be expected to have sufficient information to conclude whether a transaction is orderly when it is party to the transaction. Refer to FASB ASC 820 for more information.

Disclosures

20.34 FASB ASC 820-10-50 discusses the disclosures required for assets and liabilities measured at fair value. "Pending Content" in paragraphs 1–2 and 5 of FASB ASC 820-10-50 explain that the reporting entity should disclose information that enables users of its financial statements to assess both (*a*) for assets and liabilities that are measured at fair value on a recurring basis in periods subsequent to initial recognition or that are measured on a nonrecurring basis in periods subsequent to initial recognition, the valuation techniques and the inputs used to develop those measurements and (*b*) for recurring fair value measurements using significant unobservable inputs (level 3), the effect of the measurements on earnings for the period. For both recurring and nonrecurring measurements using level 2 or level 3 inputs, a description of the valuation technique (or multiple valuation techniques) used and the inputs used should be disclosed.[†]

Fair Value Option[‡]

20.35 FASB ASC 825 creates a fair value option under which an entity may irrevocably elect fair value as the initial and subsequent measure for many financial instruments and certain other items, with changes in fair value recognized in the statement of activities as those changes occur. FASB ASC 825-10-35-4 explains that a business entity should report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. An election is made on an instrument-by-instrument basis (with certain exceptions), generally when an instrument is initially recognized in the financial statements. The fair value option need not be applied to all identical items, except as required by FASB ASC 825-10-25-7. Most financial assets and financial liabilities are eligible to be recognized using the fair value option, as are firm commitments for financial instruments and certain nonfinancial contracts.

20.36 As explained by FASB ASC 825-10-15-5, specifically excluded from eligibility is an investment in a subsidiary that the entity is required to

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[†] In January 2010, FASB issued ASU No. 2010-06, *Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Fair Value Measurements*. This ASU establishes new disclosure requirements regarding transfers in and out of levels 1 and 2 of the fair value hierarchy and activity in level 3 fair value measurements. The amendments in this ASU became effective for interim and annual reporting periods beginning after December 15, 2009, except for the disclosures in the level 3 fair value measurement roll forward. Those disclosures are effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years. Examples related to the guidance in this ASU were added to FASB ASC 820-10-55.

[‡] In May 2010, FASB issued proposed ASU *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities—Financial Instruments (Topic 825) and Derivatives and Hedging (Topic 815)*. The main objective of this proposal is to provide financial statement users with a more timely and representative depiction of an entity's involvement in financial instruments while reducing the complexity in accounting for those instruments. It develops a consistent framework for classifying financial instruments, removes the threshold for recognizing credit impairments creating a single credit impairment model for both loans and debt securities, and makes changes to the requirements to qualify for hedge accounting.

On February 9, 2011, FASB issued a discussion paper, *Invitation to Comment—Selected Issues about Hedge Accounting*, to solicit input on the International Accounting Standards Board (IASB's) exposure draft, *Hedge Accounting*, in order to improve, simplify, and converge the financial reporting requirements for hedging activities.

Readers are encouraged to visit the FASB website for the latest developments regarding the accounting for financial instruments project, including a summary of decisions reached to date since the issuance of the proposed guidance.

consolidate, an interest in a variable interest entity that the entity is required to consolidate, employer's and plan's obligations for pension benefits, other postretirement benefits (including health care and life insurance benefits), postemployment benefits, employee stock option and stock purchase plans, and other forms of deferred compensation arrangements (or assets representing net overfunded positions in those plans), financial assets and liabilities recognized under leases (this does not apply to a guarantee of a third-party lease obligation or a contingent obligation arising from a cancelled lease), deposit liabilities of depository institutions, and financial instruments that are, in whole or in part, classified by the issuer as a component of shareholder's equity (including temporary equity).

20.37 FASB ASC 825-10-45 and 825-10-50[5] also include presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. Paragraphs 1–2 of FASB ASC 825-10-45[||] state that entities should report assets and liabilities that are measured using the fair value option in a manner that separates those reported fair values from the carrying amounts of similar assets and liabilities measured using another measurement attribute. To accomplish that, an entity should either (*a*) report the aggregate of both fair value and non-fair-value items on a single line, with the fair value amount parenthetically disclosed or (*b*) present separate lines for the fair value carrying amounts and the non-fair-value carrying amounts. As discussed in FASB ASC 825-10-25-3, upfront costs and fees, such as debt issue costs, may not be deferred for items that the fair value option has been elected.

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[5] TIS section 1800.05, "Applicability of Fair Value Disclosure Requirements and Measurement Principles in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 820, *Fair Value Measurements and Disclosures*, to Certain Financial Instruments" (AICPA, *Technical Practice Aids*), addresses the applicability of FASB ASC 820, *Fair Value Measurement*, to financial instruments that are not recognized at fair value in the statement of financial position, but that fair value is required to be disclosed in the notes to financial statements in accordance with paragraphs 10–19 of FASB ASC 825-10-50.

[||] In January 2011, FASB issued the proposed ASU *Balance Sheet Offsetting*. The proposed guidance was initiated as a joint project between FASB and the IASB to provide users of financial statements with information to understand the extent of offsetting in the statement of financial position and improve comparability between IFRSs and U.S. GAAP. The proposed guidance as issued would eliminate the exception in U.S. GAAP that allows offsetting for some derivative and sale and repurchase (and reverse sale and repurchase) contracts when the right of setoff is conditional, there is no intention to set off, or such intention is conditional. The proposed guidance would also enhance disclosures required by U.S. GAAP by requiring improved information about eligible assets and eligible liabilities subject to setoff, and related arrangements (such as collateral arrangements) and the effect of those arrangements on an entity's financial position.

In June 2011, FASB and the IASB discussed alternative approaches for requiring offsetting of financial assets and financial liabilities on the face of the balance sheet. The majority of FASB board members supported providing an exception from the general offsetting criteria for derivative instruments, which would allow offsetting of fair value amounts recognized for derivatives and fair value amounts recognized for the right to reclaim cash collateral or the obligation to return cash collateral arising from derivative instruments recognized at fair value with the same counterparty under a master netting arrangement. During July 2011, FASB and IASB also discussed revisions to the proposed offsetting disclosures.

Readers are encouraged to visit the FASB website for the latest developments regarding the offsetting project, including a summary of decisions reached to date since the issuance of the proposed guidance. FASB expects to issue final guidance during 2011.

Auditing Considerations

20.38 AU section 328, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*),[#] addresses audit considerations relating to the measurement and disclosure of assets, liabilities, and specific components of equity presented or disclosed at fair value in financial statements.[6]

20.39

Considerations for Audits Performed in Accordance with Public Company Accounting Oversight Board (PCAOB) Standards[7]

PCAOB Staff Audit Practice Alert No. 2, *Matters Related to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400 par. .02), provides guidance on auditors' responsibilities for auditing fair value measurements of financial instruments and when using the work of specialists under the existing standards of the PCAOB. This alert is focused on specific matters that are likely to increase audit risk related to the fair value of financial instruments in a rapidly changing economic environment. This practice alert highlights certain requirements in the auditing standards related to fair value measurements and disclosures in the financial statements and certain aspects of generally accepted accounting principles that are particularly relevant to the current economic environment.

PCAOB Staff Audit Practice Alert No. 3, *Audit Considerations in the Current Economic Environment* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400 par. .03), assists auditors in identifying matters related to the current economic environment that might affect audit risk and require additional emphasis. This practice alert is organized into six sections: (1) overall audit considerations; (2) auditing fair value measurements; (3) auditing accounting estimates; (4) auditing the adequacy of disclosures; (5) auditor's consideration of a company's ability to continue as a going concern; and (6) additional audit considerations for selected financial reporting areas.

[#] The Auditing Standards Board (ASB) has finalized a new clarified auditing standard, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*. This auditing standard, which will supersede AU section 328, *Auditing Fair Value Measurements and Disclosures*, and AU section 342, *Auditing Accounting Estimates* (AICPA, *Professional Standards*), addresses the auditor's responsibilities relating to accounting estimates, including fair value accounting estimates and related disclosures. Additionally, it expands on how other clarified auditing standards are to be applied in relation to accounting estimates, and includes requirements and guidance related to misstatements of individual accounting estimates and indicators of possible management bias. This clarified auditing standard has been finalized but not yet issued. See the preface of this guide for further information on the ASB's Clarity Project. The effective date of this clarified standard is for audits of financial statements for periods ending on or after December 15, 2012, unless otherwise established (early implementation is not permitted).

[6] For additional guidance refer to Interpretation No. 1, "Auditing Interests in Trusts Held by a Third-Party Trustee and Reported at Fair Value," of AU section 328 (AICPA, *Professional Standards*, AU sec. 9328 par. .01).

[7] Public Company Accounting Oversight Board Staff Audit Practice Alerts are not rules of the board and do not reflect any board determination or judgment about the conduct of any particular firm, auditor, or any other person.

PCAOB Staff Audit Practice Alert No. 4, *Auditor Considerations Regarding Fair Value Measurements, Disclosures, and Other-Than-Temporary Impairments* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400 par. .04), informs auditors about potential implications of recently issued FASB guidance on reviews of interim financial information and annual audits. This alert addresses the following topics: (*a*) reviews of interim financial information; (*b*) audits of financial statements, including integrated audits; (*c*) disclosures; and (*d*) auditor reporting considerations.

Chapter 21

Trust and Asset Management Activities

Introduction

21.01 Among other engagements, auditors may be engaged to (*a*) report on trust company financial statements, particularly of common or collective funds, (*b*) report on internal control over financial reporting in the institution's trust department, or (*c*) perform procedures agreed to by management or regulators or extended audit services to supplement the institution's internal audit efforts.[1,2,3]

21.02 Trust and asset management activities include fiduciary services provided to customers. One type of fiduciary service involves acting as a trustee. Trust activities of an institution may be an integral part of the institution's services; however, because of strict laws[4] governing fiduciary responsibilities, institutions conduct trust activities independently through

a. a separate department or division of the institution;

b. a separately chartered trust company; and

c. a contractual arrangement with the trust department or a trust company of another depository institution.

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[1] Usually, such an engagement is the result of the need of auditors of the financial statements of pension plans, mutual funds, and other entities to obtain audit evidence regarding internal control in the departments of a bank or savings institution controlling assets of other entities. Because an institution may administer many plans, it may not be economically feasible for each plan's auditor to carry out audit procedures at the trustee institution. Accordingly, an auditor may perform procedures in the area or department administering all plans at the institution and issue a report to the user institution on internal accounting controls related to administration of the plans. Guidance is provided in Statement on Standards for Attestation Engagements (SSAE) No. 16, *Reporting on Controls at a Service Organization* (AICPA, *Professional Standards*, AT sec. 801), which was issued in April 2010. SSAE No. 16 supersedes the guidance for service auditors in AU section 324, *Service Organizations* (AICPA, *Professional Standards*), and is effective for service auditors' reports for periods ending on or after June 15, 2011. The related Audit Guide *Service Organizations: Applying SAS No. 70, as Amended* has been revised by a task force of the Auditing Standards Board to reflect the requirements and guidance in SSAE No. 16. The revised Audit Guide, *Service Organizations: Applying SSAE No. 16,* Reporting on Controls at a Service Organization, is currently available to readers. AT section 501, *An Examination of an Entity's Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements* (AICPA, *Professional Standards*), states that an auditor may apply the relevant concepts described in AU section 324 to the examination of internal control.

[2] Auditors should consider all applicable professional independence rules when providing extended audit services, such as supplementing internal audit efforts. In particular, the auditor should comply with the AICPA's *Code of Professional Conduct* and, if applicable, Section 201 of the Sarbanes-Oxley Act of 2002 and related Securities and Exchange Commission (SEC) and Public Company Accounting Oversight Board rulings.

[3] The Gramm-Leach-Bliley Act of 1999 (GLBA) repealed the blanket exemption for banks from the definition of a *broker* set forth in Section 3(a)(4) of the Securities Exchange Act of 1934 (Exchange Act). In place of the blanket exemption, GLBA provided specific exceptions the definition of *broker*. The statutory exceptions were designed to allow banks to continue to effect securities transactions in connection with certain traditional bank activities. The SEC and the Federal Reserve Board jointly issued Regulation R, "Definition of Terms and Exemptions Relating to the 'Broker' Exceptions for Banks," on October 3, 2007. Regulation R defines important terms relating to the broker exceptions in the Exchange Act and provides a number of exemptions.

[4] Most notably, Title 12 U.S. *Code of Federal Regulations* Parts 9 and 550; state fiduciary laws often provide additional requirements.

21.03 The organizational structures of institutions' trust departments or of trust companies vary greatly depending upon factors such as the scope of trust activities, the complexity of trust services offered, management's preference, and the historical development of the entity. Trust organizations vary from small operations with one person devoted to trust activities on a part-time basis to large organizations with a variety of specialized staff such as tax attorneys, employee benefit specialists, and investment specialists.

21.04 Trusts can be broadly categorized as personal, corporate, or employee benefit.

21.05 This chapter deals primarily with how trust services and activities affect audits of the financial statements of financial institutions. However, it is important that auditors be fully aware of any regulatory expectations that may exist in the area of trust departments and design any engagements arising from those expectations in an appropriate manner.

21.06 Regulatory focus on the adequacy of auditing of trust operations of financial institutions has increased in recent years. The proliferation of trust charters in bank holding companies has led the bank and savings institution regulators to more closely assess the adequacy of secondary monitoring provided by audit functions. In cases where internal audit departments do not exist or lack the expertise necessary to audit the complexities of financial institutions or trust operations, or both, the regulators are looking often to independent auditors to supplement the existing resources. In their respective rules on audits of fiduciary activities, the Office of Thrift Supervision (OTS) (Title 12 U.S. *Code of Federal Regulations* [CFR] Part 550.440) and the Office of the Comptroller of the Currency (OCC) (12 CFR 9.9) require that management arrange for a suitable audit of trust operations through the efforts of external or internal auditors, or both, on an annual basis or as part of a continuous audit process.

21.07 The audit requirements of the OTS and OCC are largely related to operating and compliance controls that may not be tested in the audit of financial statements of a financial institution. In addition, the depth of testing of financial reporting controls will likely be greater than in a financial statement audit. Accordingly, the testing in these areas should be the subject of separate engagements under standards for attestation engagements or consulting standards as they relate to extended audit services.

Personal Trusts

21.08 Personal trust accounts may be established for individuals or other entities such as foundations, college endowments, and not-for-profit organizations. A brief description of the primary kinds of personal trusts follows:

a. *Testamentary trusts* are created under a will. Administrative responsibility begins when assets are transferred from the estate to the trust. Almost all testamentary trusts are irrevocable.

b. *Voluntary trusts* (*inter vivos*), also referred to as *living trusts*, are established by individuals during their lifetimes. This type of trust is often established with powers of revocation or amendment. Furthermore, it has been increasingly common for the grantor of the trust to retain the power to control or participate in deciding on investments resulting in a self-directed trust.

c. *Court trusts* are trusts in which the trustee is accountable to a court.

Court trusts generally include decedents' estates (under which the courts appoint administrator institutions to settle the estates of persons who either died without leaving wills or who nominated the institutions as executors in their wills), guardianships, and some testamentary trusts.

d. *Agency agreements* provide for the care of other parties' securities and properties. Safekeeping and custodianship agreements are two of the more common types.

e. *Property management agreements* provide for the management of property, for example, real estate or securities investments, by the trustee institution. The institution, as agent, has managerial duties and responsibilities appropriate to the kind of property being managed. (Such agreements also may exist for employee benefit trusts.)

21.09 Closely held business management responsibilities may arise through the normal course of events when an institution serves as trustee of a personal trust (or employee benefit trust) that holds ownership of the enterprise, through involvement in winding down the affairs of an estate, or through a specialized property management agreement.

Corporate Trusts

21.10 A brief description of the primary kinds of corporate trust activities follows:

a. As *transfer agent*, the trust department or trust company transfers registered (in contrast to bearer) securities from one owner to another and maintains the records of ownership.

b. As *registrar*, the trust department or trust company maintains for corporations control over the number of shares issued and outstanding.

c. As *joint registrar transfer agent*, the trust department or trust company acts jointly as registrar and transfer agent for the same issue.

d. As *paying agent*, the trust department or trust company distributes interest or dividend payments or redeems bonds and bond coupons of corporations and political subdivisions within the terms of an agency agreement.

e. When an institution is a *trustee under indenture*, the trust department or trust company acts as an agent designated by a municipality, corporation, or other entity to administer specified cash receipt or payment functions. The trust department or trust company performs the duties specified in the agreement, which might include holding collateral; issuing bond instruments; maintaining required records, accounts and documentation; monitoring for default; ensuring legal compliance; and effecting the payment of principal and interest.

Employee Benefit Trusts

21.11 In most cases, the assets of an employee benefit plan must be held in trust with the trustee named in the trust instrument or benefit plan. The trustee manages and controls the assets of an employee benefit plan, although actual investment decisions might be turned over to an investment committee or investment manager. Trustees of employee benefit plans are, in most cases,

fiduciaries. The fiduciary's responsibility is to manage the assets of the employee benefit plan so that those assets are used exclusively to provide benefits for employees and beneficiaries and to defray administrative costs of the plan. The fiduciary is charged with using the care and skill in managing the plan that a prudent man would in similar circumstances. The fiduciary must diversify the investments of the plan to minimize the risk of large losses. Finally, the fiduciary must discharge its duties in accordance with the documents and instruments governing the employee benefit plan and the Employee Retirement Income Security Act of 1974 (ERISA), the federal law dealing with employee benefit plans. A brief description of the primary kinds of employee benefit trusts follows:

a. *Pension or profit sharing trusts* provide for a trustee institution to manage trust funds established for the benefit of eligible company officers or employees or for members of a union, professional organization, or association. Such trusts are established by comprehensive written plans in which the trustees' powers are limited and their duties are well defined. These trusts may exist in connection with a variety of types of benefit plans, including defined benefit plans, defined contribution plans, individual retirement accounts, and health and welfare plans.

b. *Master trusts* are special trust devices used to bring together various employee benefit trusts of a plan sponsor for ease of administration. For instance, an employer may have similar benefit plans for different subsidiaries, divisions, or classes of employees. Rather than maintain separate employee benefit trusts for each plan, all of the plans, subject to restrictions of ERISA, may pool the trust assets in a single master trust and maintain separate subaccounts for each plan to preserve accountability. A master trust may also be structured to establish separate pools of trust assets managed by different investment advisers selected by the plan sponsor.

Common or Collective Trust Funds

21.12 A *common* or *collective trust* fund is a bank-administered trust that holds commingled individual trust accounts (that is, personal or employee benefit trusts). The account assets are pooled to achieve greater diversification of investment, stability of income, or other investment objectives. They are similar to a mutual fund but are not regulated by the Securities and Exchange Commission (SEC) and are not required to be registered with the SEC under an exclusion from the Investment Company Act of 1940. They are instead required to follow OCC regulations at 12 CFR 9. Under OCC regulations, there are two types of funds: (*a*) common trust funds,[5] which are maintained exclusively for the collective investment of accounts for which the institution serves as trustee, executor, administrator, conservator, and guardian, and (*b*) collective trust funds or commingled pension trust funds, which consist solely of assets of retirement, pension, profit sharing, stock bonus, or other trusts that are exempt from federal income taxes.

[5] Common trust funds are exempt from federal income taxes under Section 584 of the Internal Revenue Code. Collective investment funds are exempt from federal income taxes under IRS Revenue Ruling 81-100.

Regulatory Matters

21.13 Some institutions are also involved with mutual funds. Their involvement may range from corporate trust activities, which are generally administrative in nature, to investment advisory activities, or may simply involve custodial activities. Some institutions sell funds sponsored by an independent fund group. Others may use their name on a fund sponsored by an affiliate.

21.14 The federal banking agencies use the Uniform Interagency Trust Rating System (UITRS) as a tool to evaluate the soundness of fiduciary activities of financial institutions on a uniform basis and to identify those institutions requiring special supervisory attention. The UITRS was revised in 1998 to place more emphasis on risk management and more closely align the ratings definitions language and tone with those of the capital adequacy, asset quality, management, earnings, and liquidity ratings definitions.

Accounting and Financial Reporting

21.15 Although a trust department or trust entity may have responsibility for the custody of trust assets, they are not assets of the institution and, therefore, should not be included in the institution's financial statements according to the Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 942-605-25-3. However, cash accounts of individual trusts are often deposited with the institution in demand and time deposit accounts, and revenues and expenses related to fees for trust activities are recognized in the institution's income. Trust department income should be presented on the accrual basis.

21.16 Financial institutions often make financial statement disclosures describing the nature of the trust activities and are required to apply the provisions of FASB ASC 450, *Contingencies*, to any contingencies that may exist related to trust activities.

Auditing[6]

Objectives

21.17 The primary objectives of financial statement audit procedures applied in the trust operations area are to obtain sufficient appropriate evidence that

a. the institution has properly described and disclosed contingent liabilities associated with trust activities in the financial statements; and

[6] In December 2009, the SEC adopted rules designed to substantially increase the protections for investor funds and securities of which an investment adviser registered with the SEC has custody. Depending on the investment adviser's custody arrangement, the rules require the adviser to be subject to a surprise exam and custody controls review generally not required previously. Readers are encouraged to review the full text of final rule Release No. IA-2968, *Custody of Funds or Securities of Clients by Investment Advisers* and the related interpretive Release No. IA-2969, *Commission Guidance Regarding Independent Public Accountant Engagements Performed Pursuant to Rule 206(4)-2 Under the Investment Advisers Act of 1940*. Additionally, the SEC has released frequently asked questions about the custody rule, which can be located at www.sec.gov/divisions/investment/custody_faq_030510.htm.

b. fee income resulting from trust activities is recognized properly in the institution's financial statements.

Planning

21.18 In accordance with AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), the auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures (see chapter 5, "Audit Considerations and Certain Financial Reporting Matters," for additional information). The following is a list of factors related to trust services and activities that could influence the risks of material misstatement:

a. The organization of the trust department and the degree of separation from the commercial banking departments (for example, the role of legal counsel in trust account administration and the vulnerability to disclosure of insider information)

b. The nature of comments on trust operations indicated in supervisory agency or internal audit reports

c. The extent and nature of insurance coverage

d. The type and frequency of lawsuits, if any, brought against the institution and arising from trust operations

e. The nature, complexity, and reliability of data processing systems

f. The nature and extent of lending of securities from trust accounts

The significance of an institution's exposure to liability (including liability related to the reporting of tax information) is a function of (*a*) the relative significance of the trust assets administered, (*b*) whether the institution has discretionary investment authority, (*c*) the complexity of transactions entered into by the trust, (*d*) the number of trusts administered, and (*e*) the effectiveness of administration of the trust. It is important for auditors not to underestimate the importance of an institution's trust department.

Internal Control Over Financial Reporting and Possible Tests of Controls

21.19 AU section 314 establishes standards and provides guidance on obtaining a sufficient understanding of the entity and its environment, including its internal control. It provides guidance on understanding the components of internal control and explains how an auditor should obtain a sufficient understanding of internal control for the purposes of assessing the risks of material misstatement. Paragraph .40 of AU section 314 requires that, in all audits, the auditor should obtain an understanding of the five components of internal control (the control environment, risk assessment, control activities, information and communication systems, and monitoring), sufficient to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. The auditor should obtain a sufficient understanding by performing risk assessment procedures to evaluate the design of controls relevant to an

audit of financial statements and to determine whether they have been implemented. The auditor should identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions, account balances, and disclosures, as stated in paragraph .102 of AU section 314.

21.20 Accounting systems for trust departments generally use sophisticated electronic data processing systems. The accounting records of a trust department generally reflects the department's asset holdings and liabilities to trust customers, the status of each trust account, and all transactions relating to each trust account. Records providing detailed information for each trust account generally should include the following:

- Principal (corpus) control account
- Principal cash account
- Income cash account
- Investment records for each asset owned, such as stocks, bonds, notes and mortgages, savings and time accounts, real property, and sundry assets
- Liability record for each principal trust liability
- Investment income

21.21 The auditor may need to evaluate trust departments' and trust companies' overall internal control over financial reporting, including, but not limited to, the following controls:

- Individual account and departmental transactions (activity control) and suspense items are reconciled and recorded in a complete, accurate, and timely manner.
- Written policies, procedures, and controls exist for securities lending activities, including review of the borrower's creditworthiness, a formal lending agreement, and minimum collateral requirements.
- Periodic reconciliations of the trust funds on deposit with the institution or its custodian are performed by an employee having no check signing authority or access to unissued checks and related records.
- Measures have been taken to safeguard trust assets by dual control.
- Accurate files of documents creating trusts and authorizing transactions are maintained.
- Vault deposits and withdrawals are reconciled with accounting records to promptly reflect the purchase and sale of trust assets.
- Reconciliation of agency accounts (for example, dividends, coupons, and bond redemptions) is performed regularly by an employee having no access to unissued checks or participation in the disbursement function.
- Periodic physical inspection of assets or confirmation of trust assets is conducted by an independent person.
- There is frequent reporting and written approval of uninvested cash balances and overdrafts.
- Procedures exist to ensure compliance with income and other tax filing and remittance requirements.

- Reviews are conducted to make sure all duties required by the governing trust instruments or agency contracts (legal compliance) are performed.

Financial Reporting Controls of the Trust

21.22 Additional controls that the auditor may wish to consider for engagements not limited to the audit of financial statements (for example, directors' exams, engagements under AU section 324, *Service Organizations* (AICPA, *Professional Standards*),[*] and agreed upon procedures or other extended audit services) include the following:

- Authorization and review procedures are in place to ensure that assets accepted into a trust conform to provisions of the trust and applicable laws and regulations.
- The physical and administrative security (physical control) of assets for which the trust department has responsibility is segregated from transaction authorization and recordkeeping.
- Trust assets are segregated from the institution's assets and are periodically inspected by people outside the trust department or trust company.
- Trust assets are registered in the name of the institution as fiduciary or in the name of the nominee.
- Proper approval is obtained from cofiduciaries (or investment power holders in self-directed trusts) for investment changes, disbursements, and so forth.
- Approval of the individual purchase and sale of all trust investments is performed by the trust or investment committee or its designees. It is important that for assets where the trustee has discretionary (investment powers) authority, investment restrictions imposed by the client are being adhered to. AU section 314 paragraph .86 states that in obtaining an understanding of the financial reporting process (including the closing process), the auditor should obtain an understanding of the automated and manual procedures an entity uses to prepare financial statements and related disclosures, and how misstatements may occur.
- Procedures exist to ensure proper classification of trust assets, both by trust title and by nature of asset, daily posting of journals containing detailed descriptions of principal and income transactions, and establishment of control accounts for various asset classifications, including principal and income cash.
- Procedures exist to safeguard unissued supplies of stocks and bonds by dual control.
- Periodic mailings, at least quarterly, are made of account statements of activity to an external party designated by the client.
- Policies and procedures exist related to identification and resolution of failed trades and the contractual settlement of trades posted to trust accounts.
- Complete legal files are maintained.

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[*] See discussion of AU section 324 in footnote 1.

- Based on the nature of trust contracts, accurate tax reporting is performed.

Substantive Tests Related to Financial Statement Audits

21.23 *Testing of trust department revenues and expenses.* Although a substantial amount of activity may be conducted and reported on within the trust department, items typically reflected in the institution's financial statements are income from trust or agency services and trust operation expenses. Those areas may be tested independently or may be integrated, as appropriate, with other tests of trust operations.

21.24 *Contingent liabilities.* The auditor designs audit procedures to determine whether any contingent liabilities should be recognized or disclosed in the institution's financial statements. Acceptance of certain assets, such as real estate with environmental contamination that subjects the trustee to environmental liabilities and ineligible investments in employee benefit trusts subject to ERISA, may result in substantial liabilities for both the trust and trustee. If the institution is providing guarantees to beneficiaries or others associated with the trusts, procedures may need to be performed to determine if the institution has complied with the requirements of FASB ASC 460, *Guarantees* or FASB ASC 815, *Derivatives and Hedging*, if the guarantee meets the definition of a derivative. Further, the auditor considers determining the extent to which an institution has engaged in off balance sheet activities that create commitments or contingencies, including innovative transactions involving securities and loans (such as transfers with recourse or put options), that could affect the financial statements, including disclosures in the notes. Inquiries of management relating to such activities might be formalized in the representation letter normally obtained at year-end. The auditor also considers reviewing the institution's documentation to determine whether particular transactions are sales or financing arrangements.

Substantive Procedures Related to the Trust

21.25 Additional substantive procedures that the auditor may wish to consider for engagements not limited to the audit of financial statements (for example, directors' exams, engagements under AU section 324[*] and agreed upon procedures or other extended audit services) are included in the following paragraphs.

21.26 Examination of a trust department's activity includes tests of systems and procedures that are common to the management of all or most individual trusts or agency accounts and tests of the activity in selected representative individual trust accounts in each area of trust department service (for example, personal, corporate, and employee benefit).

21.27 *Testing of trust activities' common procedures.* The procedures followed for the numerous types of trusts and agency activities involve many common or similar functions. Tests of the department's conduct of those activities may be on the department as a whole rather than on individual trusts. Functions that may be tested by the department include, but are not limited to, the following:

- Opening of new accounts

[*] See footnote * in paragraph 21.22.

- Receipt and processing of the initial assets that constitute an account
- Processing of purchases, sales, and exchanges of principal assets
- Receipt and payment of cash or other assets
- Collateralization of trust assets held in deposit accounts at the institution, affiliate, or outside custodian, where contractually required
- Execution of specified trust or agency activities
- Determination of fees and charging of fees to accounts
- Processing of trust assets in and out of the trust vault
- Closing of accounts

21.28 *Testing of account activity.* Paragraph .55 of AU section 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*), states that tests of details are ordinarily more appropriate to obtain audit evidence regarding certain relevant assertions about account balances, including existence and valuation. The auditor's determination as to the substantive procedures that are most responsive to the planned level of detection risk is affected by whether the auditor has obtained audit evidence about the operating effectiveness of controls.

21.29 The tests may cover asset validation, asset valuation, and account administration. For asset validation, a sample of accounts may be selected, trial balances of assets obtained, and the physical existence of assets for which the trust is responsible determined on a test basis. For account administration, a sample of trust accounts may be selected for testing of individual transactions. If appropriate, certain of those transactions may be incorporated in testing of common procedures in the trust department. The auditor may coordinate the selection of accounts for testing asset validation and account administration. The auditor might perform the following procedures for the selected accounts:

a. Read the governing instrument and note the significant provisions.

b. Review activity during the period being audited for compliance with the governing trust instrument and applicable laws and regulations.

c. Review the assets held for compliance with the provisions of the governing trust instrument.

d. Examine brokers' advices or other documentary evidence supporting the purchase and sale of investments.

e. For real estate accepted or acquired, determine that appropriate measures are taken to identify potential environmental liability and to properly document the evaluation.

f. Ascertain that real estate holdings are insured and are inspected on a periodic basis and that appraisals are performed or otherwise obtained as required by the governing trust instrument and applicable laws and regulations.

g. Obtain reasonable assurance that income from trust assets has been received and credited to the account.

h. Obtain reasonable assurance that necessary payments have been made.

i. Test computation and collection of fees.

j. Determine whether the account has been reviewed by the investment committee as required by the supervisory authorities or by local regulations.

k. Test the amounts of uninvested cash to determine whether amounts maintained and time held are not unreasonable.

l. Review any overdrafts and obtain reasonable assurance that they have a valid business purpose and are covered by appropriate borrowings to avoid violations of laws and regulations.

m. Independently test market values used in valuing investments.

n. Review the "soft dollar" charges allocated to funds for appropriateness.

o. Determine whether required tax returns have been filed in accordance with Internal Revenue Code regulations.

p. Review the adequacy of trust reporting of co-trustees and beneficiaries.

q. Confirm individual trust account assets, liabilities, and activity with co-trustees and beneficiaries.

r. Test valuation procedures.

Audits of Unit Investment Trusts

21.30 The AICPA Audit and Accounting Guide *Investment Companies* provides guidance on the auditing of financial statements of investment companies and unit investment trusts.

Chapter 22

Insurance Activities

Introduction

22.01 Insurance operations ordinarily are an integral part of consumer finance activities. 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

22.02 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

22.03 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.

22.04 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.

22.05 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

22.06 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

22.07 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 desired. 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

22.08 An insurance subsidiary of a finance company may be a direct writing or a reinsurance company. A direct writing company writes the insurance policies in its name. A reinsurance company insures policies written by direct writing companies.

22.09 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

22.10 Insurers, both insurance subsidiaries and independent companies, may pay commissions to companies. Those payments may be in the form of advance commissions computed as a percentage of premiums, retrospective or experience-rated commissions, or combinations of advance commissions and retrospective commissions.

Regulatory Matters

22.11 Credit unions may offer through a credit union service organization (CUSO), the following insurance brokerage or agency services:

a. Agency for sale of insurances

b. Provision of vehicle warranty programs

c. Provision of group purchasing programs

d. Real estate settlement services

Other activities or services that CUSOs may provide are outlined in Part 712 of the National Credit Union Administration Rules and Regulations.

Accounting

22.12 The primary source of accounting guidance for enterprises that issue insurance contracts is the Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 944, *Financial Services—Insurance*.* Additionally, the AICPA Audit and Accounting Guides *Life and Health Insurance Entities* and *Property and Liability Insurance Entities* provide further information.

Premium Income

22.13 FASB ASC 944-605 provides guidance to insurance entities on accounting for and financial reporting of revenue from insurance contracts. As discussed in FASB ASC 944-20-15-2, insurance contracts should be classified as short or long-duration contracts, depending on whether the contracts are expected to remain in force for an extended period.

22.14 FASB ASC 944-20-15 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 at the end of any contract period, such as adjusting the amount of premiums charged or coverage provided, according to FASB ASC 944-20-15-7.

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* The International Accounting Standards Board (IASB) and its predecessor organization have been working for several years to develop guidance on accounting for insurance contracts. The project was split into two phases. Phase I addressed the application of existing International Financial Reporting Standards to entities that issue insurance contracts. Phase II, initiated in September 2004, is a comprehensive project on accounting for insurance contracts.

On August 2, 2007, the Financial Accounting Standards Board (FASB) issued an Invitation to Comment, *An FASB Proposal: Accounting for Insurance Contracts by Insurers and Policyholders*. That invitation to comment included a discussion paper issued by the IASB, *Preliminary Views on Insurance Contracts*, setting forth its preliminary views on the main components of an accounting model for an issuer's rights and obligations (assets and liabilities) under an insurance contract. FASB issued the invitation to comment to gather information from its constituents to help decide whether there was a need for a comprehensive project on accounting for insurance contracts and whether FASB should undertake such a project jointly with the IASB.

In October 2008, FASB decided to join the IASB's insurance contract project.

In July 2010, the IASB issued an exposure draft, *Insurance Contracts*. In developing the IASB's exposure draft, most of the discussions about the proposed insurance accounting approaches were held jointly with FASB. While the boards reached common decisions in many areas, they reached different conclusions in others. Some FASB members prefer the IASB's proposed measurement model; however, the majority prefers an alternative model. Regardless of FASB members' individual views and uniform commitment to convergence, FASB determined that additional information was needed about whether the possible new accounting guidance would represent a sufficient improvement to U.S. generally accepted accounting principles to justify issuing new guidance. On September 17, 2010, FASB issued, for public comment, a discussion paper, *Preliminary Views on Insurance Contracts*.

The boards are redeliberating significant issues based on feedback received on the IASB exposure draft and FASB discussion paper. The IASB is expected to issue a final standard and FASB is expected to release an exposure draft by the end of 2011. Readers should remain alert to any final pronouncements.

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, according to FASB ASC 944-20-15-10.

22.15 Paragraphs 1 and 5 of FASB ASC 944-20-55 state that examples of short duration contracts include most property and liability insurance contracts and certain term life insurance contracts, such as credit life insurance. Accident and health insurance contracts may be of short duration or long duration, depending on whether the contracts are expected to remain in force for an extended period. For example, individual and group insurance contracts that are noncancelable or guaranteed renewable (renewable at the option of the insured), or collectively renewable (individual contracts within a group are not cancelable), ordinarily are long-duration contracts.

22.16 Insurance policies issued in connection with consumer lending generally are considered to represent short-duration contracts.

22.17 FASB ASC 944-605-25-1 states that premiums from short duration contracts should be recognized as revenue over the period of the contract in proportion to the amount of insurance protection provided. For those few types of contracts for which the period of risk differs significantly from the contract period, premiums should be recognized as revenue over the period of risk in proportion to the amount of insurance protection provided. 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.

Acquisition Costs[†]

22.18 *Acquisition costs*, as defined in the FASB ASC glossary, are costs incurred in the acquisition of new and renewal insurance contracts, and include

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[†] In October 2010, FASB issued Accounting Standards Update (ASU) No. 2010-26, *Financial Services—Insurance (Topic 944): Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts*. The objective of this update is to address diversity in practice regarding the interpretation of which costs relating to the acquisition of new or renewal insurance contracts qualify for deferral. The amended guidance is labeled as "Pending Content" within FASB *Accounting Standards Codification* (ASC) 944, *Financial Services—Insurance,* due to the transition and effective date information discussed in FASB ASC 944-10-65-1. The amendments in this ASU are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2011. The amendments in this ASU should be applied prospectively upon adoption. Retrospective application to all prior periods presented upon the date of adoption also is permitted but not required. Early adoption is permitted, but only at the beginning of an entity's annual reporting period.

ASU No. 2010-26 specifies that the following costs incurred in the acquisition of new and renewal contracts should be capitalized in accordance with the amendments in this ASU:

a. Incremental direct costs of contract acquisition. Incremental direct costs are those costs that result directly from and are essential to the contract transaction(s) and would not have been incurred by the insurance entity had the contract transaction(s) not occurred.

b. Certain costs related directly to the following acquisition activities performed by the insurer for a contract that actually has been acquired:

i. Underwriting

ii. Policy issuance and processing

iii. Medical and inspection

iv. Sales force contract selling

those costs that both vary with and are primarily related to the acquisition of insurance contracts. FASB ASC 944-30-25-1 states that acquisition costs should be capitalized, and as discussed in FASB ASC 944-30-35-1A charged to expense in proportion to insurance premium revenue recognized under FASB ASC 944-605. To associate such costs with related premium revenue, acquisition costs should be allocated by groupings of insurance contracts consistent with the entity's manner of acquiring, servicing, and measuring the profitability of its insurance contracts. FASB ASC 944-720-25-2 requires that other costs incurred during the period—such as those relating to investments, general administration, and policy maintenance—that do not vary with and are not primarily related to the acquisition of new and renewal insurance contracts should be charged to expense as incurred.

22.19 Commissions paid to affiliated 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.

22.20 The "Internal Replacement Transactions" subsections in FASB ASC 944-30 provide guidance to insurance entities on accounting for and financial reporting of unamortized acquisition costs in the event of an internal replacement transaction. This guidance is applicable to modifications and replacements made to short-duration and long-duration contracts (including those contracts defined as *investment contracts* per the FASB ASC glossary), according to FASB ASC 944-30-15-8.

22.21 The FASB ASC glossary defines an *internal replacement* as a modification in product benefits, features, rights, or coverages that occurs by a contract exchange, by amendment, endorsement, or rider to a contract; or by the election of a benefit, feature, right, or coverage within a contract. The FASB ASC glossary defines a *contract exchange* as the legal extinguishment of one contract and the issuance of another contract.

22.22 The AICPA also issued a series of Technical Questions and Answers (TIS) on accounting and financial reporting issues related to the "Internal Replacement Transactions" subsections in FASB ASC 944-30 (see TIS sections 6300.25–.34).

(footnote continued)

The costs related directly to those activities include only the portion of an employee's total compensation (excluding any compensation that is capitalized as incremental direct costs of contract acquisition) and payroll-related fringe benefits related directly to time spent performing those activities for actual acquired contracts and other costs related directly to those activities that would not have been incurred if the contract had not been acquired.

All other acquisition-related costs—including costs incurred by the insurer for soliciting potential customers, market research, training, administration, unsuccessful acquisition or renewal efforts, and product development—should be charged to expense as incurred. Administrative costs, rent, depreciation, occupancy, equipment, and all other general overhead costs are considered indirect costs and should be charged to expense as incurred.

The amendments in this ASU modify the definition of the types of costs incurred by insurance entities that can be capitalized in the acquisition of new and renewal contracts. This revised definition may represent a significant change in practice for many insurance entities. For example, many insurance entities capitalize costs relating to unsuccessful contract acquisitions. The amendments in this ASU specify that the costs must be based on successful efforts (that is, acquiring a new or renewal contract). The amendments also specify that advertising costs only should be included as deferred acquisition costs if the direct-response advertising criteria in FASB ASC 340-20 are met.

Investment Portfolios

22.23 Insurance subsidiaries maintain investment portfolios usually composed of the same types of securities found in the portfolios of independent insurance companies. State regulations restrict the types of investments that insurance companies may make.

22.24 FASB ASC 320-10-15-2 states that the guidance in FASB ASC 320, *Investments—Debt and Equity Securities*, applies to all entities including cooperatives and mutual entities (such as credit unions and mutual insurance entities) and trusts that do not report substantially all of their securities at fair value. FASB ASC 320 establishes standards of financial accounting and reporting for both investments in equity securities that have readily determinable fair values and all investments in debt securities, including debt instruments that have been securitized.

22.25 FASB ASC 825, *Financial Instruments*, creates a fair value option under which an organization may irrevocably elect fair value as the initial and subsequent measure for many financial instruments and certain other items, with changes in fair value recognized in the statement of activities as those changes occur.

22.26 FASB ASC 944-320-50-1 states that an entity should disclose the carrying amount of securities deposited by insurance subsidiaries with state regulatory authorities.

State Laws

22.27 Insurance companies are regulated by state insurance laws, which require maintenance of accounting records and adoption of accounting practices. The insurance laws and regulations of the states require insurance companies domiciled in those states to comply with the guidance provided in the National Association of Insurance Commissioners *Accounting Practices and Procedures Manual* except as otherwise prescribed or permitted by state law. Some prescribed or permitted statutory accounting practices differ from accounting principles generally accepted in the United States of America (U.S. GAAP). Accordingly, the financial statements of insurance subsidiaries prepared for submission to regulatory authorities must be adjusted to conform to U.S. GAAP before they can be consolidated with the financial statements of the parent companies.

Commissions

22.28 A finance company may receive commissions from an independent insurer for policies issued to finance customers, according to FASB ASC 942-605-05-2.

22.29 According to FASB ASC 942-605-25-1, 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 ASC 944.

22.30 FASB ASC 605-20-25-7 states that income from experience-rated or retrospective commission arrangements should be recognized over the applicable insurance risk period.

22.31 Commissions paid to the parent company by an insurance subsidiary are eliminated in consolidation.

Consolidation Policy

22.32 Consolidation is appropriate if a reporting entity has a controlling financial interest in another entity and a specific scope exception does not apply, as stated in FASB ASC 810-10-25-1. The usual condition for a controlling financial interest is ownership of a majority voting interest, but in some circumstances control does not rest with the majority owner. See FASB ASC 810-10-15 for entities that are subject to consolidation.

22.33 The "Variable Interest Entities" subsections of FASB ASC 810-10 clarify the application of consolidation to certain legal entities in which equity investors do not have sufficient equity at risk for the legal entity to finance its activities without additional subordinated financial support, or, as a group, according to "Pending Content" in FASB ASC 810-10-05-8, the holders of the equity investment at risk lack any one of the following three characteristics:

a. The power, through voting rights or similar rights, to direct the activities of a legal entity that most significantly impact the entity's economic performance

b. The obligation to absorb the expected losses of the legal entity

c. The right to receive the expected residual returns of the legal entity

If the activities legal entity, according to "Pending Content" in FASB ASC 810-10-15-17(d), are primarily related to securitizations or other forms of asset-backed financings or single-lessee leasing arrangements, then the legal entity should be evaluated by a reporting entity to determine if the potential variable interest entity (VIE) is a VIE.

22.34 Insurance subsidiaries of financial institutions may also participate in VIEs through investing in other structured investments, such as synthetic asset-backed securities and catastrophe bonds, certain structured reinsurance transactions, joint ventures without substantive operations, financial guarantees, debt issuance vehicles, synthetic leases, collateralized bond obligation issuances, or limited partnerships.

22.35 Per "Pending Content" in FASB ASC 810-10-15-17, separate accounts of life insurance entities as described in FASB ASC 944 are not subject to consolidation according to the requirements of the "Variable Interest Entities" subsections. FASB ASC 944-80 provides insurance entities guidance on accounting for and financial reporting of separate accounts, including an insurance entity's accounting for separate account assets and liabilities related to contracts for which all or a portion of the investment risk is borne by the insurer.

22.36 Separate accounts of life insurance entities are described in more detail in the AICPA Audit and Accounting Guide *Life and Health Insurance Entities*.

Financial Statement Presentation

22.37 FASB ASC 942-210-45-1 states that, unearned premiums and unpaid claims on certain insurance coverage issued to finance customers by a subsidiary may represent intra-entity 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.

22.38 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

22.39 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. Unearned premiums and unpaid claims for credit life and accident and health coverage should not be applied in consolidation against related finance receivables for which the related receivables are assets of unrelated entities as stated in FASB ASC 942-210-45-1.

22.40 FASB ASC 942-210-45-2 states that, in the consolidated financial statements, unpaid claims for property insurance and level term life insurance should not be offset 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 entities. In those circumstances, such amounts should be presented as liabilities.

Auditing

22.41 The AICPA Audit and Accounting Guide *Life and Health Insurance Entities* and the Audit and Accounting Guide *Property and Liability Insurance Entities* provide guidance on auditing concepts and procedures for insurance companies. In addition, the auditor should consider whether accounts between the finance company and the insurance subsidiaries are reconciled regularly.

22.42 Based on the significance of the premiums and commissions associated with insurance provided to finance customers the auditor might consider audit procedures that include 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 23

Reporting Considerations

Introduction

23.01 This chapter applies the guidance found in AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*), and related Public Company Accounting Oversight Board (PCAOB)[*] requirements when performing integrated audits, to audit reports on the financial statements of financial institutions. Such reports may contain an unqualified opinion, an unqualified opinion with explanatory language, a qualified opinion, an adverse opinion, or a disclaimer of opinion. This chapter contains a brief discussion of each of those reports, with an emphasis on illustrating issues that an auditor may encounter in the industry. The reports are illustrative; the facts and circumstances of each particular audit will govern the appropriate form of report. Paragraphs 23.13–.15 apply only to credit unions.

Reports

Unqualified Opinion

23.02 The auditor's standard report states that the financial statements present fairly, in all material respects, an entity's financial position, results of operations, and cash flows in conformity with generally accepted accounting principles (GAAP). This conclusion may be expressed only when the auditor has formed such an opinion on the basis of an audit performed in accordance with generally accepted auditing standards (GAAS). The following is an illustration of an auditor's standard report (unqualified opinion) on the financial statements of a bank or savings institution:

Independent Auditor's Report[1]

To the [*Institution, Board of Directors, or Stockholders*]:

We have audited the accompanying balance sheets of ABC Institution as of December 31, 20X1 and 20X0, and the related statements of income, changes in stockholders' equity, and cash flows for the years

[*] In June 2011, the Public Company Accounting Oversight Board (PCAOB) issued Concept Release No. 2011-03, "Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards," for public comment. The objective of this concept release is to discuss several alternatives for changing the auditor's reporting model that could increase its transparency and relevance to financial statement users, while not compromising audit quality. These alternatives include (1) a supplement to the auditor's report in which the auditor would be required to provide additional information about the audit and the company's financial statements, (2) required and expanded use of emphasis paragraphs in the auditor's report, (3) auditor reporting on information outside the financial statements, and (4) clarification of certain language in the auditor's report. These alternatives are not mutually exclusive. A revised auditor's report could include one or a combination of these alternatives or elements of these alternatives. Readers are encouraged to visit the PCAOB website www.pcaobus.org for the full text of the concept release and should remain alert for developments.

[1] For audits conducted in accordance with PCAOB standards, Auditing Standard No. 1, *References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), replaces this title with the following title, "Report of Independent Registered Public Accounting Firm." See the PCAOB website at www.pcaobus.org for the full text of PCAOB auditing standards.

then ended. These financial statements are the responsibility of the Institution's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America.[2] Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. [*Optional: An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Institution's internal control over financial reporting. Accordingly, we express no such opinion.*][3] An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of ABC Institution as of December 31, 20X1 and 20X0, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

[*Signature*]

[*Date*]

23.03

Considerations for Audits Performed in Accordance with PCAOB Standards

When performing an integrated audit of financial statements and internal control over financial reporting in accordance with the

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[2] For audits conducted in accordance with PCAOB standards, PCAOB Auditing Standard No. 1 replaces this sentence with the following sentence, "We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States)." See the PCAOB website at www.pcaobus.org for the full text of PCAOB auditing standards.

Interpretation No. 18, "Reference to PCAOB Standards in an Audit Report on a Nonissuer," of AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, AU sec. 9508 par. .89–.92), provides reporting guidance for audits of nonissuers. Interpretation No. 18 provides guidance on the appropriate referencing of PCAOB auditing standards in audit reports when an auditor is engaged to perform the audit in accordance with both generally accepted auditing standards and PCAOB auditing standards.

[3] This optional wording may be added in accordance with Interpretation No. 17, "Clarification in the Audit Report of the Extent of Testing of Internal Control Over Financial Reporting in Accordance With Generally Accepted Auditing Standards," of AU section 508 (AICPA, *Professional Standards*, AU sec. 9508 par. .85–.88). Interpretation No. 17 addresses how auditors may expand their independent audit report to explain that their consideration of internal control provided the auditor a sufficient understanding of the internal control to plan the audit and determine the nature, timing and extent of tests to be performed, but was not sufficient to express an opinion on the effectiveness of the internal control over financial reporting. If this optional language is added, then the remainder of the paragraph should read as follows:

> An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

auditing standards of the PCAOB, the auditor may choose to issue a combined report or separate reports on the company's financial statements and on internal control over financial reporting. Refer to paragraphs 85–98 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), for direction on reporting on internal control over financial reporting.

23.04 If the auditor issues separate reports on the company's financial statements and on internal control over financial reporting, the following paragraph, as presented in paragraph 88 of Auditing Standard No. 5, should be added to the auditor's report on the company's financial statements:

> We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), X Company's internal control over financial reporting as of December 31, 20X1, based on [*identify control criteria*] and our report dated [*date of report, which should be the same as the date of the report on the financial statements*] expressed [*include nature of opinion*].

The auditor also should add the following paragraph to the report on internal control over financial reporting:

> We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the [*identify financial statements*] of X Company and our report dated [*date of report, which should be the same as the date of the report on the effectiveness of internal control over financial reporting*] expressed [*include nature of opinion*].

23.05 When performing an integrated audit of financial statements and internal control over financial reporting in accordance with the PCAOB auditing standards, the auditor's report on the company's financial statements and on internal control over financial reporting should be dated the same date. Refer to paragraph 89 of PCAOB Auditing Standard No. 5.

Explanatory Language Added to the Auditor's Standard Report

23.06 According to paragraph .11 of AU section 508, certain circumstances, although not affecting the auditor's unqualified opinion, may require that the auditor add an explanatory paragraph (or other explanatory language) to the standard report. This section addresses one of them, namely, the existence of substantial doubt about an institution's ability to continue as a going concern.[†]

[†] Based on the Financial Accounting Standards Board (FASB) technical plan as of January 2011, the *Going Concern* project has now been renamed *Disclosures about Risks and Uncertainties and the Liquidation Basis of Accounting*. The objective of this project is to incorporate into FASB literature guidance on (1) the required disclosures about risks and uncertainties that may interfere with an entity's ability to meet its obligations when they become due and (2) the adoption and application of the liquidation basis of accounting. FASB originally undertook this project to determine what analysis and disclosures in financial statements management should be required to make about whether there is substantial doubt about an entity's ability to continue as a going concern. FASB decided to broaden the scope of this project to address concerns about the ability of users of financial statements to understand the risks and uncertainties about an entity's ability to continue as a going concern and to meet its obligations when they become due. In addition, FASB decided to provide guidance on the liquidation basis of accounting at the request of constituents. Readers are encouraged to visit the FASB website at www.fasb.org for additional developments regarding this project.

23.07 AU section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*), describes the auditor's responsibility for evaluating whether there is substantial doubt about the ability of the entity whose financial statements are being audited to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited. Chapter 17, "Equity and Disclosures Regarding Capital Matters," of this guide describes going-concern considerations as they relate to banks and savings institutions and discusses how an institution's regulatory capital position should be considered in the auditor's assessment of whether there is substantial doubt about the institution's ability to continue as a going concern. If the auditor concludes that there is substantial doubt about an institution's ability to continue as a going concern for a reasonable period of time, the report should include an explanatory paragraph (following the opinion paragraph), as described in paragraph .13 of AU section 341, to express that conclusion. Paragraph .14 of AU section 341 states that if the auditor concludes that the entity's disclosures with respect to the entity's ability to continue as a going concern for a reasonable period of time are inadequate, a departure from GAAP exists. This may result in either a qualified (except for) or an adverse opinion. Reporting guidance for such situations is provided in AU section 508. Paragraph .12 of AU section 341 states that the auditor's conclusion about the entity's ability to continue as a going concern should be expressed through the use of the phrase "substantial doubt about its (the entity's) ability to continue as a going concern" or similar wording that includes the terms *substantial doubt* and *going concern*.[4] The following is an illustration of an auditor's report on the financial statements of a bank or savings institution that includes an explanatory paragraph because of the existence of substantial doubt about the institution's ability to continue as a going concern for a reasonable period of time:

Independent Auditor's Report

To the [*Institution, Board of Directors, or Stockholders*]:

[*Same first, second, and third paragraphs as the standard (unqualified) report. See illustrative example at paragraph 23.02*]

The accompanying financial statements have been prepared assuming that ABC Institution will continue as a going concern. As discussed in Note XX to the financial statements, at December 31, 20X1, the Institution did not meet its minimum capital requirements established by the Office of the Comptroller of the Currency (OCC). The Institution also has suffered recurring losses from operations. The Institution has filed a capital plan with the OCC outlining its plans for attaining the required levels of regulatory capital by December 31, 20X2. To date, the Institution has not received notification from the OCC regarding acceptance or rejection of its capital plan. Failure to meet the capital requirements and interim capital targets included in the capital plan would expose the Institution to regulatory sanctions that may include restrictions on operations and growth, mandatory asset dispositions, and seizure. These matters raise substantial doubt about the ability of ABC Institution to continue as a going concern. The ability of the Institution to continue as a going concern is dependent on many factors, one of which is regulatory

[4] Footnote 5 to paragraph .13 of AU section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*), states that in a going-concern explanatory paragraph, the auditor should not use conditional language in expressing a conclusion concerning the existence of substantial doubt about the entity's ability to continue as a going concern.

action, including ultimate acceptance of its capital plan. Management's plans in regard to these matters are described in Note XX. The accompanying financial statements do not include any adjustments that might result from the outcome of this uncertainty.

[*Signature*]

[*Date*]

23.08 AU section 341 states that the inclusion of an explanatory paragraph (following the opinion paragraph) in the auditor's report as described previously serves adequately to inform users of the financial statements of the auditor's substantial doubt. Nevertheless, AU section 341 does not preclude the auditor from declining to express an opinion in cases involving uncertainties. If the auditor disclaims an opinion, the uncertainties and their possible effects should be disclosed in an appropriate manner and the auditor's report should state all of the substantive reasons for the disclaimer of opinion. The following is an illustration of an auditor's disclaimer of opinion because of the existence of substantial doubt about an institution's ability to continue as a going concern for a reasonable period of time:

Independent Auditor's Report

To the [*Institution, Board of Directors, or Stockholders*]:

We have audited the accompanying balance sheets of ABC Institution as of December 31, 20X1 and 20X0, and the related statements of income, changes in stockholders' equity, and cash flows for the years then ended.[5] These financial statements are the responsibility of the Institution's management. Our responsibility is to report on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America.[6] Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our report.[7]

The accompanying financial statements have been prepared assuming that ABC Institution will continue as a going concern. As discussed in Note X to the financial statements, at December 31, 20X1, the Institution did not meet its minimum capital requirements established by the Office of the Comptroller of the Currency (OCC). The Institution also has suffered recurring losses from operations. The Institution has filed a capital restoration plan with the OCC outlining its plans for attaining the required levels of regulatory capital by December 31, 20X2. To date, the Institution has not

[5] If the auditor was disclaiming an opinion due to a scope limitation, this sentence would state the following, "We were engaged to audit the accompanying balance sheets of ABC Institution as of December 31, 20X1 and 20X0, and the related statements of income, changes in stockholders' equity, and cash flows for the years then ended." (See paragraph 23.12 on "Disclaimer of Opinion.")

[6] See footnote 1.

[7] If the auditor was disclaiming an opinion due to a scope limitation, this paragraph would be omitted. (See paragraphs 23.12–.13 and 23.20 on "Disclaimer of Opinion.")

received notification from the OCC regarding acceptance or rejection of its capital restoration plan. Failure to meet the capital requirements and interim capital targets included in the Institution's capital plan would expose the bank to regulatory sanctions that may include restrictions on operations and growth, mandatory asset dispositions, and seizure. These matters raise substantial doubt about the ability of ABC Institution to continue as a going concern. The ability of the Institution to continue as a going concern is dependent on many factors, one of which is regulatory action, including ultimate acceptance of its capital plan. Management's plans in regard to these matters are described in Note XX. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

Because of the significance of the uncertainty discussed above, we are unable to express, and we do not express, an opinion on the financial statements for the year ended December 31, 20X1.

In our opinion, the 20X0 financial statements referred to above present fairly, in all material respects, the financial position of ABC Institution as of December 31, 20X0, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

[*Signature*]

[*Date*]

Emphasis of a Matter

23.09 In some circumstances, the auditor may wish to emphasize a matter regarding the financial statements but, nevertheless, intends to express an unqualified opinion. For example, the auditor may wish to emphasize that the bank or savings institution is a subsidiary of a holding company or that it has had significant transactions with related parties, or the auditor may wish to emphasize an unusually important subsequent event or an accounting matter affecting the comparability of the financial statements with those of the preceding period. Paragraph .19 of AU section 508 states that such explanatory information should be presented in a separate paragraph of the auditor's report that may precede or follow the opinion paragraph. Furthermore, paragraph .19 of AU section 508 states that phrases such as "with the foregoing explanation" should not be used in the opinion paragraph in situations of this type. The following is an illustration of an unqualified opinion with an emphasis of a matter paragraph regarding an institution's failure to meet minimum regulatory capital standards on the institution's financial statements (note that in this illustration, this emphasis of a matter is not a going-concern matter):

Independent Auditor's Report

To the [*Institution, Board of Directors, or Stockholders*]:

[*Same first, second, and third paragraphs as the standard (unqualified) report. See illustrative example at paragraph 23.02*]

As discussed in Note XX to the financial statements, at December 31, 20X1, the Institution failed to meet the risk-based capital requirement established by the Federal Deposit Insurance Corporation (FDIC). The Institution has filed, and the FDIC has accepted, a

capital plan for attaining the required level of regulatory risk-based capital by December 31, 20X2.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of ABC Institution as of December 31, 20X1 and 20X0, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

[*Signature*]

[*Date*]

Qualified Opinion

23.10 Paragraphs .20–.57 of AU section 508 describe certain circumstances that may require the auditor to qualify his or her opinion on financial statements. A qualified opinion states that, except for the effects of the matter to which the qualification relates, the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows in conformity with GAAP. Such an opinion is expressed when

a. there is a lack of sufficient appropriate audit evidence or there are restrictions on the scope of the audit that have led the auditor to conclude that an unqualified opinion cannot be expressed and the auditor has concluded not to disclaim an opinion.

b. the auditor believes, on the basis of the audit, that the financial statements contain a departure from GAAP, the effect of which is material, and has concluded not to express an adverse opinion.

Adverse Opinion

23.11 Paragraphs .58–.60 of AU section 508 describe adverse opinions. An adverse opinion states that the financial statements do not present fairly the financial position or the results of operations or cash flows in conformity with GAAP. Such an opinion is expressed when, in the auditor's judgment, the financial statements taken as a whole are not presented fairly in conformity with GAAP. When the auditor expresses an adverse opinion, he or she should disclose in a separate explanatory paragraph(s) preceding the opinion paragraph of the report (*a*) all the substantive reasons for the adverse opinion and (*b*) the principal effects of the subject matter of the adverse opinion on financial position, results of operations, and cash flows, if practicable. If the effects are not reasonably determinable, the report should so state. When an adverse opinion is expressed, the opinion paragraph should include a direct reference to a separate paragraph that discloses the basis for the adverse opinion.

Disclaimer of Opinion

23.12 Paragraphs .61–.63 of AU section 508 describe disclaimers of opinion and provide an illustrative example of a report disclaiming an opinion.

> A disclaimer of opinion states that the auditor does not express an opinion on the financial statements. An auditor may decline to express an opinion whenever he is unable to form or has not formed an opinion as to fairness of presentation of the financial statements in conformity with generally accepted accounting principles. If the auditor disclaims an opinion, the auditor's report should give all of the substantive reasons for the disclaimer.

A disclaimer is appropriate when the auditor has not performed an audit sufficient in scope to enable him or her to form an opinion on the financial statement. A disclaimer of opinion should not be expressed because the auditor believes, on the basis of his or her audit, that there are material departures from GAAP (see paragraphs .35–.57 of AU section 508). When disclaiming an opinion because of a scope limitation, the auditor should state in a separate paragraph or paragraphs all of the substantive reasons for the disclaimer. The auditor should state that the scope of the audit was not sufficient to warrant the expression of an opinion. The auditor should not identify the procedures that were performed nor include the paragraph describing the characteristics of an audit (that is, the scope paragraph of the auditor's standard report); to do so may tend to overshadow the disclaimer. In addition, the auditor should also disclose any other reservations he or she has regarding fair presentation in conformity with GAAP.

Financial Statements Prepared in Conformity With an Other Comprehensive Basis of Accounting

23.13 Title II of the Credit Union Membership Access Act of 1998, requires all federally insured credit unions with assets of $10 million or more to follow U.S. GAAP. Credit unions with assets under $10 million may use a basis of accounting other than U.S. GAAP. Paragraphs .04–.05 of AU section 623, *Special Reports* (AICPA, *Professional Standards*), recognize a basis of accounting that the reporting entity uses to comply with the requirements or financial reporting provisions of a governmental regulatory agency to whose jurisdiction the entity is subject as comprehensive basis of accounting other than GAAP, and provides guidance on reporting on an other comprehensive basis of accounting financial statements.

23.14 The following is an example of an auditor's report on financial statements prepared in conformity with a comprehensive basis of accounting prescribed by the National Credit Union Administration. Only credit unions with assets under $10 million may use a basis of accounting other than U.S. GAAP.

Independent Auditor's Report

To the [*Institution, Board of Directors, or Stockholders*]:

We have audited the accompanying statements of financial condition—regulatory basis of XYZ Credit Union as of December 31, 20X1 and 20X0, and the related statements of income—regulatory basis, members' equity—regulatory basis, and cash flows—regulatory basis for

the years then ended. These financial statements are the responsibility of the credit union's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described in Note X, these financial statements were prepared in conformity with the accounting principles prescribed or permitted by the National Credit Union Administration (NCUA), which is a comprehensive basis of accounting other than accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of XYZ Credit Union as of December 31, 20X1 and 20X0, and the results of its operations and its cash flows for the years then ended, on the basis of accounting described in Note X.

This report is intended solely for the information and use of the board of directors and management of XYZ Credit Union and the NCUA, and is not intended to be and should not be used by anyone other than these specified parties.

[*Signature*]

[*Date*]

Members' Shares Reported as Equity

23.15 As discussed in paragraph 13.43 of this guide, U.S. GAAP requires that members' shares be reported as liabilities in the statement of financial condition. If members' shares are not reported as such, or in any other manner in which it is not unequivocal that members' shares are liabilities, and the shares are material to the financial statements, the auditor should express a qualified opinion or, in certain cases, an adverse opinion on the financial statements unless the financial statements are prepared using a comprehensive basis of accounting other than U.S. GAAP (see paragraphs 23.13–.14). An illustration of a report modified in those circumstances follows:

Independent Auditor's Report

[*Same first and second paragraphs as the standard report*]

The Credit Union has reported members' shares as equity in the accompanying statements of financial condition that, in our opinion, should be reported as liabilities in order to conform with accounting principles generally accepted in the United States of America. If these shares were properly reported, liabilities would increase and equity would decrease by $_______ and $_______ as of December 31, 20X1 and 20X0, respectively.

In our opinion, except for the effects of reporting members' shares as equity as discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of XYZ Credit Union as of December 31, 20X1 and 20X0, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Communication of Internal Control Related Matters

23.16 Whenever an auditor expresses an opinion (including a disclaimer of opinion) on the financial statements of a nonissuer, paragraph .17 of AU section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*), states that the auditor must communicate, in writing, to management and those charged with governance, control deficiencies identified during the audit that are considered significant deficiencies or material weaknesses in the internal control process. The communication required by AU section 325 includes significant deficiencies and material weaknesses identified and communicated to management and those charged with governance in prior audits but not yet remediated. The written communication, as stated in paragraph .18 of AU section 325, is best made by the report release date but should be made no later than 60 days following the report release date. Paragraph .21 of AU section 325 states that nothing precludes the auditor from communicating to management and those charged with governance other matters that the auditor believes to be of potential benefit to the entity or control deficiencies that are not significant deficiencies or material weaknesses. Paragraph .25 of AU section 325 states that the auditor should not issue a written communication stating that no significant deficiencies were identified during the audit.

23.17 AU section 325 is not applicable if the auditor is engaged to examine the design and operating effectiveness of an entity's internal control over financial reporting that is integrated with an audit of the entity's financial statements under AT section 501, *An Examination of an Entity's Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements* (AICPA, *Professional Standards*). For entities not subject to Section 404 of the Sarbanes-Oxley Act of 2002, AT section 501 establishes requirements and provides guidance that applies when an auditor is engaged to perform an examination of the design and operating effectiveness of an entity's internal control over financial reporting that is integrated with an audit of financial statements. For entities subject to Section 404 of the Sarbanes-Oxley Act of 2002, PCAOB Auditing Standard No. 5 is applicable.

23.18 Part 363 of the Federal Deposit Insurance Corporation (FDIC)'s Rules and Regulations requires the independent public accountant's report on internal control over financial reporting to include a statement that the evaluation included controls over the preparation of regulatory financial statements in accordance with regulatory reporting instructions including identification of the regulatory reporting instructions. Exhibit C, "Reporting Under Section 112 of the Federal Deposit Insurance Corporation Improvement Act (FDICIA)," of AT section 501 provides guidance and an illustrative definition paragraph to assist auditors' in complying with FDICIA and Part 363. Additional guidance concerning the reports by auditors on internal control over regulatory reporting may be found in question No. 31 of the PCAOB's Staff Question and Answer, "Auditing Internal Control Over Financial Reporting," to the superseded PCAOB Auditing Standard No. 2, *An Audit of Internal Control*

Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements. Although PCAOB Auditing Standard No. 2 has been superseded by PCAOB, the guidance in question 31 is still appropriate and consistent with the requirements of AT section 501 and Part 363.

Reports on Supervisory Committee Audits

23.19 The form and content of reports that are currently prepared by independent auditors in connection with supervisory committee audits reflect a diversity of practice. As a result, supervisory committee members may not understand the fundamental differences between an engagement for the application of agreed-upon procedures to specified elements, accounts, or items of a financial statement in connection with a supervisory committee audit and an audit of a credit union's financial statements in accordance with GAAS. This is of particular concern when the limitations of the supervisory committee audit relate to areas of higher risk in the credit union industry. Further, supervisory committee members may incorrectly assume that the application of agreed-upon procedures included obtaining an understanding of the credit union's internal control similar to that obtained in an audit of the credit union's financial statements in accordance with GAAS.

23.20 Independent auditors' reports on audits of financial statements must comply with the reporting provisions contained in applicable AICPA *Professional Standards*. AU section 508 provides guidance on reports on audited financial statements, and paragraph .62 of AU section 508 states that a disclaimer of opinion is appropriate when the auditor has not performed an audit sufficient in scope to enable him or her to form an opinion on the financial statements.

23.21 Independent auditors' reports on the performance of agreed-upon procedures in connection with a supervisory committee audit should be prepared in accordance with Statements on Standards for Attestation Engagements. Paragraph .31 of AT section 201, *Agreed-Upon Procedures Engagements* (AICPA, *Professional Standards*), states that such reports should contain the following elements:

- A title that includes the word *independent*
- Identification of specified parties (See paragraph .36 of AT section 201)
- Identification of the subject matter (or the written assertion related thereto) and the character of the engagement
- Identification of the responsible party
- A statement that the subject matter is the responsibility of the responsible party
- A statement that the procedures performed were those agreed to by the specified parties identified in the report
- A statement that the agreed-upon procedures engagement was conducted in accordance with attestation standards established by the AICPA
- A statement that the sufficiency of the procedures is solely the responsibility of the specified parties and a disclaimer of responsibility for the sufficiency of those procedures

- A list of the procedures performed (or reference thereto) and related findings (The practitioner should not provide negative assurance—see paragraph .24 of AT section 201.)
- Where applicable, a description of any agreed-upon materiality limits (See paragraph .25 of AT section 201.)
- A statement that the practitioner was not engaged to and did not conduct an examination of the subject matter, the objective of which would be the expression of an opinion, a disclaimer of opinion on the subject matter, and a statement that if the practitioner had performed additional procedures, other matters might have come to his or her attention that would have been reported
- A statement of restrictions on the use of the report because it is intended to be used solely by the specified parties
- Where applicable, reservations or restrictions concerning procedures or findings (as discussed in paragraphs .33, .35, and .39–.40 of AT section 201)
- For an agreed-upon procedures engagement on prospective financial information, all items included in paragraph .55 of AT section 301, *Financial Forecasts and Projections* (AICPA, *Professional Standards*)
- Where applicable, a description of the nature of the assistance provided by a specialist as discussed in paragraphs .19–.21 of AT section 201
- The manual or printed signature of the practitioner's firm
- The date of the report

23.22 As mentioned earlier, some regulatory agencies require that supervisory committee audit reports include financial statements or other data. In such instances, the supervisory committee usually includes the auditor's report on the application of agreed-upon procedures and the unaudited financial statements or data in its report to the regulatory agency.

23.23 An auditor may be requested to perform specific procedures in conjunction with a compilation or review of financial statements. The procedures employed in compilation and review engagements, and reports thereon, must comply with, among other professional standards, the provisions of AR section 60, *Framework for Performing and Reporting on Compilation and Review Engagements*, AR section 80, *Compilation of Financial Statements*, and AR section 90, *Review of Financial Statements* (AICPA, *Professional Standards*). Any procedures that the accountant might have performed before or during the review engagement, including those performed in connection with a compilation of the financial statements, should not be described in his or her report. However, this would not preclude the auditor from issuing a separate, special-purpose report on the nature and extent of procedures performed.

Example Report on the Application of Agreed-Upon Procedures Performed in Connection With a Supervisory Committee Audit

23.24 The following is an example of a report on the application of agreed-upon procedures performed in connection with a supervisory committee audit:

Independent Accountant's Report on Applying Agreed-Upon Procedures

Supervisory Committee
XYZ Credit Union

We have performed the procedures enumerated in the attached supplement, which were agreed to by [*list specified parties*,[8] *ordinarily the Supervisory Committee of XYZ Credit Union*], solely to assist you in connection with your supervisory audit of XYZ Credit Union conducted pursuant to section 715 of the National Credit Union Administration regulations for the period ended June 30, 20X1. The procedures performed by us and enumerated in the attached supplement are in accordance with the minimum procedures described in appendix A of the National Credit Union Administration's Supervisory Committee Guide for Federal Credit Unions. Because the committee is responsible to ensure that a complete set of procedures is performed and because appendix A procedures are designed for smaller, less complex credit unions, we performed supplemental procedures at the committee's request. This engagement to apply agreed-upon procedures was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. The sufficiency of the procedures is solely the responsibility of those parties specified in this report. Consequently, we make no representation regarding the sufficiency of the procedures described in the supplement either for the purpose for which this report has been requested or for any other purpose.

We were not engaged to and did not perform an audit, the objective of which would be the expression of an opinion on the specified elements, accounts, or items. Accordingly, we do not express such an opinion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you.

This report is intended solely for the information and use of [*the specified parties*] and is not intended to be and should not be used by anyone other than these specified parties.

____

[*Signature*]

[*Date*]

[8] The National Credit Union Association (NCUA) should not be named as a specified party.

Supplement to Illustrative Report[9]

Loans

We obtained trial balances or subsidiary ledgers of the notes or both from the service center and reconciled the totals to the general ledger in the following amounts:

Account	*Amount Outstanding at June 30, 20X0*
Business loans	$
Consumer loans	
Real estate loans	
Participations purchased	
	$

Certain [*specify number*] loans, including lines of credit that had not been fully funded, were selected for confirmation directly with borrowers. The results of our confirmation efforts are summarized in schedule A. Borrowers with lines of credit of $_______ or more as of June 30, 20X0, who did not respond to confirmation requests by July 31, 20X0, are listed in schedule B.

We obtained and read selected [*specify number*] loan agreements on hand, as well as readily marketable securities, and other collateral recorded as held in respect of certain selected secured loans were inspected.

We obtained the Credit Union's listing of business loans, real estate loans, and participations purchased five days or more past due as of June 30, 20X0, and compared it with a similar listing as of July 31, 20X0. The following loans were listed in both reports:

[*List loans.*]

Similarly, we obtained the Credit Union's listing of consumer loans ten days or more past due as of June 30, 20X0, and compared it to a like listing as of July 31, 20X0. The following loans were listed in both reports:

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[9] This supplement is for illustrative purposes only and, therefore, is not considered to be an all-inclusive list of accounts that may be examined and procedures that may be performed. The illustrative procedures listed may or may not be relevant to a particular engagement. The independent auditor should describe those accounts examined and procedures relevant to the specific engagement. The accounts and procedures described in the report should generally conform to those described in the engagement letter. Procedures for other accounts should be specified in detail, and differences and subsequent disposition should be reported.

Refer to appendix A to the NCUA's Supervisory Committee Guide for Federal Credit Unions for a complete and optional procedure discussion of the minimum procedures that a supervisory committee or its auditor or other accountant must complete when a Supervisory Committee chooses the Supervisory Committee Guide option for completing its annual audit requirement under Part 715 of the NCUA Rules and Regulations.

Name	*Due Date*	*Amount Outstanding at June 30, 20X0*	*Amount Outstanding at July 31, 20X0*
____________	____________	____________	____________

Loan participations [*Specify "all" or number*] "sold" and serviced by the credit union were confirmed with the purchasers, without exception.

We obtained the Credit Union's listing of overdrafts as of June 30, 20X0, and compared it to a similar listing as of July 31, 20X0. The following overdrafts were listed in both reports:

Name	*Date of Overdraft*	*Amount at June 30, 20X0*	*Amount at July 31, 20X0*
____________	____________	____________	____________

The interest rates and repayment terms of five judgmentally selected loans granted to directors, officers, and other related parties during May 20X0 were compared to the interest rate and repayment terms of similar loans granted to outsiders during the same month. No instances of the granting of favorable interest rates or repayment terms to directors, officers, and other related parties were found.

The maturity date and amount of loan commitments in excess of $50,000 were confirmed as of May 20X0 by the customers for whose benefit they were issued, without exception. We judgmentally selected five loan commitments and tested the computation of deferred fee income. [*Specify results of computations.*]

Requests for confirmation of loan balances could not be mailed to the following borrowers due to lack of sufficient addresses:

Name	*Account Number*	*Balance as of June 30, 20X0*
___________	__________	__________

Lack of Evaluation of Collectibility and Adequacy of Collateral

As noted in our engagement letter and report, we did not evaluate the collectibility of loans or the adequacy of collateral thereon.

Lack of Evaluation of the Allowance for Loan Losses

As noted in our engagement letter and report, we did not evaluate the reasonableness of the allowance for loan losses determined by management.

Confirmation Statistics

[*Confirmation Date*]

	Loans	*Share Draft Accounts*	*Savings Accounts*	*Certificates of Deposit*
Dollar amounts				
Total				
Circularized				
Percent circularized to total				
Replies received to total circularized				
Selected but not circularized				
Not delivered by post office				
Number of accounts				
Total				
Circularized				
Percent circularized to total				
Replies received				
Percent replies received to total circularized				
Selected but not circularized				
Not delivered by post office				

Confirmation Requests Not Mailed

	Name and Address	*Reason for Not Mailing*	*Balance as of [Audit Date]*
Loans			
Share draft accounts			
Savings accounts			
Certificates of deposit			

Note: An indication of how the samples were selected (that is, on a random, statistical, or judgmental basis), as well as an indication of the type of confirmation (that is, positive or negative requests), should be included. If the loans are categorized by type in the report, similar categories would normally be used in this schedule.

Example Reports on the Federal Deposit Insurance Corporation Loss Sharing Purchase and Assumption Transactions

23.25 The FDIC's Resolutions Handbook (handbook) states that a loss sharing transaction is a purchase and assumption (P&A) transaction that the FDIC commonly uses as a resolution tool for handling failed institutions with more than $500 million in assets. A P&A is a resolution transaction in which a healthy institution purchases some or all of the assets of a failed bank or thrift and assumes some or all of the liabilities, including all insured deposits. The handbook also states that a loss sharing P&A uses the basic P&A structure, except for the provision regarding transferred assets. Instead of selling some or all of the assets to the acquirer at a discounted price, the FDIC agrees to share in future loss experienced by the acquirer on a fixed pool of assets. The handbook for P&A agreements requires that within 90 days after each calendar year end, the acquiring bank must furnish the FDIC a report signed by its independent public accountants containing specified statements[10] relative to the accuracy of any computations made regarding shared loss assets.

23.26 AICPA Technical Questions and Answers (TIS) section 9110.16, "Example Reports on Federal Deposit Insurance Corporation Loss Sharing Purchase and Assumption Transactions" (AICPA, *Technical Practice Aids*), provides examples of how the auditor might respond to FDIC reporting requirements for an engagement covering an FDIC loss sharing P&A transaction. TIS section 9110.16 suggests that the auditor may respond by issuing a report following the guidance in paragraphs .19–.21 of AU section 623 and also provides illustrative auditor reports for three possible outcomes for which the auditor might report.

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[10] The term *specified statements* is not defined in the Federal Deposit Insurance Corporation's Resolutions Handbook. The practitioner is advised to read the terms of the loss share agreement and confirm that the audit requirement in that agreement provides for the receipt of a report expressing negative assurance.

Appendix A

FDI Act Reporting Requirements

A-1 Section 36 of the Federal Deposit Insurance Act (FDI Act) and its implementing regulation Title 12 U.S. *Code of Federal Regulations* Part 363 require reports by managements and auditors on financial statements and internal control over financial reporting. Section 36 and Part 363 also establish minimum qualifications for auditors that provide audit and attest services to insured depository institutions. Section 36 and Part 363 apply to each Federal Deposit Insurance Corporation (FDIC)-insured depository institution having total assets of $500 million or greater at the beginning of its fiscal year. Despite the asset threshold, Section 36 and Part 363 do not override any non-FDI Act requirements for audited financial statements or other requirements that an institution exempt from Section 36 and Part 363 must otherwise satisfy.[1]

A-2 Part 363 was initially adopted by the FDIC's Board of Directors in 1993 and was most recently amended on June 23, 2009. The general requirements are summarized in the following paragraphs; the side-by-side analysis of the detailed regulation and guidelines is presented in the exhibit that follows. Each institution's management, board of directors, and audit committee and independent public accountants that provide audit and attestation services to institutions subject to Part 363 are encouraged to read and become familiar with the Part 363 regulatory text, the guidelines and interpretations in appendix A, and the illustrative management reports in appendix B to obtain a complete understanding of the compliance requirements of Part 363.

Part 363 Annual Reports for Institutions With $500 Million or More but Less Than $1 Billion in Total Assets

A-3 Insured depository institutions with at least $500 million but less than $1 billion in total assets are required to file a Part 363 Annual Report that must include the following:

a. Audited comparative annual financial statements;

b. An independent public accountant's report on the audited financial statements;

c. A management report that contains

i. a statement of management's responsibilities for

(1) preparing the annual financial statements;

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[1] The Federal Deposit Insurance Corporation adopted the Federal Financial Institutional Examination Council Interagency Policy Statement on External Auditing Programs of Banks and Savings Associations. The other banking agencies have also adopted the interagency policy statement. The interagency policy statement encourages institutions to adopt an annual external auditing program and, where practicable, to establish an audit committee composed entirely of outside directors. The interagency policy statement states that the banking agencies consider an annual audit of an institution's financial statements performed by an independent public accountant to be the preferred type of external auditing program. The statement also describes two alternatives to a financial statement audit that an institution may elect to have performed annually in order to have an acceptable external auditing program.

(2) establishing and maintaining an adequate internal control structure over financial reporting;[2] and

(3) complying with the designated safety and soundness laws and regulations pertaining to insider loans and dividend restrictions; and

ii. an assessment by management of the institution's compliance with the designated laws and regulations pertaining to insider loans and dividend restrictions during the year, which must state management's conclusion regarding compliance and disclose any noncompliance with these laws and regulations. The assessment must clearly state whether the institution has or has not complied with these regulations. Disclosure is not dependent on the degree or materiality of any noncompliance. Statements such as "management believes that the institution complied, in all material respects with the designated safety and soundness laws and regulations" do not present a definitive and unconditional conclusion regarding compliance as envisioned under Part 363.

A-4 In general, an institution that is required to file, or whose parent holding company is required to file, management's assessment of the effectiveness of internal control over financial reporting with the Securities and Exchange Commission (SEC) or the appropriate federal banking agency in accordance with Section 404 of the Sarbanes-Oxley Act of 2002 must submit a copy of such assessment with its Part 363 Annual Report as additional information. However, this assessment will not be considered part of the institution's Part 363 Annual Report.

Part 363 Annual Reports for Institutions With $1 Billion or More in Total Assets

A-5 Insured depository institutions with $1 billion or more in total assets are required to file a Part 363 Annual Report that must include the following:

a. Audited comparative annual financial statements;

b. The independent public accountant's report on the audited financial statements;

c. A management report that contains

i. a statement of management's responsibilities for

(1) preparing the annual financial statements;

(2) establishing and maintaining an adequate internal control structure over financial reporting;[3] and

(3) complying with the designated safety and soundness laws and regulations pertaining to insider loans and dividend restrictions; and

ii. An assessment by management on the effectiveness of the institution's internal control structure over financial reporting as of the end of the fiscal year that must

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[2] For purposes of Title 12 U.S. *Code of Federal Regulations* Part 363, financial reporting encompasses both financial statements prepared in accordance with generally accepted accounting principles and those prepared for regulatory reporting purposes.

[3] See footnote 2.

(1) identify the internal control framework[4] used by management to evaluate the effectiveness of internal control over financial reporting;

(2) state that the assessment included controls over the preparation of regulatory financial statements in accordance with regulatory reporting instructions and identify the regulatory reporting instructions;

(3) state management's conclusion regarding whether internal control over financial reporting is effective as of the institution's fiscal year-end;[5] and

(4) disclose all material weaknesses in internal control over financial reporting, if any, that management has identified that have not been remediated prior to the institution's fiscal year-end.

iii. An assessment by management of the institution's compliance with the designated laws and regulations pertaining to insider loans and dividend restrictions during the year, which must state management's conclusion regarding compliance and disclose any noncompliance with these laws and regulations. The assessment must clearly state whether the institution has or has not complied with these regulations. Disclosure is not dependent on the degree or materiality of any noncompliance. Statements such as "management believes that the institution complied, in all material respects with the designated safety and soundness laws and regulations" do not present a definitive and unconditional conclusion regarding compliance as envisioned under Part 363.

d. An independent public accountant's attestation report concerning the effectiveness of the institution's internal control structure over financial reporting. The accountant's report must not be dated prior to the date of the management report and management's assessment of the effectiveness of internal control over financial reporting and must

i. identify the internal control framework used by the independent public accountant, which must be the same as the internal control framework used by management, to evaluate the effectiveness of the institution's internal control over financial reporting;

ii. state that the independent public accountant's evaluation included controls over the preparation of regulatory financial statements in accordance with regulatory reporting instructions and identify the regulatory reporting instructions;

iii. state the independent public accountant's conclusion regarding

[4] For example, in the United States, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) has published *Internal Control—Integrated Framework*, including an addendum on safeguarding assets. Known as the COSO report, this publication provides a suitable and available framework for purposes of management's assessment.

[5] If there are one or more material weaknesses that have not been remediated prior to the institution's fiscal year-end, management must conclude that internal control over financial reporting is ineffective.

whether internal control over financial reporting is effective as of the institution's fiscal year-end;[6] and

iv. disclose all material weaknesses in internal control over financial reporting, if any, that the independent public accountant has identified that have not been remediated prior to the institution's fiscal year-end.

Filing Deadlines for Part 363 Annual Reports

A-6 For fiscal years ending on or after June 15, 2010, an institution shall file its Part 363 Annual Report within 120 days after the end of its fiscal year if (1) it is neither a public company nor a subsidiary of a public company or (2) it is a subsidiary of a public holding company and its consolidated total assets (or the consolidated total assets of all of its parent holding company's insured depository institution subsidiaries) comprise less than 75 percent of the consolidated total assets of the public holding company as of the beginning of its fiscal year.

A-7 An institution shall file its Part 363 Annual Report within 90 days after the end of its fiscal year if (1) it is a public company or (2) it is a subsidiary of a public holding company and its consolidated total assets (or the consolidated total assets of all of its parent holding company's insured depository institution subsidiaries) comprise 75 percent or more of the consolidated total assets of the public holding company as of the beginning of its fiscal year.

A-8 If an institution will be unable to file its Part 363 Annual Report by the specified deadline, it must submit a notification of late filing.

Other Requirements—All Institutions With $500 Million or More in Total Assets

Other Reports and Letters Issued by the Independent Public Accountant

A-9 Except for the independent public accountant's reports that are included in its Part 363 Annual Report, each insured depository institution must file with the FDIC, the appropriate federal banking agency, and any appropriate state bank supervisor a copy of any management letter or other report issued by its independent public accountant with respect to the institution and the audit and attestation services provided by the accountant within 15 days after receipt. Such reports include, but are not limited to

- any written communication regarding matters that the accountant is required to communicate to the audit committee (for example, critical accounting policies, alternative accounting treatments discussed with management, and any schedule of unadjusted differences);
- any written communication of significant deficiencies and material weaknesses in internal control required by the auditing or attestation standards of the AICPA or the Public Company Accounting Oversight Board (PCAOB), as appropriate;

[6] If there are one or more material weaknesses that have not been remediated prior to the institution's fiscal year-end, the independent public accountant must conclude that internal control over financial reporting is ineffective.

- for an institution with total assets of $500 million or more but less than $1 billion as of the beginning of its fiscal year that is (1) a public company or (2) a subsidiary of a public holding company and its consolidated total assets (or the consolidated total assets of all of its parent holding company's insured depository institution subsidiaries) comprise 75 percent or more of the consolidated total assets of the public holding company as of the beginning of its fiscal year, any report by the independent public accountant on the audit of internal control over financial reporting required by Section 404 of the Sarbanes-Oxley Act of 2002 and the PCAOB's auditing standards;
- for an institution that is (1) a public company or (2) a subsidiary of a public holding company and its consolidated total assets (or the consolidated total assets of all of its parent holding company's insured depository institution subsidiaries) comprise 75 percent or more of the consolidated total assets of the public holding company as of the beginning of its fiscal year, any written communication by the independent public accountant of all deficiencies in internal control over financial reporting that are of a lesser magnitude than significant deficiencies, which is required by the PCAOB's auditing standards; and
- for an institution that is (1) a nonpublic company or (2) a subsidiary of a nonpublic holding company and its consolidated total assets (or the consolidated total assets of all of its parent holding company's insured depository institution subsidiaries) comprise 75 percent or more of the consolidated total assets of the nonpublic holding company as of the beginning of its fiscal year, any written communication by the independent public accountant of all deficiencies in internal control over financial reporting that are of a lesser magnitude than significant deficiencies, which is required by the AICPA's auditing and attestation standards.

Notice of Engagement, Change, Dismissal, or Resignation of Accountants

A-10 Within 15 days after a change in or the dismissal or resignation of the institution's independent public accountant or the engagement of a new independent public accountant, the institution must file written notice with the FDIC, the appropriate federal banking agency, and any appropriate state bank supervisor. Also, within 15 days after the institution's independent public accountant resigns or is dismissed, the independent public accountant must file written notice with the FDIC, the appropriate federal banking agency, and any appropriate state bank supervisor. These written notices should set forth in reasonable detail the reasons for the resignation or dismissal of the institution's independent public accountant.

A-11 In this regard, before engaging an independent public accountant, the institution's audit committee should satisfy itself that the independent public accountant is in compliance with the qualifications and other requirements applicable to independent public accountants set forth in Part 363, including the independence standards of the AICPA, the SEC, and the PCAOB. Also, the audit committee should ensure that engagement letters and any related agreements with the independent public accountant for audit and attestation services to be performed under Part 363 do not contain any limitation of liability provisions that: (1) indemnify the independent public accountant against claims made by third parties; (2) hold harmless or release

the independent public accountant from liability for claims or potential claims that might be asserted by the client institution, other than claims for punitive damages; or (3) limit the remedies available to the client institution.

Peer Reviews and Inspection Reports

A-12 Within 15 days of receiving notification that a peer review has been accepted or a PCAOB inspection report has been issued, or before commencing any audit or attestation service under Part 363, whichever is earlier, the independent public accountant must file two copies of its most recent peer review report and the public portion of its most recent PCAOB inspection report, if any, accompanied by any letters of comments, response, and acceptance, with the FDIC, Accounting and Securities Disclosure Section, 550 17th Street, NW, Washington, DC 20429, if the report has not already been filed. Also, within 15 days of the PCAOB making public a previously nonpublic portion of an inspection report, the independent public accountant must file 2 copies of the previously nonpublic portion of the inspection report with the FDIC.

Notification of Late Filing

A-13 An institution that is unable to timely file all or any portion of its Part 363 Annual Report or any other report or notice required to be filed by Part 363 must submit a written notice of late filing to the FDIC, the appropriate federal banking agency, and any appropriate state bank supervisor. The notice shall disclose the institution's inability to timely file the report or notice and the reasons for the late filing in reasonable detail and state the date by which the report or notice will be filed. The written notice should be filed on or before the deadline for filing the Part 363 Annual Report or any other required report or notice, as appropriate.

Standards for Audits of Financial Statements and Internal Control Over Financial Reporting

A-14 The financial statement audit is to be performed in accordance with generally accepted auditing standards or the PCAOB's auditing standards, if applicable and Section 37 of the FDI Act. The examination of management's assertion about the institution's internal controls over financial reporting is to be performed in accordance with generally accepted standards for attestation engagements or the PCAOB's auditing standards, if applicable.

General Qualifications of Auditors

A-15 To provide audit and attest services to insured depository institutions, an independent public accountant should be registered or licensed to practice as a public accountant, and be in good standing, under the laws of the state or other political subdivision of the United States in which the home office of the institution (or the insured branch of a foreign bank) is located. The auditor must also agree to provide regulators with workpapers, policies, and procedures related to services performed under Part 363. Guideline 13 to Part 363 also provides that the independent public accountant must agree to provide copies of workpapers to regulators. Independent accountants should be familiar with Interpretation No. 1, "Providing Access to or Copies of Audit Documentation to a Regulator," of AU section 339, *Audit Documentation* (AICPA, *Professional Standards*, AU sec. 9339 par. .01–.15).

A-16 The independent public accountant must comply with the independence standards and interpretations of the AICPA, the SEC, and the PCAOB.

To the extent that any of the rules within any one of these independence standards (AICPA, SEC, and PCAOB) is more or less restrictive than the corresponding rule in the other independence standards, the independent public accountant must comply with the more restrictive rule.

Enforcement Actions Against Accountants

A-17 In August 2003, the FDIC, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Office of Thrift Supervision (the agencies) jointly issued final rules that establish procedures under which the agencies can remove, suspend, or bar an accountant or firm from performing audit and attestation services for insured depository institutions subject to the annual audit and reporting requirements of Section 36 of the FDI Act. The final rule can be accessed at www.fdic.gov/news/news/financial/2003/fil0366.html.

A-18 Under the final rules, certain violations of law, negligent conduct, reckless violations of professional standards, or lack of qualifications to perform auditing services may be considered good cause to remove, suspend, or bar an accountant or firm from providing audit and attestation services for institutions subject to Section 36 of the FDI Act and Part 363. In addition, the rules prohibit an accountant or accounting firm from performing these services if the accountant or firm has been removed, suspended, or debarred by one of the agencies, or if the SEC or the PCAOB takes certain disciplinary actions against the accountant or firm. The rules also permit immediate suspensions of accountants and firms in limited circumstances.

Communication With Auditors

A-19 Section 36(h) of the FDI Act and Guideline 17 to Part 363 require an institution to provide its auditor with certain information including copies of the institution's most recent reports of condition and examination; any supervisory memorandum of understanding or written agreement with any federal or state regulatory agency; and a report of any action initiated or taken by federal or state banking regulators.

Audit Committees

A-20 Each insured depository institution is required to establish an audit committee of its board of directors, the composition of which complies with paragraphs (a)(1), (2), and (3) and (b) of Section 363.5. The duties of the audit committees shall include the appointment, compensation, and oversight of the independent public accountant who performs services required under Part 363, and reviewing with management and the independent public accountant the basis for the reports issued under Part 363. Each insured depository institution with total assets of $1 billion or more as of the beginning of its fiscal year shall establish an independent audit committee of its board of directors, the members of which shall be outside directors who are independent of management of the institution. Each insured depository institution with total assets of $500 million or more but less than $1 billion as of the beginning of its fiscal year shall establish an audit committee of its board of directors, the members of which shall be outside directors, the majority of whom shall be independent of management of the institution. Each insured depository institution with total assets of $3 billion or more as of the beginning of its fiscal year shall include members with banking or financial management expertise, have access to

outside counsel, and not include any large customers of the institution. Guideline 35 to Part 363 provides transition guidance for forming and restructuring audit committees.

Audit and Reporting Requirements

A-21 Reprinted here is Part 363 of FDIC's rules and regulations, *Part 363—Annual Independent Audits and Reporting Requirements*, (left column) and appendix A to "Part 363—Guidelines and Interpretations" (right column). Part 363 and appendix A were initially published in 1993. The most recent amendments to this regulation were published in June 2009 and include a new appendix B to Part 363. Appendix B provides guidance regarding reporting scenarios that satisfy the annual reporting requirements of Part 363, illustrative management reports, and an illustrative cover letter for use when an institution complies with the annual reporting requirements at the holding company level.

Regulation

§363.1 Scope and definitions

(a) *Applicability.* This part applies to any insured depository institution with respect to any fiscal year in which its consolidated total assets as of the beginning of such fiscal year are $500 million or more. The requirements specified in this part are in addition to any other statutory and regulatory requirements otherwise applicable to an insured depository institution.

(b) *Compliance by subsidiaries of holding companies.* (1) For an insured depository institution that is a subsidiary of a holding company, the audited financial statements requirement of § 363.2(a) may be satisfied:

(i) For fiscal years ending on or before June 14, 2010, by audited consolidated financial statements of the top-tier or any mid-tier holding company.

(ii) For fiscal years ending on or after June 15, 2010, by audited consolidated

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1. Measuring Total Assets. To determine whether this part applies, an institution should use total assets as reported on its most recent Report of Condition (Call Report) or Thrift Financial Report (TFR), the date of which coincides with the end of its preceding fiscal year. If its fiscal year ends on a date other than the end of a calendar quarter, it should use its Call Report or TFR for the quarter end immediately preceding the end of its fiscal year.

2. Insured Branches of Foreign Banks. Unlike other institutions, insured branches of foreign banks are not separately incorporated or capitalized. To determine whether this part applies, an insured branch should measure claims on non-related parties reported on its Report of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks (form FFIEC 002).

3. Compliance by Holding Company Subsidiaries. Audited consolidated financial statements and other reports or notices required by this part which are submitted by a holding company for any subsidiary institution, should be accompanied by a cover letter identifying all subsidiary institutions subject to part 363 that are included in the holding company's submission. When submitting a Part 363 Annual Report, the cover letter should identify all subsidiary institutions subject to part 363 included in the consolidated financial statements and state whether the other annual report requirements (i.e.,

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financial statements of the top-tier or any mid-tier holding company provided that the consolidated total assets of the insured depository institution (or the consolidated total assets of all of the holding company's insured depository institution subsidiaries, regardless of size, if the holding company owns or controls more than one insured depository institution) comprise 75 percent or more of the consolidated total assets of this top-tier or mid-tier holding company as of the beginning of its fiscal year.

(2) The other requirements of this part for an insured depository institution that is a subsidiary of a holding company may be satisfied by the top-tier or any mid-tier holding company if the insured depository institution meets the criterion specified in § 363.1(b)(1) and if:

(i) The services and functions comparable to those required of the insured depository institution by this part are provided at this top-tier or mid-tier holding company level; and

(ii) The insured depository institution has as of the beginning of its fiscal year:

(A) Total assets of less than $5 billion; or

(B) Total assets of $5 billion or more and a composite CAMELS rating of 1 or 2.

(3) The appropriate Federal banking agency may revoke the exception in paragraph (b)(2) of this section for any institution with total assets in excess of $9 billion for any period of time during which the appropriate Federal banking agency determines that the institution's exemption would create a significant risk to the Deposit Insurance Fund.

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management's statement of responsibilities, management's assessment of compliance with designated safety and soundness laws and regulations, and, if applicable, management's assessment of the effectiveness of internal control over financial reporting and the independent public accountant's attestation report on management's internal control assessment) are being satisfied for these institutions at the holding company level or at the institution level. An institution filing holding company consolidated financial statements as permitted by §363.1(b)(1) also may report on changes in its independent public accountant on a holding company basis. An institution that does not meet the criteria in §363.1(b)(2) must satisfy the remaining provisions of this part on an individual institution basis and maintain its own audit committee. Subject to the criteria in §§363.1(b)(1) and (2), a multi-tiered holding company may satisfy all of the requirements of this part at the top-tier or any mid-tier holding company level.

4. *Comparable Services and Functions.* Services and functions will be considered "comparable" to those required by this part if the holding company:

(a) Prepares reports used by the subsidiary institution to meet the requirements of this part;

(b) Has an audit committee that meets the requirements of this part appropriate to its largest subsidiary institution; and

(c) Prepares and submits management's assessment of compliance with the Designated Laws and Regulations defined in guideline 7A and, if applicable, management's assessment of the effectiveness of internal control over financial reporting based on information concerning the relevant activities and operations of those subsidiary institutions within the scope of the Rule.

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Regulation	Guidelines
(c) *Financial reporting.* For purposes of the management report requirement of § 363.2(b) and the internal control reporting requirement of § 363.3(b), "financial reporting," at a minimum, includes both financial statements prepared in accordance with generally accepted accounting principles for the insured depository institution or its holding company and financial statements prepared for regulatory reporting purposes. For recognition and measurement purposes, financial statements prepared for regulatory reporting purposes shall conform to generally accepted accounting principles and section 37 of the Federal Deposit Insurance Act.	4A. *Financial Statements Prepared for Regulatory Reporting Purposes*. (a) As set forth in § 363.3(c)[7] of this part, "financial reporting," at a minimum, includes both financial statements prepared in accordance with generally accepted accounting principles for the insured depository institution or its holding company and financial statements prepared for regulatory reporting purposes. More specifically, financial statements prepared for regulatory reporting purposes include the schedules equivalent to the basic financial statements that are included in an insured depository institution's or its holding company's appropriate regulatory report (for example, Schedules RC, RI, and RI-A in the Consolidated Reports of Condition and Income (Call Report) for an insured bank; and Schedules SC and SO, and the Summary of Changes in Equity Capital section in Schedule SI in the Thrift Financial Report (TFR) for an insured thrift institution). For recognition and measurement purposes, financial statements prepared for regulatory reporting purposes shall conform to generally accepted accounting principles and section 37 of the Federal Deposit Insurance Act. (b) Financial statements prepared for regulatory reporting purposes do not include regulatory reports prepared by a non-bank subsidiary of a holding company or an institution. For example, if a bank holding company or an insured depository institution owns an insurance subsidiary, financial statements prepared for regulatory reporting purposes would not include any regulatory reports that the insurance subsidiary is required to submit to its appropriate insurance regulatory agency.
(d) *Definitions.* For purposes of this part, the following definitions apply: (1) *AICPA* means the American Institute of Certified Public Accountants. (2) *GAAP* means generally accepted accounting principles. (3) *PCAOB* means the Public Company Accounting Oversight Board.	

[7] The reference to the definition of financial reporting in Guideline 4A is not correct. It should be § 363.1(c), not § 363.3(c).

(4) *Public company* means an insured depository institution or other company that has a class of securities registered with the U.S. Securities and Exchange Commission or the appropriate Federal banking agency under Section 12 of the Securities Exchange Act of 1934 and*nonpublic company* means an insured depository institution or other company that does not meet the definition of a *public company*.

(5) *SEC* means the U.S. Securities and Exchange Commission.

(6) *SOX* means the Sarbanes—Oxley Act of 2002.

§363.2 Annual reporting requirements

(a) *Audited financial statements*. Each insured depository institution shall prepare annual financial statements in accordance with GAAP, which shall be audited by an independent public accountant. The annual financial statements must reflect all material correcting adjustments necessary to conform with GAAP that were identified by the independent public accountant.

5. Annual Financial Statements. Each institution (other than an insured branch of a foreign bank) should prepare comparative annual consolidated financial statements (balance sheets and statements of income, changes in equity capital, and cash flows, with accompanying footnote disclosures) in accordance with GAAP for each of its two most recent fiscal years. Statements for the earlier year may be presented on an unaudited basis if the institution was not subject to this part for that year and audited statements were not prepared.

5A. Institutions Merged Out of Existence. An institution that is merged out of existence after the end of its fiscal year, but before the deadline for filing its Part 363 Annual Report (120 days after the end of its fiscal year for an institution that is neither a public company nor a subsidiary of a public company that meets the criterion specified in § 363.1(b)(1), and 90 days after the end of its fiscal year for an institution that is a public company or a subsidiary of a public company that meets the criterion specified in § 363.1(b)(1)), is not required to file a Part 363 Annual Report for the last fiscal year of its existence.

6. Holding Company Statements. Subject to the criterion specified in § 363.1(b)(1), subsidiary institutions may file copies of their holding company's audited financial statements filed with the SEC or prepared for their FR Y-6 Annual Report under the

(continued)

Regulation	Guidelines
	Bank Holding Company Act of 1956 to satisfy the audited financial statements requirement of § 363.2(a).
	7. Insured Branches of Foreign Banks. An insured branch of a foreign bank should satisfy the financial statements requirement by filing one of the following for each of its two most recent fiscal years:
	(*a*) Audited balance sheets, disclosing information about financial instruments with off-balance-sheet risk;
	(*b*) Schedules RAL and L of form FFIEC 002, prepared and audited on the basis of the instructions for its preparation; or
	(*c*) With written approval of the appropriate Federal banking agency, consolidated financial statements of the parent bank.
	7A. Compliance with Designated Laws and Regulations. The designated laws and regulations are the Federal laws and regulations concerning loans to insiders and the Federal and, if applicable, State laws and regulations concerning dividend restrictions (the Designated Laws and Regulations). Table 1 to this Appendix A lists the designated Federal laws and regulations pertaining to insider loans and dividend restrictions (but not the State laws and regulations pertaining to dividend restrictions) that are applicable to each type of institution.
(b) *Management report.* Each insured depository institution annually shall prepare, as of the end of the institution's most recent fiscal year, a management report that must contain the following:	8. Management Report. Management should perform its own investigation and review of compliance with the Designated Laws and Regulations and, if required, the effectiveness of internal control over financial reporting. Management should maintain records of its determinations and assessments until the next Federal safety and soundness examination, or such later date as specified by the FDIC or appropriate Federal banking agency. Management should provide in its assessment of the effectiveness of internal controls over financial reporting, or supplementally, sufficient information to enable the accountant to report on its assertions. The management report of an insured branch of a foreign bank should be signed by the branch's managing official if the branch does not have a chief executive officer or a chief accounting or financial officer.

Regulation	*Guidelines*
(1) A statement of management's responsibilities for preparing the institution's annual financial statements, for establishing and maintaining an adequate internal control structure and procedures for financial reporting, and for complying with laws and regulations relating to safety and soundness that are designated by the FDIC and the appropriate Federal banking agency;	8A. Management's Reports on Internal Control over Financial Reporting under Part 363 and Section 404 of SOX. An institution with $1 billion or more in total assets as of the beginning of its fiscal year that is subject to both part 363 and the SEC's rules implementing section 404 of SOX (as well as a public holding company permitted under the holding company exception in § 363.1(b)(2) to file an internal control report on behalf of one or more subsidiary institutions with $1 billion or more in total assets) can choose either of the following two options for filing management's report on internal control over financial reporting. (i) Management can prepare two separate reports on the institution's or the holding company's internal control over financial reporting to satisfy the FDIC's part 363 requirements and the SEC's section 404 requirements; or (ii) Management can prepare a single report on internal control over financial reporting provided that it satisfies all of the FDIC's part 363 requirements and all of the SEC's section 404 requirements. 8B. Internal Control Reports and Part 363 Annual Reports for Acquired Businesses. Generally, the FDIC expects management's and the related independent public accountant's report on an institution's internal control over financial reporting to include controls at an institution in its entirety, including all of its consolidated entities. However, it may not always be possible for management to conduct an assessment of the internal control over financial reporting of an acquired business in the period between the consummation date of the acquisition and the due date of management's internal control assessment. (a) In such instances, the acquired business's internal control structure and procedures for financial reporting may be excluded from management's assessment report and the accountant's attestation report on internal control over financial reporting. However, the FDIC expects management's assessment report to identify the acquired business, state that the acquired business is excluded, and indicate the significance of this business to the institution's consolidated financial statements. Notwithstanding management's

(continued)

Regulation | *Guidelines*

exclusion of the acquired business's internal control from its assessment, management should disclose any material change to the institution's internal control over financial reporting due to the acquisition of this business. Also, management may not omit the assessment of the acquired business's internal control from more than one annual part 363 assessment report on internal control over financial reporting. When the acquired business's internal control over financial reporting is excluded from management's assessment, the independent public accountant may likewise exclude this acquired business's internal control over financial reporting from the accountant's evaluation of internal control over financial reporting.

(b) If the acquired business is or has a consolidated subsidiary that is an insured depository institution subject to part 363 and the institution is not merged out of existence before the deadline for filing its Part 363 Annual Report (120 days after the end of its fiscal year for an institution that is neither a public company nor a subsidiary of a public company that meets the criterion specified in § 363.1(b)(1), and 90 days after the end of its fiscal year for an institution that is a public company or a subsidiary of public company that meets the criterion specified in § 363.1(b)(1)), the acquired institution must continue to comply with all of the applicable requirements of part 363, including filing its Part 363 Annual Report.

(2) An assessment by management of the insured depository institution's compliance with such laws and regulations during such fiscal year. The assessment must state management's conclusion as to whether the insured depository institution has complied with the designated safety and soundness laws and regulations during the fiscal year and disclose any noncompliance with these laws and regulations; and

8C. Management's Disclosure of Noncompliance with the Designated Laws and Regulations. Management's disclosure of noncompliance, if any, with the Designated Laws and Regulations should separately indicate the number of instances or frequency of noncompliance with the Federal laws and regulations pertaining to insider loans and the Federal (and, if applicable, State) laws and regulations pertaining to dividend restrictions. The disclosure is not required to specifically identify by name the individuals (e.g., officers or directors) who were responsible for or were the subject of any such noncompliance. However, the disclosure should include appropriate qualitative and quantitative information to describe the nature, type, and severity of the noncompliance and the dollar amount of the insider loan(s) or dividend(s) involved.

Regulation	*Guidelines*
	Similar instances of noncompliance may be aggregated as to number of instances and quantified as to the dollar amounts or the range of dollar amounts of insider loans and/or dividends for which noncompliance occurred. Management may also wish to describe any corrective actions taken in responses to the instances of noncompliance as well any controls or procedures that are being developed or that have been developed and implemented to prevent or detect and correct future instances of noncompliance on a timely basis.
(3) For an insured depository institution with consolidated total assets of $1 billion or more as of the beginning of such fiscal year, an assessment by management of the effectiveness of such internal control structure and procedures as of the end of such fiscal year that must include the following:	
(i) A statement identifying the internal control framework1 used by management to evaluate the effectiveness of the insured depository institution's internal control over financial reporting;	
(ii) A statement that the assessment included controls over the preparation of regulatory financial statements in accordance with regulatory reporting instructions including identification of such regulatory reporting instructions; and	
(iii) A statement expressing management's conclusion as to whether the insured depository institution's internal control over financial reporting is effective as of the end of its fiscal year. Management must disclose all material weaknesses in internal control over financial reporting, if any, that it has identified that have not been remediated prior to the insured depository institution's fiscal year-end. Management is precluded from concluding that the institution's internal control over financial reporting is effective if there are one or more material weaknesses.	
(c) *Management report signatures*. Subject to the criteria specified in § 363.1(b):	

(continued)

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(1) If the audited financial statements requirement specified in § 363.2(a) is satisfied at the insured depository institution level and the management report requirement specified in § 363.2(b) is satisfied in its entirety at the insured depository institution level, the management report must be signed by the chief executive officer and the chief accounting officer or chief financial officer of the insured depository institution;

(2) If the audited financial statements requirement specified in § 363.2(a) is satisfied at the holding company level and the management report requirement specified in § 363.2(b) is satisfied in its entirety at the holding company level, the management report must be signed by the chief executive officer and the chief accounting officer or chief financial officer of the holding company; and

(3) If the audited financial statements requirement specified in§ 363.2(a) is satisfied at the holding company level and (i) the management report requirement specified in § 363.2(b) is satisfied in its entirety at the insured depository institution level or (ii) one or more of the components of the management report specified in § 363.2(b) is satisfied at the holding company level and the remaining components of the management report are satisfied at the insured depository institution level, the management report must be signed by the chief executive officers and the chief accounting officers or chief financial officers of both the holding company and the insured depository institution and the management report must clearly indicate the level (institution or holding company) at which each of its components is being satisfied.

9. Safeguarding of Assets. "Safeguarding of assets," as the term relates to internal control policies and procedures regarding financial reporting, and which has precedent in accounting and auditing literature, should be encompassed in the management report and the independent public accountant's attestation discussed in guideline 18. Testing the existence of and compliance with internal controls on the management of assets, including loan

underwriting and documentation, presents a reasonable implementation of section 36. The FDIC expects such internal controls to be encompassed by the assertion in the management report, but the term "safeguarding of assets" need not be specifically stated. The FDIC does not require the accountant to attest to the adequacy of safeguards, but does require the accountant to determine whether safeguarding policies exist.[2]

10. Standards for Internal Controls. The management of each insured depository institution with $1 billion or more in total assets as of the beginning of its fiscal year should base its assessment of the effectiveness of the institution's internal control over financial reporting on a suitable, recognized control framework established by a body of experts that followed due-process procedures, including the broad distribution of the framework for public comment. In addition to being available to users of management's reports, a framework is suitable only when it:

- Is free from bias;
- Permits reasonably consistent qualitative and quantitative measurements of an institution's internal control over financial reporting;
- Is sufficiently complete so that those relevant factors that would alter a conclusion about the effectiveness of an institution's internal control over financial reporting are not omitted; and
- Is relevant to an evaluation of internal control over financial reporting.

In the United States, *Internal Control—Integrated Framework*, including its addendum on safeguarding assets, which was published by the Committee of Sponsoring Organizations of the Treadway Commission, and is known as the COSO report, provides a suitable and recognized framework for purposes of management's assessment. Other suitable frameworks have been published in other countries or may be developed in the future. Such other suitable frameworks may be used by management and the institution's independent public accountant in assessments, attestations, and audits of internal control over financial reporting.[2]

11. Service Organizations. Although service organizations should be considered in determining if internal control over

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financial reporting is effective, an institution's independent public accountant, its management, and its audit committee should exercise independent judgment concerning that determination. Onsite reviews of service organizations may not be necessary to prepare the report required by the Rule, and the FDIC does not intend that the Rule establish any such requirement.

12. [Reserved]

§363.3 Independent public accountant

(a) *Annual audit of financial statements*. Each insured depository institution shall engage an independent public accountant to audit and report on its annual financial statements in accordance with generally accepted auditing standards or the PCAOB's auditing standards, if applicable, and Section 37 of the Federal Deposit Insurance Act (12 U.S.C. 1831n). The scope of the audit engagement shall be sufficient to permit such accountant to determine and report whether the financial statements are presented fairly and in accordance with GAAP.

13. General Qualifications. To provide audit and attest services to insured depository institutions, an independent public accountant should be registered or licensed to practice as a public accountant, and be in good standing, under the laws of the State or other political subdivision of the United States in which the home office of the institution (or the insured branch of a foreign bank) is located. As required by Section 36(g) (3)(A)(i), the accountant must agree to provide copies of any working papers, policies, and procedures relating to services performed under this part.

14. [Reserved]

15. Peer Review Guidelines. The following peer review guidelines are acceptable:

(*a*) The external peer review should be conducted by an organization independent of the accountant or firm being reviewed, as frequently as is consistent with professional accounting practices;

(*b*) The peer review (other than a PCAOB inspection) should be generally consistent with AICPA Peer Review Standards; and

(*c*) The review should include, if available, at least one audit of an insured depository institution or consolidated depository institution holding company.

16. [Reserved]

17. Information to be Provided to the Independent Public Accountant. Attention is directed to section 36(h) which requires institutions to provide specified information to their accountants. An institution also should provide its accountant with copies of any notice that the institution's capital category is being changed or reclassified

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	under Section 38 of the FDI Act, and any correspondence from the appropriate Federal banking agency concerning compliance with this part.
(b) *Internal control over financial reporting*. For each insured depository institution with total assets of $1 billion or more at the beginning of the institution's fiscal year, the independent public accountant who audits the institution's financial statements shall examine, attest to, and report separately on, the assertion of management concerning the effectiveness of the institution's internal control structure and procedures for financial reporting. The attestation and report shall be made in accordance with generally accepted standards for attestation engagements or the PCAOB's auditing standards, if applicable. The accountant's report must not be dated prior to the date of the management report and management's assessment of the effectiveness of internal control over financial reporting. Notwithstanding the requirements set forth in applicable professional standards, the accountant's report must include the following:	18. Attestation Report and Management Letters. The independent public accountant should provide the institution with any management letter and, if applicable, an internal controls attestation report, (as required by section 36(c)(1)) at the conclusion of the audit. The independent public accountant's attestation report on internal control over financial reporting must specifically include a statement as to regulatory reporting. If a holding company subsidiary relies on its holding company management report to satisfy the Part 363 Annual Report requirements, the accountant may attest to and report on the management's assertions in one report, without reporting separately on each subsidiary covered by the Rule. The FDIC has determined that management letters are exempt from public disclosure.
(1) A statement identifying the internal control framework used by the independent public accountant, which must be the same as the internal control framework used by management, to evaluate the effectiveness of the insured depository institution's internal control over financial reporting;	
(2) A statement that the independent public accountant's evaluation included controls over the preparation of regulatory financial statements in accordance with regulatory reporting instructions including identification of such regulatory reporting instructions; and	
(3) A statement expressing the independent public accountant's conclusion as to whether the insured depository institution's internal control over financial reporting is effective as of the end of its fiscal year. The report must disclose all material weaknesses in internal control over financial reporting that the independent public accountant has identified that have not been	

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remediated prior to the insured depository institution's fiscal year-end. The independent public account is precluded from concluding that the insured depository institution's internal control over financial reporting is effective if there are one or more material weaknesses.	

18A. Internal Control Attestation Standards for Independent Auditors. (a) § 363.3(b) provides that the independent public accountant's attestation and report on management's assertion concerning the effectiveness of an institution's internal control structure and procedures for financial reporting shall be made in accordance with generally accepted standards for attestation engagements or the PCAOB's auditing standards, if applicable. The standards that should be followed by the institution's independent public accountant concerning internal control over financial reporting for institutions with $1 billion or more in total assets can be summarized as follows:

(1) For an insured institution that is neither a public company nor a subsidiary of a public company, its independent public accountant need only follow the AICPA's attestation standards.

(2) For an insured institution that is a public company that is required to comply with the auditor attestation requirement of section 404 of SOX, its independent public accountant should follow the PCAOB's auditing standards.

(3) For an insured institution that is a public company but is not required to comply with the auditor attestation requirement of section 404 of SOX, its independent public accountant is not required to follow the PCAOB's auditing standards. In this case, the accountant need only follow the AICPA's attestation standards.

(4) For an insured institution that is a subsidiary of a public company that is required to comply with the auditor attestation requirement of section 404 of SOX, but is not itself a public company, the institution and its independent public accountant have flexibility in complying with the internal control requirements of Part 363. If the conditions specified in § 363.1(b) (2) are met, management and the

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	independent public accountant may choose to report on internal control over financial reporting at the consolidated holding company level. In this situation, the independent public accountant's work would be performed for the public company in accordance with the PCAOB's auditing standards. Alternatively, the institution may choose to comply with the internal control reporting requirements of Part 363 at the institution level and its independent public accountant could follow the AICPA's attestation standards.
	(b) If an independent public accountant need only follow the AICPA's attestation standards, the accountant and the insured institution may instead agree to have the internal control attestation performed under the PCAOB's auditing standards.
	19. Reviews with Audit Committee and Management. The independent public accountant should meet with the institution's audit committee to review the accountant's reports required by this part before they are filed. It also may be appropriate for the accountant to review its findings with the institution's board of directors and management.
(c) *Notice by accountant of termination of services.* An independent public accountant performing an audit under this part who ceases to be the accountant for an insured depository institution shall notify the FDIC, the appropriate Federal banking agency, and any appropriate State bank supervisor in writing of such termination within 15 days after the occurrence of such event, and set forth in reasonable detail the reasons for such termination. The written notice shall be filed at the place identified in § 363.4(f).	20. Notice of Termination. The notice required by §363.3(c) should state whether the independent public accountant agrees with the assertions contained in any notice filed by the institution under §363.4(d), and whether the institution's notice discloses all relevant reasons for the accountant's termination. Subject to the criterion specified in § 363.1(b)(1) regarding compliance with the audited financial statements requirement at the holding company level, the independent public accountant for an insured depository institution that is a public company and files reports with its appropriate Federal banking agency, or is a subsidiary of a public company that files reports with the SEC, may submit the letter it furnished to management to be filed with the institution's or the holding company's current report (e.g., SEC Form 8-K) concerning a change in accountant to satisfy the notice requirements of § 363.3(c). Alternatively, if the independent public accountant confirms that management has filed a current report (e.g., SEC Form 8-K) concerning a change in accountant that satisfies the notice

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requirements of § 363.4(d) and includes an independent public accountant's letter that satisfies the requirements of § 363.3(c), the independent public accountant may rely on the current report (e.g., SEC Form 8-K) filed with the FDIC by management concerning a change in accountant to satisfy the notice requirements of § 363.3(c).

21. Reliance on Internal Auditors. Nothing in this part or this Appendix is intended to preclude the ability of the independent public accountant to rely on the work of an institution's internal auditor.

(d) *Communications with audit committee.* In addition to the requirements for communications with audit committees set forth in applicable professional standards, the independent public accountant must report the following on a timely basis to the audit committee:

(1) All critical accounting policies and practices to be used by the insured depository institution,

(2) All alternative accounting treatments within GAAP for policies and practices related to material items that the independent public accountant has discussed with management, including the ramifications of the use of such alternative disclosures and treatments, and the treatment preferred by the independent public accountant, and

(3) Other written communications the independent public accountant has provided to management, such as a management letter or schedule of unadjusted differences.

(e) *Retention of working papers.* The independent public accountant must retain the working papers related to the audit of the insured depository institution's financial statements and, if applicable, the evaluation of the institution's internal control over financial reporting for seven years from the report release date, unless a longer period of time is required by law.

(f) *Independence.* The independent public accountant must comply with the independence standards and interpretations of the AICPA, the SEC, and the PCAOB. To the extent that any

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of the rules within any one of these independence standards (AICPA, SEC, and PCAOB) is more or less restrictive than the corresponding rule in the other independence standards, the independent public accountant must comply with the more restrictive rule.

(g) *Peer reviews and inspection reports.*

(1) Prior to commencing any services for an insured depository institution under this part, the independent public accountant must have received a peer review, or be enrolled in a peer review program, that meets acceptable guidelines. Acceptable peer reviews include peer reviews performed in accordance with the AICPA's Peer Review Standards and inspections conducted by the PCAOB.

(2) Within 15 days of receiving notification that a peer review has been accepted or a PCAOB inspection report has been issued, or before commencing any audit under this part, whichever is earlier, the independent public accountant must file two copies of the most recent peer review report and the public portion of the most recent PCAOB inspection report, if any, accompanied by any letters of comments, response, and acceptance, with the FDIC, Accounting and Securities Disclosure Section, 550 17th Street, NW, Washington, DC 20429, if the report has not already been filed. The peer review reports and the public portions of the PCAOB inspection reports will be made available for public inspection by the FDIC.

(3) Within 15 days of the PCAOB making public a previously nonpublic portion of an inspection report, the independent public accountant must file two copies of the previously nonpublic portion of the inspection report with the FDIC, Accounting and Securities Disclosure Section, 550 17th Street, NW, Washington, DC 20429. Such previously nonpublic portion of the PCAOB inspection report will be made available for public inspection by the FDIC.

§363.4 Filing and notice requirements

(a) *Part 363 Annual Report.*

22. [Reserved]

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(1) Each insured depository institution shall file with each of the FDIC, the appropriate Federal banking agency, and any appropriate State bank supervisor, two copies of its Part 363 Annual Report. A Part 363 Annual Report must contain audited comparative annual financial statements, the independent public accountant's report thereon, a management report, and, if applicable, the independent public accountant's attestation report on management's assessment concerning the institution's internal control structure and procedures for financial reporting as required by §§ 363.2(a),363.3(a), 363.2(b), and 363.3(b) respectively.

(2) Subject to the criteria specified in § 363.1(b), each insured depository institution with consolidated total assets of less than $1 billion as of the beginning of its fiscal year that is required to file, or whose parent holding company is required to file, management's assessment of the effectiveness of internal control over financial reporting with the SEC or the appropriate Federal banking agency in accordance with section 404 of SOX must submit a copy of such assessment to the FDIC, the appropriate Federal banking agency, and any appropriate State bank supervisor with its Part 363 Annual Report as additional information. This assessment will not be considered part of the institution's Part 363 Annual Report.

(3)(i) Each insured depository institution that is neither a public company nor a subsidiary of a public company that meets the criterion specified in § 363.1(b)(1) shall file its Part 363 Annual Report within 120 days after the end of its fiscal year. (ii) Each insured depository institution that is a public company or a subsidiary of a public company that meets the criterion specified in § 363.1(b)(1) shall file its Part 363 Annual Report within 90 days after the end of its fiscal year.

(b) *Public availability*. Except for the annual report in paragraph (a)(1) of this section and the peer reviews and inspection reports in § 363.3(g), which shall be available for public inspection, the FDIC has determined that all other

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reports and notifications required by this part are exempt from public disclosure by the FDIC.	
	23. Notification of Late Filing. (a) An institution's submission of a written notice of late filing does not cure the requirement to timely file the Part 363 Annual Report or other reports or notices required by § 363.4. An institution's failure to timely file is considered an apparent violation of Part 363.
	(b) If the late filing notice submitted pursuant to § 363.4(e) relates only to a portion of a Part 363 Annual Report or any other report or notice, the insured depository institution should file the other components of the report or notice within the prescribed filing period together with a cover letter that indicates which components of its Part 363 Annual Report or other report or notice are omitted. An institution may combine the written late filing notice and the cover letter into a single notice that is submitted together with the other components of the report or notice that are being timely filed.
	24. Public Availability. Each institution's Part 363 Annual Report should be available for public inspection at its main and branch offices no later than 15 days after it is filed with the FDIC. Alternatively, an institution may elect to mail one copy of its Part 363 Annual Report to any person who requests it. The Part 363 Annual Report should remain available to the public until the Part 363 Annual Report for the next year is available. An institution may use its Part 363 Annual Report under this part to meet the annual disclosure statement required by 12 CFR 350.3, if the institution satisfies all other requirements of 12 CFR Part 350.
(c) *Independent public accountant's letters and reports.* Except for the independent public accountant's reports that are included in its Part 363 Annual Report, each insured depository institution shall file with the FDIC, the appropriate Federal banking agency, and any appropriate State bank supervisor, a copy of any management letter or other report issued by its independent public accountant with respect to such institution and the services provided by such accountant pursuant to this part	25. [Reserved]

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within 15 days after receipt. Such reports include, but are not limited to:

(1) Any written communication regarding matters that are required to be communicated to the audit committee (for example, critical accounting policies, alternative accounting treatments discussed with management, and any schedule of unadjusted differences),

(2) Any written communication of significant deficiencies and material weaknesses in internal control required by the AICPA's or the PCAOB's auditing standards;

(3) For institutions with total assets of less than $1 billion as of the beginning of their fiscal year that are public companies or subsidiaries of public companies that meet the criterion specified in § 363.1(b)(1), any independent public accountant's report on the audit of internal control over financial reporting required by section 404 of SOX and the PCAOB's auditing standards; and

(4) For all institutions that are public companies or subsidiaries of public companies that meet the criterion specified in § 363.1(b)(1), any independent public accountant's written communication of all deficiencies in internal control over financial reporting that are of a lesser magnitude than significant deficiencies required by the PCAOB's auditing standards.

(d) *Notice of engagement or change of accountants.* Each insured depository institution shall provide, within 15 days, after the occurrence of any such event, written notice to the FDIC, the appropriate Federal banking agency, and any appropriate State bank supervisor of the engagement of an independent public accountant, or the resignation or dismissal of the independent public accountant previously engaged. The notice shall include a statement of the reasons for any such resignation or dismissal in reasonable detail.

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26. Notices Concerning Accountants. With respect to any selection, change, or termination of an independent public accountant, an institution's management and audit committee should be familiar with the notice requirements in § 363.4(d) and guideline 20, and management should send a copy of any notice required under § 363.4(d) to the independent public accountant when it is filed with the FDIC. An insured depository institution that is a public company and files reports required under the Federal securities laws with its appropriate Federal banking agency, or is a subsidiary of a public company that files such reports with the SEC, may use its current report (e.g., SEC Form 8-K) concerning a change in accountant to satisfy the notice requirements of § 363.4(d) subject to the criterion of § 363.1(b)(1)

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regarding compliance with the audited financial statements requirement at the holding company level.

(e) *Notification of late filing.* No extensions of time for filing reports required by § 363.4 shall be granted. An insured depository institution that is unable to timely file all or any portion of its Part 363 Annual Report or any other report or notice required by § 363.4 shall submit a written notice of late filing to the FDIC, the appropriate Federal banking agency, and any appropriate State bank supervisor. The notice shall disclose the institution's inability to timely file all or specified portions of its Part 363 Annual Report or any other report or notice and the reasons therefore in reasonable detail. The late filing notice shall also state the date by which the report or notice will be filed. The written notice shall be filed on or before the deadline for filing the Part 363 Annual Report or any other report or notice, as appropriate.

(f) *Place for filing.* The Part 363 Annual Report, any written notification of late filing, and any other report or notice required by § 363.4 should be filed as follows:

(1) FDIC: Appropriate FDIC Regional or Area Office (Division of Supervision and Consumer Protection), i.e., the FDIC regional or area office in the FDIC region or area that is responsible for monitoring the institution or, in the case of a subsidiary institution of a holding company, the consolidated company. A filing made on behalf of several covered institutions owned by the same parent holding company should be accompanied by a transmittal letter identifying all of the institutions covered.

(2) Office of the Comptroller of the Currency (OCC): Appropriate OCC Supervisory Office.

(3) Federal Reserve: Appropriate Federal Reserve Bank.

(4) Office of Thrift Supervision (OTS): Appropriate OTS District Office.

(5) State bank supervisor: The filing office of the appropriate State bank supervisor.

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363.5 Audit committees	
(a) *Composition and duties.* Each insured depository institution shall establish an audit committee of its board of directors, the composition of which complies with paragraphs (a)(1), (2), and (3) of this section. The duties of the audit committee shall include the appointment, compensation, and oversight of the independent public accountant who performs services required under this part, and reviewing with management and the independent public accountant the basis for the reports issued under this part.	27. Composition. The board of directors of each institution should determine whether each existing or potential audit committee member meets the requirements of section 36 and this part. To do so, the board of directors should maintain an approved set of written criteria for determining whether a director who is to serve on the audit committee is an outside director (as defined in § 363.5(a)(3)) and is independent of management. At least annually, the board of each institution should determine whether each existing or potential audit committee member is an outside director. In addition, at least annually, the board of an institution with $1 billion or more in total assets as of the beginning of its fiscal year should determine whether all existing and potential audit committee members are "independent of management of the institution" and the board of an institution with total assets of $500 million or more but less than $1 billion as of the beginning of its fiscal year should determine whether the majority of all existing and potential audit committee members are "independent of management of the institution." The minutes of the board of directors should contain the results of and the basis for its determinations with respect to each existing and potential audit committee member. Because an insured branch of a foreign bank does not have a separate board of directors, the FDIC will not apply the audit committee requirements to such branch. However, any such branch is encouraged to make a reasonable good faith effort to see that similar duties are performed by persons whose experience is generally consistent with the Rule's requirements for an institution the size of the insured branch.
(1) Each insured depository institution with total assets of $1 billion or more as of the beginning of its fiscal year shall establish an independent audit committee of its board of directors, the members of which shall be outside directors who are independent of management of the institution.	
(2) Each insured depository institution with total assets of $500 million or more but less than $1 billion as of the beginning of its fiscal year shall establish an audit committee of its board of directors, the members of which shall	

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be outside directors, the majority of whom shall be independent of management of the institution. The appropriate Federal banking agency may, by order or regulation, permit the audit committee of such an insured depository institution to be made up of less than a majority of outside directors who are independent of management, if the agency determines that the institution has encountered hardships in retaining and recruiting a sufficient number of competent outside directors to serve on the audit committee of the institution.

(3) An outside director is a director who is not, and within the preceding fiscal year has not been, an officer or employee of the institution or any affiliate of the institution.

28. <u>"Independent of Management" Considerations</u>. It is not possible to anticipate, or explicitly provide for, all circumstances that might signal potential conflicts of interest in, or that might bear on, an outside director's relationship to an insured depository institution and whether the outside director should be deemed "independent of management." When assessing an outside director's relationship with an institution, the board of directors should consider the issue not merely from the standpoint of the director himself or herself, but also from the standpoint of persons or organizations with which the director has an affiliation. These relationships can include, but are not limited to, commercial, banking, consulting, charitable, and family relationships. To assist boards of directors in fulfilling their responsibility to determine whether existing and potential members of the audit committee are "independent of management," paragraphs (a) through (d) of this guideline provide guidance for making this determination.

(a) If an outside director, either directly or indirectly, owns or controls, or has owned or controlled within the preceding fiscal year, 10 percent or more of any outstanding class of voting securities of the institution, the institution's board of directors should determine, and document its basis and rationale for such determination, whether such ownership of voting securities would interfere with the outside director's exercise

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of independent judgment in carrying out the responsibilities of an audit committee member, including the ability to evaluate objectively the propriety of management's accounting, internal control, and reporting policies and practices. Notwithstanding the criteria set forth in paragraphs (b), (c), and (d) of this guideline, if the board of directors determines that such ownership of voting securities would interfere with the outside director's exercise of independent judgment, the outside director will not be considered "independent of management."

(b) The following list sets forth additional criteria that, at a minimum, a board of directors should consider when determining whether an outside director is "independent of management." The board of directors may conclude that additional criteria are also relevant to this determination in light of the particular circumstances of its institution. Accordingly, an outside director will not be considered "independent of management" if:

(1) The director serves, or has served within the last three years, as a consultant, advisor, promoter, underwriter, legal counsel, or trustee of or to the institution or its affiliates.

(2) The director has been, within the last three years, an employee of the institution or any of its affiliates or an immediate family member is, or has been within the last three years, an executive officer of the institution or any of its affiliates.

(3) The director has participated in the preparation of the financial statements of the institution or any of its affiliates at any time during the last three years.

(4) The director has received, or has an immediate family member who has received, during any twelve-month period within the last three years, more than $100,000 in direct and indirect compensation from the institution, its subsidiaries, and its affiliates for consulting, advisory, or other services other than director and committee fees and pension or other forms of deferred compensation for prior service (provided such compensation is not contingent in any way on continued service). Direct compensation also would not include compensation received by the director for

former service as an interim chairman or interim chief executive officer.

(5) The director or an immediate family member is a current partner of a firm that performs internal or external auditing services for the institution or any of its affiliates; the director is a current employee of such a firm; the director has an immediate family member who is a current employee of such a firm and who participates in the firm's audit, assurance, or tax compliance practice; or the director or an immediate family member was within the last three years (but no longer is) a partner or employee of such a firm and personally worked on the audit of the insured depository institution or any of its affiliates within that time.

(6) The director or an immediate family member is, or has been within the last three years, employed as an executive officer of another entity where any of the present executive officers of the institution or any of its affiliates at the same time serves or served on that entity's compensation committee.

(7) The director is a current employee, or an immediate family member is a current executive officer, of an entity that has made payments to, or received payments from, the institution or any of its affiliates for property or services in an amount which, in any of the last three fiscal years, exceeds the greater of $200 thousand, or 5 percent of such entity's consolidated gross revenues. This would include payments made by the institution or any of its affiliates to not-for-profit entities where the director is an executive officer or where an immediate family member of the director is an executive officer.

(8) For purposes of paragraph (b) of this guideline:

(i) An "immediate family member" includes a person's spouse, parents, children, siblings, mothers- and fathers-in-law, sons- and daughters-in-laws, brothers- and sisters-in-law, and anyone (other than domestic employees) who shares such person's home.

(ii) The term affiliate of, or a person affiliated with, a specified person, means a person or entity that directly, or indirectly through one or more intermediaries,

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controls, or is controlled by, or is under common control with, the person specified.

(iii) The term indirect compensation for consulting, advisory, or other services includes the acceptance of a fee for such services by a director's immediate family member or by an organization in which the director is a partner or principal that provides accounting, consulting, legal, investment banking, or financial advisory services to the institution, any of its subsidiaries, or any of its affiliates.

(iv) The terms direct and indirect compensation and payments do not include payments such as dividends arising solely from investments in the institution's equity securities, provided the same per share amounts are paid to all shareholders of that class; interest income from investments in the institution's deposit accounts and debt securities; loans from the institution that conform to all regulatory requirements applicable to such loans except that interest payments or other fees paid in association with such loans would be considered payments; and payments under non-discretionary charitable contribution matching programs.

(c) An insured depository institution that is a public company and a listed issuer (as defined in Rule 10A-3 of the Securities Exchange Act of 1934 (Exchange Act)), or is a subsidiary of a public company that meets the criterion specified in § 363.1(b)(1) and is a listed issuer, may choose to use the definition of audit committee member independence set forth in the listing standards applicable to the public institution or its public company parent for purposes of determining whether an outside director is "independent of management."

(d) All other insured depository institutions may choose to use the definition of audit committee member independence set forth in the listing standards of a national securities exchange that is registered with the SEC pursuant to section 6 of the Exchange Act or a national securities association that is registered with the SEC pursuant to section 15A(a) of the Exchange Act for purposes of determining whether an outside director is "independent of management."

29. [Reserved]

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30. Holding Company Audit Committees. (a) When an insured depository institution satisfies the requirements for the holding company exception specified in §§ 363.1(b)(1) and (2), the audit committee requirement of this part may be satisfied by the audit committee of the top-tier or any mid-tier holding company. Members of the audit committee of the holding company should meet all the membership requirements applicable to the largest subsidiary depository institution subject to Part 363 and should perform all the duties of the audit committee of a subsidiary institution subject to Part 363, even if the holding company directors are not directors of the institution.

(b) When an insured depository institution subsidiary with total assets of $1 billion or more as of the beginning of its fiscal year does not meet the requirements for the holding company exception specified in §§ 363.1(b)(1) and (2) or maintains its own separate audit committee to satisfy the requirements of this part, the members of the audit committee of the top-tier or any mid-tier holding company may serve on the audit committee of the subsidiary institution if they are otherwise independent of management of the subsidiary institution, and, if applicable, meet any other requirements for a large subsidiary institution covered by this part.

(c) When an insured depository institution with total assets of $500 million or more but less than $1 billion as of the beginning of its fiscal year does not meet the requirements for the holding company exception specified in §§ 363.1(b)(1) and (2) or maintains its own separate audit committee to satisfy the requirements of this part, the members of the audit committee of the top-tier or any mid-tier holding company may serve on the audit committee of the subsidiary institution provided a majority of the institution's audit committee members are independent of management of the subsidiary institution.

(d) Officers and employees of a top-tier or any mid-tier holding company may not serve on the audit committee of a subsidiary institution subject to Part 363.

31. Duties. The audit committee should perform all duties determined by the

(continued)

Regulation	Guidelines

institution's board of directors and it should maintain minutes and other relevant records of its meetings and decisions. The duties of the audit committee should be appropriate to the size of the institution and the complexity of its operations, and at a minimum, should include the appointment, compensation, and oversight of the independent public accountant; reviewing with management and the independent public accountant the basis for their respective reports issued under §§363.2(a) and (b) and §§363.3(a) and (b); reviewing and satisfying itself as to the independent public accountant's compliance with the required qualifications for independent public accountants set forth in §§ 363.3(f) and (g) and guidelines 13 through 16; ensuring that audit engagement letters comply with the provisions of § 363.5(c) before engaging an independent public accountant; being familiar with the notice requirements in § 363.4(d) and guideline 20 regarding the selection, change, or termination of an independent public accountant; and ensuring that management sends a copy of any notice required under § 363.4(d) to the independent public accountant when it is filed with the FDIC. Appropriate additional duties could include:

(*a*) Reviewing with management and the independent public accountant the scope of services required by the audit, significant accounting policies, and audit conclusions regarding significant accounting estimates;

(*b*) Reviewing with management and the accountant their assessments of the effectiveness of internal control over financial reporting, and the resolution of identified material weaknesses and significant deficiencies in internal control over financial reporting, including the prevention or detection of management override or compromise of the internal control system;

(*c*) Reviewing with management the institution's compliance with the Designated Laws and Regulations identified in guideline 7A;

(*d*) Discussing with management and the independent public accountant any significant disagreements between management and the independent public accountant; and

Regulation	*Guidelines*
	(*e*) Overseeing the internal audit function.
(b) *Committees of large institutions*. The audit committee of any insured depository institution with total assets of more than $3 billion, as of the beginning of its fiscal year, shall include members with banking or related financial management expertise, have access to its own outside counsel, and not include any large customers of the institution. If a large institution is a subsidiary of a holding company and relies on the audit committee of the holding company to comply with this rule, the holding company's audit committee shall not include any members who are large customers of the subsidiary institution.	32. Banking or Related Financial Management Expertise. At least two members of the audit committee of a large institution shall have "banking or related financial management expertise" as required by Section 36(g)(1)(C)(i). This determination is to be made by the board of directors of the insured depository institution. A person will be considered to have such required expertise if the person has significant executive, professional, educational, or regulatory experience in financial, auditing, accounting, or banking matters as determined by the board of directors. Significant experience as an officer or member of the board of directors or audit committee of a financial services company would satisfy these criteria. A person who has the attributes of an "audit committee financial expert" as set forth in the SEC's rules would also satisfy these criteria.
	33. Large Customers. Any individual or entity (including a controlling person of any such entity) which, in the determination of the board of directors, has such significant direct or indirect credit or other relationships with the institution, the termination of which likely would materially and adversely affect the institution's financial condition or results of operations, should be considered a "large customer" for purposes of §363.5(b).
	34. Access to Counsel. The audit committee should be able to retain counsel at its discretion without prior permission of the institution's board of directors or its management. Section 36 does not preclude advice from the institution's internal counsel or regular outside counsel. It also does not require retaining or consulting counsel, but if the committee elects to do either, it also may elect to consider issues affecting the counsel's independence. Such issues would include whether to retain or consult only counsel not concurrently representing the institution or any affiliate, and whether to place limitations on any counsel representing the institution concerning matters in which such counsel previously participated personally and substantially as outside counsel to the committee.

(continued)

Regulation	Guidelines

35. Transition Period for Forming and Restructuring Audit Committees.

(a) When an insured depository institution's total assets as of the beginning of its fiscal year are $500 million or more for the first time and it thereby becomes subject to Part 363, no regulatory action will be taken if the institution (1) develops and approves a set of written criteria for determining whether a director who is to serve on the audit committee is an outside director and is independent of management and (2) forms or restructures its audit committee to comply with § 363.5(a)(2) by the end of the fiscal year.

(b) When an insured depository institution's total assets as of the beginning of its fiscal year are $1 billion or more for the first time, no regulatory action will be taken if the institution forms or restructures its audit committee to comply with § 363.5(a)(1) by the end of that fiscal year, provided that the composition of its audit committee meets the requirements specified in § 363.5(a)(2) at the beginning of that fiscal year, if such requirements were applicable.

(c) When an insured depository institution's total assets as of the beginning of its fiscal year are $3 billion or more for the first time, no regulatory action will be taken if the institution forms or restructures its audit committee to comply with § 363.5(b) by the end of that fiscal year, provided that the composition of its audit committee meets the requirements specified in § 363.5(a)(1) at the beginning of that fiscal year, if such requirements were applicable.

36. Modifications of Guidelines. The FDIC's Board of Directors has delegated to the Director of the FDIC's Division of Supervision and Consumer Protection authority to make and publish in the *Federal Register* minor technical amendments to the Guidelines in this Appendix and the guidance and illustrative reports in Appendix B, in consultation with the other appropriate Federal banking agencies, to reflect the practical experience gained from implementation of this part. It is not anticipated any such modification would be effective until affected institutions have been given reasonable advance notice of the modification. Any material modification or amendment will be subject

Regulation	Guidelines
	to review and approval of the FDIC Board of Directors.

(c) *Independent public accountant engagement letters*. (1) In performing its duties with respect to the appointment of the institution's independent public accountant, the audit committee shall ensure that engagement letters and any related agreements with the independent public accountant for services to be performed under this part do not contain any limitations of liability provisions that:

(i) Indemnify the independent public accountant against claims made by third parties;

(ii) Hold harmless or release the independent public accountant from liability for claims or potential claims that might be asserted by the client insured depository institution, other than claims for punitive damages; or

(iii) Limit the remedies available to the client insured depository institution.

(2) Alternative dispute resolution agreements and jury trial waiver provisions are not precluded from engagement letters provided that they do not incorporate any limitations of liability provisions set forth in paragraph (c)(1) of this section.

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[1] For example, in the United States, the Committee of Sponsoring Organizations (COSO) of the Treadway Commission has published *Internal Control—Integrated Framework*, including an addendum on safeguarding assets. Known as the COSO report, this publication provides a suitable and available framework for purposes of management's assessment.

[2] It is management's responsibility to establish policies concerning underwriting and asset management and to make credit decisions. The auditor's role is to test compliance with management's policies relating to financial reporting.

Table 1 to Appendix A

Designated Federal Laws and Regulations Applicable to:

		National Banks	*State Member Banks*	*State Nonmember Banks*	*Savings Associations*
Insider Loans—Parts and/or Sections of Title 12 of the United States Code					
375a	Loans to Executive Officers of Banks	✓	✓	(A)	(A)
375b	Extensions of Credit to Executive Officers, Directors, and Principal Shareholders of Banks	✓	✓	(A)	(A)
1468(b)	Extensions of Credit to Executive Officers, Directors, and Principal Shareholders	....	....	....	✓
1828(j)(2)	Extensions of Credit to Officers, Directors, and Principal Shareholders	....	....	✓	....
1828(j)(3)(B)	Extensions of Credit to Officers, Directors, and Principal Shareholders	(B)	....	(C)	....
Parts and/or Sections of Title 12 of the Code of Federal Regulations					
31	Extensions of Credit to Insiders	✓	....	....	....
32	Lending Limits	✓	....	....	....
215	Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks	✓	✓	(D)	(E)
337.3	Limits on Extensions of Credit to Executive Officers, Directors, and Principal Shareholders of Insured Nonmember Banks	....	....	✓	....
563.43	Loans by Savings Associations to Their Executive Officers, Directors, and Principal Shareholders	....	....	....	✓
Dividend Restrictions—Parts and/or Sections of Title 12 of the United States Code					
56	Prohibition on Withdrawal of Capital and Unearned Dividends	✓	✓	....	....

		National Banks	*State Member Banks*	*State Nonmember Banks*	*Savings Associations*
60	Dividends and Surplus Fund	✓	✓	....	....
1467a(f)	Declaration of Dividends	....	....	....	✓
1831o(d)(1)	Prompt Corrective Action—Capital Distributions Restricted	✓	✓	✓	✓
	Parts and/or Sections of Title 12 of the Code of Federal Regulations				
5 Subpart E	Payment of Dividends	✓	....	....	....
6.6	Prompt Corrective Action—Restrictions on Undercapitalized Institutions	✓	....	....	....
208.5	Dividends and Other Distributions	....	✓	....	....
208.45	Prompt Corrective Action—Restrictions on Undercapitalized Institutions	....	✓	....	....
325.105	Prompt Corrective Action—Restrictions on Undercapitalized Institutions	....	....	✓	....
563 Subpart E	Capital Distributions	....	....	....	✓
565.6	Prompt Corrective Action—Restrictions on Undercapitalized Institutions	....	....	....	✓

(A) Subsections (g) and (h) of section 22 of the Federal Reserve Act [12 U.S.C. 375a, 375b]

(B) Applies only to insured Federal branches of foreign banks.

(C) Applies only to insured State branches of foreign banks.

(D) *See* 12 CFR 337.3.

(E) *See* 12 CFR 563.43.

Appendix B

Regulatory Reporting Matters—Interpretation and Reporting Related to U.S. GAAP[1]

[See table on following page.]

[1] Every national bank, state member bank, and insured state nonmember bank is required to file Federal Financial Institutions Examination Council (FFIEC) *Consolidated Reports of Condition and Income*, commonly referred to as the Call Report. Every national and state chartered saving and loan association is required to file a Thrift Financial Report (TFR). Beginning with the March 31, 2012, report date, national and state chartered savings associations will be required to file the Call Report rather than the TFR. Every federally insured credit union is required to file the National Credit Union Administration (NCUA) 5300 Call Report. Call Reports (for example, FFIEC and NCUA) and TFR (the Regulatory Reports) present an institution's financial condition and results of operations on a consolidated basis in accordance with U.S. generally accepted accounting principles (GAAP). Regulatory reporting topics noted herein are consistent with acceptable practices under U.S. GAAP. The Call Report and TFR instructions explain certain specific reporting guidance in greater detail. Information may often be found in the appropriate entries in the glossary section of the regulatory report instructions or, in more detail, in the U.S. GAAP standards. Financial institutions are encouraged to discuss specific events and transactions not covered by U.S. GAAP or the guidance in the regulatory report instructions with their primary supervisory agency for more technical detail on the application of the U.S. GAAP accounting standards. This appendix serves as an aid in specific selected areas and is not intended to be a comprehensive discussion of the principles of bank accounting or reporting.

Generally Accepted Accounting Principles (GAAP)		Regulatory Reporting Matters	
Description	*References*	*Description*	*References*
I. RECOGNITION AND MEASUREMENT			
Interest Income Practices for Loans and Other Assets:			
Accrual and Nonaccrual Matters			
Interest income on loans that are not impaired should be accrued and credited to interest income as it is earned. However, U.S. GAAP does not provide specific criteria for when a loan should be placed on nonaccrual.	Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 310-10-35	Regulatory guidance provides a general rule to ensure an institution's net income is not over-stated by defining that loans (and other assets) should be placed on nonaccrual (1) when the loan (or asset) is maintained on a cash basis because of deterioration in the financial condition of the borrower, (2) when payment in full of principal or interest is not expected, or (3) when principal or interest has been in default for a period of 90 days or more unless the asset is *both* well secured *and* in the process of collection. Certain other loans need not be placed on nonaccrual status, such as loans and other assets that have been acquired at a discount and consumer loans. Nevertheless, consistent with the objective to not overstate income, financial	The "Nonaccrual Status" section of the glossary of the Federal Financial Institutions Examination Council's Consolidated Reports of Condition and Income (Call Report) Instructions, and Schedule RC-N of the Call Report Schedule PD (Consolidated Past Due and Nonaccrual) of the Thrift Financial Report (TFR)

Generally Accepted Accounting Principles (GAAP)		Regulatory Reporting Matters	
Description	*References*	*Description*	*References*
		institutions should use alternative methods of evaluation to ensure that this objective is met.	
Income Recognition and Restoration Matters			
FASB ASC 310-10-35-40 provides two alternative income recognition methods to account for changes in the net carrying amount of an impaired loan subsequent to the initial measure of impairment: *a.* Under the first income recognition method, a creditor should accrue interest on the net carrying amount of the impaired loan and report other changes in the net carrying amount of the loan as an adjustment to bad-debt expense. *b.* Under the second income recognition method, a creditor should recognize all changes in the net carrying amount of the loan as an adjustment to bad-debt expense. See FASB ASC 310-10-50-19 for a disclosure requirement related to this method.		As a general rule, when a loan (or other asset) has been placed on nonaccrual status, interest payments received may be recognized as interest income on a cash basis as long as the remaining recorded investment in the loan (or other asset), after charge-off of any identified losses, is deemed to be fully collectible. If doubt exists as to the collectibility of the remaining recorded investment in an asset placed on nonaccrual status, any payments received must be applied to reduce the recorded investment in the asset to the extent necessary to eliminate such doubt (for example, cost recovery basis).	

(continued)

Generally Accepted Accounting Principles (GAAP)		Regulatory Reporting Matters	
Description	*References*	*Description*	*References*
Those income recognition methods are not required, and a creditor is not precluded from using either of those methods.		Loans (or other assets) may be restored to accrual status (using the effective interest rate) when (1) none of its principal and interest is due and unpaid and the institution expects repayment of the remaining contractual principal and interest[2] or (2) when the loan (or other asset) becomes well secured and in the process of collection. The determination to return a loan (or other asset) to an accrual status should also consider the borrower's historical payment performance over a reasonable period of time. The regulators consider a reasonable period of payment performance to generally be a minimum of 6 months for an amortizing loan.	

[2] There are additional requirements for applying the first part of this test, please see the "Nonaccrual Status" section of the Call Report Instructions.

Generally Accepted Accounting Principles (GAAP)		Regulatory Reporting Matters	
Description	*References*	*Description*	*References*
Measuring Loan Impairment			
Impaired Collateral Dependent Loans Matters			
U.S. GAAP requires the measurement of impairment on a collateral dependent impaired loan at fair value of the collateral when the creditor determines foreclosure is probable. The FASB ASC glossary defines *probable* as the future event or events are likely to occur. The creditor may choose from alternative measurement methods for a collateral dependent impaired loan unless foreclosure is probable, including the, (1) present value of expected future cash flows at the loan's effective interest rate, (2) observable market price of the loan or (3) the fair value of the collateral.	FASB ASC 310-10-35	The agencies *require* the measurement of impairment on a collateral dependent loan to be measured using the fair value of collateral method.	The "Loan Impairment" section of the glossary of the Call Report Instructions
Charge-Offs			
No specific guidance exists on the timing of charge-offs.		In general, any portion of the recorded investment in an impaired collateral-dependent loan	

(continued)

Generally Accepted Accounting Principles (GAAP)		Regulatory Reporting Matters	
Description	*References*	*Description*	*References*
		(including recorded accrued interest, net deferred loan fees or costs, and unamortized premium or discount) in excess of the fair value of the collateral that can be identified as uncollectible should be promptly charged off against the allowance for loan and lease losses (ALLL).	
Restructured Lease Matters			
No specific guidance exists on disclosure of impaired modified finance lease receivables in FASB ASC 840-10-50.		Restructured loans and leases are reported in bank Call Report schedules RC-C/RC-N, TFR schedules PD/LD, and in National Credit Union Administration Loan related schedules (which equally applies to finance and leveraged lease restructures that would be akin to a troubled debt restructuring). In certain situations a modified finance lease with a debtor in financial difficulty will result in removal of the finance lease from these loan and lease related schedules. After reclassified as a new operating lease, the operating	

Generally Accepted Accounting Principles (GAAP)		Regulatory Reporting Matters	
Description	*References*	*Description*	*References*
		lease property is reported as an "Other asset" and depreciated.	
Other Matters:			
Credit Losses on International Loans			
Valuation allowances (for example, an ALLL) are deducted from the assets or group of assets that the allowances relate to. Additions and deductions from a valuation allowance should not be made for impairments or credit losses of unrelated assets.	FASB ASC 310-10-45	Allocated transfer risk reserves are intended to recognize and measure impairment and credit losses of international assets, which are recognized and measured separately from loans. However, institutions are allowed to recognize and measure in the ALLL, credit losses on loan impairments or credit losses on international assets unrelated to those loans in the ALLL.	Title 12 U.S. *Code of Federal Regulations* Part 28.52(c) (2) and (4), Section 905(a) of the International Lending Supervision Act of 1983; reported in Schedule RI-B, to the Call Report
Acquirer's Accounting Pushed Down to Acquiree's Financial Statements			
Push-down accounting is not required for institutions that are not subject to the Securities and Exchange Commission's (SEC) reporting requirements. For SEC registrants, if ownership of an institution changes by 95 percent or more, the acquired institution	SEC Staff Accounting Bulletin (SAB) No. 54, *Application of Push Down Basis of Accounting in Financial Statements of Subsidiaries Acquired by Purchase* [codified by SAB No. 103, *Update of*	Push down accounting is required for all entities, public or private, if a institution's voting stock becomes at least 95 percent owned, directly or indirectly, by an investor (which may be a holding company) or a group of investors working collaboratively, and the	The "Business Combinations" section of the glossary of the Call Report Instructions

(continued)

Generally Accepted Accounting Principles (GAAP)		Regulatory Reporting Matters	
Description	*References*	*Description*	*References*
must use the acquiring institution's basis of accounting in preparing the acquired institution's financial statements (push-down accounting). A change in control means that a person, company or control group obtains ownership in a transaction or planned series of transactions.	*Codification of Staff Accounting Bulletins* (Codification of *Staff Accounting Bulletins*, topic 5(J), "New Basis of Accounting Required in Certain Circumstances")]; FASB ASC 805-50-25-3	institution does not have outstanding publicly traded debt or preferred stock that may impact the investor's or group of investors' ability to control the form of ownership. Push down accounting also is required if the institution's separate financial statements are presented on a push down basis in reports filed with the SEC. Push down accounting may also be used when an institution's voting stock becomes at least 80 percent, but less than 95 percent, owned by an investor or a group of investors working collaboratively. In all cases, the institution's primary federal supervisory authority reserves the right to determine whether or not an institution must use push down accounting for purposes of the Call Report.	

Generally Accepted Accounting Principles (GAAP)		Regulatory Reporting Matters	
Description	*References*	*Description*	*References*
Income Taxes of Subsidiaries Within a Consolidated Group			
In practice, income taxes generally are allocated to members within a consolidated group in accordance with a tax sharing agreement.	None.	The agencies treat each financial institution subsidiary as if it were filing a separate return for intercompany tax allocation purposes. This treatment is also applied in determining net deferred tax asset limitations for regulatory capital purposes. If the holding company forgives payment by the subsidiary of the current portion of the income taxes required on a separate entity basis, the forgiveness is treated as a capital contribution. If the subsidiary pays an amount greater than that required on a separate return basis or if it pays its deferred tax liability in addition to its current tax liability, the institution must report these differences as a cash dividend to the holding company. Failure of the holding company to pay the subsidiary bank an equitable refund of the bank's net operating	The "Income Taxes of a Bank Subsidiary of a Holding Company" section of the glossary of the Call Report Instructions; and *Interagency Policy Statement on Income Tax Allocation in a Holding Company Structure*, issued December 23, 1998

(continued)

Generally Accepted Accounting Principles (GAAP)		Regulatory Reporting Matters	
Description	*References*	*Description*	*References*
		loss should also be considered a cash dividend paid by the bank to the parent holding company.	
Related Party Transactions[3]			
Transfers of *nonmonetary assets* to a stockholder (such as dividends in-kind) must be recorded at fair value; however, that accounting does not apply to transfers of nonmonetary assets solely between companies or persons under common control. Rather, such transfers are accounted for at historical cost.	FASB ASC 845-10	Transfers of assets other than cash (for example, securities of another company or real estate) to a stockholder or related party must be recorded at their fair value, as if the transfer were completed at arm's length. However, this accounting is governed by the facts and circumstances of the transaction and there are often exceptions to this policy.	See the "Dividends" section, subsection "Property Dividends" of glossary of the Call Report Instructions and Schedule RC-M of the Call Report Instructions
Institutions must *disclose the aggregate amount of loans to directors, officers, employees, and stockholders*, as well as to entities that directors, officers, employees, and stockholders are affiliated with.	General guidance on related party disclosures is established in FASB ASC 850-10-50	Institutions must disclose extensions of credit to executive officers, directors, principal shareholders, and their related interests.	

[3] Inter-Company Transactions, product offerings, performance of services and other business relationships between, or involving two or more, legal vehicles must also be conducted in compliance with the applicable statutory and regulatory requirements of sections 23A–23B of the Federal Reserve Act (*Banks and Banking*, U.S. Code 12, Section 371c and 371c–1) and Regulation W (Title 12 U.S. *Code of Federal Regulations* Part 223) of the Federal Reserve (the "Guidelines").

Generally Accepted Accounting Principles (GAAP)		Regulatory Reporting Matters	
Description	*References*	*Description*	*References*
II. DISPLAY			
Accounting Changes			
U.S .GAAP provides guidance on the accounting for and reporting of accounting changes and error corrections. FASB ASC 250-10 establishes, unless impracticable, retrospective application as the required method for reporting a change in accounting principle in the absence of explicit transition requirements specific to a newly adopted accounting principle.	FASB ASC 250-10	Regulatory reports cover a single discrete period. As a result, the agencies require that the effect (on undivided profits) of required retroactive application of a new pronouncement be excluded from net income and reported as a direct adjustment to equity capital in the related regulatory reports in the period of adoption.	The "Accounting Changes" section of glossary of the Call Report Instructions. Cumulative catch-up adjustment due to a change in accounting principle is reported on line 2 of Schedule RI-A and on line 4 of Schedule RI-E
Gain/Loss on Certain Sales			
SEC registrants are required to include in *noninterest expense* the net cost of foreclosed real estate,	Article 9.04.14(d) of SEC Regulation S-X	The agencies require that institutions always include rental income in noninterest income. In	Line 5(i)–5(l) and 7(d) on Schedule RI and the related Call

Generally Accepted Accounting Principles (GAAP)		Regulatory Reporting Matters	
Description	*References*	*Description*	*References*
including gains, losses, and rental income. In practice, classification by nonregistrants of gains and losses on sales of loans, real estate owned, fixed assets (including branch office assets), and other assets varies.		addition, there are specific Call Report line items for gains (losses) on sales of loans and leases, real estate owned, and other assets. Banks should consistently report net gains (losses) on the sale of certain others assets, such as foreign currency, as either other noninterest income or as other noninterest expense.	Report instructions.

Appendix C

Information Sources

Further information on matters addressed in this guide is available through various publications and services listed in the table that follows. Many non-government and some government publications and services involve a charge or membership requirement.

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

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

Organization	***General Information***	***Fax Services***	***Website***	***Recorded Announcements***
American Bankers Association	1120 Connecticut Ave., NW Washington, DC 20036 (800) BANKERS		www.aba.com	
American Institute of Certified Public Accountants	*Member Service Center* 220 Leigh Farm Road Durham, NC 27707 (888) 777- 7077 Information about AICPA continuing professional education programs is available through the AICPA CPE Division (888) 777-7077 or (888) 247-3277	(800) 362-5066	www.aicpa.org www.cpa2biz.com	
Conference of State Bank Supervisors	1155 Connecticut Ave., NW Washington, DC 20036 (202) 296-2840	(202) 296-1928	www.csbs.org	
Credit Union National Association	601 Pennsylvania Ave., NW South Building Washington, DC 20004-2601 (202) 638-5777	(202) 638-7734	www.cuna.org	
Federal Deposit Insurance Corporation	*Public Information Center* 3501 North Fairfax Drive Arlington, VA 22226 (877) 275-3342 (703) 562-2200	*Facsimile Bulletin Board System* (804) 642-0003	www.fdic.gov	

Organization	***General Information***	***Fax Services***	***Website***	***Recorded Announcements***
Federal Reserve System	*Publications Services* Board of Governors of the Federal Reserve System Publications Fulfillment Mail Stop N-127 Washington, DC 20551 (202) 452-3245		www.federalreserve.gov	*Federal Reserve Board Highlights* (202) 452-3206
Federal Home Loan Mortgage Corporation (Freddie Mac)	*Corporate Office Headquarter 1* 8200 Jones Branch Drive McLean, VA 22102-3110 (800) 424-5401 (703) 903-2000		www.freddiemac.com	
Financial Accounting Standards Board	401 Merritt 7 PO Box 5116 Norwalk, CT 06856-5116 (800) 748-0659 (203) 847-0700		www.fasb.org	
Financial Managers Society	100 West Monroe Suite 1700 Chicago, IL 60603 (312) 578-1300	(312) 578-1308	www.fmsinc.org	

(continued)

Organization	*General Information*	*Fax Services*	*Website*	*Recorded Announcements*
Independent Community Bankers of America	1615 L Street NW Suite 900 Washington, DC 20036 (800) 422-8439 (202) 659-8111		www.icba.org	
Mortgage Bankers Association of America	1717 Rhode Island Avenue, NW Suite 400 Washington, DC 20036 (202) 557-2700		www.mbaa.org	
National Association of Federal Credit Union	3138 10th Street North Arlington, VA 22201-2149 (800) 336-4644 (703) 552-4770	(703) 524-1082	www.nafcunet.org	
National Association of Insurance Commissioners	*Central Office* 2301 McGee Street Suite 800 Kansas City, MO 64108-2662 (816) 842-3600 *Customer Service* (816) 783-8300 *Help Desk* (816) 783-8500	*Central Office* (816) 783-8175 *Customer Service* (816) 460-7593 *Help Desk* (816) 460-7456	www.naic.org	

Organization	*General Information*	*Fax Services*	*Website*	*Recorded Announcements*
National Association of Real Estate Investment Trusts	1875 I Street, NW Suite 600 Washington, DC 20006 (800) 362-7348 (202) 739-9400	(202) 739-9401	www.reit.com	
National Credit Union Administration	1775 Duke Street Alexandria, VA 22314 (703) 518-6300 *Consumer Assistance* (800) 755-1030		www.ncua.gov	
Public Company Accounting Oversight Board	1666 K Street, NW Washington, DC 20006 (202) 207-9100	(202) 862-8430	www.pcaobus.org	
Securities Industry and Financial Markets Association	*New York* 120 Broadway, 35th Floor New York, NY 10271-0080 (212) 313-1200 *Washington, DC* 1101 New York Avenue, NW 8th Floor Washington, DC 20005 (202) 962-7300	*New York* (212) 313-1301 *Washington, DC* (202) 962-7305	www.sifma.org	

(continued)

Organization	*General Information*	*Fax Services*	*Website*	*Recorded Announcements*
The Electronic Payments Association	13450 Sunrise Valley Drive Suite 100 Herndon, VA 20171 (703) 561-1100	(703) 787-0996	www.nacha.org	
U.S. Department of the Treasury—Office of the Comptroller of the Currency	*General Correspondence* Comptroller of the Currency Administrator of National Banks Washington, DC 20219 *Customer Assistance* (800) 613-6743 (713) 658-0340		www.occ.treas.gov	
U.S. Department of the Treasury—Office of Thrift Supervision	1700 G Street, NW Washington, DC 20552 (202) 906-6000		www.ots.treas.gov	
U.S. Department of Education	400 Maryland Avenue, SW Washington, DC 20202 (800) USA-LEARN		www.ed.gov	
U.S. General Accounting Office	441 G Street, NW Washington, DC 20548 (202) 512-3000		www.gao.gov	
U.S. Government Printing Office	732 North Capitol Street, NW Washington, DC 20401-0001 (202) 512-1800	(202) 512-2104	www.access.gpo.gov	

Organization	***General Information***	***Fax Services***	***Website***	***Recorded Announcements***
U.S. Securities and Exchange Commission	*SEC Headquarters* 100 F Street, NE Washington, DC 20549-0001 (202) 942-8088 *SEC Investor Information Service* (800) SEC-0330		www.sec.gov	

Appendix D

International Financial Reporting Standards

Introduction

The following information provides a brief overview of the ongoing globalization of accounting standards, International Financial Reporting Standards (IFRSs) as a body of accounting literature, the status of convergence with IFRSs in the United States, and the related issues that accounting professionals need to consider today.

Globalization of Accounting Standards

As the business world becomes more globally connected, regulators, investors, audit firms, and public and private companies of all sizes are expressing an increased interest in having common accounting standards among participants in capital markets and trading partners around the world. Proponents of convergence with, or adoption of, IFRSs for financial reporting in the United States believe that one set of financial reporting standards would improve the quality and comparability of investor information and promote fair, orderly, and efficient markets.

Many critics, however, believe that U.S. generally accepted accounting principles (GAAP) are the superior standards and question whether the use of IFRSs will result in more useful financial statements in the long term and whether the cost of implementing IFRSs will outweigh the benefits. Implementing IFRSs will require a staggering effort by management, auditors, and financial statement users, not to mention educators.

The increasing acceptance of IFRSs, both in the United States and around the world, means that now is the time to become knowledgeable about these changes. The discussion that follows explains the underpinnings of the international support for a common set of high quality global standards and many of the challenges and potential opportunities associated with such a fundamental shift in financial accounting and reporting.

The international standard setting process began several decades ago as an effort by industrialized nations to create standards that could be used by developing and smaller nations. However, as cross-border transactions and globalization increased, other nations began to take interest, and the global reach of IFRSs expanded. More than 100 nations and reporting jurisdictions permit or require IFRSs for domestic listed companies (and most have fully conformed to IFRSs as promulgated by the International Accounting Standards Board [IASB] and include a statement acknowledging such conformity in audit reports). Several countries are expected to transition to IFRSs by, or beginning in, 2011, and many other countries have plans to converge (or eliminate significant differences between) their national standards and IFRSs.

For many years, the United States has been a strong leader in international efforts to develop globally accepted standards. Among other actions in support of IFRSs, the U.S. Securities and Exchange Commission (SEC) removed the requirement for foreign private issuers registered in the United States to reconcile their financial reports with U.S. GAAP if their accounts complied with IFRSs as issued by the IASB. In addition, the SEC continues to analyze and

evaluate appropriate steps toward, and challenges related to, converging U.S. GAAP with IFRSs, as subsequently described.

In addition to the support received from certain U.S. based entities, financial and economic leaders from various organizations have announced their support for global accounting standards. Most notably, in 2009, the Group of Twenty Finance Ministers and Central Bank Governors (G20), a group from 20 of the world's systematically important industrialized and developing economies (with the 20th member being the European Union, collectively), called for standard setters to redouble their efforts to complete convergence in global accounting standards.

Acceptance of a single set of high quality accounting standards may present many significant opportunities, including the improvement in financial reporting to global investors, the facilitation of cross-border investments, and the integration of capital markets. Further, U.S. entities with international operations could realize significant cost savings from the use of a single set of financial reporting standards. For example, U.S. issuers raising capital outside the United States are required to comply with the domestic reporting standards of the foreign country and U.S. GAAP. As a result, additional costs arise from the duplication and translation of financial reporting information.

Many multinational companies support the use of common accounting standards to increase comparability of financial results among reporting entities from different countries. They believe common standards will help investors better understand the entities' business activities and financial position. Large public companies with subsidiaries in multiple jurisdictions would be able to use one accounting language company-wide and present their financial statements in the same language as their competitors. In addition, some believe that in a truly global economy, financial professionals, including CPAs, will be more mobile, and companies will more easily be able to respond to the human capital needs of their subsidiaries around the world.

Although certain cost reductions are expected, the initial cost of convergence with IFRSs is expected to be one of the largest obstacles for many entities, including accounting firms and educational institutions. Substantial internal costs for U.S. corporations in the areas of employee training, IT conversions, and general ledger software have been predicted. In addition, the time and effort required from various external functions, including the education of auditors, investors, lenders, and other financial statement users, will be significant factors for consideration.

Although the likelihood of acceptance of IFRSs may lack clarity for the time being, U.S. companies should consider preparing for the costly transition to new or converged standards, which likely will include higher costs in the areas of training and software compliance.

Who is the IASB?

The IASB is the independent standard setting body of the IFRS Foundation, formerly, the International Accounting Standards Committee Foundation. As a private sector organization, the IFRS Foundation has no authority to impose funding regimes on countries. However, a levy system and national contributions through regulatory and standard-setting authorities or stock exchanges have been introduced in a number of countries to fund the organization. Although the AICPA was a founding member of the International Accounting Standards Committee (IASC), the IASB's predecessor organization, it is not affiliated with the IASB.

The IASB, founded on April 1, 2001, in London, England, is responsible for developing IFRSs and promoting the use and application of these standards. In pursuit of this objective, the IASB cooperates with national accounting standard setters to achieve convergence in accounting standards around the world.

The structure includes the following primary groups: (*a*) the IFRS Foundation, an independent organization having two main bodies: the IFRS Foundation trustees and the IASB; (*b*) the IFRS Advisory Council; and (*c*) the IFRS Interpretations Committee, formerly the International Financial Reporting Interpretations Committee (IFRIC). The trustees appoint the IASB members, exercise oversight, and raise the funds needed, but the IASB itself has responsibility for establishing IFRSs.

The IASB board members are selected chiefly upon their professional competence and practical experience. The trustees are required to select members so that the IASB will comprise the best available combination of technical expertise and international business and market experience and to ensure that the IASB is not dominated by any particular geographical interest or constituency. The IASB has members from several different countries, including the United States. The members are responsible for the development and publication of IFRSs, including *International Financial Reporting Standard for Small- and Medium-sized Entities* (*IFRS for SMEs*), and for approving the interpretations of IFRSs as developed by the IFRS Interpretations Committee.

The IFRS Interpretations Committee, founded in March 2002, is the successor of the previous interpretations committee, the Standing Interpretations Committee (SIC), and is the interpretative body of the IASB. The role of the IFRS Interpretations Committee is to provide timely guidance on newly identified financial reporting issues not specifically addressed in IFRSs or issues in which interpretations are not sufficient.

IFRSs are developed through a formal system of due process and broad international consultation, similar to the development of U.S. GAAP.

Readers are encouraged to become involved in the standard-setting process by responding to open calls from the standard setting organizations.

What Are IFRSs?

The term *IFRSs* has both a narrow and broad meaning. Narrowly, IFRSs refers to the numbered series of pronouncements issued by the IASB, collectively called *standards*. More broadly, however, IFRSs refer to the entire body of authoritative IASB literature, including the following:

- Standards, whether labeled IFRSs or International Accounting Standards (IASs)[1]
- Interpretations, whether labeled IFRIC (the former name of the interpretive body) or SIC (the predecessor to IFRIC)[2]

The preface to the IFRS *2010 Bound Volume* states that IFRSs are designed to apply to the general purpose financial statements and other financial reporting of all profit-oriented entities, including commercial, industrial, and financial entities, regardless of legal form or organization. IFRSs are not designed to

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[1] See www.iasb.org for a current listing of International Financial Reporting Standards (IFRSs) and International Accounting Standards (IASs).

[2] See www.iasb.org for a current listing of International Financial Reporting Interpretations Committee and Standing Interpretations Committee interpretations.

apply to not-for-profit entities or those in the public sector,[3] but these entities may find IFRSs appropriate in accounting for their activities.

The IASB's *Framework for the Preparation and Presentation of Financial Statements* (IASB Framework) establishes the concepts that underlie the preparation and presentation of financial statements for external users. The IFRS Foundation is guided by the IASB Framework in the development of future standards and in its review of existing standards. The IASB Framework is not an IFRS, and when there is a conflict between the IASB Framework and any IFRS, the standard will prevail. The IASB Framework is an overall statement of guidance for those interpreting financial statements, whereas IFRSs are issue and subject specific.

When an IFRS specifically applies to a transaction, other event, or condition, the accounting policy or policies applied to that item shall be determined by applying the IFRS and considering any relevant implementation guidance issued by the IASB for the IFRS.

Further, if an IFRS does not address a specific transaction, event, or condition explicitly, IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*, states that management should use its judgment in developing and applying an accounting policy that results in information that is relevant and reliable. With respect to the reliability of financial statements, IAS 8 states that the financial statements (*a*) represent faithfully the financial position, financial performance, and cash flows of the entity; (*b*) reflect the economic substance of transactions, other events, and conditions; (*c*) are neutral; (*d*) are prudent; and (*e*) are complete in all material respects. When making this type of judgment, management should refer to, and consider the applicability of, the following in descending order:

- The requirements and guidance in IFRSs dealing with similar and related issues
- The definitions, recognition criteria, and measurement concepts for assets, liabilities, income, and expenses in the IASB Framework
- The most recent pronouncements of other standard setting bodies (for example, U.S. GAAP, other accounting literature, and accepted industry practices) to the extent that these do not conflict with IFRSs

IFRS for SMEs

IFRS for SMEs is a modification and simplification of full IFRSs aimed at meeting the needs of private company financial reporting users and easing the financial reporting burden on private companies through a cost-benefit approach. *IFRS for SMEs* is a self-contained, global accounting and financial reporting standard applicable to the general purpose financial statements of entities that, in many countries, are known as small- and medium-sized entities (SMEs). Full IFRSs and *IFRS for SMEs* are promulgated by the IASB.

SMEs are entities that publish general purpose financial statements for external users and do not have public accountability. An entity has public accountability under the IASB's definition if it files its financial statements with a securities commission or other regulatory organization or it holds assets in a fiduciary capacity (for example, banks, insurance companies, brokers and dealers in securities, pension funds, and mutual funds). It is not the IASB's intention to exclude entities that hold assets in a fiduciary capacity for reasons

[3] Generally speaking, *public* means government-owned entities, and *private* means nongovernment-owned entities.

incidental to their primary business (for example, travel agents, schools, and utilities) from utilizing *IFRS for SMEs*.

The needs of users of SME financial statements often are different from the needs of users of public company financial statements and other entities that likely would use full IFRSs. Whereas full IFRSs were designed specifically to meet the needs of equity investors in the public capital markets, *IFRS for SMEs* was developed with the needs of a wide range of users in mind. Users of the financial statements of SMEs may be more focused on shorter-term cash flows, liquidity, balance sheet strength, interest coverage, and solvency issues. Full IFRSs may impose a burden on SME preparers in that full IFRSs contain topics and detailed implementation guidance that generally are not relevant to SMEs. This burden has been growing as IFRSs have become more detailed. As such, a significant need existed for an accounting and financial reporting standard for SMEs that would meet the needs of their financial statement users while balancing the costs and benefits from a preparer perspective.

Practically speaking, *IFRS for SMEs* is viewed as an accounting framework for entities that do not have the capacity or resources to use full IFRSs. In the United States, the term SME would encompass many private companies.

In May 2008, the AICPA Governing Council voted to recognize the IASB as an accounting body for purposes of establishing international financial accounting and reporting principles and amended appendix A, "Council Resolution Designating Bodies to Promulgate Technical Standards," of Rule 202, *Compliance With Standards* (AICPA, *Professional Standards*, ET sec. 202 par. .01), and Rule 203, *Accounting Principles* (AICPA, *Professional Standards*, ET sec. 203 par. .01). This amendment gives AICPA members the option to use IFRSs as an alternative to U.S. GAAP. Accordingly, IFRSs are not considered to be an other comprehensive basis of accounting. Rather, they are a source of GAAP.

As such, a key professional barrier to using IFRSs and, therefore, *IFRS for SMEs*, has been removed. Any remaining barriers may come in the form of unwillingness by a private company's financial statement users to accept financial statements prepared under *IFRS for SMEs* and a private company's expenditure of money, time, and effort to convert to *IFRS for SMEs*.[4]

The AICPA has developed a resource that compares *IFRS for SMEs* with corresponding requirements of U.S. GAAP. This resource is available in a Wiki format, which allows AICPA members and others to contribute to its development. To learn more about the resource, view available sections, and contribute to its content, visit the Wiki at http://wiki.ifrs.com/.

The Financial Accounting Standards Board and IASB Convergence Efforts[5]

To address significant differences between IFRSs and U.S. GAAP, the Financial Accounting Standards Board (FASB) and the IASB agreed to a "Memorandum of Understanding" (MoU), which was originally issued in 2006 and subsequently updated. Readers are encouraged to monitor the FASB and IASB

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[4] CPAs are encouraged to consult their state boards of accountancy to determine the status of reporting on financial statements prepared in accordance with *International Financial Reporting Standard for Small- and Medium-sized Entities* within their individual state.

[5] Because the convergence projects discussed are active and subject to change, updates will be posted periodically to www.journalofaccountancy.com. Readers also are encouraged to monitor the progress of these projects at the respective boards' websites: www.iasb.org and www.fasb.org.

websites for additional developments regarding the convergence efforts, such as discussion papers, exposure drafts, and requests for comments.

Comparison of U.S. GAAP and IFRSs

One of the major differences between U.S. GAAP and IFRSs lies in the conceptual approach: U.S. GAAP is based on principles, with heavy use of rules to illustrate the principles; however, IFRSs are principles based, without heavy use of rules.

In general, a principles-based set of accounting standards, such as IFRSs, is broad in scope. The standards are concise, written in plain language, and provide for limited exceptions and bright lines. Principles-based standards typically require a higher level of professional judgment, which may facilitate an enhanced focus on the economic purpose of a company's transactions and how the transactions are reflected in its financial reporting.

A noticeable result of these differences is that IFRSs provide much less overall detail. In developing an IFRS, the IASB expects preparers to rely on core principles and limited application guidance with fewer prescriptive rules. In contrast, FASB often leans more toward providing extensive prescriptive guidance and detailed rules. The guidance provided in IFRSs regarding revenue recognition, for example, is significantly less extensive than U.S. GAAP. IFRSs also contain relatively little industry-specific guidance.

An inherent issue in a principles-based system is the potential for different interpretations of similar transactions across jurisdictions and entities, which may affect the relative comparability of financial reporting.

Because of long-standing convergence projects between the IASB and FASB, the extent of the specific differences between IFRSs and U.S. GAAP is decreasing. Yet, significant differences remain, which could result in significantly different reported results, depending on a company's industry and individual facts and circumstances. For example, some differences include the following:

- IFRSs do not permit last in, first out (LIFO) inventory accounting.
- IFRSs allow for the revaluation of assets in certain circumstances.
- IFRSs use a single-step method for impairment write-downs rather than the two-step method used in U.S. GAAP, making write-downs more likely.
- IFRSs have a different probability threshold and measurement objective for contingencies.
- IFRSs generally do not allow net presentation for derivatives.

U.S. GAAP also addresses some specific transactions not currently addressed in IFRSs, such as accounting for reorganizations, including quasi reorganizations; troubled debt restructuring; spin-offs; and reverse spin-offs. In addition, U.S. GAAP is designed to apply to all nongovernmental entities, including not-for-profit entities, and includes specific guidance for not-for-profit entities, development stage entities, limited liability entities, and personal financial statements.

The difference in the amount of industry-specific guidance also illustrates the different approaches. Currently, IFRSs include only several standards (for

example, IAS 41, *Agriculture*)[6] that might be regarded as primarily industry-specific guidance. However, the scope of these standards includes all entities to which the scope of IFRSs applies. In contrast, U.S. GAAP has considerable guidance for entities within specific industries. For example, on liability recognition and measurement alone, U.S. GAAP contains specific guidance for entities in the following industries, which is not found in IFRSs:

- Health care
- Contractors and construction
- Contractors and the federal government
- Entertainment, with separate guidance for casinos, films, and music
- Financial services, with separate guidance for brokers and dealers and depository and lending, insurance, and investment companies

For nonmonetary transactions, U.S. GAAP provides specific guidance for the airline, software, and entertainment industries.

SEC Work Plan

The SEC continues to affirm its support for a single set of high-quality, globally accepted accounting standards and for the convergence of U.S. GAAP and IFRSs. In February 2010, the SEC issued Release No. 33-9109, *Commission Statement in Support of Convergence and Global Accounting Standards*. This release provides an update to Release No. 33-8982, *Roadmap for the Potential Use of Financial Statements Prepared in Accordance with International Financial Reporting Standards by U.S. Issuers*. The February 2010 release provides a confirmation of the SEC's continued support for convergence, highlights positive aspects of narrowing the differences between the two sets of standards, and outlines additional considerations required before adoption of a single standard is achieved.

The release also states that a more comprehensive work plan is necessary to lay out the work required to support a decision on the appropriate course to incorporate IFRSs into the U.S. financial reporting system for U.S. issuers, including the scope, timeframe, and methodology for any such transition. The SEC has indicated that it will carefully consider and deliberate whether a potential transition is in the best interest of U.S. investors and markets.

During 2011, assuming completion of the convergence projects and the SEC staff's work plan, the SEC will decide whether to incorporate IFRSs into the U.S. financial reporting system and, if so, when and how. The work plan is included as an appendix at the end of the SEC's release, which is located on the SEC's website at www.sec.gov.[*]

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[6] In addition to IAS 41, *Agriculture*, the other IFRSs that address issues specific to certain industries are IFRS 4, *Insurance Contracts*, and IFRS 6, *Exploration for and Evaluation of Mineral Resources*.

[*] On May 26, 2011, the Office of the Chief Accountant of the Securities and Exchange Commission (SEC) issued a staff paper seeking feedback on a possible method of incorporating international financial reporting standards as issued by the International Accounting Standards Board into the U.S. financial reporting system. The staff paper makes clear that the SEC has not yet made a decision concerning whether and, if so, how to incorporate IFRSs into the financial reporting system for U.S. issuers. The focus of the staff paper is to outline a possible approach (the condorsement approach) for incorporating IFRSs into the U.S. financial reporting system, as the SEC staff continues to work on the work plan. Readers are encouraged to visit the SEC website (www.sec.gov/spotlight/globalaccountingstandards/ifrs-work-plan-paper-052611.pdf) for a detailed discussion of the staff paper.

AICPA

On February 24, 2010, president and CEO of the AICPA Barry Melancon issued a statement on the SEC's plan to work toward the incorporation of IFRSs in the U.S. financial reporting system. The statement noted that the AICPA supports the thoughtful and concrete steps the SEC is taking, as outlined in its plan, to prepare for the transition. The AICPA understands that it will need to fulfill a number of responsibilities to make the use of IFRSs in the United States a success. Ongoing efforts include the following:

- Continuing to educate AICPA members about IFRSs
- Working with accounting educators, textbook authors, and educational institutions to prepare future professionals to use IFRSs
- Making certain the voice of U.S. CPAs is heard internationally
- Incorporating questions about IFRSs into the Uniform CPA Exam

The AICPA believes that it is critical for the SEC to set a specific date for the use of IFRSs in the United States and encourages the SEC, as it completes this work plan in 2011, to ensure investor confidence is maintained and key milestones lead successfully to global standards in 2015. In moving forward, it is essential that all stakeholders—regulators, investors, auditors, educators, financial statement users, and preparers—have the knowledge and tools they need to successfully navigate any change in U.S. accounting rules. The AICPA is doing its part now to prepare these stakeholders for this fundamental shift in financial reporting.

Additional Resources

Website	*URL*
AICPA	www.aicpa.org
AICPA International Financial Reporting Standards Resources	www.ifrs.com
International Accounting Standards Board	www.iasb.org
Comparison Wiki of *International Financial Reporting Standard for Small- and Medium-sized Entities* and U.S. generally accepted accounting principles	http://wiki.ifrs.com
Financial Accounting Standards Board	www.fasb.org

Appendix E

Schedule of Changes Made to the Text From the Previous Edition

This schedule of changes identifies areas in the text and footnotes of this guide that have changed since the previous edition. Entries in the table of this appendix reflect current numbering, lettering (including that in appendix names), and character designations that resulted from the renumbering or reordering that occurred in the updating of this guide.

Reference	*Change*
Preface	Updated.
Text box before paragraph 1.01	Deleted.
Paragraph 1.06	Revised for clarification; revised to reflect the issuance of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).
Paragraph 1.08*d*	Revised to reflect the issuance of the Dodd-Frank Act.
Paragraph 1.20	Revised to reflect the issuance of the Financial Crimes Enforcement Network's final rule *Transfer and Reorganization of Bank Secrecy Act Regulations* published in the *Federal Register* Vol. 75, No. 206 [26 October 2010], pp. 65806–65879; footnote * added.
Former paragraph 1.24	Deleted for clarification.
Paragraph 1.24	Revised for clarification.
Paragraph 1.25	Added to reflect the issuance of the Dodd-Frank Act.
Paragraph 1.26	Added to reflect the issuance of the Federal Deposit Insurance Corporation's (FDIC's) new Restoration Plan; added to reflect issuance of the FDIC's final rule *Deposit Insurance Assessment Base, Assessment Rate Adjustments, Dividends, Assessment Rates, and Large Bank Pricing Methodology* published in the *Federal Register* Vol. 76, No. 38 [25 February 2011], pp. 10672–10733; footnote † added.
Heading before paragraph 1.28 and paragraphs 1.28–.34	Added to reflect the issuance of the Dodd-Frank Act.

(continued)

Reference	Change
Footnote ‡ in paragraph 1.34	Added.
Paragraph 1.35	Added to reflect the issuance of the Dodd-Frank Act.
Footnote || in paragraph 1.35	Added.
Paragraphs 1.36–.37	Added to reflect the issuance of the Dodd-Frank Act.
Footnote # in paragraph 1.37	Added.
Paragraphs 1.38–.39	Added to reflect the issuance of the Dodd-Frank Act.
Footnotes **, ††, and ‡‡ in paragraph 1.39	Added.
Paragraphs 1.40–.41	Added to reflect the issuance of the Dodd-Frank Act.
Footnote ** in paragraph 1.44	Added.
Former footnote * in paragraph 1.44	Deleted.
Footnotes |||| and ## in paragraphs 1.49 and 1.50, respectively.	Added.
Former footnote † to the heading before paragraph 1.53	Deleted.
Footnote ** in paragraph 1.55	Added.
Paragraph 1.58	Added to reflect the federal banking agencies' final rule *Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Regulatory Capital; Impact of Modifications to Generally Accepted Accounting Principles; Consolidation of Asset-Backed Commercial Paper Programs; and Other Related Issues* published in the *Federal Register* Vol. No. 75, No. 18 [28 January 2010], pp. 4636–4654.

Reference	Change
Paragraphs 1.59–.62	Added to reflect the issuance of the Office of the Comptroller of the Currency (OCC), Board of Governors of the Federal Reserve System (FRB), and FDIC's final rule *Risk-Based Capital Standards: Advanced Capital Adequacy Framework—Basel II: Establishment of a Risk-Based Capital Floor* published in the *Federal Register* Vol. 76, No. 124 [28 June 2011], pp. 37620–37628.
Former footnote ‡ in paragraph 1.90	Deleted.
Paragraph 1.95	Added to reflect the issuance of Securities and Exchange Commission (SEC) Final Rule Release No. 33-9142.
Paragraph 1.100	Revised to reflect the issuance of Department of Housing and Urban Development (HUD) Mortgagee Letter 2011-05, *Revised Audited Financial Statement Reporting Requirements for Supervised Lenders in Parent–Subsidiary Structures and New Financial Reporting Requirements for Multifamily Mortgagees*.
Paragraph 2.02	Revised to reflect the issuance of the Dodd-Frank Act.
Former footnote * to heading before paragraph 2.18	Deleted.
Footnote * in paragraph 2.18	Added.
Paragraph 2.21	Revised to reflect the issuance of National Credit Union Administration's (NCUA's) final rule *Display of Official Sign; Permanent Increase in Standard Maximum Share Insurance Amount* published in the *Federal Register* Vol. 75, No. 170 [2 September 2010], pp. 53841–53843.
Paragraphs 2.42–.43	Revised for clarification.
Footnote * to heading before paragraph 2.48	Added.
Former footnote * in paragraph 2.50	Deleted.
Former paragraph 2.53	Deleted to reflect NCUA's final rule *Corporate Credit Unions* published in the *Federal Register* Vol. 75, No. 202 [20 October 2010], pp. 64786–64862.
Paragraph 2.54	Revised for clarification.

(continued)

Reference	*Change*
Paragraph 4.16	Revised to reflect the issuance of Accounting Standards Update (ASU) No. 2011-04, *Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*.
Paragraph 4.17	Revised for clarification.
Paragraph 4.26	Revised to reflect Home Affordable Mortgage Program—Principal Reduction Alternative.
Paragraph 4.32	Revised to reflect HUD Mortgagee Letter 2009-31, *Strengthening Counterparty Risk Management*.
Footnote * in paragraph 4.32	Added.
Paragraph 4.33, footnote 1, and paragraphs 4.34–.35	Added to reflect the issuance of HUD Mortgagee Letter 2011-05, *Revised Audited Financial Statement Reporting Requirements for Supervised Lenders in Parent–Subsidiary Structures and New Financial Reporting Requirements for Multifamily Mortgagees*.
Footnote 2 in paragraph 4.38	Revised to reflect the issuance of SEC Final Rule Release No. 33-9175.
Footnote * in paragraph 5.06	Added.
Footnote 1 in paragraph 5.06	Added for clarification.
Footnote 3 in paragraph 5.08	Revised to reflect the issuance of Statement on Standards for Attestation Engagements (SSAE) No. 16, *Reporting on Controls at a Service Organization* (AICPA, *Professional Standards*, AT sec. 801).
Footnote † in paragraph 5.08	Added.
Former footnote * in paragraph 5.08	Deleted.
Former footnote † in paragraph 5.15	Deleted.
Footnote 4 in paragraph 5.15	Added for clarification.
Footnote ‡ in paragraph 5.18	Added.
Footnote 5 in paragraph 5.35	Added for clarification.
Footnote || in paragraph 5.41	Added.

Reference	*Change*
Former footnote ‡ to heading before paragraph 5.45	Deleted.
Footnote 9 to heading before paragraph 5.45	Added for clarification.
Former footnote || to heading before paragraph 5.54	Deleted.
Footnote 10 to heading before paragraph 5.54	Added for clarification.
Footnote † in paragraph 5.74	Added.
Footnote 14 in paragraph 5.85	Revised for clarification.
Former footnote # in paragraph 5.103	Deleted.
Footnote 19 in paragraph 5.103	Added for clarification.
Footnote 21 in paragraph 5.106, footnote 22 to heading before paragraph 5.107, paragraph 5.113, footnotes 25 and 26 in paragraph 5.125, paragraph 5.149, and footnote 31 in paragraph 5.166	Revised for clarification.
Former footnote †† in paragraph 5.170	Deleted.
Footnote || in paragraphs 5.203–.204	Added.
Paragraph 5.207	Revised for clarification.
Footnote || in paragraph 5.209	Added.
Former footnote * in paragraph 6.04	Deleted.
Footnote * in paragraph 6.04	Added.
Paragraphs 6.05, 6.13, and 6.29	Revised for clarification.
Footnote † in paragraph 6.32	Added.

(continued)

Reference	Change
Former footnote * in paragraph 7.20	Deleted.
Paragraph 7.31	Revised to reflect Financial Accounting Standards Board (FASB) Statement Nos. 166, *Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140*, and 167, *Amendments to FASB Interpretation No. 46(R)*; former footnote † deleted; former footnote ‡ deleted.
Former footnotes ǁ and # in paragraph 7.61	Deleted.
Footnote 1 in paragraph 7.61	Added to reflect the issuance of Technical Questions and Answers (TIS) section 2130.40, "Certificates of Deposit and FASB ASC 320" (AICPA, *Technical Practice Aids*).
Former footnote ** to heading before paragraph 7.62	Deleted.
Paragraph 7.65	Added to reflect the issuance of the NCUA's Corporate System Resolution Plan.
Paragraph 7.66 and footnote 2	Added to reflect the issuance of NCUA's final rule *Corporate Credit Unions* published in the *Federal Register* Vol. 75, No. 202 [20 October 2010], pp. 64786–64862.
Footnote 3 in paragraph 7.71	Added for clarification.
Footnote 4 in paragraph 7.81	Revised for clarification.
Paragraph 7.83	Added for clarification.
Heading before paragraph 7.84, paragraph 7.84, and footnote *	Added to reflect the OCC's *Bank Accounting Advisory Series*.
Footnote † in paragraph 7.86	Added.
Paragraph 7.88	Revised to reflect FASB Statement No. 166; former footnote †† deleted.
Paragraph 7.91	Revised to reflect the issuance of ASU No. 2011-04.
Footnote ‡ in paragraph 7.103 and footnote ǁ to heading before paragraph 7.104	Added.
Former paragraph 7.110	Deleted for clarification.

Reference	*Change*
Former paragraph 7.111 and footnote ǀǀ ǀǀ	Deleted to reflect FASB Statement No. 166.
Former paragraph 7.112	Deleted for clarification.
Former footnote ‡‡ to heading before paragraph 7.114	Deleted.
Footnote # to heading before paragraph 7.114	Added.
Paragraph 7.114	Added to reflect FASB Statement No. 167.
Former footnote † in paragraph 7.118	Deleted.
Footnotes ** in paragraph 7.135, †† in paragraph 7.151, ‡ in paragraph 7.153, and ‡‡ in paragraphs 7.155–.158	Added.
Paragraph 7.159	Revised to reflect the issuance of Public Company Accounting Oversight Board Staff Audit Practice Alert No. 4, *Auditor Considerations Regarding Fair Value Measurements, Disclosures, and Other-Than-Temporary Impairments* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400 par. .04).
Footnote 9 in paragraph 7.159	Revised for clarification.
Footnotes ǀǀ ǀǀ and ## in paragraph 7.159	Added.
Paragraph 8.29	Revised for clarification.
Paragraph 8.41	Revised for clarification; revised for the passage of time.
Paragraph 8.56	Revised for clarification.
Former footnote * to heading before paragraph 8.57	Deleted.
Paragraphs 8.58–.59	Revised for clarification.
Paragraph 8.63	Added to reflect the issuance of *Interagency Appraisal and Evaluation Guidelines* issued in December 2010.
Paragraph 8.64	Revised to reflect the issuance of *Interagency Appraisal and Evaluation Guidelines* issued in December 2010.

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Reference	*Change*
Paragraph 8.65	Revised for clarification; footnote 5 added for clarification.
Paragraph 8.71	Revised for clarification.
Heading before paragraph 8.72	Added for clarification.
Paragraph 8.72	Added to reflect the federal banking agencies' *Correspondent Concentration Risks Interagency Guidance*.
Heading before paragraph 8.80, paragraph 8.80, and footnote *	Added for clarification.
Footnote † to heading before paragraph 8.81	Revised.
Paragraph 8.81	Revised to reflect FASB Statement No. 166.
Former footnote ‡ in paragraph 8.81	Deleted.
Paragraph 8.82	Revised to reflect FASB Statement No. 166.
Former footnote ǁ in paragraph 8.82	Deleted.
Former paragraph 8.84	Deleted for clarification.
Former footnote ‡ in paragraph 8.85	Deleted.
Heading before paragraph 8.86	Revised for clarification.
Former paragraph 8.88	Moved to paragraph 8.89 for clarification.
Paragraph 8.89	Moved from former paragraph 8.88 for clarification.
Paragraphs 8.90 and 8.98	Revised for clarification.
Paragraph 8.99	Added for clarification.
Former footnote # in paragraph 8.102	Deleted.
Paragraphs 8.103–.104	Revised for clarification.
Paragraphs 8.105–.109	Added for clarification.
Former paragraph 8.113	Deleted; see paragraph 8.154.
Footnote ‡ to heading before paragraph 8.113	Added.
Paragraphs 8.116–.119	Added to reflect the issuance of ASU No. 2011-02, *Receivables (Topic 310): A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring*; footnote ǁ in paragraphs 8.116 and 8.119 added.

Reference	Change
Paragraph 8.124	Revised to reflect the issuance of ASU No. 2011-04.
Heading before paragraph 8.125	Revised for clarification.
Footnote # to heading before paragraph 8.131	Added.
Former paragraph 8.136	Deleted; see paragraph 8.152.
Paragraph 8.136	Revised for clarification.
Former paragraph 8.139	Deleted to reflect the issuance of ASU No. 2010-20, *Receivables (Topic 310): Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*.
Paragraphs 8.144 and 8.146	Revised to reflect the issuance of ASU No. 2010-20; footnotes ** and †† added.
Paragraph 8.147, footnote ‡‡, paragraph 8.148, and footnote ||||	Added to reflect the issuance of ASU No. 2010-20.
Paragraph 8.149	Revised to reflect the issuance of ASU No. 2010-20; footnote ## added.
Paragraph 8.150	Moved from former paragraph 8.135 for clarification.
Paragraph 8.151, footnote ***, paragraph 8.152, footnote †††	Added to reflect the issuance of ASU No. 2010-20.
Paragraph 8.153 and footnote ‡‡‡	Added to reflect the issuance of ASU No. 2010-20.
Paragraphs 8.156–.157 and footnote ||	Added to reflect the issuance of ASU No. 2011-02.
Paragraph 8.158	Revised to reflect FASB Statement No. 166.
Footnotes #, || || ||, and ### in paragraphs 8.160, 8.165, and 8.166, respectively	Added.
Former footnote ** to heading before paragraph 8.176	Deleted.
Footnote 13 to heading before paragraph 8.176	Added to reflect FDIC Financial Institution Letter-23-2009, "Annual Audit and Reporting Requirements: Final Amendments to Part 363."
Paragraph 8.176	Revised for clarification.

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Reference	*Change*
Footnote **** in paragraph 8.189	Added.
Footnote 14 in paragraph 8.189	Revised to reflect the issuance of SSAE No. 16.
Footnote †††† in paragraph 8.190	Added.
Paragraph 8.193	Revised for clarification.
Footnotes **** and ‡‡‡‡ in paragraphs 8.210 and 8.218, respectively	Added.
Footnote 18 in paragraph 8.219	Revised for clarification.
Paragraphs 9.09, 9.13, and 9.19	Revised for clarification.
Former paragraph 9.21	Deleted for the passage of time.
Footnote 2 in paragraph 9.21	Added for clarification.
Former paragraph 9.22	Deleted for the passage of time.
Paragraphs 9.22–.23 and 9.26	Revised for clarification.
Paragraph 9.28	Added for clarification.
Paragraph 9.29	Revised for clarification.
Footnote * in paragraph 9.29, footnote † in paragraph 9.49, footnote ‡ to heading before paragraph 9.55	Added.
Heading before paragraph 9.55, paragraphs 9.55 and 9.57	Revised to reflect the issuance of ASU No. 2010-20; footnote ǀǀ in paragraph 9.55 added; former footnote * in paragraph 9.55 deleted; footnote # in paragraph 9.57 added.
Paragraph 9.58, footnotes ** and 3, and paragraph 9.59	Added to reflect the issuance of ASU No. 2010-20.
Footnote †† in paragraph 9.62 and footnote ‡‡ in paragraph 9.71	Added.
Footnote 1 to heading before paragraph 10.06	Added to reflect the issuance of the Dodd-Frank Act.
Heading before paragraph 10.08 and paragraph 10.08	Added for clarification.

Reference	Change
Footnote 2 in paragraph 10.08	Added to reflect FASB Statement No. 166.
Paragraph 10.14	Added to reflect the issuance of the FDIC's final rule *Treatment by the Federal Deposit Insurance Corporation as Conservator or Receiver of Financial Assets Transferred by an Insured Depository Institution in Connection With a Securitization or Participation After September 30, 2010*.
Former paragraph 10.16	Moved to paragraph 10.21 for clarification.
Paragraph 10.16 and footnote *	Added for to reflect the OCC's *Bank Accounting Advisory Series*.
Paragraph 10.18	Revised to reflect FASB Statement No. 166; former footnote * deleted.
Paragraph 10.20	Added for clarification.
Paragraph 10.21	Moved from former paragraph 10.16 for clarification.
Footnote † in paragraphs 10.23–.26	Added.
Paragraph 10.26	Revised to reflect the issuance of ASU No. 2011-04.
Former paragraph 10.31	Deleted to reflect FASB Statement No. 166.
Former footnote * to heading before paragraph 10.32	Deleted.
Paragraph 10.33	Revised to reflect FASB Statement No. 166.
Paragraph 10.34	Added to reflect FASB Statement No. 166.
Former paragraph 10.35	Moved to paragraph 10.66 for clarification.
Paragraphs 10.35–.37	Added to reflect FASB Statement No. 166.
Paragraph 10.38	Revised to reflect FASB Statement No. 166.
Paragraph 10.39	Added to reflect FASB Statement No. 166.
Footnote ‡ in paragraph 10.40	Added.
Former paragraph 10.41	Deleted to reflect FASB Statement No. 166.
Former footnote * to heading before paragraph 10.41	Deleted.
Paragraphs 10.41–.42	Added to reflect FASB Statement No. 166.
Paragraph 10.43	Revised to reflect FASB Statement No. 166.
Paragraph 10.44	Added to reflect FASB Statement No. 166.
Paragraphs 10.45–.46	Revised to reflect FASB Statement No. 166.

(continued)

Reference	*Change*
Former footnote * to heading before paragraph 10.47	Deleted.
Paragraphs 10.48 and 10.50	Revised to reflect FASB Statement No. 166.
Paragraph 10.51	Added to reflect FASB Statement No. 166.
Former paragraph 10.57	Deleted to reflect FASB Statement No. 166; deleted for clarification.
Former paragraph 10.63	Deleted for clarification.
Former footnote * to heading before paragraph 10.65	Deleted.
Paragraph 10.66	Moved from former paragraph 10.35 for clarification; revised to reflect FASB Statement No. 166.
Former footnote * to heading before paragraph 10.68	Deleted.
Paragraph 10.69	Revised to reflect FASB Statement No. 166.
Paragraph 10.72	Revised for clarification.
Heading before paragraph 10.76, footnote ||, and paragraphs 10.76–.78	Added to reflect FASB Statement Nos. 166 and 167.
Former paragraph 10.79	Deleted to reflect FASB Statement No. 166.
Paragraph 10.79	Added to reflect FASB Statement No. 167.
Former paragraph 10.80 and former footnote 1	Deleted for clarification.
Paragraphs 10.80–.81	Added to reflect FASB Statement No. 167.
Former paragraph 10.82	Deleted to reflect FASB Statement No. 166.
Paragraph 10.82	Added to reflect FASB Statement No. 167.
Former paragraph 10.83	Deleted to reflect FASB Statement No. 166.
Paragraphs 10.83–.84	Added to reflect FASB Statement No. 167.
Former paragraph 10.85	Deleted to reflect FASB Statement No. 166.
Paragraphs 10.85–.86	Added to reflect FASB Statement No. 167.
Former paragraph 10.87	Deleted to reflect FASB Statement No. 166.
Paragraphs 10.87–.88	Added to reflect FASB Statement No. 167.
Former paragraph 10.89	Deleted to reflect FASB Statement No. 166.
Paragraphs 10.89–.91	Added to reflect FASB Statement No. 167.
Former paragraphs 10.92–.93	Deleted to reflect FASB Statement No. 166.

Reference	*Change*
Paragraph 10.93	Revised for clarification.
Former footnotes † and ‡ to heading before paragraph 10.103	Deleted.
Paragraphs 10.103–.109	Revised to reflect FASB Statement No. 166.
Footnote †in paragraph 10.111	Added.
Paragraphs 10.112–.113 and 10.120	Revised to reflect FASB Statement No. 166.
Paragraph 10.111	Added to reflect AU section 9336, *Using the Work of a Specialist: Auditing Interpretations of Section 336* (AICPA, *Professional Standards*).
Former paragraph 11.08	Deleted; see paragraph 8.61.
Paragraph 11.08	Revised for clarification.
Former paragraph 11.09	Deleted; see paragraph 9.25.
Paragraph 11.10	Added for clarification.
Former paragraph 11.11	Deleted; see paragraph 11.15.
Paragraph 11.12	Added for clarification.
Paragraph 11.13	Revised for clarification.
Paragraph 11.16	Moved from paragraph 11.08 for clarification.
Paragraph 11.20	Revised for clarification.
Paragraph 11.21	Added for clarification.
Paragraphs 11.23 and 11.27	Revised for clarification.
Footnote * to heading before paragraph 11.31	Added.
Former paragraph 11.42 and former footnote *	Deleted for clarification.
Paragraph 11.42	Revised for clarification.
Footnote † in paragraph 11.51	Added.
Paragraph 12.08	Revised to reflect FASB Statement No. 164, *Not-for-Profit Entities: Mergers and Acquisitions—Including an amendment of FASB Statement No. 142*.
Paragraph 12.11	Revised to reflect the issuance of the NCUA's final rule *Fixed Assets, Member Business Loans, and Regulatory Flexibility Program* published in the *Federal Register* Vol. 75, No. 208 [28 October 2010], pp. 66295– 66298.
Paragraph 12.16	Added for clarification.

(continued)

Reference	Change
Footnote * to heading before paragraph 12.17	Added.
Former footnote * in paragraph 12.22	Deleted.
Paragraph 12.22	Revised to reflect FASB Statement No. 167.
Paragraph 12.23	Revised for clarification.
Paragraph 12.24	Moved from paragraph 12.23 and revised for clarification.
Former paragraph 12.25	Deleted; see paragraph 12.24.
Paragraphs 12.25–.26	Revised for clarification.
Paragraphs 12.35–.36	Revised to reflect FASB Statement No. 164.
Paragraphs 12.37 and 12.39	Revised for clarification.
Footnotes † and ‡ in paragraph 12.45	Added.
Footnote 1 in paragraph 12.64	Added for clarification.
Paragraph 12.66	Revised for clarification.
Former footnote * in paragraph 12.69	Deleted.
Paragraph 12.69	Revised to reflect FASB Statement No. 167.
Paragraph 12.71	Revised for clarification.
Paragraph 12.72	Revised to reflect the issuance of ASU No. 2011-04.
Footnote || in paragraph 12.73 and footnote # in paragraph 12.84	Added.
Footnote * to heading before paragraph 13.04	Added.
Footnote 2 to heading before paragraph 13.41	Added to reflect TIS sections 2130.38–.40 (AICPA, *Technical Practice Aids*).
Paragraphs 13.44, 13.46, 13.53, and 13.61	Revised for clarification.
Footnote 4 in paragraph 14.23	Revised for the passage of time.
Former footnote * in paragraph 14.26	Deleted.
Paragraph 14.27	Revised to reflect FASB Statement No. 166.
Footnote * in paragraph 14.27	Added.
Paragraphs 14.29–.30	Revised to reflect FASB Statement No. 166.

Reference	*Change*
Former footnote * in paragraph 14.30	Deleted.
Footnote * in paragraphs 14.30–.31	Added.
Paragraph 14.31	Revised to reflect FASB Statement No. 166.
Footnotes * and † in paragraphs 14.35 and 14.39, respectively	Added.
Former footnote † in paragraph 14.50	Deleted.
Footnote ‡ in paragraph 14.50	Added.
Footnote 5 in paragraph 14.50	Revised to reflect SSAE No. 16.
Former paragraph 14.52	Deleted; see paragraph 14.55.
Footnotes ‖ and # in paragraph 14.62	Added.
Former footnote ‡ in paragraph 14.62	Deleted.
Footnote * in paragraph 15.33	Added.
Former footnote * in paragraph 15.35	Deleted.
Paragraphs 15.36, 15.41, and 15.44	Added for clarification.
Former paragraph 15.51	Deleted for clarification.
Paragraphs 15.51–.52	Added for clarification.
Paragraph 15.55	Revised for clarification.
Former footnote * in paragraph 15. 55	Deleted.
Footnote ‡ in paragraph 15.56	Added.
Former footnote * in paragraph 15.5 7	Deleted.
Paragraph 15.58	Revised to reflect the issuance of ASU No. 2011-04; revised for clarification.
Footnote 2 in paragraph 15.59	Revised for clarification.
Paragraph 15.60	Revised for the passage of time.
Footnote ‖ in paragraph 15.64	Added.

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Reference	*Change*
Footnote 3 in paragraph 15.64	Revised to reflect the issuance of SSAE No. 16.
Paragraph 15.71	Revised for clarification.
Footnote * in paragraph 16.09	Added.
Footnote 3 in paragraph 16.26	Revised for clarification.
Former paragraph 16.27	Deleted for the passage of time.
Footnote * in paragraph 17.08	Added.
Footnote 1 to heading before paragraph 17.11	Revised to reflect the issuance of the OCC, FRB, and FDIC's final rule *Risk-Based Capital Standards: Advanced Capital Adequacy Framework Basel II; Establishment of a Risk-Based Capital Floor* published in the *Federal Register* Vol. 76, No. 124 [28 June 2011], pp. 37620–37629.
Paragraph 17.13	Revised for clarification.
Paragraph 17.14	Moved from paragraph 17.13 for clarification.
Paragraph 17.18	Revised for clarification.
Paragraph 17.20	Added to reflect the issuance of the Dodd-Frank Act.
Footnote † in paragraph 17.22	Revised.
Former paragraph 17.33	Moved into paragraph 17.34 for clarification.
Paragraph 17.34	Revised for clarification.
Footnote * in paragraph 17.51	Added.
Footnote 4 in paragraph 17.52	Added for clarification.
Footnote ‡ in paragraph 17.52	Added.
Paragraph 17.53	Revised for clarification.
Paragraph 17.54	Moved from former paragraph 17.56 for clarification.
Former paragraph 17.55	Deleted for clarification.
Paragraph 17.55	Moved from former paragraph 17.58 for clarification.
Former paragraph 17.56	Moved to paragraph 17.54 for clarification.
Former paragraph 17.57	Moved to paragraph 17.53 for clarification.
Former paragraph 17.58	Moved to paragraph 17.55 for clarification.

Reference	*Change*
Former footnote † to heading before paragraph 17.63	Deleted.
Footnote ‖ to heading before paragraph 17.63, footnote # in paragraph 17.63, footnote ** in paragraph 17.64, and footnotes †† and ‡‡ in paragraphs 17.65 and 17.67	Added.
Paragraph 17.67	Revised to reflect NCUA's final rule *Corporate Credit Unions* published in the *Federal Register* Vol. 75, No. 202 [20 October 2010], pp. 64786–64862.
Footnote ‡‡ in paragraph 17.68	Added.
Former paragraph 17.71	Deleted to reflect NCUA's final rule *Corporate Credit Unions* published in the *Federal Register* Vol. 75, No. 202 [20 October 2010], pp. 64786–64862.
Footnote * in paragraph 17.71, footnote ‖‖ in paragraph 17.72, and footnote †† in paragraph 17.77	Added.
Paragraph 17.77	Revised to reflect NCUA's final rule *Corporate Credit Unions* published in the *Federal Register* Vol. 75, No. 202 [20 October 2010], pp. 64786–64862.
Footnote * in paragraph 18.04	Added.
Paragraph 18.20	Revised for clarification.
Paragraph 18.40	Added for clarification.
Paragraph 18.52	Revised for the passage of time.
Paragraph 18.53	Added for clarification.
Paragraphs 18.55–.56	Revised for clarification.
Paragraph 18.73	Added to reflect the Federal Financial Institutions Examination Council's *Advisory on Interest Rate Risk Management*.
Paragraphs 18.74–.75	Added to reflect the *Interagency Policy Statement on Funding and Liquidity Risk Management* published in the *Federal Register* Vol. 75, No. 54 [22 March 2010], pp. 13656–13666.

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Reference	*Change*
Paragraph 18.76	Added to reflect the issuance of FRB's *Conformance Period for Entities Engaged in Prohibited Proprietary Trading or Private Equity Fund or Hedge Fund Activities* published in the *Federal Register* Vol. 76, No. 30 [14 February 2011], pp. 8265–8278.
Paragraph 18.77	Added to reflect the issuance of the federal banking agencies *Interagency Supervisory Guidance on Counterparty Credit Risk*.
Footnote † to heading before paragraph 18.78	Revised for the passage of time.
Paragraph 18.79	Moved from paragraph 18.91 for clarification.
Footnote ‡ in paragraph 18.79	Added.
Paragraph 18.85	Revised for clarification.
Footnote || in paragraph 18.86	Added.
Footnote 2 in paragraph 18.89	Revised for clarification.
Footnote 3 in paragraph 18.90	Added for clarification.
Paragraphs 18.91–.92	Revised for clarification.
Paragraph 18.93	Moved from paragraph 18.92 for clarification.
Paragraph 18.96	Added for clarification.
Former footnote † to heading before paragraph 18.99	Deleted.
Footnote * and # in paragraph 18.99	Added.
Paragraph 19.06	Added for clarification.
Former paragraph 19.08	Deleted for the passage of time.
Paragraph 19.08	Added to reflect the issuance of *Interagency Supervisory Guidance on Bargain Purchases and FDIC- and NCUA-Assisted Acquisitions*.
Paragraph 19.09	Revised for the passage of time.
Paragraph 19.16	Revised to reflect ASU No. 2010-07, *Not-for-Profit Entities (Topic 958): Not-for-Profit Entities: Mergers and Acquisitions*.
Paragraphs 19.26–.28	Revised for clarification.
Paragraph 19.29	Moved from paragraph 19.28 for clarification.
Former footnote * to chapter 20 title	Deleted.

Reference	*Change*
Footnote * to chapter 20 title	Added.
Paragraph 20.01	Revised to reflect the issuance of ASU No. 2011-04.
Footnote 1 to heading before paragraph 20.02	Added for clarification.
Headings before paragraphs 20.05 and 20.07	Revised for clarification.
Former footnote † to heading before paragraph 20.07	Deleted.
Paragraph 20.07	Revised to reflect ASU No. 2009-05, *Fair Value Measurements and Disclosures (Topic 820)—Measuring Liabilities at Fair Value*.
Paragraphs 20.08–.11	Added to reflect ASU No. 2009-05.
Paragraph 20.12	Moved from paragraph 20.07 for clarification.
Former paragraph 20.14	Deleted for clarification.
Former paragraph 20.18	Deleted; moved into paragraph 20.21 for clarification.
Paragraphs 20.20–.21	Revised for clarification.
Former footnote ‡ in paragraph 20.21	Deleted.
Former paragraph 20.22	Deleted for clarification.
Former footnote || to heading before paragraph 20.24	Deleted.
Former paragraph 20.24	Deleted; moved into paragraph 20.25 for clarification.
Paragraphs 20.24–.25	Revised for the passage of time; footnote 2 in paragraph 20.25 added for clarification.
Former paragraph 20.26	Deleted for clarification.
Paragraph 20.26	Added for clarification.
Paragraph 20.27	Revised for the passage of time.
Paragraph 20.28 and footnote 4	Added for clarification.
Paragraph 20.31	Revised for clarification.
Former paragraph 20.33	Deleted; see paragraph 18.98.
Paragraph 20.34 and footnote †	Revised to reflect ASU No. 2010-06, *Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements*.

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Reference	*Change*
Footnote ‡ to heading before paragraph 20.35	Revised.
Paragraph 20.36	Revised for the passage of time.
Footnote 5 in paragraph 20.37	Added to reflect TIS section 1800.05, “Applicability of Fair Value Disclosure Requirements and Measurement Principles in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 820, *Fair Value Measurements and Disclosures*, to Certain Financial Instruments” (AICPA, *Technical Practice Aids*).
Footnote || in paragraph 20.37	Added.
Former footnote †† to heading before paragraph 20.38	Deleted.
Footnote # in paragraph 20.38	Added.
Footnote 6 in paragraph 20.38	Revised for clarification.
Paragraph 20.39	Revised for the passage of time.
Footnote 1 in paragraph 21.01	Revised to reflect the issuance of SSAE No. 16.
Former footnote * to heading before paragraph 21.17	Deleted.
Footnote 6to heading before paragraph 21.17	Added to reflect SEC Final Rule Release No. IA–2968.
Footnote * in paragraphs 21.22 and 21.25	Added.
Footnote * in paragraph 22.12	Revised.
Former footnote † to heading before paragraph 22.18	Deleted.
Footnote † to heading before paragraph 22.18	Added.
Former footnote ‡ in paragraph 22.33	Deleted.
Paragraph 22.33	Revised to reflect FASB Statement No. 167.
Former footnote || in paragraph 22.35	Deleted.

Reference	*Change*
Footnote * in paragraph 23.01	Added.
Footnote 1 in paragraph 23.02	Added for clarification.
Paragraphs 23.02 and 23.04	Revised for clarification.
Footnote † in paragraph 23.06	Revised.
Paragraph 23.07	Revised for clarification; former footnote 4 deleted for clarification.
Paragraph 23.09	Revised for clarification; former footnote 8 deleted for clarification.
Paragraph 23.12	Revised for clarification.
Former paragraph 23.13	Deleted; moved into paragraph 23.12 for clarification.
Paragraph 23.23	Revised to reflect the issuance of Statement on Standards for Accounting and Review Services No. 19, *Compilation and Review Engagements*.
Appendix A	Former paragraph A-6 deleted for the passage of time.
Appendix B	Revised for clarification.
Appendix C	Revised for the passage of time.
Appendix D	Revised for the passage of time.
Index	Revised.

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