AICPA

Audit and Accounting Guide

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

July 1, 2017

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Preface

(Updated as of July 1, 2017)

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 U.S. generally accepted accounting principles (GAAP) and to assist practitioners in performing and reporting on their audit or their attestation engagements.

AICPA Guides may include certain content presented as "Supplement," "Appendix," or "Exhibit." A supplement is a reproduction, in whole or in part, of authoritative guidance originally issued by a standard setting body (including regulatory bodies) and applicable to entities or engagements within the purview of that standard setter, independent of the authoritative status of the applicable AICPA Guide. Both appendixes and exhibits are included for informational purposes and have no authoritative status.

The Financial Reporting Executive Committee (FinREC) is the designated senior committee of the AICPA authorized to speak for the AICPA in the areas of financial accounting and reporting. Conforming changes made to the financial accounting and reporting guidance contained in this guide are approved by the FinREC Chair (or his or her designee). Updates made to the financial accounting and reporting guidance in this guide exceeding that of conforming changes are approved by the affirmative vote of at least two-thirds of the members of FinREC.

This guide does the following:

- Identifies certain requirements set forth in the 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 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 SEC.

An AICPA Guide containing auditing guidance related to generally accepted auditing standards (GAAS) is recognized as an interpretive publication as defined in AU-C section 200, *Overall Objectives of the Independent Auditor and* *the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards* (AICPA, *Professional Standards*). Interpretive publications are recommendations on the application in specific circumstances, including engagements for entities in specialized industries.

Interpretive publications are issued under the authority of the AICPA 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 GAAS. The members of the ASB have found the auditing guidance in this guide to be consistent with existing GAAS.

Although interpretive publications are not auditing standards, AU-C section 200 requires the auditor to consider applicable interpretive publications in planning and performing the audit because interpretive publications are relevant to the proper application of GAAS in specific circumstances. If the auditor does not apply the auditing guidance in an applicable interpretive publication, the auditor should document how the requirements of GAAS were complied with in the circumstances addressed by such auditing guidance.

The ASB is the designated senior committee of the AICPA authorized to speak for the AICPA on all matters related to auditing. Conforming changes made to the auditing guidance contained in this guide are approved by the ASB Chair (or his or her designee) and the Director of the AICPA Audit and Attest Standards Staff. Updates made to the auditing guidance in this guide exceeding that of conforming changes are issued after all ASB members have been provided an opportunity to consider and comment on whether the guide is consistent with the Statements on Auditing Standards (SASs).

Any auditing guidance in a guide appendix or exhibit (whether a chapter or back matter appendix or exhibit), though not authoritative, is considered an "other auditing publication." In applying such guidance, the auditor should, exercising professional judgment, assess the relevance and appropriateness of such guidance to the circumstances of the audit. Although the auditor determines the relevance of other auditing guidance, auditing guidance in a guide appendix or exhibit has been reviewed by the AICPA Audit and Attest Standards staff and the auditor may presume that it is appropriate.

An AICPA Guide containing attestation guidance is recognized as an interpretive publication as defined in AT-C section 105, *Concepts Common to All Attestation Engagements* (AICPA, *Professional Standards*). Interpretive publications are 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 the attestation guidance in this guide to be consistent with existing SSAEs.

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

Any attestation guidance in a guide appendix or exhibit (whether a chapter or back matter appendix or exhibit), though not authoritative, is considered an "other attestation publication." In applying such guidance, the practitioner should, exercising professional judgment, assess the relevance and appropriateness of such guidance to the circumstances of the engagement. Although the practitioner determines the relevance of other attestation guidance, such guidance in a guide appendix or exhibit has been reviewed by the AICPA Audit and Attest Standards staff and the practitioner may presume that it is appropriate.

The ASB is the designated senior committee of the AICPA authorized to speak for the AICPA on all matters related to attestation. Conforming changes made to the attestation guidance contained in this guide are approved by the ASB Chair (or his or her designee) and the Director of the AICPA Audit and Attest Standards Staff. Updates made to the attestation guidance in this guide exceeding that of conforming changes are issued after all ASB members have been provided an opportunity to consider and comment on whether the guide is consistent with the SSAEs.

Purpose and Applicability

This AICPA 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, "FDI Act Reporting Requirements," 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 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 FDIC'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 GAAP

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.

Recognition

AICPA Senior Committees

Auditing Standards Board

Jay Brodish, Jr., Member
Michael J. Santay, *Chair*

Financial Reporting Executive Committee

Muneera Carr, *Member*
Jim Dolinar, *Chair*

The AICPA gratefully acknowledges those members of the AICPA Depository and Lending Institutions Expert Panel (2016–2017) who reviewed or otherwise contributed to the development of this edition of the guide:

Sydney Garmong, *Chair*
Larry Gee
Mike Lundberg
Jeffrey C. Skumin
Lindsay Stevenson
Chris Vallez

In addition to the 2015–2016 expert panel members listed, the AICPA gratefully acknowledges those who reviewed and otherwise contributed to the development of this guide: Tom Canfarotta, Kathleen Healy, Jeff Honeycutt, Scott Klitsch, John G. Klinge, Jennifer Lauer, Randy Morse, Randy Oberdiek, and Barry M. Pelagatti.

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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, and other revisions as deemed appropriate. Relevant guidance issued through July 1, 2017, has been considered in the development of this edition of the guide. However, this guide does not include all audit, accounting, reporting, and other requirements applicable to an entity or a particular engagement. This guide is intended to be used in conjunction with all applicable sources of relevant guidance.

Relevant guidance that is issued and effective on or before July 1, 2017, is incorporated directly in the text of this guide. Relevant guidance issued but not yet effective as of July 1, 2017, but becoming effective on or before December 31, 2017, is also presented directly in the text of the guide, but shaded gray and accompanied by a footnote indicating the effective date of the new guidance. The distinct presentation of this content is intended to aid the reader in differentiating content that may not be effective for the reader's purposes (as part of the guide's "dual guidance" treatment of applicable new guidance).

Relevant guidance issued but not yet effective as of the date of the guide and not becoming effective until after December 31, 2017, is referenced in a "guidance update" box; that is, a box that contains summary information on the guidance issued but not yet effective.

In updating this guide, all guidance issued up to and including the following was considered, but not necessarily incorporated, as determined based on applicability:

- FASB Accounting Standards Update (ASU) No. 2017-10, *Service Concession Arrangements (Topic 853): Determining the Customer of the Operation Services (a consensus of the FASB Emerging Issues Task Force)*
- SAS No. 132, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, AU-C sec. 570)
- Interpretation No. 3, "Reporting on Audits Conducted in Accordance With Auditing Standards Generally Accepted in the United States of America and International Standards on Auditing" (AICPA, *Professional Standards*, AU-C sec. 9700 par. .08–.13), of AU-C section 700, *Forming an Opinion and Reporting on Financial Statements*
- Revised interpretations issued through July 1, 2017, including Interpretation No. 3, "Appropriateness of Identifying No Significant Deficiencies or No Material Weaknesses in an Interim Communication" (AICPA, *Professional Standards*, AU-C sec. 9265 par. .08–.10), of AU-C section 265, *Communicating Internal Control Related Matters Identified in an Audit*
- Statement of Position 13-2, *Performing Agreed-Upon Procedures Engagements That Address the Completeness, Mapping, Consistency, or Structure of XBRL-Formatted Information* (AICPA, *Professional Standards*, AUD sec. 55)
- SSAE No. 18, *Attestation Standards: Clarification and Recodification* (AICPA, *Professional Standards*)

- Interpretation No. 4, "Performing and Reporting on an Attestation Engagement Under Two Sets of Attestation Standards" (AICPA, *Professional Standards*, AT-C sec. 9105 par. .31–.35), of AT-C section 105, *Concepts Common to All Attestation Engagements*
- PCAOB Auditing Standard No. 18, *Related Parties* (AICPA, *PCAOB Standards and Related Rules*)

Users of this guide should consider guidance issued subsequent to those items listed previously to determine their effect, if any, on entities and engagements 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 appendix H, "Schedule of Changes Made to the Text From the Previous Edition." The changes do not include all those that might be considered necessary if the guide were subjected to a comprehensive review and revision.

FASB ASC Pending Content

Presentation of Pending Content in FASB ASC

Amendments to FASB ASC (issued in the form of ASUs) are initially incorporated into FASB ASC in "pending content" boxes that follow the paragraphs being amended with links to the transition information. The pending content boxes are meant to provide users with information about how the guidance in a paragraph will change as a result of the new guidance.

Pending content applies to different entities at different times due to varying fiscal year-ends, and because certain guidance may be effective on different dates for public and nonpublic entities. As such, FASB maintains amended guidance in pending content boxes 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 could still be applied.

Presentation of FASB ASC Pending Content in AICPA Guides

Amended FASB ASC guidance that is included in pending content boxes in FASB ASC on July 1, 2017, is referenced as "Pending Content" in this guide. Readers should be aware that "Pending Content" referenced in this guide will eventually be subjected to FASB's roll-off process and no longer be labeled as "Pending Content" in FASB ASC (as discussed in the previous paragraph).

Terms Used to Define Professional Requirements in This AICPA Guide

Any requirements described in this guide are normally referenced to the applicable standards or regulations from which they are derived. Generally, the terms used in this guide describing the professional requirements of the referenced standard setter (for example, the ASB) are the same as those used in the applicable standards or regulations (for example, "must" or "should"). However, where the accounting requirements are derived from FASB ASC, this guide uses "should," whereas FASB uses "shall." In its resource document "About the Codification" that accompanies FASB ASC, FASB states that it considers the terms "should" and "shall" to be comparable terms and to represent the same concept—the requirement to apply a standard.

Readers should refer to the applicable standards and regulations for more information on the requirements imposed by the use of the various terms used to define professional requirements in the context of the standards and regulations in which they appear.

Certain exceptions apply to these general rules, particularly in those circumstances where the guide describes prevailing or preferred industry practices, or both, for the application of a standard or regulation. In these circumstances, the applicable senior committee responsible for reviewing the guide's content believes the guidance contained herein is appropriate for the circumstances.

Applicability of GAAS and PCAOB Standards

Appendix A, "Council Resolution Designating Bodies to Promulgate Technical Standards," of the AICPA Code of Professional Conduct recognizes both the ASB and the PCAOB as standard setting bodies designated to promulgate auditing, attestation, and quality control standards. Paragraph .01 of the "Compliance With Standards Rule" (AICPA, *Professional Standards*, ET sec. 1.310.001 and 2.310.001) requires an AICPA member who performs an audit to comply with the applicable standards.

Audits of the financial statements of those entities subject to the oversight authority of the PCAOB (that is, those audit reports within the PCAOB's jurisdiction as defined by the Sarbanes-Oxley Act of 2002, as amended) are to be conducted in accordance with standards established by the PCAOB, a private sector, nonprofit corporation created by the Sarbanes-Oxley Act of 2002. The SEC has oversight authority over the PCAOB, including the approval of its rules, standards, and budget. In citing the auditing standards of the PCAOB, references generally use section numbers within the reorganized PCAOB auditing standards and not the original standard number, as appropriate.

Audits of the financial statements of those entities not subject to the oversight authority of the PCAOB (that is, those audit reports not within the PCAOB's jurisdiction as defined by the Sarbanes-Oxley Act of 2002, as amended)—hereinafter referred to as *nonissuers*[1]—are to be conducted in accordance with GAAS as issued by the ASB. 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 AICPA *Professional Standards*. In citing GAAS and their related interpretations, references generally use section numbers within the codification of currently effective SASs and not the original statement number, as appropriate.

The auditing content in this guide primarily discusses GAAS issued by the ASB and is applicable to audits of nonissuers. Users of this guide may find the

[1] See the definition of the term *nonissuer* in the AU-C Glossary (AICPA, *Professional Standards*).

tool developed by the PCAOB's Office of the Chief Auditor helpful in identifying comparable PCAOB standards. The tool is available at https://pcaobus.org/Standards/Auditing/Pages/FindAnalogousStandards.aspx.

Considerations for audits of entities subject to the oversight authority of the PCAOB may also be discussed within this guide's chapter text. When such discussion is provided, the related paragraphs are designated with the following title: *Considerations for Audits Performed in Accordance With PCAOB Standards*. PCAOB guidance included in an AICPA guide has not been reviewed, approved, disapproved, or otherwise acted upon by the PCAOB and has no official or authoritative status.

Applicability of Quality Control Standards

QC section 10, *A Firm's System of Quality Control* (AICPA, *Professional Standards*), addresses a CPA firm's responsibilities for its system of quality control for its accounting and auditing practice. A system of quality control consists of policies that a firm establishes and maintains to provide it with reasonable assurance that the firm and its personnel comply with professional standards, as well as applicable legal and regulatory requirements. The policies also provide the firm with reasonable assurance that reports issued by the firm are appropriate in the circumstances.

QC section 10 applies to all CPA firms with respect to engagements in their accounting and auditing practice. In paragraph 13 of QC section 10, an *accounting and auditing practice* is defined as "a practice that performs engagements covered by this section, which are audit, attestation, compilation, review, and any other services for which standards have been promulgated by the ASB or the AICPA Accounting and Review Services Committee under the "General Standards Rule" (AICPA, *Professional Standards*, ET sec.1.300.001) or the "Compliance With Standards Rule" (AICPA, *Professional Standards*, ET sec. 1.310.001) of the AICPA Code of Professional Conduct. Although standards for other engagements may be promulgated by other AICPA technical committees, engagements performed in accordance with those standards are not encompassed in the definition of an *accounting and auditing practice*."

In addition to the provisions of QC section 10, readers should be aware of other sections within AICPA *Professional Standards* that address quality control considerations, including the following provisions that address engagement level quality control matters for various types of engagements that an accounting and auditing practice might perform:

- AU-C section 220, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards* (AICPA, *Professional Standards*)
- AT-C section 105, *Concepts Common to All Attestation Engagements* (AICPA, *Professional Standards*)
- AR-C section 60, *General Principles for Engagements Performed in Accordance With Statements on Standards for Accounting and Review Services* (AICPA, *Professional Standards*)

Because of the importance of engagement quality, this guide includes appendix D, "Overview of Statements on Quality Control Standards." This appendix summarizes key aspects of the quality control standard. This summarization should be read in conjunction with QC section 10, AU-C section 220, AT-C section 105, AR-C section 60, and the quality control standards issued by the PCAOB, as applicable.

Alternatives Within U.S. GAAP

The Private Company Council (PCC), established by the Financial Accounting Foundation's Board of Trustees in 2012, and FASB, working jointly, will mutually agree on a set of criteria to decide whether and when alternatives within U.S. GAAP are warranted for private companies. Based on those criteria, the PCC reviews and proposes alternatives within U.S. GAAP to address the needs of users of private company financial statements. These U.S. GAAP alternatives may be applied to those entities that are not public business entities, not-for-profits, or employee benefit plans.

The FASB ASC Master Glossary defines a *public business entity* as follows:

> A public business entity is a business entity meeting any one of the criteria below. Neither a not-for-profit entity nor an employee benefit plan is a business entity.
>
> a. It is required by the SEC to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing).
>
> b. It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC.
>
> c. It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer.
>
> d. It has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market.
>
> e. It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including footnotes) and make them publicly available on a periodic basis (for example, interim or annual periods). An entity must meet both of these conditions to meet this criterion.
>
> An entity may meet the definition of a public business entity solely because its financial statements or financial information is included in another entity's filing with the SEC. In that case, the entity is only a public business entity for purposes of financial statements that are filed or furnished with the SEC.

Considerations related to alternatives for private companies may be discussed within this guide's chapter text. When such discussion is provided, the related paragraphs are designated with the following title: *Considerations for Private Companies That Elect to Use Standards as Issued by the Private Company Council*.

AICPA.org Website

The AICPA encourages you to visit the website at www.aicpa.org and the Financial Reporting Center at www.aicpa.org/FRC. The Financial Reporting Center supports members in the execution of high-quality financial reporting. Whether you are a financial statement preparer or a member in public practice, this center provides exclusive member-only resources for the entire financial reporting process, and provides timely and relevant news, guidance and examples supporting the financial reporting process. Another important focus of the Financial Reporting Center is keeping those in public practice up to date on issues pertaining to preparation, compilation, review, audit, attestation, assurance and advisory engagements. Certain content on the AICPA's websites referenced in this guide may be restricted to AICPA members only.

Select Recent Developments Significant to This Guide

Attestation Clarity Project

To address concerns over the clarity, length, and complexity of its standards, the ASB established clarity drafting conventions and undertook a project to redraft all the standards it issues in clarity format. The redrafting of Statements on Standards for Attestation Engagements (SSAEs or attestation standards) in SSAE No. 18, *Attestation Standards: Clarification and Recodification*, represents the culmination of that process.

The attestation standards are developed and issued in the form of SSAEs and are codified into sections. SSAE No. 18 recodifies the "AT" section numbers designated by SSAE Nos. 10–17 using the identifier "AT-C" to differentiate the sections of the clarified attestation standards (AT-C sections) from the attestation standards that are superseded by SSAE No. 18 (AT sections).

The AT sections in AICPA *Professional Standards* remain effective through April 2017, by which time substantially all engagements for which the AT sections were still effective are expected to be completed. The clarified attestations found in AT-C sections are effective for practitioners' reports dated on or after May 1, 2017.

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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 Board of Governors of the Federal Reserve System (Federal Reserve) 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. Institutions have 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.

- Regulatory policy has expanded and become increasingly complex in response to increasing complexities in the industry and recent economic recessions.

1.04 In addition, competition arose from within the industry, and 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 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 that contributed to unprecedented strain and stress on financial institutions and in financial markets. As a result, certain financial institutions either failed or came close to failure and many additional widespread repercussions affected or continue to affect this industry. Total assets of "problem" institutions reached their highest levels since 1993 during the first quarter of 2010, per the FDIC's Quarterly Banking Profile. In addition, the number of bank failures reached 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 1.31.

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 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. 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 Federal Reserve's discount window and payments system. (See chapter 2, "Industry Overview—Credit Unions," of this guide 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 three agencies:

a. The Federal Reserve, established in 1913 as the central bank of the United States, which has supervisory responsibilities for bank and saving and loan holding companies, state chartered banks that are members of the Federal Reserve, 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, which has supervisory responsibilities for state chartered banks and savings institutions that are not members of the Federal Reserve

c. The Office of the Comptroller of the Currency (OCC), created in 1863, which regulates and provides federal charters for national banks and federal savings associations

1.09 The Federal Reserve and the FDIC are independent agencies of the federal government. The OCC is a bureau 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 U.S. generally accepted accounting principles (GAAP) in regulatory reporting. For example, the agencies also have certain authority over the activities of auditors serving the industry. Further, the Federal Reserve, the FDIC, the OCC, and the 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 (the 1934 Act). Holding companies whose securities are registered under the 1934 Act must comply with its reporting requirements through periodic filings with the SEC. Publicly held institutions that are not part of a holding company are required under Section 12(i) of the

1934 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 1934 Act.

1.14 Both the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) and the FDIC 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 (PCA) 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, calculated as the target insurance fund size as a percentage of estimated insured deposits, 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 (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 Federal Reserve 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 December 2, 2014, the FFIEC released the revised *Bank Secrecy Act/Anti-Money Laundering (BSA/AML) Examination Manual* (manual). The revised manual provides current 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 2010 update.

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 1.99–.111 provide additional information regarding regulatory issuances related to the Sarbanes-Oxley Act. In addition, the Sarbanes-Oxley Act created the PCAOB, which has the authority to set and enforce auditing, attestation, quality control, and ethics (including independence) standards for auditors of entities subject to the oversight authority of the PCAOB. It also is empowered to inspect the auditing operations of public accounting firms that audit entities subject to the oversight authority of the PCAOB 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.

Deposit Insurance Fund

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 ratio of not less than 1.15 percent for any year and to increase the level of the DIF to 1.35 percent of estimated insured deposits by September 30, 2020.[1] In March 2016, the FDIC approved a final rule, effective July 1, to increase the DIF to the statutorily required minimum level of 1.35 on institutions with total consolidated assets of $10 billion or more while providing credits to institutions that have assets or less than $10 billion. Readers are encouraged to consult the full text of this final rule on FDIC's website at www.fdic.org. The Dodd-Frank Act also called for a revision to the definition of the deposit insurance assessment base. The intent of changing the assessment base was to shift a greater percentage of overall total assessments away from community institutions and toward the largest institutions.

1.26 In response to the provisions of the Dodd-Frank Act, in February 2011, the FDIC's board of directors, through the issuance of Financial Institution Letter (FIL)-8-2011, adopted the 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 the assessment rates; implement the Dodd-Frank Act's DIF dividend provisions; and revise the risk-based assessment system for all large insured depository institutions (IDIs).[2] The final rule

- redefines the *deposit insurance assessment base* as average consolidated total assets minus average tangible equity (the assessment base had previously been defined as total domestic deposits).
- makes generally conforming changes to the unsecured debt and brokered deposit adjustments to assessment rates.
- creates a depository institution debt adjustment.
- eliminates the secured liability adjustment.
- adopts a new assessment rate schedule which became effective April 1, 2011, and, in lieu of dividends, other rate schedules when the reserve ratio reaches certain levels.

1.27 In addition, the final rule establishes a new methodology for calculating deposit insurance assessment rates for highly complex and other large IDIs (commonly referred to as the Large Bank Pricing Rule). The new methodology combines capital adequacy, asset quality, management, earnings, liquidity, and sensitivity to market risk (CAMELS) ratings and financial measures to produce a score that is converted into an institution's assessment rate. The Large Bank Pricing Rule authorizes the FDIC to adjust, up or down, an institution's

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[1] The Deposit Insurance Fund (DIF) is used to (*a*) insure the deposits of, and protect the depositors of, failed FDIC-insured institutions and (*b*) resolve failed FDIC-insured institutions upon appointment of the FDIC as receiver. The reserve ratio represents the ratio of the net worth of the DIF to aggregate estimated insured deposits of FDIC-insured institutions. The DIF is funded primarily through deposit insurance assessments.

[2] A large insured depository institution (IDI) has at least $10 billion in total assets. In general, a highly complex IDI will be (*a*) an IDI (other than a credit card bank) with more than $50 billion in total assets that is controlled by a parent or an intermediate parent company with more than $500 billion in total assets or (*b*) a processing bank or trust company with at least $10 billion in total assets.

total score by 15 basis points. The final rule became effective on April 1, 2011. For further information, readers can access the final rule on the FDIC website at www.fdic.gov.

1.28 In September 2011, the FDIC adopted guidelines describing the process that the FDIC will follow to determine whether to make an adjustment, to determine the size of any adjustment, and to notify an institution of an adjustment made to its assessment rate score, as allowed under the Large Bank Pricing Rule. The guidelines also provide examples of circumstances that might give rise to an adjustment. Further information on the guidelines can be found in FIL-64-2011, *Assessments: Assessment Rate Adjustment Guidelines*, on the FDIC website at www.fdic.gov.

1.29 In October 2012, the FDIC's board of directors, through the issuance of FIL-44-2012, *Assessments: Final Rule on Assessments, Large Bank Pricing*, adopted a final rule to amend and clarify definitions related to higher risk assets as used by the deposit insurance pricing scorecards for large and highly complex IDIs. The rule applies only to institutions with $10 billion or more in assets. Specifically, the rule revises the definition of certain higher risk assets, such as leveraged loans and subprime consumer loans; clarifies the timing of identifying an asset as higher risk; clarifies the way securitizations (including those that meet the definition of nontraditional mortgage loans) are identified as higher risk; and further defines terms that are used in the large bank pricing rule adopted in February 2011. The final rule became effective on April 1, 2013. For further information, readers are encouraged to access the final rule in FIL-44-2012 on the FDIC website at www.fdic.gov.

1.30 In November 2014, the FDIC issued the *Assessments* final rule to revise the FDIC's risk-based deposit insurance assessment system to reflect changes in the regulatory capital rules. The final rule

- conforms the capital ratios and ratio thresholds in the small institution assessment system to the new PCA capital ratios and ratio thresholds.
- conforms the assessment base calculation for custodial banks to the new asset risk weights using the standardized approach in the regulatory capital rules.
- requires that all highly complex institutions measure counterparty exposure for the assessment purposes using the Basel III standardized approach credit equivalent amount for derivatives and the Basel III standardized approach exposure amount for securities financing transactions in the regulatory capital rules.

For further information, readers can access the final rule in FIL-57-2014, *Assessments: Final Rule*, on the FDIC website at www.fdic.gov.

The Dodd-Frank Act

1.31 The Dodd-Frank Act was signed into law by President Obama on July 21, 2010. It aims to promote U.S. financial stability by improving accountability and transparency in the financial system, putting an end to the belief that certain financial institutions were too big to fail, protecting American taxpayers by ending bailouts, and protecting consumers from abusive financial services practices. The Dodd-Frank Act contains many provisions; some highlights that may be of particular interest to readers are summarized in the following sections.

1.32 A copy of the full Dodd-Frank Act, as signed by the president, can be found at www.gpo.gov. The AICPA is also following any developments related to the Dodd-Frank Act on its website at aicpa.org on the "Federal Issues" page under "Advocacy."

Financial Stability Oversight Council

1.33 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 banking system 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.

Leverage and Risk-Based Capital Requirements

1.34 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 should not be less than the generally applicable requirements, which should 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. The provisions of Section 171 of the Dodd-Frank Act regarding trust preferred securities can be found in paragraph 17.20 of this guide.

1.35 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.

Consumer Financial Protection Bureau

1.36 The Consumer Financial Protection Bureau (CFPB) is an independent agency that consolidates much of the federal regulation of financial services offered to consumers. The CFPB 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 CFPB also oversees the enforcement of federal laws intended to ensure the fair, equitable, and nondiscriminatory access to credit for individuals. The director of the CFPB replaces the director of the Office of Thrift Supervision (OTS) on the FDIC board. The CFPB is led by an independent director appointed by the president and confirmed by the Senate and has a dedicated budget in the Federal Reserve.

1.37 The CFPB 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 CFPB also can autonomously write rules for consumer protections governing all financial institutions (banks and nonbanks) offering consumer financial services or products.

1.38 For further information on the CFPB and the progress the agency has made since its inception, readers can access the CFPB website at www.consumerfinance.gov.

Derivatives Trading

1.39 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 regulatory authority over specific security-based swaps (including credit default swaps), and the CFTC has primary regulatory 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. The Dodd-Frank Act requires all cleared swaps to be traded on a registered exchange or board of trade.[3]

1.40 The Dodd-Frank Act also provided regulators the authority to impose capital and margin requirements on swap dealers and major swap participants.[4] The credit exposure from derivative transactions will be considered in banks' lending limits.

1.41 Banks can continue engaging in principal transactions involving interest-rate, foreign-exchange, gold, silver, and investment-grade credit default swaps, subject to Section 619 of the Dodd-Frank Act (commonly referred to as the Volcker Rule) limitations on proprietary trading. See discussion of the Volcker Rule in paragraph 1.48. For commodities, most other metals, energy, and equities, banks must shift their swap operations to a separately capitalized affiliate within the holding entity.

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[3] The SEC has proposed numerous rulings related to the provisions on derivative trading included in the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). Readers are encouraged to visit the "Dodd-Frank Act Rulemaking: Derivatives" page on the SEC website to access further information.

[4] In November 2015, the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Federal Reserve), the FDIC, the Farm Credit Administration, and the Federal Housing Finance Agency (collectively, the agencies) issued the final rule *Margin and Capital Requirements for Covered Swap Entities* to implement Sections 731 and 764 of the Dodd-Frank Act. The final regulations 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. The final rule was effective April 1, 2016. Readers may access the full text of the regulation from any of the agencies websites.

Lending Limits

1.42 Section 610 of the Dodd-Frank Act revises the statutory definition of loans and extensions of credit to include credit exposures arising from derivative transactions, repurchase agreements, reverse repurchase agreements, securities lending transactions, and securities borrowing transactions (collectively, securities financing transactions). This revised definition also is applicable to all savings associations.

1.43 In June 2013, the OCC finalized its lending limits interim rule, which consolidated the lending limits rules applicable to national banks and savings associations, removed the separate OCC regulation governing lending limits for savings associations, and implemented Section 610 of the Dodd-Frank Act. The final rule outlines the methods that banks can choose from to measure credit exposures of derivative transactions and securities financing transactions. A bank may choose which method it will use; however, the OCC may specify that a bank use a particular method for safety and soundness reasons. Banks may request OCC approval to use a different method to calculate credit exposure for certain transactions. If the Model Method[5] is used, the OCC must approve the use of the model and any subsequent changes to an approved model. The final rule continues to provide that loans and extensions of credit, including those that arise from derivative transactions and securities financing transactions, must be consistent with safe and sound banking practices.

1.44 *Derivative transactions.* Banks can generally choose to measure the credit exposure of derivatives transactions through

- the Conversion Factor Matrix Method.[6]
- the Current Exposure Method.[7]
- an OCC-approved internal model.

1.45 For credit derivatives (transactions in which banks buy or sell credit protection against loss on a third-party reference entity), the final rule provides a special rule for calculating credit exposure based on exposure to the counterparty and reference entity.

1.46 *Securities financing transactions.* The final rule specifically exempts securities financing transactions relating to Type I securities (such as U.S. or

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[5] Under the Model Method, the credit exposure of a derivative transaction should equal the sum of the current credit exposure of the derivative transaction and the potential future credit exposure of the derivative transaction. See Title 12 U.S. *Code of Federal Regulations* (CFR) Part 32.9 for further discussion on the calculation of current credit exposure and the potential future credit exposure.

[6] Under the Conversion Factor Matrix Method, credit exposure arising from a derivative transaction should equal and remain fixed at the potential future credit exposure of the derivative transaction, which should equal the product of the notional principal amount of the derivative transaction and a fixed multiplicative factor utilizing the conversion factor matrix found in Table 1 to 12 CFR 32.9.

[7] Under the Current Exposure Method, credit exposure for derivative transactions is calculated by adding the current exposure (the greater of zero or the mark-to-market value) and the potential future credit exposure (calculated by multiplying the notional amount by a specified conversion factor taken from Table 4 of the Advanced Approaches Appendix of the capital rules, which varies based on the type and remaining maturing of the contract) of the derivative transactions. The current exposure method incorporates additional calculations for netting arrangements and collateral and utilizes multipliers that are more tailored to compute the potential future credit exposure of derivative transactions.

state government obligations) from the lending limits calculations. For other securities financing transactions, banks can choose to measure credit exposure by the following methods:

- Locking in the attributable exposure based on the type of transaction
- Using an OCC-approved internal model
- Using the Basel Collateral Haircut Method[8]

1.47 *Information for community banks.* The final rule minimizes the compliance burden on small and midsize banks of measuring the credit exposure of derivative transactions and securities financing transactions by providing different options for measuring the exposures for each transaction type. The options permit banks to adopt compliance alternatives that fit their size and risk management requirements, consistent with safety and soundness and the goals of the statute. Community banks should note that derivative transactions include interest rate swaps; however, community banks may use the Conversion Factor Matrix Method, which is an easy-to-use lookup table that locks in the attributable exposure at the execution of the transaction. The simplest calculation of securities financing transactions, excluding those related to Type 1 securities, is the Basic Method, which locks in the attributable exposure based on the type of transaction.

Volcker Rule

1.48 The Volcker Rule prohibits banking entities and affiliated companies 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 can make de minimis investments in hedge funds and private equity funds using no more than 3 percent of their tier 1 capital in all such funds combined. Also, a bank's investment in a private fund may not exceed 3 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 paragraphs 18.77–.78 of this guide.

Thrift Regulations

1.49 The Dodd-Frank Act abolished the OTS, which had been the federal supervisor for federal savings associations and thrift holding companies. Its authority for federal savings associations and rulemaking for all savings associations was transferred to the OCC, its authority for state savings associations was transferred to the FDIC, and its authority for thrift holding companies (also known as savings and loan holding companies or SLHCs) was transferred to the Federal Reserve. However, the thrift charter has been

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[8] The Basel collateral haircut method applies standard supervisory haircuts (the percentage reduction of the amount that will be repaid to creditors) for measuring counterparty credit risk for such transactions under the capital rules' Basel II Advanced Internal Ratings-Based Approach or the Basel III Advanced Approaches.

preserved. In January 2011, the Federal Reserve, the FDIC, the OCC, and the OTS issued a *Joint Implementation Plan* to provide an overview of actions taken by the agencies to efficiently and effectively implement Sections 301–326 of the Dodd-Frank Act. The transfer of authority took place on July 21, 2011, and certain regulations have been enacted in response, as subsequently discussed.

1.50 In July 2011, the OCC issued an interim final rule that republishes regulations issued by the OTS, prior to its transfer of powers, that the OCC has authority to promulgate and enforce. This rule, which was effective immediately, renumbers and issues these former OTS regulations as new OCC regulations (recodified in Chapter I at Parts 100–197), with nomenclature and other technical amendments to reflect the OCC supervision of federal savings associations. These newly issued OCC regulations supersede the OTS regulations for purposes of the OCC supervision of federal savings associations.

1.51 In August 2011, the Federal Reserve issued an interim final rule establishing regulations for SLHCs. This rule provides for the corresponding transfer from the OTS to the Federal Reserve of the regulations necessary for the Federal Reserve to administer the statutes governing SLHCs. The three components to the rule include new Regulation LL (Part 238), which sets forth regulations generally governing SLHCs; new Regulation MM (Part 239), which sets forth regulations governing SLHCs in mutual form; and technical amendments to current Federal Reserve regulations necessary to accommodate the transfer of supervisory authority for SLHCs from the OTS to the Federal Reserve.

1.52 In August 2011, the FDIC published an interim final rule reissuing and redesigning certain transferring OTS regulations. In republishing these rules, the FDIC only made technical changes to existing OTS regulations. The OTS regulations were recodified in Chapter III at Parts 390–391.

1.53 In December 2011, the OCC issued Bulletin OCC 2011-47, *OTS Integration: Supervisory Policy Integration Process*, to outline the process that the OCC intends to follow to fully integrate the OTS policy guidance documents into a common set of supervisory policies that applies to both national banks and federal savings associations. Phase 1 involves rescinding a significant number of documents including OTS documents that transmitted or summarized rules, interagency guidance, or *Examination Handbook* sections that are no longer useful because of the elimination of the OTS, the passage of time, or duplicate existing OCC guidance. The OCC has announced the rescission through numerous bulletins. Phase II focuses on guidance that requires further review, substantive revision, or combination or guidance that is considered unique to federal savings associations. Readers are encouraged to access the "OTS Integration" page on the OCC website for further developments on the integration of the two agencies.[9]

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[9] Office of Thrift Supervision (OTS) policies and guidance remain applicable to federal savings associations until rescinded, superseded, or revised. In some cases, the OCC may amend an OTS rule, policy, or practice that is cross-referenced in more than one document or affects only a portion of a document. If overlapping guidance exists, any guidance or regulation issued by the OCC after July 21, 2011, that specifically includes federal savings associations in its scope will prevail. If a document has not been rescinded, but a portion of the content no longer applies, the superseded portion will be grayed out electronically.

Resolution Plans[10]

1.54 The FDIC and the Federal Reserve issued a joint rule to implement Section 165(d) of the Dodd-Frank Act. This rule requires bank holding companies with assets of $50 billion or more and companies designated as systemically important by the FSOC to report periodically to the FDIC and the Federal Reserve the company's plan for its rapid and orderly resolution in the event of material financial distress or failure.

1.55 The goal of this rule is to achieve a rapid and orderly resolution of an organization that would not cause a systemic risk to the financial system. The final rule also establishes specific standards for the resolution plans (commonly referred to as *living wills*), including requiring a strategic analysis of the plan's components; a description of the range of specific actions to be taken in the resolution; and analyses of the company's organization, material entities, interconnections and interdependencies, and management information systems, among other elements.

1.56 The rule requires companies to update their plans annually. A company that experiences a material event after a plan is submitted has 45 days to notify regulators of the event.

1.57 Separately, the FDIC's board of directors approved a complementary final rule under the FDI Act to require IDIs with $50 billion or more in total assets to submit periodic contingency plans to the FDIC for resolution in the event of the depository institution failure. The final rule became effective on April 1, 2012.

1.58 The final rule requires these IDIs to submit a resolution plan that will enable the FDIC, as receiver, to resolve the bank to ensure that depositors receive access to their insured deposits within one business day of the institution's failure, maximize the net present value return from the sale or disposition of its assets, and minimize the amount of any loss to be realized by the institution's creditors.

1.59 Both the final rule related to certain bank holding companies and systemically important companies and the final rule related to certain IDIs can be found on the FDIC website at www.fdic.gov.

Stress Testing

1.60 Section 165(i) of the Dodd-Frank Act requires certain companies to conduct annual stress tests (commonly referred to as Dodd-Frank Act Stress Testing) in accordance with the regulations proposed by their respective primary financial regulatory agencies, as well as semiannual company-run stress tests. Specifically, it requires the primary financial regulatory agency to define the stress tests; establish methodologies for the conduct of the stress tests, which must include at least three different sets of conditions (baseline, adverse, and severely adverse); establish the form and content of the report that

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[10] In December 2014, the FDIC issued guidance for resolutions plans that IDIs with assets greater than $50 billion must submit periodically to the FDIC. The guidance includes direction regarding the elements that should be discussed in a fully developed resolution strategy and the cost analysis, clarification regarding assumptions made in the plan, and a list of significant obstacles to an orderly and least costly resolution that institutions should address.

institutions are required to submit; and instruct the institution to publish a summary of the results of the Dodd-Frank Act institutional stress test.

1.61 In May 2012, the Federal Reserve, the OCC, and the FDIC jointly issued final supervisory guidance on stress testing for banking organizations with more than $10 billion in total consolidated assets that became effective on July 23, 2012. The guidance highlights the importance of stress testing as an ongoing risk management practice that supports a banking organization's forward-looking assessment of its risks. In addition, the guidance highlights five principles that should be part of a banking organization's stress testing framework. The framework should (*a*) include activities and exercises that are tailored to the exposures, activities, and risks of the organization; (*b*) employ multiple conceptually sound activities and approaches; (*c*) be forward looking and flexible; (*d*) be clear, actionable, well supported, and used in the decision-making process, and (*e*) include strong governance and effective internal control. Furthermore, the guidance discusses four types of stress testing approaches and applications, which include scenario analysis, sensitivity analysis, enterprise-wide stress testing, and reverse stress testing. Readers can access the supervisory guidance from any of the agencies' websites.

1.62 In conjunction with the release of stress testing guidance, the Federal Reserve, the FDIC, and the OCC also released a statement to clarify that community banks are not required or expected to conduct the type of stress testing required of larger organizations. However, the statement also noted that all banking organizations, regardless of size, should have the capacity to analyze the potential impact of adverse outcomes on their financial condition. Examples of such interagency guidance that addresses potential adverse outcomes as a part of sound risk management practices include, but are not limited to, interest rate risk (IRR) management, commercial real estate concentrations, and funding and liquidity management.

1.63 On October 9, 2012, the Federal Reserve, the FDIC, and the OCC issued final rules on company-run stress testing for companies with more than $10 billion in total assets as required by the Dodd-Frank Act. Readers can access the stress test requirements of each agency from the respective agencies' websites.[11]

Regulatory Capital Matters

1.64 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 PCA, as well as specific capital adequacy guidelines set forth by each agency.[12]

1.65 In addition to assessing financial statement disclosures, which are discussed in chapter 17, "Equity and Disclosures Regarding Capital Matters," of this guide, the auditor considers regulatory capital from the perspective

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[11] In March 2014, the OCC, the Federal Reserve, and the FDIC issued *Supervisory Guidance for Banking Organizations With Total Consolidated Assets of More Than $10 Billion but Less Than $50 Billion*.

[12] 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.

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

1.66 The FDIC, the OCC, and the Federal Reserve historically had common capital adequacy guidelines which differed in some respects from those of the OTS, prior to its transfer of powers, involving minimum (*a*) leverage capital and (*b*) risk-based capital requirements.[13] 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's Consolidated Reports of Condition and Income (Call Report) and the Federal Reserve's Consolidated Financial Statements for Holding Companies—FR Y-9C. The reports are required to be filed quarterly and contain certain financial information, including information used in calculating regulatory capital ratios and amounts.[14]

1.67 The OCC, the Federal Reserve, and the FDIC established a minimum common equity tier 1 capital ratio of 4.5 percent, tier 1 capital ratio of 6 percent, total capital ratio of 8 percent, and leverage ratio of 4 percent. The capital rules limit capital distributions and certain discretionary bonus payments if banks do not maintain a capital conservation buffer of common equity tier 1 capital above minimum capital requirements. Advanced approaches organizations (defined as banking organizations with $250 billion or more in total consolidated assets or total consolidated on-balance sheet foreign exposure of $10 billion or more) must also maintain a minimum supplementary leverage ratio of 3 percent. Although advanced approaches banking organizations are not required to comply with the minimum supplementary leverage ratio until January 1, 2018, they were required to begin reporting the ratio as of January 1, 2015. By statute, the FDIC and the OCC also require all federal and state savings associations to maintain a tangible capital requirement of 1.5 percent of assets. The advanced approaches and standardized capital ratio calculations can be found at 12 CFR 3.10 (OCC), 12 CFR 217.10 (Federal Reserve), and 12 CFR 324.10 (FDIC).

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[13] In accordance with FASB *Accounting Standards Codification* 942-505-50-1G, 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," of this guide provides additional guidance.

[14] Banking agencies provide additional regulatory capital guidance through examination manuals and other communications, such as Supervision and Regulation (SR) letters issued by the Federal Reserve, Financial Institution Letters issued by the FDIC, and Bulletins issued by the OCC. The OTS provided additional regulatory capital guidance through examination manuals and other communications such as CEO memos, thrift bulletins, and regulatory bulletins. Readers are encouraged to visit the "OTS Integration" page of the OCC website for further information regarding OTS documents, which have either been rescinded or maintained.

Update 1-1 *Regulatory*: Regulatory Capital Rules

The regulatory final rule *Regulatory Capital Rules: Regulatory Capital, Enhanced Supplementary Leverage Ratio Standards for Certain Bank Holding Companies and Their Subsidiary Insured Depository Institutions*, issued by the Federal Reserve, the OCC, and the FDIC in April 2014, will become effective on January 1, 2018. Banking organizations subject to the requirements were required to calculate and publicly disclose the ratio beginning January 1, 2015.

The final regulatory rule strengthens the agencies' supplementary leverage ratio standards for large, interconnected U.S. banking organizations and is applicable to any U.S. top-tier bank holding company with more than $700 billion in total consolidated assets or more than $10 trillion in assets under custody and any IDI subsidiary of these bank holding companies. The final rule establishes enhanced supplementary leverage ratio standards for covered bank holding companies and their subsidiary IDIs. Among other provisions of the final rule, an IDI that is a subsidiary of a covered bank holding company must maintain a supplementary leverage ratio of at least 6 percent to be well capitalized under the agencies' PCA framework.

Readers are encouraged to consult the full text of this final rule at any of the respective agencies' websites.

1.68 Risk-based capital standards of the FDIC, the OCC, and the Federal Reserve 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.

1.69 The FDIC, the OCC, and the Federal Reserve 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.[15,16] The policy statement also suggests that institutions with complex systems for measuring IRR may seek assurance about the institution's risk management process from internal and external auditors.

1.70 The Market Risk Rule (MRR) establishes risk-based regulatory capital requirements for bank holding companies, state member banks, SLHCs, national banks, federal savings associations, and state savings associations (collectively, banking organizations) with significant exposure to certain market risks. The MRR implements the Amendment to the Capital Accord (Market Risk Amendment or MRA) to incorporate market risks issued by the Basel Committee on Banking Supervision in 1996 and modified in 1997, 2005, 2009, and 2010. The MRR is set forth at 12 CFR 217, subpart F (Federal Reserve), 12 CFR 3, subpart F (OCC), and 12 CFR 324, subpart F (FDIC).

1.71 The effect of the market risk capital rules is that any banking organization regulated by the federal banking agencies, with significant exposure to market risk, generally must measure that risk using its own internal value

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

[16] The OCC incorporated the joint policy statement into its "Interest Rate Risk" booklet of the *Comptroller's Handbook*.

at risk model, and hold a commensurate amount of capital. The amount of capital required to be held includes tier 1 and tier 2 capital. The regulatory capital requirements only apply to banking organizations whose trading activity on a worldwide consolidated basis equals 10 percent or more of the total assets or totals $1 billion or more.

1.72 In June 2012, the OCC, the Federal Reserve, and the FDIC amended the market risk capital rule. The amendment revises the calculation of market risk to better characterize the risks facing a particular institution and to help ensure the adequacy of capital related to the institution's market risk-related positions. Under the amendment, additional charges were implemented for stressed VaR, credit risk, correlation trading, and other securitizations. The amendment became effective on January 1, 2013, and can be accessed from any of the agencies' websites.

1.73 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 ratios and amounts.

1.74 Under the capital adequacy standards of the OCC, the Federal Reserve, and the FDIC, a banking organization must deduct certain assets from common equity tier 1 capital. A banking organization is permitted to net associated deferred tax liability against some of those assets prior to making the deduction from tier 1 capital, if the deferred tax liability is associated with the assets and the deferred tax liability would be extinguished if the associated asset becomes impaired or is derecognized under GAAP. Deductions from common equity tier 1 capital include goodwill and other intangible, deferred tax assets that arise from net operating loss and tax credit carryforwards, gains on sale in connection with a securitization, any defined benefit pension fund net asset held by entities that are not depository institutions (unless the banking organizations has unrestricted and unfettered access to the assets in that fund), investments in a banking organization's own capital instruments, mortgage servicing rights (above certain levels) and investments in the capital of unconsolidated financial institutions (above certain levels).

Prompt Corrective Action

1.75 The FDICIA made capital an essential tool for 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 PCA provisions.

1.76 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 1.79) based primarily on four capital measures, total risk-based capital; tier 1 based capital; common equity tier 1 capital; and leverage ratios.[17] These capital ratios are defined in the same manner for Section 38 purposes as under the respective agencies' capital adequacy

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[17] With respect to an advanced approaches national bank or advanced approaches federal savings association, on January 1, 2018, and thereafter, the leverage measure also includes the supplementary leverage ratio.

guidelines and regulations. For savings associations, tier 1 leverage capital is comparable to core capital.

1.77 Regulations also specify a minimum requirement for tangible equity, which is defined as tier 1 capital plus outstanding perpetual preferred stock not included in tier 1 capital. In calculating the tangible capital ratio, the regulations specify specific deductions that should be applied to total assets included in the ratio denominator.

1.78 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.

1.79 Under Section 38 of the FDI Act, an institution is considered

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

b. *adequately capitalized* if its capital levels *meets* the required minimum level for each relevant capital measure;

c. *undercapitalized* if its capital level *fails to meet* the required minimum level for each relevant capital measure;

d. *significantly undercapitalized* if its capital level *is significantly below* the required minimum level for each relevant capital measure; and

e. *critically undercapitalized* if its capital level *fails to meet* any level specified under subsection (c)(3)(A) of Section 38 of the FDI Act.

1.80 The PCA levels are defined as follows:

Category	***Total Risk-Based Capital Ratio (Percent)***	***Tier 1 Risk-Based Capital Ratio (Percent)***	***Common Equity Tier 1 Risk-Based Capital Ratio (Percent)***	***Leverage Ratio*** * ***(Percent)***
Well capitalized	≥10 and	≥8 and	>6.5 and	≥5
Adequately capitalized	≥8 and	≥6 and	>4.5 and	≥4
Undercapitalized	<8 or	<6 or	<4.5 or	<4
Significantly undercapitalized	<6 or	<4 or	<3 or	<3

* With respect to an advanced approaches national bank or advanced approaches federal savings association, on January 1, 2018, and thereafter, the leverage measure also includes capital adequacy guidelines for the supplementary leverage ratio in determination of both adequate capitalization and undercapitalization.

1.81 Critically undercapitalized institutions are those having a ratio of tangible equity to total assets of 2 percent or less.

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

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

1.84 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

1.85 Noncompliance or expected noncompliance with regulatory capital 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.

Annual Independent Audits and Reporting Requirements

1.86 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 2013. Section 36 and Part 363 also establish minimum qualifications for auditors that provide audit and attest services to IDIs. Section 36 and Part 363 apply to each FDIC IDI having total assets of $500 million or more at the beginning of its fiscal year. The requirements specified in Section 36 and Part 363 are in addition to any other statutory and regulatory requirements otherwise applicable to an IDI.

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

1.88 Also, audit requirements for savings associations, state savings associations, and SLHCs are set forth in 12 CFR 162.4 (OCC), 12 CFR 238.5 (Federal Reserve), and 12 CFR 390.322 (FDIC). In general, the OCC, the Federal Reserve, and the FDIC may require an independent audit of any such entity that they supervise when needed for any identified safety and soundness reason. However, audits for safety and soundness are required as follows:

- Savings associations supervised by the OCC, regardless of size, with a composite safety and soundness CAMELS rating of 3, 4, or 5

- SLHCs supervised by the Federal Reserve, which control savings association subsidiary(ies) with aggregate consolidated assets of $500 million or more
- State savings associations supervised by the FDIC, regardless of size, with a composite safety and soundness CAMELS rating of 3, 4, or 5

12 CFR 162.4 (OCC), 12 CFR 238.5 (Federal Reserve), and 12 CFR 390.322 (FDIC) provide that these audits should be conducted by an independent public accountant who is in compliance with the AICPA Code of Professional Conduct and meets the independence requirements and interpretations of the SEC.[18]

1.89 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 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 for an institution to be eligible to comply with Part 363 at the holding company level became effective for fiscal years ending on or after June 15, 2010.

1.90 Part 363 applies to any 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 FIL-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.

1.91 *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:[19]

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

b. A management report that must contain the following:

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[18] 12 CFR 162.4 (OCC), 12 CFR 238.5 (Federal Reserve), and 12 CFR 390.322 (FDIC) have not been updated to include a reference to the independence requirements of the PCAOB or independent public accountants registered with the PCAOB.

[19] 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.

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 management of the effectiveness of such internal control structure and procedures as of the end of such fiscal year. (See paragraphs 1.104–.105 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 the CFO at the insured depository level or the holding company level as specified in Section 363.2(c).

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

a. Each IDI should 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 should 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 should 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-C section 260, *The Auditor's Communication With Those Charged With Governance*; AU-C section 240, *Consideration of Fraud in a Financial Statement Audit*; AU-C section 265, *Communicating Internal Control Related Matters Identified in an Audit*; and AU-C section 940, *An Audit of 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 AS 1301, *Communications with Audit Committees*, and AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*), address the requirements for communication of certain matters to audit committees for audits of entities subject to the oversight authority of the PCAOB.

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.

1.93 *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. For an institution with consolidated total assets of $1 billion or more at the beginning of its fiscal year, an assessment by management of the effectiveness of such internal control structure and procedures as of the end of such fiscal year
   v. 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, 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 should 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.)

1.94 *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.

1.95 *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" (AICPA, *Professional Standards*, AU-C sec. 9230 par. .01–.15), of AU-C section 230, *Audit Documentation*, and AU-C section 230 provide additional information to auditors.

1.96 *Enforcement actions against auditors.* In August 2003, the FDIC, the OCC, the Federal Reserve, and the 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.

1.97 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.

1.98 *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

1.99 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.

1.100 In addition to the previously mentioned regulations, in June 2003, the SEC adopted rules requiring companies subject to the reporting requirements of the 1934 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 1.102–.105 and 1.111 for additional information regarding these rules.

1.101 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, the OTS, the OCC, and the Federal Reserve issued *Interagency Policy Statement on the Internal Audit Function and Its Outsourcing*.[20] 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 respective savings association agency under Section 12 of the 1934 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 their respective primary federal regulator pursuant to 12 CFR 162 (OCC), 12 CFR 238.5 (Federal Reserve), or Subpart R to 12 CFR 390 (FDIC).

  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 Federal Reserve, the OCC, and the 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, the OCC, the Federal Reserve, and the 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.

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[20] In January 2013, the Federal Reserve issued SR letter 13-1, *Supplemental Policy Statement on the Internal Audit Function and Its Outsourcing*, to provide institutions with additional guidance related to interagency guidance that was issued in 2003. Building upon the 2003 interagency guidance, the supplemental guidance addresses characteristics, governance, and operational effectiveness of an institution's internal audit function. Further, this supplemental guidance explains changes over the past several years in banking regulations related to auditor independence and limitations placed on the external auditor.

- Effective April 1, 2003, the Federal Reserve adopted a final rule to reflect the amendments made to Section 12(i) of the 1934 Act. These amendments vest the Federal Reserve 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 1934 Act.
- 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.

1.102 *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, the 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 the SEC's 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.

1.103 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	***FDIC 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
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 concerning whether internal control over financial reporting is effective as of the end of its fiscal year

(continued)

Sarbanes-Oxley	*FDIC Improvement Act of 1991*
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 the effectiveness of internal control over financial reporting	Not required by Part 363
Inclusion of the registered public accounting firm's attestation report on the effectiveness of internal control over financial reporting 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

1.104 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.

1.105 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 1934 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 regarding 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 the effectiveness 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 1934 Act. For purposes of the report of management and the attestation report, financial reporting generally must encompass both financial statements prepared in accordance with GAAP and those prepared for regulatory reporting purposes.

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

1.107 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 should 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 1934 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, Final Rule Release No. 33-9142 can be accessed on the SEC website at www.sec.gov. 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.

1.108 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 AS 2201.

1.109 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 AU-C section 940.

1.110 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.

1.111 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

1.112 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-C section 315, *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.[21]

b. *Federal Home Loan Mortgage Corporation (Freddie Mac) borrowings*. Banks or savings institutions that are members of the Freddie Mac 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 concerning 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-C section 215, *Agreed-Upon Procedures Engagements* (AICPA, *Professional Standards*), or (ii) an audit engagement performed in accordance with AU-C section 806, *Reporting on Compliance With Aspects of Contractual Agreements or Regulatory Requirements in Connection With Audited Financial Statements* (AICPA, *Professional Standards*).

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[21] Readers are encouraged to visit the National Council of Higher Education Loan Program's website for the most recent audit guide and related amendments.

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* (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.[22] 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-C section 315 as further described in paragraphs 4.40–.41 of this guide.

d. *U.S. Department of Housing and Urban Development (HUD) programs*. To the extent that a bank or savings institution originates or services 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 4.37–.39 of this guide.

e. *FDIC Loss Sharing Purchase and Assumption (P&A) Transactions.* The FDIC's *Resolutions Handbook* states that a loss sharing transaction is a 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 *Resolutions 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 (covered assets). The *Resolutions Handbook* for P&A agreements requires 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[23] relative to the accuracy of any computations made regarding shared loss assets. AICPA Technical Questions and Answers (Q&A) section 9110.16, "Example Reports on Federal Deposit Insurance Corporation Loss Sharing Purchase and Assumption Transactions" (AICPA, *Technical Questions and Answers*), provides examples of how the auditor might respond.

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[22] In September 2014, the SEC published Regulation AB II, which incorporates significant revisions to Regulation AB and other rules governing the offering process, disclosure, and reporting for asset-backed securities. Regulation AB II became effective November 24, 2014. A one-year transition period was adopted by the SEC for all the new rules under Regulation AB II with the exception of those rules related to asset-level disclosure that fall under a two-year transition period.

[23] 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.

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. A credit union is a member-owned financial cooperative, democratically controlled by its members and operating for the purpose of providing financial services to its members. Credit unions are organized as not-for-profit entities and are exempt from certain taxes. A credit union is subject to rules that restrict membership to the entity.

2.02 In 1934, Congress passed the Federal Credit Union Act (FCUA), establishing a federal regulatory system, which authorized the formation of federally chartered credit unions in all states. In 1970, the National Credit Union Administration (NCUA), an independent governmental agency, was created by Congress to charter, supervise, and regulate federal credit unions. It also extended supervision to state chartered federally insured credit unions. Other legislative initiatives that have affected credit unions include the following:

- In 1970, the National Credit Union Share Insurance Fund (NCUSIF) was formed to insure credit union share (deposit) accounts up to applicable limits in all federal credit unions and federally insured state-chartered credit unions.
- In 1977, legislation was passed expanding services available to credit union members, including share certificates and mortgage lending.
- 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.
- The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.
- The Consumer Financial Protection Bureau (CFPB) regulations.

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, multiple common bond, and community. 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 has a common bond of occupation or association. 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 The 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 CPA 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 U.S. generally accepted accounting principles (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 The CUMAA further addressed minimum capital (net worth) requirements and prompt corrective action (PCA) to restore capital. Net worth standards based on a percentage of assets were established for federally insured credit unions, as well as risk-based net worth standards for complex credit unions as defined by the NCUA. The 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, the 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; however, based on state law, not all state chartered credit unions require a 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 an asset-liability 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 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 regulations. In addition, the supervisory committee is generally responsible for overseeing the financial reporting process and ensuring that management has established effective internal controls. Section 115 of the FCUA (*Banks and Banking*, *U.S. Code* 12, Section 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, depending on state laws. 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 to 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 a credit union.

The Credit Committee

2.10 The credit committee (composed of volunteers either appointed or elected by the board of directors) 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.

Charters, 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 or combined state credit union leagues. In turn, credit union leagues or associations 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 Strategic Services, Inc., and the CUNA Mutual Group) 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. NASCUS is the primary resource and voice of the 47 state governmental agencies that charter, regulate, and examine the nation's state-chartered credit unions. (Delaware, South Dakota, and Wyoming have no laws permitting state-chartered credit unions.) NASCUS is the only organization dedicated to the defense and promotion of the state credit union charter and the autonomy of state credit union regulatory agencies. NASCUS promotes a dual-chartering system and the advancement of the autonomy and expertise of state credit union regulatory agencies.

2.16 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 Unions

2.17 A *corporate credit union* is defined as a credit union organized by natural person credit unions to offer central liquidity, investment, back office processing, deposit and lending facilities for natural person credit unions similar to those provided by other correspondent banking service providers.

Regulation and Oversight

Government Supervision

2.18 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.

2.19 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. Credit unions are allowed to obtain insurance from other sources that are sponsored by a private insurer, depending on state laws. Participation in an insurance program is mandatory for all credit unions.

2.20 Credit unions are subject to the federal, state, and local laws applicable to financial institutions in general. Most state laws allow and follow federal parity whereby they will basically follow NCUA rules and regulations. Such laws include the Uniform Commercial Code, the Truth-in-Lending Laws, the Uniform Consumer Code, Truth-in-Savings regulations, CFPB 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 Board of Governors of the Federal Reserve System (Federal Reserve), 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 SEC 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.

NCUA

2.21 The NCUA 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 letters to credit unions, legal opinions, and regulatory updates
- Federal *Credit Union Bylaws*

- NCUA *Chartering and Field of Membership Manual*
- NCUA *Examiner's Guide*
- NCUA *Letters to Credit Unions*
- *Accounting Manual for Federal Credit Unions* (and interim *Accounting Bulletins*)
- *Supervisory Committee Guide 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.

2.22 Credit unions with under $10 million in assets are provided the *Accounting Manual for Federal Credit Unions*, 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 GAAP in the Call Reports they file with the 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 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.

2.23 The NCUA administers a Central Liquidity Facility (CLF). The CLF is a mixed ownership government corporation created to improve the general financial stability of credit unions by serving as a liquidity lender to credit unions experiencing unusual or unexpected liquidity shortfalls. Membership is voluntary and is open to all natural person and corporate credit unions that purchase a prescribed amount of CLF stock. The NCUA encourages all credit unions to participate in either the CLF or have direct access to Federal Reserve borrowings.

Regulatory Capital Matters

Natural Person Credit Unions

Capital Adequacy

Update 2-1 *Regulatory*: Risk-Based Capital

The NCUA regulatory final rule *Risk-Based Capital*, issued in October 2015, is effective on January 1, 2019, for federally insured, natural person credit unions with assets over $100 million.

The final regulation restructures the NCUA's PCA regulations and makes various revisions, including amending the agency's current risk-based net worth requirement (RBNWR) by replacing it with a new risk-based capital ratio for federally insured natural person credit unions. The risk-based capital requirement set forth in the final rule is more consistent with the NCUA's risk-based capital measure for corporate credit unions and, as the law requires, more comparable to the regulatory risk-based capital measures used by the FDIC, the Federal Reserve, and the Office of the Comptroller of the Currency.

The final rule also eliminates several provisions in the NCUA's current PCA regulations, including provisions relating to regular reserve accounts, risk-mitigation credits, and alternative risk-weights.

This edition of the guide has not been updated to reflect changes as a result of this final rule, however, this section will be updated in a future edition. Readers are encouraged to consult the full text of this regulation on NCUA's website at www.ncua.gov.

2.24 Title III of the CUMAA established a system of tiered net worth requirements for all insured natural person 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* with respect to the RBNWR. Specific requirements are set forth in Title 12 U.S. *Code of Federal Regulations* (CFR) Parts 700, 702, 741, and 747.

2.25 Under the existing net worth standard, a credit union's *net worth*, the numerator of the net worth ratio, is defined in 12 CFR 702.2 as the retained earnings balance of the credit union at quarter-end as determined under GAAP together with any amounts that were previously retained earnings of any other credit union with which the credit union has combined.[1]

2.26 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.

2.27 Credit unions with a ratio of less than 7 percent net worth to total assets and any complex credit union, as defined in the following, not meeting its RBNWR 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. However, a

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[1] In response to the FASB 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 correction 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.

credit union's net worth category may be downgraded if any supervisory or safety and soundness issues are identified at the credit union by the NCUA or any applicable state regulatory authority.

2.28 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. See 12 CFR 702 for details of the system of PCA.

2.29 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 $50 million.
- The credit union's RBNWR exceeds 6 percent.

2.30 Under the PCA regulations of the NCUA, a credit union is classified in a net worth category as presented in exhibit 2-1.

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

2.31 Under PCA regulations, the net worth category of a credit union that is not considered *complex* is determined by calculating the ratio of the credit union's net worth (equal to retained earnings as defined under GAAP) to total assets (computed under any of the four methods described previously) based on the net worth categories in exhibit 2-1.

2.32 A credit union that is considered *complex* must compare its net worth ratio to its RBNWR to determine its net worth category. If a complex credit union's net worth ratio exceeds its RBNWR, the net worth category under the PCA regulations is determined by calculating its net worth ratio and based on the net worth categories in exhibit 2-1.

2.33 A complex credit union whose RBNWR is greater than its net worth ratio cannot be classified as either "well capitalized" or "adequately capitalized" under PCA regulations. If its net worth ratio is 6 percent or more, the actual net worth classification under PCA regulations would be the first tier of "undercapitalized." For a complex credit union with a net worth ratio less than 6 percent, any net worth restoration plan submitted by the credit union would have to consider the RBNWR if that requirement were greater than 6 percent.

2.34 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.

2.35 As noted previously, a credit union that fails to meet its applicable RBNWR using either the standard or 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.

2.36 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.

2.37 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.

2.38 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.

New Credit Unions

2.39 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. *uncapitalized* if it has a net worth of less than 0 percent.

2.40 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.

2.41 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.

2.42 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.

Notice and Effective Date of Net Worth Classification

2.43 A federally insured credit union should have notice of its net worth ratio (including any applicable RBNWR) and should 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 received subsequent written notice from NCUA or, if state-chartered from the appropriate state official, of a decline in net worth category due to correction of an error or misstatement in the credit union's most recent Call Report
- 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

2.44 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 a credit union'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

2.45 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 to its applicable state law capital requirement, if any. For NCUA regulatory purposes, corporate credit union *total capital*, as defined in 12 CFR 704.2, consists

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[2] Readers may refer to Title 12 U.S. *Code of Federal Regulations* (CFR) Part 702.101 for additional information.

of the sum of tier 1 and tier 2 capital,[3] less the corporate credit union's equity investments not otherwise deducted when calculating tier 1 capital. *Tier 1 capital*, as defined in 12 CFR 704.2, represents the sum of (1) retained earnings; (2) perpetual contributed capital (PCC); (3) the retained earnings of any acquired credit union, or of an integrated set of activities and assets, calculated at the point of acquisition, if the acquisition was a mutual combination; and (4) minority interests in the equity accounts of credit union service organization (CUSOs) that are fully consolidated less all of the following:

a. The amount of the corporate credit union's intangible assets that exceed one half percent of its moving daily average net assets. However, the NCUA (on its own initiative, upon petition by the applicable state regulator, or upon application from a corporate credit union) may direct the corporate credit union to add back some of these assets.

b. Investments, both equity and debt, in unconsolidated CUSOs.

c. An amount equal to any PCC or nonperpetual capital account that the corporate credit union maintains at another corporate credit union.

d. Beginning on October 20, 2016, and ending on October 20, 2020, any amount of PCC that causes PCC minus retained earnings, all divided by moving daily net average assets, to exceed two percent.

e. Beginning after October 20, 2020, any amount of PCC that causes PCC to exceed retained earnings.

2.46 The essential function of PCC and nonperpetual 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 PCC and nonperpetual capital are depleted to the extent necessary to resolve the deficit. PCC and nonperpetual 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.

2.47 For NCUA purposes, a corporate credit union must maintain at all times (*a*) a leverage ratio[4] of 4.0 percent or greater, (*b*) a tier 1 risk-based capital ratio[5] of 4.0 percent or greater, and (*c*) a total risk-based capital ratio[6] of 8.0 percent or greater.

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[3] *Tier 2 capital*, as defined in 12 CFR 704.2, is the sum of nonperpetual capital accounts, as amortized under 12 CFR 704.3(b)(3); allowance for loan and lease losses calculated under U.S. generally accepted accounting principles to a maximum of 1.25 percent of risk-weighted assets; any perpetual contributed capital from tier 1 capital; and 45 percent of unrealized gains on available-for-sale equity securities with readily determinable fair values.

[4] *Leverage ratio*, as defined in 12 CFR 704.2, means the ratio of tier 1 capital to moving daily average net assets. The *moving daily average net assets*, as defined in 12 CFR 704.2, means the average of daily average net assets for the month being measured and the previous 11 months.

[5] *Tier 1 risk-based capital ratio*, as defined in 12 CFR 704.2, means the ratio of tier 1 capital to the moving monthly average net risk-weighted assets. The *moving monthly average net risk-weighted assets*, as defined in 12 CFR 704.2, means the average of the net risk-weighted assets for the month being measured and the previous 11 months. Measurements must be taken on the last day of each month.

[6] *Total risk-based capital ratio*, as defined in 12 CFR 704.2, means the ratio of total capital to moving monthly average net risk-weighted assets.

2.48 NCUA may also establish different minimum capital requirements for an individual corporate credit union based on its circumstances.

2.49 In 2010, the NCUA amended the corporate credit union rules to strengthen the corporate credit union system regulation. As part of these amendments, the NCUA adopted new PCA provisions similar to those currently applicable to banks. Each corporate credit union will be assigned to one of five capital categories. See 12 CFR 704.4 for details of the system of PCA.

2.50 Under the PCA regulations of the NCUA, a corporate credit union is classified in a capital category as follows:

a. *Well capitalized* if it has a total risk-based capital ratio of 10 percent or greater; has a tier 1 risk-based capital ratio of 6 percent or greater; has a leverage ratio of 5 percent or greater; and is not subject to any written agreement, order, capital directive, or PCA directive issued by the NCUA to meet and maintain a specific capital level for any capital measure.

b. *Adequately capitalized* if it has a total risk-based capital ratio of 8 percent or greater; has a tier 1 risk-based capital ratio of 4 percent or greater; has a leverage ratio of 4 percent or greater; and does not meet the definition of a *well capitalized corporate credit union*.

c. *Undercapitalized* if it has a total risk-based capital ratio that is less than 8 percent; has a tier 1 risk-based capital ratio that is less than 4 percent; or has a leverage ratio that is less than 4 percent.

d. *Significantly undercapitalized* if it has a total risk-based capital ratio that is less than 6 percent; has a tier 1 risk-based capital ratio that is less than 3 percent; or has a leverage ratio that is less than 3 percent.

e. *Critically undercapitalized* if it has a total risk-based capital ratio that is less than 4 percent; has a tier 1 risk-based capital ratio that is less than 2 percent; or has a leverage ratio that is less than 2 percent.

2.51 The NCUA may reclassify a well capitalized corporate credit union as adequately capitalized and may require an adequately capitalized or undercapitalized corporate credit union to comply with certain mandatory or discretionary supervisory actions as if the corporate credit union were in the next lower capital category in the following circumstances:

a. Unsafe or unsound condition. The NCUA has determined, after notice and opportunity for hearing pursuant to 12 CFR 704.4(h)(1), that the corporate credit union is in an unsafe or unsound condition.

b. Unsafe or unsound practice. The NCUA has determined, after notice and an opportunity for hearing pursuant to 12 CFR 704.4(h)(1), that the corporate credit union received a less-than-satisfactory CAMEL rating (three or lower, in other words) for any rating category (other than in a rating category specifically addressing capital adequacy) and has not corrected the conditions that served as the basis for the less than satisfactory rating. Ratings under this paragraph refer to the most recent ratings (as determined either on-site or off-site by the most recent examination) of which the corporate credit union has been notified in writing.

2.52 The potential consequences of failing to meet capital standards include restrictions on activities, restrictions on investments and asset growth, restrictions on the payment of dividends, restrictions on executive compensation, requirements to elect new directors or dismiss management, and possible conservatorship.

2.53 According to PCA regulations, corporate credit unions classified as undercapitalized, significantly undercapitalized, or critically undercapitalized must submit a written capital restoration plan for restoring the credit union to adequate capitalization. Among other things, the plan must include

- the steps the corporate credit union will take to become adequately capitalized;
- the levels of capital to be attained during each year in which the plan will be in effect;
- how the corporate credit union will comply with the restrictions or requirements that are put into effect;
- the types and levels of activities in which the corporate credit union will engage; and
- a description of the steps the corporate credit union will take to correct the unsafe or unsound condition or practice if required to submit a capital restoration plan as the result of a reclassification of the corporate credit union pursuant to paragraph 2.51.

2.54 Noncompliance or expected noncompliance with regulatory capital 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 a corporate credit union's ability to remain a going concern.

Annual Audits

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

a. If the credit union is federally insured with assets of $500 million or more, 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 four 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 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.

2.56 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.

2.57 Although GAAP basis accounting is not mandated for internal reporting, GAAP is required for Call Reports filed with the NCUA board for credit unions with assets of $10 million or more.[7]

2.58 A federally-chartered credit union with $10 million or less in total assets must obtain an annual Supervisory Committee audit.

2.59 The minimum requirements for a supervisory committee audit of federally chartered credit unions are prescribed by 12 CFR 715.[8] State-chartered credit unions are subject to the audit requirements established by state regulatory agencies if they are more stringent than 12 CFR 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.

2.60 The NCUA requires CUSOs to obtain a separate financial statement audit from a CPA in accordance with generally accepted auditing standards before a federally insured credit union can invest or lend to that CUSO. 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 investing federally insured credit union. See 12 CFR 712.3 for additional information.

2.61 The NCUA requires internal control and reporting requirements for corporate credit unions similar to those required for banks under the FDIC Improvement Act of 1991 and the Sarbanes-Oxley Act of 2002. The most significant revisions, which became effective January 1, 2012, require a corporate credit union to

- ensure that its annual financial statements and regulatory reports reflect all material correcting adjustments necessary to conform with GAAP as identified by the independent public accountant.
- prepare an annual management report, signed by the CEO and the chief accounting officer or CFO, that contains
  - — a statement of management's responsibility for preparing the financial statements, for establishing and maintaining an adequate internal control structure, and for complying with safety and soundness laws and regulations;

[7] Readers may refer to 12 CFR 741.6(b) for additional information.

[8] Under the National Credit Union Administration's (NCUA's) supervisory committee audits regulations, all federal credit unions engaging in derivatives activities are required to have a financial statement audit, regardless of asset size (see 12 CFR 715.5). NCUA derivatives regulations are set forth in 12 CFR 703 Subpart B.

  - an assessment of compliance with such laws and regulations; and
  - an assessment of the effectiveness of the internal control structure. The assessment requirement is effective January 1, 2013, and therefore would be applicable to management reports for the calendar year 2012 and thereafter.

- ensure that its independent public accountant
  - reports to the supervisory committee all critical accounting policies;
  - retains for seven years the working papers related to an audit;
  - complies with the independence standards and interpretations of the AICPA;
  - has an acceptable peer review;
  - notifies the NCUA if the independent public accountant ceases being a corporate credit union's independent accountant; and
  - reports separately to the supervisory committee on management's assertions concerning the effectiveness of internal control structure. The requirement is effective January 1, 2014, and therefore would be applicable to management reports prepared for the calendar year 2013 and thereafter.
- ensure that it files a copy of its annual report to the NCUA within 180 days after the end of the calendar year, which the NCUA will make available for public inspection.
- provide the NCUA with a copy of any letter or report issued by its independent public accountant.
- inform the NCUA when it engages an independent public accountant or loses an independent public accountant through dismissal or resignation.
- provide a notice to NCUA of late filing of the annual report.
- submit a summary of its annual report to the membership.
- ensure that its supervisory committee consists of members who are independent of the corporate credit union.
- supervise the independent public accountant.
- ensure that audit engagement letters do not contain unsafe and unsound limitation of liability provisions.

See 12 CFR 704.15 for further information.

Other Reporting Considerations

2.62 The independent accountant may be requested to perform assurance services other than those required by the CUMAA to the extent that a credit union may be *a.* originating or holding student loans,

b. servicing residential mortgage loans for others,

c. originating or servicing Federal Housing Administration or Government National Mortgage Association loans subject to generally accepted government auditing standards (the U.S. Department of Housing and Urban Development),

d. borrowing from a district Federal Home Loan Bank,

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

f. originating or receiving automated-clearinghouse transactions,

g. using outside technology partners, and

h. 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 entities (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 entities 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 and indirect consumer loans, including auto, credit card, and mortgage loans and retail sales financing. Direct loan companies provide loans directly to the customers. Indirect lenders either purchase loans from retail establishments and other companies, or provide financing, typically secured by loans to the retailer's customers, to retail establishments. Many companies that provide consumer financing also offer a variety of insurance services or other ancillary products to their borrowers.

3.04 *Insurance and other ancillary products and 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; debt cancellation products to cover the remaining obligation on certain events covered in the contract; and property insurance to protect the values of loan collateral against damage, theft, or destruction. Some lenders may also sell extended service contracts, auto clubs, or other ancillary products or receive commissions for those products. Some lenders may provide insurance through subsidiaries. Others act as brokers and, if licensed, often receive commissions from independent insurers or third-party service providers. 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 activities of commercial finance companies are called *asset based financial services* because of the lenders' reliance on collateral.

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

3.06 Commercial loans may be secured by various types of assets, including notes and accounts receivable; inventories; and property, plant, and equipment; or they may be 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 entities now do business directly with potential customers of finance companies 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 of the finance company 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, and Fitch Ratings have been used to differentiate an obligor's credit quality.

3.09 Unlike most depository institutions, finance companies typically do not utilize low-cost 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 1934 Act), and the Sarbanes-Oxley Act of 2002. Companies whose securities are registered under the 1934 Act must comply with its reporting requirements through periodic filings with the SEC.

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, collateral, compliance with state laws, and consumer loan product disclosure requirements; 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," of this guide.

3.14 Lending and other activities of finance companies are also generally subject to oversight by the Consumer Financial Protection Bureau (CFPB). The CFPB was created by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act).

3.15 *Securitizations*. The Dodd-Frank Act requires changes to rules and regulations for securitization transactions. The Dodd-Frank Act also requires entities that sponsor products such as mortgage-backed securities to retain at least 5 percent of the credit risk, unless the underlying loans meet standards that reduce the risk. It also requires these sponsors to disclose more information about the underlying assets, including analysis of the quality of the underlying assets.

3.16 In January 2011, 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*. These rules require securitizers of asset-backed securities to disclose fulfilled and unfulfilled repurchase requests. The rules also require nationally recognized statistical rating organizations to include information regarding the representations, warranties and enforcement mechanisms available to investors in an asset-backed securities offering in any report accompanying a credit rating issued in connection with such offering, including a preliminary credit rating.[2]

3.17 Pursuant to Section 945 of the Dodd-Frank Act, the SEC issued Release No. 33-9176, *Issuer Review of Assets in Offerings of Asset-Backed Securities*, which requires any issuer registering the offer and sale of an asset-backed security to perform a review of the assets underlying the asset-backed security.

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[2] In August 2011, the SEC made a technical correction to the final ruling due to an incorrect paragraph reference in an instruction to Rule 15Ga-1. See Release No. 33-9175A, *Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act*.

In addition, the rule amended Regulation AB by requiring an asset-backed security issuer to disclose the nature, findings, and conclusion of its review of the assets.

3.18 Section 942(a) of the Dodd-Frank Act eliminated the automatic suspension of the duty to file under Section 15(d) of the 1934 Act for asset-backed securities issuers and granted the SEC the authority to issue rules providing for the suspension or termination of such duty. To implement Section 942(a), the SEC issued Release No. 34-65148, *Suspension of the Duty to File Reports for Classes of Asset-Backed Securities Under Section 15(d) of the Securities Exchange Act of 1934*, which establishes rules to provide certain thresholds for suspension of the reporting obligations for asset-backed securities issuers.

3.19 In October 2014, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the FDIC, the SEC, the Federal Housing Finance Agency, and the U.S. Department of Housing and Urban Development issued the joint final rule *Credit Risk Retention* to implement the credit risk retention requirements of Section 15G of the 1934 Act, 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 5 percent of the credit risk of the assets collateralizing the asset-backed securities. Section 15G includes a variety of exemptions for these requirements, including an exemption for asset-backed securities that are collateralized exclusively by residential mortgages that qualify as qualified residential mortgages. The final rule became effective February 23, 2015.

3.20 In connection with making amendments to its "safe harbor" rule that were necessary due to the implementation of FASB Statement No. 166, *Accounting for Transfers of Financial Assets, an amendment of FASB Statement No. 140* (codified in FASB Accounting Standards Codification [ASC] 860, *Transfers and Servicing*), and FASB Statement No. 167, *Amendments to FASB Interpretation No. 46(R)* (codified in FASB ASC 810, *Consolidation*), the FDIC included a condition to qualify for the safe harbor that, among other conditions, sponsors must retain an economic interest of no less than 5 percent of the credit risk of the financial assets underlying a securitization until the joint interagency regulations that are required to be adopted under the Dodd-Frank Act become effective. The sponsor is not permitted to hedge the credit risk of the retained interest but may hedge certain other risks (such as interest rate and currency). Other conditions are also necessary to qualify for the safe harbor. The rule grandfathers the previous safe harbor rule for transfers of financial assets on or prior to December 31, 2010. For further information on the FDIC's safe harbor rule, readers are encouraged to access the September 27, 2010, board minutes from the "FDIC Board Meetings" page on the FDIC website.

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 finance demands of the general public in various geographic locations. The market where mortgage banking entities originate loans to borrowers is referred to as the *primary market*. The market where originated 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 entities (GSEs), such as the Federal Home Loan Mortgage Corporation (Freddie Mac) and the Federal National Mortgage Association (Fannie Mae). Also active in the secondary market are federal agencies such as the Government National Mortgage Association (Ginnie Mae), the U.S. 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. Private entities have also been active in the secondary market as issuers, investors, and guarantors, though the extent of their participation has varied significantly in response to market conditions. (Chapter 7, "Investments in Debt and Equity Securities," of this guide 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, originated by private entities, and Ginnie Mae generally purchases pools of government insured residential mortgage loans. These secondary market participants typically buy and sell originated loans, securitize them into MBSs, and sell the securities to investors.

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 (FHFA). In September 2008, the U.S.

Treasury Department acquired $1 billion of preferred shares in each GSE and has since provided additional capital as necessary. The future state of the GSEs is uncertain and has been the subject of legislative focus since they were placed into conservatorship.

4.07 The securities markets play a significant role in the execution and pricing of residential MBSs. In addition, the markets handle a significant 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 real estate investment trusts play various roles in the mortgage banking industry. In addition, mortgage lending entities have securitized other types of loan products, such as commercial mortgage loans, subprime residential mortgage loans, and home equity loans (junior lien mortgages).

4.09 The Mortgage Partnership Finance (MPF) Program, which is available through most Federal Home Loan Banks (FHLBs), provides FHLB member institutions an alternative method for funding home mortgages for their customers. Under the MPF Program, the lender 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, particularly for smaller entities that do not have the desire or ability to hedge the associated interest rate risk and prepayment risk. 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 between the rate a mortgage bank can fund its operations and the rate at which it can 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 in the secondary market 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, in order to meet asset/liability objectives or capital requirements.

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*, respectively). Fannie Mae, Freddie Mac, Ginnie Mae, and securitization vehicles do not have their own servicing functions, so mortgage companies that sell loans to those entities in the secondary market typically sell the loans servicing retained or sell the servicing to another party. Servicing rights offer the servicer additional and potentially significant sources of income in the form of servicing fees, late fees, float earnings, and other ancillary fees. Servicing fees are typically expressed as a percentage of a loan's unpaid principal balance, such as 0.25 percent or 25 basis points per year, which is deducted from the amounts due to the investor (that is, the servicing fee is a "strip" of the loan's stated coupon interest). Servicing also provides intangible benefits such as customer relationships, which may yield future sources of revenue such as refinancing fees.

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 or similar 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 as compared to the adequate servicing compensation that another substitute servicer would demand in the market. The market for purchases and sales of loan servicing rights is limited; thus, there is a limited degree of liquidity and observable market prices for servicing rights. Even when there is a price discovery for servicing rights, an entity needs to consider the relevance of observable prices because the transactions may involve unique terms or may reflect features that are not an attribute of the unit of account being measured (for example, intangible assets). Furthermore, servicing portfolios are subject to significant volatility in valuation as unanticipated periods of rapid prepayments, increases in loan losses, increases in market 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 is based are critical to the reported financial results of the servicing entity. Refer to FASB

Accounting Standards Codification (ASC) 860, *Transfers and Servicing*, for accounting requirements relating to servicing rights. See paragraphs 4.21–.32 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. In addition, FASB ASC 820, *Fair Value Measurement*, 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, *Financial Instruments*, allows entities to choose, at specified election dates, to measure eligible items at fair value (the fair value option) with gains and losses recorded in earnings at each subsequent reporting date. Additionally, FASB ASC 860-50-30-1 requires an entity at initial recognition to measure a servicing asset or servicing liability that qualifies for separate recognition regardless of whether explicit consideration was exchanged at fair value.[1] In accordance with FASB ASC 860-50-35-1, an entity should subsequently measure each class of servicing asset and servicing liability using either the amortization method or the fair value measurement method. Paragraphs 2 and 4 of FASB ASC 860-50-35 state that the election should be made separately for each class of servicing assets and servicing liabilities and the entity should apply the same subsequent measurement method to each servicing asset and servicing liability in a class. A detailed discussion on the accounting for servicing assets and servicing liabilities can be found in chapter 10, "Transfers and Servicing and Variable Interest Entities," of this guide.

4.17 Some mortgage banking entities elect to account for loans held for sale at fair value under the fair value option in accordance with FASB ASC 825. Because derivative instruments are often used to mitigate the risks of subsequent changes in fair value of the loans between the commitment date and the sale, applying the fair value election eliminates the operational burden of achieving fair value hedge accounting in accordance with the requirements of FASB ASC 815, *Derivatives and Hedging*, because both the loans and the derivative instruments used to hedge the risks of changes in fair value are recorded at fair value through earnings.

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 because they influence the demand for loans, the qualification of borrowers for loans, prices of loans, and how long the loans will be outstanding before they are repaid (for example, prepayment risk). Risk mitigation 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 the mortgage loan pipeline (the inventory of loan commitments in various stages of process) and prepayment risk inherent in the servicing asset, an entity that sells loans it

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[1] 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. A summary of the guidance in FASB ASC 820 may be found in chapter 20, "Fair Value," of this guide.

originated or purchased also is subject to recourse or repurchase risk under specific provisions or representations and warranties in the sale agreement. Recourse risk is the risk that an investor may either reject a loan or mandate the mortgage lender to repurchase the loan or reimburse the investor for credit-related losses if there is a defect related to the underwriting or documentation of the loan that contributes to a subsequent loss 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. An entity will establish a liability measured at fair value at the date of transfer related to these various representations and warranties that reflect management's estimate of losses for loans for which it has repurchase or make-whole obligations and will adjust that contingent liability subsequently based on actual claims activity and changes in expectations. Many investors have filed lawsuits against private issuers of MBSs over defects in the underwriting process and inadequate disclosures over credit risks inherent in the underlying loans.

4.20 Mortgage banking is a complex financial services business requiring advanced analytical skills, financial modeling, and forecasting abilities. The necessary level of computer systems support for mortgage banking operations is significant. Access to large volumes of 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 (the 1934 Act), and the Sarbanes-Oxley Act of 2002. Companies whose securities are registered under the 1934 Act must comply with its reporting requirements through periodic filings with the 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," of this guide. On February 25, 2003, the Office of the Comptroller of the Currency (OCC); the FDIC; the Board of Governors of the Federal Reserve System (Federal Reserve) (collectively, the federal banking agencies); and the Office of Thrift Supervision (OTS), prior to its transfer of powers to the OCC, the FDIC, and the Federal Reserve,[2] 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, along with the OTS, 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, along with the OTS, and the 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, along with the OTS, and the 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, along with the OTS, and the 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 In March 2009, the Treasury Department announced guidelines under the Home Affordable Mortgage Program to promote sustainable loan modifications for homeowners at risk of losing their homes due to foreclosure. Modifications come in the form of lower monthly payments and principal reductions. Also in March 2009, the FHFA, which regulates Fannie Mae and Freddie Mac, created the Home Affordable Refinance Program (HARP). HARP incentivizes mortgage servicers to modify loans to give healthy borrowers access to market interest rates in instances in which the loan collateral is worth less than the balance on the mortgage. The FHA and VA also have comparable loan modification programs. These modification programs were introduced as temporary responses to the financial crisis and, as such, had expiration dates in the short term; however, the programs have been extended past those dates and continue to be available to borrowers at risk of foreclosure.

4.27 In February 2014, the OCC issued an updated "Mortgage Banking" booklet of the *Comptroller's Handbook*. The booklet provides updated guidance to examiners and bankers on assessing the quantity of risk associated with mortgage banking and the quality of mortgage banking risk management. It also addresses changes to the functional area of production, secondary marketing, servicing, and mortgage servicing rights to incorporate regulatory changes. Furthermore, it addresses, among other statutory and regulatory changes, amendments to Regulation X and Regulation Z (such as, new servicing-related

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[2] See chapter 1, "Industry Overview—Banks and Savings Institutions," of this guide for further discussion on the Office of Thrift Supervision transfer of powers.

standards and requirements and ability-to-repay requirements) issued by the Consumer Financial Protection Bureau. The booklet applies to all banks engaged in mortgage banking activities. Readers are encouraged to view this publication under the "Publications—Comptroller Handbook" page at www.occ.gov.

4.28 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.

4.29 The 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.

4.30 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.

4.31 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 meet various eligibility requirements as prescribed in chapter 2, "Eligibility Requirements—Approval as a Ginnie Mae Issuer," of the *Ginnie Mae MBS Guide*. Among the requirements, an issuer must be an approved FHA mortgagee in good standing and maintain specific net worth, liquidity, institution-wide capital, and insurance requirements.

4.32 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.

4.33 Institutions may incur losses as a result of uncollectible receivables from other government programs such as the FHA or Ginnie Mae, from other investors such as Freddie Mac and Fannie Mae, or from insolvent private mortgage insurers.

4.34 The VA Home Loan Guaranty Program helps VA loan participants to compete for better loan terms in the housing market. The loan guaranty program can be used by any veteran who served after September 16, 1940, as well as men and women on active duty, surviving spouses and reservists. 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' residential properties 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.

4.35 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), *Code of Federal Regulations* (CFR), *Loan Guaranty*, Title 38, Sections 36.4302(a)(4) and 36.4802(a)(4), and in the VA Lender's Handbook. The guaranty amount for loans remains unchanged for situations in which 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 VA website for details regarding the maximum guarantee calculation.

4.36 In an environment with increased risk of foreclosure losses (including unrecoverable servicer 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 becomes increasingly difficult. Chapter 11, "Real Estate Investments, Real Estate Owned, and Other Foreclosed Assets," of this guide provides guidance on the valuation of foreclosed real estate, and chapter 9 of this guide, provides guidance on the evaluation of the collectability of real estate loans.

Reporting Considerations

HUD Programs

4.37 To participate in HUD programs, a *nonsupervised mortgagee* (a lender other than a financial institution that is a member of the Federal Reserve or whose accounts are insured by the FDIC or the NCUA) and a supervised mortgagee must comply with the requirements of the *Consolidated Audit Guide for Audits of HUD Programs*, issued by the HUD Office of the Inspector General. 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 internal control over compliance 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.

4.38 In August 2002, HUD released the Final Uniform Financial Reporting Standards Rule (CFR, *General HUD Program Requirements; Waivers*, Title 24, 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. The required information and associated attestation were historically performed on the Lender Assessment Subsystem (LASS). In 2014, LASS was replaced by the Lender Electronic Assessment Portal.

4.39 HUD releases Mortgagee Letters to notify lenders about amendments to FHA operations, policies, and procedures. Readers are encouraged to visit the "Mortgagee Letters" page at www.hud.gov to assess the applicability of the releases and how the releases might impact accounting and financial reporting matters, as well as audit requirements.

Asset Servicing for Investors

4.40 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. The USAP examination engagement is performed in accordance with AT-C section 315, *Compliance Attestation* (AICPA, *Professional Standards*). USAP was developed by the Mortgage Bankers Association and is intended to provide the minimum servicing standards with which an investor should expect a servicing entity to comply.

4.41 Regulation AB[3] 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.

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[3] Readers are encouraged to view the full text of SEC Regulation AB, issued December 22, 2004, at www.sec.gov/rules/final/33-8518.htm. In addition, readers may refer to footnote 22 in paragraph 1.112 of this guide for further discussion on subsequent revisions to Regulation AB. Readers may also access the latest Regulation AB interpretations of the staff of the Division of Corporation Finance under the "Division of Corporation Finance—Compliance and Disclosures Interpretations" page at www.sec.gov.

Chapter 5

Audit Considerations and Certain Financial Reporting Matters[1]

Gray shaded text in this chapter reflects guidance issued but not yet effective as of the date of this guide, July 1, 2017, but becoming effective on or prior to December 31, 2017, exclusive of any option to early adopt ahead of the mandatory effective date. Unless otherwise indicated, all unshaded text reflects guidance that was already effective as of the date of this guide.

Overview

5.01 AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards* (AICPA, *Professional Standards*), addresses the independent auditor's overall responsibilities when conducting an audit of financial statements in accordance with generally accepted auditing standards (GAAS). Specifically, it sets out the overall objectives of the independent auditor (the auditor) and explains the nature and scope of an audit designed to enable the auditor to meet those objectives. It also explains the scope, authority, and structure of GAAS and includes requirements establishing the general responsibilities of the auditor applicable in all audits, including the obligation to comply with GAAS.

5.02 Paragraph .12 of AU-C section 200 states that the overall objectives of the auditor, in conducting an audit of financial statements, are to

a. obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are presented fairly, in all material respects, in accordance with an applicable financial reporting framework; and

b. report on the financial statements, and communicate as required by GAAS, in accordance with the auditor's findings.

5.03 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 application of the auditor's overall objectives, including the risk assessment process and general auditing considerations for depository and lending institutions.

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[1] The auditing content in this guide focuses primarily on generally accepted auditing standards (GAAS) issued by the Auditing Standards Board (ASB) and is applicable to audits of the financial statements of those entities not subject to the oversight authority of the PCAOB (that is, those audit reports not within the PCAOB's jurisdiction as defined by the Sarbanes-Oxley Act of 2002, as amended—hereinafter referred to as *nonissuers*). However, considerations for audits of entities subject to the oversight authority of the PCAOB (that is, those audit reports within the PCAOB's jurisdiction as defined by the Sarbanes-Oxley Act of 2002, as amended) may be discussed within this guide's chapter text. When such discussion is provided, the related paragraphs are designated with the following title: *Considerations for Audits Performed in Accordance With PCAOB Standards*.

An Audit of Financial Statements

5.04 Consistent with the guidance presented in paragraph .04 of AU-C section 200, the purpose of an audit of a deposit and lending institution's financial statements is to provide financial statement users with an opinion by the auditor on whether the financial statements are presented fairly, in all material respects, in accordance with an applicable financial reporting framework, which enhances the degree of confidence that intended users can place in the financial statements. An audit conducted in accordance with GAAS and relevant ethical requirements enables the auditor to form that opinion. As the basis for the auditor's opinion, paragraph .06 of AU-C section 200 states that GAAS require the auditor to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. Reasonable assurance is a high, but not absolute, level of assurance. It is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce *audit risk* (for purposes of GAAS, that is, the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level.

5.05 Paragraphs .08 and .10 of AU-C section 200 state that GAAS contain objectives, requirements, and application and other explanatory material that are designed to support the auditor in obtaining reasonable assurance. GAAS require that the auditor exercise professional judgment and maintain professional skepticism throughout the planning and performance of the audit and, among other things,

- identify and assess risks of material misstatement, whether due to fraud or error, based on an understanding of the entity and its environment, including the entity's internal control.
- obtain sufficient appropriate audit evidence about whether material misstatements exist, through designing and implementing appropriate responses to the assessed risks.
- form an opinion on the financial statements, or determine that an opinion cannot be formed, based on an evaluation of the audit evidence obtained.

The auditor also may have certain other communication and reporting responsibilities to users, management, those charged with governance, or parties outside the entity, regarding matters arising from the audit. These responsibilities may be established by GAAS or by applicable law or regulation.

Considerations for Audits Performed in Accordance With PCAOB Standards[2]

PCAOB Staff Audit Practice Alert No. 10, *Maintaining and Applying Professional Skepticism in Audits* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400.10), reminds auditors of the requirement to appropriately apply professional skepticism throughout their audits, which includes an attitude of a questioning mind and a critical assessment of audit evidence. This practice alert highlights: (1) professional skepticism and due professional care; (2) impediments to the application of professional skepticism; (3) promoting professional skepticism via an appropriate system of quality

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[2] 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.

control; (4) the importance of supervision to the application of professional skepticism; and (5) the appropriate application of professional skepticism.

Audit Risk

5.06 Paragraph .A36 of AU-C section 200 explains that audit risk is a function of the risks of material misstatement and detection risk. The assessment of risks is based on audit procedures to obtain information necessary for that purpose and evidence obtained throughout the audit. The assessment of risks is a matter of professional judgment, rather than a matter capable of precise measurement.

5.07 Paragraphs .A38–.A40 of AU-C section 200 provide further explanation on the two levels of the risks of material misstatement. The risks of material misstatement exist at the overall financial statement level and the assertion level for classes of transactions, account balances, and disclosures. Risks of material misstatement at the overall financial statement level refer to risks of material misstatement that relate pervasively to the financial statements as a whole and potentially affect many assertions. Risks of material misstatement at the assertion level are assessed in order to determine the nature, timing, and extent of further audit procedures necessary to obtain sufficient appropriate audit evidence. This evidence enables the auditor to express an opinion on the financial statements at an acceptably low level of audit risk.

5.08 Paragraph .A44 of AU-C section 200 states that GAAS do not ordinarily refer to inherent risk and control risk separately but rather to a combined assessment of the risks of material misstatement. However, the auditor may make separate or combined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations. The assessment of the risks of material misstatement may be expressed in quantitative terms, such as in percentages or in nonquantitative terms. In any case, the need for the auditor to make appropriate risk assessments is more important than the different approaches by which they may be made.

5.09 Paragraphs .A41–.A44 and .A46–.A47 of AU-C section 200 provide further guidance on the two components of the risk of material misstatement (inherent risk and control risk) and characteristics of detection risk.

Terms of Engagement

5.10 The scope of services rendered by auditors generally depends on the types of reports to be issued as a result of the engagement. Paragraphs .09–.10 of AU-C section 210, *Terms of Engagement* (AICPA, *Professional Standards*), states that the auditor should agree upon the terms of the audit engagement with management or those charged with governance, as appropriate. The agreed-upon terms of the audit engagement should be documented in an audit engagement letter or other suitable form of written agreement (see paragraph .10 of AU-C section 210 for a listing of agreed-upon terms that should be included). Both management and the auditor have an interest in documenting the agreed-upon terms of the audit engagement before the commencement of the audit to help avoid misunderstandings with respect to the audit as stated in paragraph .A22 of AU-C section 210.

5.11 In accordance with paragraphs .A23–.A24 of AU-C section 210, the form and content of the audit engagement letter may vary for each entity. When relevant, additional services to be provided, such as those relating to regulatory requirements (see further discussion on these engagements in the section "Annual Independent Audits and Reporting Requirements" beginning in paragraph 1.86 of this guide), could be included in the audit engagement letter. In addition, the engagement letter may also include 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," of this guide includes a description of trust services and activities.)
- Reporting on management's assertions about compliance with the requirements of the *Consolidated Audit Guide for Audits of HUD Programs*, compliance with the minimum servicing standards set forth in the *Uniform Single Attestation 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," of this guide)
- Applying minimum agreed-upon procedures to assist the supervisory committee in fulfilling its responsibilities. (The scope of services is expanded beyond the minimum procedures. See chapter 2, "Industry Overview—Credit Unions," and chapter 23, "Reporting Considerations," of this guide)
- Reporting on management's assertions about compliance with certain Department of Education requirements relative to student loan activities.[3] (See chapter 1, "Industry Overview—Banks and Savings Institutions," of this guide.)
- Reporting on the controls at banks and savings institutions or credit unions functioning as service organizations in accordance with Statement on Standards for Attestation Engagements No. 16, *Reporting on Controls at a Service Organization*.[4] (See chapter 10, "Transfers and Servicing and Variable Interest Entities," chapter 13, "Deposits," and chapter 20, "Fair Value," of this guide as they relate to loan servicing, deposits, and trust activities, respectively.)

5.12 In February 2006, the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Federal Reserve), the FDIC, the Office of Thrift Supervision (prior to its transfer of powers to the OCC, the Federal Reserve, and the FDIC),[5] and the National Credit

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[3] 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.

[4] The AICPA Guide *Service Organizations: Reporting on Controls at a Service Organization Relevant to User Entities' Internal Control Over Financial Reporting* contains information for practitioners reporting on controls at a service organization that affect user entities' internal control over financial reporting. Also, the AICPA Guide *Reporting on Controls at a Service Organization Relevant to Security, Availability, Processing Integrity, Confidentiality, or Privacy (SOC 2®)* summarizes the three SOC engagements and provides detailed guidance on planning, performing, and reporting on SOC 2® engagements.

[5] See chapter 1, "Industry Overview—Banks and Savings Institutions," of this guide for further discussion on the Office of Thrift Supervision (OTS) transfer of powers.

Union Administration (NCUA) published the *Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions in External Audit Engagement Letters*. The advisory was issued because the federal agencies had observed an increase in the types and frequency of provisions in financial institutions' external audit engagement letters limiting the auditor's liability. Examples of these provisions included, but were not limited to, indemnifying the external auditor against claims made by third parties, releasing the external auditor from liability for claims or potential claims that might be asserted by the client financial institution, or limiting the remedies available to the client financial institution. The federal agencies believe that when financial institutions agree to limit their external auditors' liability, either in provisions in engagement letters or in provisions that accompany alternative dispute resolution agreements, such provisions may weaken the external auditor's objectivity, impartiality, and performance. In this regard, the Professional Ethics Executive Committee issued Interpretation No. 501-8, "Failure to Follow Requirements of Governmental Bodies, Commissions, or Other Regulatory Agencies on Indemnification of Liability Provisions in Connection With Audit and Other Attest Services" (AICPA, *Professional Standards*, ET sec. 501 par. .09). This interpretation provides that including prohibited limitation of liability provisions in engagement letters is an act discreditable to the profession.

5.13 The advisory informs financial institutions' boards of directors, audit committees, and management that they should not enter into agreements that incorporate unsafe and unsound external auditor limitation of liability provisions with respect to engagements for financial statement audits, audits of internal control over financial reporting, and attestations on management's assessment of internal control over financial reporting. It applies to all audits of financial institutions, regardless of whether an institution is public or a nonpublic company. However, the advisory does not apply to non-audit services; audits of financial institutions' 401K plans, pension plans, and other similar audits; services performed by accountants who are not engaged to perform financial institutions' audits; and other service providers. Readers may access the full text of this advisory from any of the federal agencies' websites.

Audit Planning

5.14 AU-C section 300, *Planning an Audit* (AICPA, *Professional Standards*), addresses the auditor's responsibilities to plan an audit of financial statements. AU-C section 300 is written in the context of recurring audits. Matters related to planning audits of group financial statements are addressed in AU-C section 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)* (AICPA, *Professional Standards*). Planning activities involve performing preliminary engagement activities; establishing an overall audit strategy and communicating with those charged with governance an overview of the planned scope and timing of the audit; developing a detailed, written audit plan; determining direction and supervision of engagement team members and review of their work; and determining the extent of involvement of professionals with specialized skills. Adequate planning benefits the audit of financial statements in several ways, including the following:

- Helping the auditor identify and devote appropriate attention to important areas of the audit

- Helping the auditor identify and resolve potential problems on a timely basis
- Helping the auditor properly organize and manage the audit engagement so that it is performed in an effective and efficient manner
- Assisting in the selection of engagement team members with appropriate levels of capabilities and competence to respond to anticipated risks and allocating team member responsibilities
- Facilitating the direction and supervision of engagement team members and the review of their work
- Assisting, when applicable, in coordination of work done by auditors of components and specialists

Paragraph .A1 of AU-C section 300 further explains that the nature, timing, and extent of planning activities will vary according to the size and complexity of the entity, the key engagement team members' previous experience with the entity, and changes in circumstances that occur during the audit.

5.15 In accordance with paragraph .09 of AU-C section 300, the auditor should develop an audit plan that includes a description of the nature and extent of planned risk assessment procedures, as determined under AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*) (see discussion of risk assessment procedures in paragraphs 5.23–.75); the nature, timing, and extent of planned further audit procedures at the relevant assertion level, as determined under AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*) (see discussion of planned further audit procedures in paragraphs 5.82–.98); and, other planned audit procedures that are required to be carried out so that the engagement complies with GAAS. Paragraph .A2 of AU-C section 300 explains that planning is not a discrete phase of an audit, but rather a continual and iterative process that often begins shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement.

Materiality

5.16 AU-C section 320, *Materiality in Planning and Performing an Audit* (AICPA, *Professional Standards*), addresses the auditor's responsibility to apply the concept of materiality in planning and performing an audit of financial statements. AU-C section 450, *Evaluation of Misstatements Identified During the Audit* (AICPA, *Professional Standards*), explains how materiality is applied in evaluating the effect of identified misstatements on the audit and the effect of uncorrected misstatements, if any, on the financial statements (see paragraphs 5.99–.101 for a discussion of evaluation of misstatements).

5.17 Paragraphs .04 and .06 of AU-C section 320 state that the auditor's determination of materiality is a matter of professional judgment and is influenced by the auditor's perception of the financial information needs of users of financial statements. In planning the audit, the auditor makes judgments about the size of misstatements that will be considered material. Although it is not practicable to design audit procedures to detect misstatements that could be material solely because of their nature (that is, qualitative considerations), the auditor considers not only the size but also the nature of uncorrected misstatements, and the particular circumstances of their occurrence, when evaluating their effect on the financial statements.

5.18 In accordance with paragraphs .10 and .A5 of AU-C section 320, the auditor should determine materiality for the financial statements as a whole when establishing the overall audit strategy. Determining materiality involves the exercise of professional judgment. A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole. If, in the specific circumstances of the entity, one or more particular classes of transactions, account balance, or disclosures exist for which misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users, then, taken on the basis of the financial statements, the auditor also should determine the materiality level or levels to be applied to those particular classes of transactions, account balances, or disclosures. See paragraphs .A12–.A13 of AU-C section 320 for further application guidance on materiality level or levels for particular classes of transactions, account balances, or disclosures.

Performance Materiality

5.19 Paragraph .A14 of AU-C section 320 explains that planning the audit solely to detect individual material misstatements overlooks the fact that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated and leaves no margin for possible undetected misstatements. Therefore, in accordance with paragraph .11 of AU-C section 320, the auditor should determine performance materiality for purposes of assessing the risks of material misstatement and determining the nature, timing, and extent of further audit procedures. *Performance materiality*, for purposes of GAAS, is defined in AU-C section 320 as the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. If applicable, *performance materiality* also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances, or disclosures. Performance materiality is to be distinguished from tolerable misstatement, which is the application of performance materiality to a particular sampling procedure.[6]

5.20 Paragraph .A14 of AU-C section 320 goes on to explain that the determination of performance materiality is not a simple mechanical calculation and involves the exercise of professional judgment. It is affected by the auditor's understanding of the entity, updated during the performance of the risk assessment procedures, and the nature and extent of misstatements identified in previous audits and, thereby, the auditor's expectations regarding misstatements in the current period.

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[6] AU-C section 530, *Audit Sampling* (AICPA, *Professional Standards*), defines tolerable misstatement and provides further application guidance about the concept.

Use of Assertions in Assessment of Risks of Material Misstatement

5.21 Paragraphs .A113–.A118 of AU-C section 315 discuss the use of assertions in assessment of risks of material misstatement. In representing that the financial statements are in accordance with the applicable financial reporting framework, management implicitly or explicitly makes assertions regarding the recognition, measurement, presentation, and disclosure of the various elements of financial statements and related disclosures. Assertions used by the auditor to consider the different types of potential misstatements that may occur fall into the following categories and may take the following forms.

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.
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.

5.22 According to paragraph .A116 of AU-C section 315, the auditor should use relevant assertions for classes of transactions, account balances, 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 relating the identified risks to what can go wrong at the relevant assertion, taking account of relevant controls that the auditor intends to test, and designing further audit procedures that are responsive to the assessed risks.

Risk Assessment Procedures

5.23 AU-C section 315 addresses the auditor's responsibility to identify and assess the risks of material misstatement in the financial statements through understanding the entity and its environment, including the entity's internal control.

5.24 Obtaining an understanding of the entity and its environment, including the entity's internal control (referred to hereafter as an *understanding of the entity*), is a continuous, dynamic process of gathering, updating, and analyzing information throughout the audit. As stated in paragraph .A1 of AU-C section 315, the understanding of the entity establishes a frame of reference within which the auditor plans the audit and exercises professional judgment throughout the audit when, for example

- assessing risks of material misstatement of the financial statements;
- determining materiality in accordance with AU-C section 320;
- considering the appropriateness of the selection and application of accounting policies and the adequacy of financial statement disclosures;
- identifying areas for which special audit consideration may be necessary (for example, related party transactions, the appropriateness of management's use of the going concern assumption, considering the business purpose of transactions, or the existence of complex and unusual transactions);
- developing expectations for use when performing analytical procedures;
- responding to the assessed risks of material misstatement, including designing and performing further audit procedures to obtain sufficient appropriate audit evidence; and
- evaluating the sufficiency and appropriateness of audit evidence obtained, such as the appropriateness of assumptions and management's oral and written representations.

Risk Assessment Procedures and Related Activities

5.25 In accordance with paragraph .05 of AU-C section 315, the auditor should perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and relevant assertion levels. Risk assessment procedures by themselves, however, do not provide sufficient appropriate audit evidence on which to base the audit opinion. For purposes of GAAS, *risk assessment procedures* are defined in AU-C section 315 as audit procedures performed to obtain an understanding of the entity and its environment, including the entity's internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and relevant assertion levels.

5.26 The auditor is required to exercise professional judgment[7] to determine the extent of the required understanding of the entity. Paragraph .A3 of AU-C section 315 states that the auditor's primary consideration is whether the understanding of the entity that has been obtained is sufficient to meet the objectives of AU-C section 315. The depth of the overall understanding that is required by the auditor is less than that possessed by management in managing the entity.

5.27 Paragraph .06 of AU-C section 315 states that the risk assessment procedures should include the following:

- Inquiries of management, appropriate individuals within the internal audit function (if such function exists), and others within the entity who, in the auditor's professional judgment, may have information that is likely to assist in identifying risks of material misstatement due to fraud or error
- Analytical procedures
- Observation and inspection

Analytical Procedures

5.28 Paragraphs .A7–.A10 of AU-C section 315 provide additional explanation for analytical procedures performed during the risk assessment process. Analytical procedures performed as risk assessment procedures may identify aspects of the entity of which the auditor was unaware and may assist in assessing the risks of material misstatement in order to provide a basis for designing and implementing responses to the assessed risks. Analytical procedures may enhance the auditor's understanding of the institution's business and the significant transactions and events that have occurred since the prior audit and help to identify the existence of unusual transactions or events and amounts, ratios, and trends that might indicate matters that have audit implications.

5.29 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 SEC's Industry Guide No. 3, *Statistical Disclosures by Bank Holding Companies*. The *Uniform Bank Performance Reports*, published by the Federal Financial Institutions Examination Council (FFIEC), and various reports published by the

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[7] Paragraph .18 of AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards* (AICPA, *Professional Standards*), requires the auditor to exercise professional judgment in planning and performing an audit.

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.

5.30 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

Discussion Among the Engagement Team

5.31 In accordance with paragraph .11 of AU-C section 315, the engagement partner and other key engagement team members should discuss the susceptibility of the entity's financial statements to material misstatement and the application of the applicable financial reporting framework to the entity's facts and circumstances. The engagement partner should determine which matters are to be communicated to engagement team members not involved in the discussion. Paragraph .A14 of AU-C section 315 states this discussion may be held concurrently with the discussion among the engagement team that is required by AU-C section 240, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*), to discuss the susceptibility of the entity's financial statements to fraud. Paragraphs 5.129–.132 further address the discussion among the engagement team about the risks of fraud.

Additional Guidance

5.32 In addition to the requirements discussed previously, paragraphs .07–.10 of AU-C section 315 address additional requirements on risk assessment procedures and related activities. Additional application and explanatory material regarding risk assessment requirements can be found in paragraphs .A1–.A16 of AU-C section 315.

Understanding the Entity and Its Environment, Including the Entity's Internal Control

5.33 Paragraph .12 of AU-C section 315 states that the auditor should obtain an understanding of the following:

a. Relevant industry, regulatory, and other external factors, including the applicable financial reporting framework.

b. The nature of the entity, including

   i. its operations;

   ii. its ownership and governance structures;

   iii. the types of investments that the entity is making and plans to make, including investments in entities formed to accomplish specific objectives; and

   iv. the way that the entity is structured and how it is financed,

   to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements.

c. The entity's selection and application of accounting policies, including the reasons for changes thereto. The auditor should evaluate whether the entity's accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry.

d. The entity's objectives and strategies and those related business risks that may result in risks of material misstatement.

e. The measurement and review of the entity's financial performance.

Appendix A, "Understanding the Entity and Its Environment," of AU-C section 315 contains examples of matters that the auditor may consider in obtaining an understanding of the entity and its environment. Appendix B, "Internal Control Components," of AU-C section 315 contains a detailed explanation of the internal control components.

Understanding of the Client's Business

5.34 As previously discussed in paragraph 5.33, 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 of this guide, the auditor should obtain an understanding of the nature of an entity and the entity's objectives and strategies and those related business risks that may result in risks of material misstatement. With regard to financial institutions, such matters include risk management strategies, organizational structure, product lines and services, capital structure, locations, and other operating characteristics. Paragraph .A32 of AU-C section 315 identifies examples of matters that the auditor may consider when obtaining an understanding of the entity's objectives, strategies, and related business risks that may result in a risk of material misstatement of the financial statements. For entities subject to the oversight authority of the PCAOB, the auditor should also obtain an understanding of the operating segments of the business, as defined by FASB *Accounting Standards Codification* (ASC) 280-10-50.

5.35 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 NCUA Call Reports (collectively, Call Reports)
- Sales brochures and other marketing materials
- Capital or business plans
- Internal reports and financial information utilized by management to make segment-related decisions
- Significant or unusual contracts entered into by the entity

5.36 *Related parties*. Obtaining an understanding of a client's business should also include performing the procedures set forth in AU-C section 550, *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 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.

5.37 Paragraph .A2 of AU-C section 550 states that the substance of a particular transaction may be significantly different from its form. Accordingly, financial statements prepared in accordance with U.S. generally accepted accounting principles (GAAP) generally recognize the substance of particular transactions rather than merely their legal form. Paragraph .A45 of AU-C section 550 explains that 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 transaction was consummated on terms equivalent to those that prevail in arm's length transactions.[8] Paragraphs .A47 and .A49 of AU-C section 550 further state that the preparation and fair presentation of the financial statements requires management to substantiate an assertion included in financial statements that a related party transaction was conducted on terms equivalent to those prevailing in an arm's length transaction. If the auditor believes that management's assertions are unsubstantiated or the auditor cannot obtain sufficient appropriate audit evidence to support the assertions, the auditor, in accordance with AU-C section 705, *Modifications to the Opinion in the Independent Auditor's Report* (AICPA, *Professional Standards*), considers the implications for the audit, including the opinion in the auditor's report. AU-C section 705 addresses the auditor's responsibility to issue an appropriate report in circumstances when, in forming an opinion in accordance with

[8] FASB *Accounting Standards Codification* (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.

AU-C section 700, *Forming an Opinion and Reporting on Financial Statements* (AICPA, *Professional Standards*), the auditor concludes that a modification to the auditor's opinion on the financial statements is necessary. Chapter 23 of this guide provides additional discussion on auditor reports.

5.38 *Regulation O loans.* Part 215, "Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks," of the U.S. *Code of Federal Regulations* (CFR), commonly referred to as Regulation O, governs any extension of credit made by a member bank to an executive officer, director, or principal shareholder of the member bank, of any company of which the member bank is a subsidiary, and of any other subsidiary of that company. It also applies to any extension of credit made by a member bank to a company controlled by such a person, or to a political or campaign committee that benefits or is controlled by such a person. In general, Part 215.4 states that no member bank may extend credit to any insider of the bank or insider of its affiliates unless the extension of credit

- is made on substantially the same terms (including interest rates and collateral) as, and following credit underwriting procedures that are not less stringent than, those prevailing at the time for comparable transactions by the bank with other persons that are not covered by this part and who are not employed by the bank and
- does not involve more than the normal risk of repayment or present other unfavorable features.

5.39 Management of a financial institution would generally be expected to be able to support that their related party loans were conducted on terms equivalent to those prevailing in an arm's length transaction. In instances where a bank has made such a related party loan, the auditor should perform procedures to verify this assertion, including reviewing management's documentation as well as the regulatory examination report, which would identify instances where there are possible Regulation O violations.

Industry Risk Factors

5.40 As previously discussed in paragraph 5.33*a*, auditors should obtain an understanding of the relevant industry risk factors as a part of the evaluation of the entity and its environment. No list of risk factors covers all of the complex characteristics that affect transactions in the industry.[9] However, some of those risk factors are competition for business, innovations in financial instruments, and the role of regulatory policy. 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.

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

5.41 *Interest rate risk (IRR).*[10,11] In general, financial institutions derive their income primarily from the excess of interest collected over interest paid. The rates of interest an institution earns on its assets and owes on its liabilities generally are established contractually for a period of time. Market interest rates change over time. Accordingly, an institution is exposed to lower profit margins (or losses) if it cannot adapt to interest rate changes.

5.42 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.

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[10] 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 control 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. For the complete text of the advisory see the FFIEC website at www.ffiec.gov.

In January 2012, the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Federal Reserve), the FDIC, the National Credit Union Administration (NCUA), and State Liaison Committee issued the *Interagency Advisory on Interest Rate Risk Management Frequently Asked Questions*. This document was created to clarify points in the 2010 interagency *Advisory on Interest Rate Risk Management* by providing responses to the most common questions. The responses address IRR exposure measurement and reporting, model risk management, stress testing, assumption development, and model and systems validation. Financial institution management should consider the responses in the context of their institution's complexity, risk profile, business model, and scope of operations. Readers can access the guidance from any of the respective agencies' websites.

[11] Due to changes in balance sheet composition for federally insured credit unions (FICUs) and increased uncertainty in the financial market, there is a heightened importance for FICUs to incorporate strong policies and programs addressing the credit union's management of controls for IRR. In January 2012, the NCUA issued a final rule, which became effective September 30, 2012, requiring FICUs to develop and adopt a written policy on IRR management and a program to effectively implement that policy as part of credit unions' asset liability management responsibilities. There are asset size and activity triggers for how the written IRR policy requirements would apply based on the following guidelines:

- A FICU with assets of more than $50 million must adopt a written IRR policy and implement an effective IRR program.
- A FICU with assets of $10 million or more but not greater than $50 million must adopt a written IRR policy and implement an effective IRR program if the total of first mortgage loans it holds combined with total investments with maturities greater than 5 years, as reported by the FICU on its most recent call report, is equal to or greater than 100 percent of its net worth.
- A FICU with assets less than $10 million is not required to comply regardless of the amount of first mortgage loans and total investments with maturities greater than 5 years it holds.

The final rule provides discussion on the roles and responsibilities of the FICU's board of directors and management in establishing and implementing the IRR policy and program; risk management systems, methods, and valuation measures; internal control; decision making informed by IRR measurement systems; and guidelines addressing the adequacy and effectiveness of the policy and program.

The rule also provides additional guidance for large credit unions with complex or high risk balance sheets. *Large credit unions* are defined as institutions with assets of at least $500 million. Readers can access this final rule from the NCUA website at www.ncua.gov. Readers are also encouraged to access NCUA Letters to Credit Unions No. 12-CU-11, *Interest Rate Risk Policy and Program Frequently Asked Questions*.

5.43 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.

5.44 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.

5.45 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.

5.46 Another technique used to analyze IRR involves simulation models. These models measure the effect of changes in interest rates on either net interest income or on the economic value of equity. Net interest income models measure the sensitivity of changes in net interest income as a result of different interest rate scenarios. The economic value of equity measures the difference in the market value of an institution's financial assets, liabilities, and off-balance-sheet instruments as a result of change in the interest rate environment. Simulation analysis involves the projection of various interest rate scenarios over future periods. To determine market value, the estimated cash flows for each rate scenario are discounted to arrive at a present value calculation for each rate scenario. The resulting range of probable risk exposures reflects both current and expected IRR. 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 IRR.

5.47 Several ways an institution can affect IRR 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

5.48 An institution might also invest in more complex financial instruments intended to hedge or otherwise change IRR. 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," of this guide discusses specific accounting and regulatory guidance in this area, as well as related audit considerations.

5.49 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," of this guide.

5.50 *Liquidity risk*.[12,13,14] 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 of this guide.

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[12] In March 2010, the OCC, the OTS, the FDIC, the Federal Reserve, and the NCUA 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.

[13] In October 2013, the NCUA issued a final rule, *Liquidity and Contingency Funding Plans*, requiring FICUs with less than $50 million in assets to maintain a basic written policy that provides a credit union board-approved framework for managing liquidity and a list of contingent liquidity sources that can be employed under adverse circumstances. The rule requires FICUs with assets of $50 million or more to have a contingency funding plan that clearly sets out strategies for addressing liquidity shortfalls in emergency situations. Finally, the rule requires FICUS with assets of $250 million or more to have access to a backup federal liquidity source for emergency situations. The guidance can be found in *Federal Register* Vol. 78, No. 210 [30 October 2013], pp. 64879–64883.

[14] In September 2014, the OCC, the Federal Reserve, and the FDIC issued a final rule implementing a quantitative liquidity requirement consistent with the liquidity coverage ratio standard established by the Basel Committee on Banking Supervision. The final rule requires a company subject to the rule to maintain an amount of high-quality liquid assets (the numerator of the ratio) that is no less than 100 percent of its total net cash outflows over a prospective 30 calendar day period (the denominator of the ratio). The final rule applies to large and internationally active banking organizations, generally, bank holding companies, certain savings and loan holding companies, and depository institutions with $250 billion or more in total assets or $10 billion or more in on-balance sheet foreign exposure and to their consolidated subsidiaries that are depository institutions with $10 billion or more in total consolidated assets. The final rule focuses on these financial institutions because of their complexity, funding profiles, and potential risk to the financial system. Therefore, the agencies do not intend to apply the final rule to community banks. The final rule became effective January 1, 2015, with transition periods for compliance with the requirements of the rule. The final rule can be accessed from any of the respective agencies' websites.

5.51 The composition of an institution's deposits also affects liquidity and IRR 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 of this guide addresses audit considerations for deposits.)

5.52 *Asset-quality risk*. 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," of this guide addresses credit losses.

5.53 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.

5.54 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.

5.55 *Fiduciary risk*. 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.

5.56 *Processing risk*. 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.

5.57 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.

The Entity's Internal Control[15,16]

5.58 As explained in paragraph .A44 of AU-C section 315, the way in which internal control is designed, implemented, and maintained varies with

[15] The AICPA's Technical Questions and Answers (Q&A) section 8200, *Internal Control* (AICPA, *Technical Questions and Answers*), provides nonauthoritative guidance to auditors. For more information, visit the AICPA website at www.aicpa.org.

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

an entity's size and complexity. The assets of financial institutions generally are more negotiable and more liquid than those of other entities. 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.

5.59 Paragraphs .13–.14 of AU-C section 315 states that the auditor should obtain an understanding of internal control relevant to the audit. Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit. It is a matter of the auditor's professional judgment whether a control, individually or in combination with others, is relevant to the audit. When obtaining an understanding of controls that are relevant to the audit, the auditor should evaluate the design of those controls and determine whether they have been implemented by performing procedures in addition to inquiry of the entity's personnel. Paragraph .A42 of AU-C section 315 further explains that an understanding of internal control assists the auditor in identifying types of potential misstatements and factors that affect the risks of material misstatement and in designing the nature, timing, and extent of further audit procedures.

5.60 *Purpose of internal control.* Paragraph .A44 of AU-C section 315 explains that internal control is designed, implemented, and maintained to address identified business risks that threaten the achievement of any of the entity's objectives that concern (*a*) the reliability of the entity's financial reporting, (*b*) the effectiveness and efficiency of its operations, and (*c*) its compliance with applicable laws and regulations.

5.61 *Division of internal control*. For purposes of GAAS, internal control is divided into the following five 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, analysis, and management of risks relevant to the preparation and fair presentation of financial statements.

c. *Information system, including the related business processes relevant to financial reporting and communication* consists of the procedures and records designed and established to

   i. initiate, authorize, record, process, and report entity transactions (as well as events and conditions) and maintain accountability for the related assets, liabilities, and equity;

   ii. resolve incorrect processing of transactions (for example, automated suspense files and procedures followed to clear suspense items out on a timely basis);

   iii. process and account for system overrides or bypasses to controls;

   iv. transfer information from transaction processing systems to the general ledger;

   v. capture information relevant to financial reporting for events and conditions other than transactions, such as the depreciation and amortization of assets and changes in the recoverability of accounts receivables; and

vi. ensure information required to be disclosed by the applicable financial reporting framework is accumulated, recorded, processed, summarized, and appropriately reported in the financial statements.

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

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

Audit requirements and application guidance related to the preceding components can be found in paragraphs .15–.25 and .A71–.A107, respectively, of AU-C section 315.

5.62 *Controls relevant to the audit*. Paragraphs .A61–.A62 of AU-C section 315 state a direct relationship exists between an entity's objectives and the controls it implements to provide reasonable assurance about their achievement. The entity's objectives and, therefore, controls relate to financial reporting, operations, and compliance; however, not all of these objectives and controls are relevant to the auditor's risk assessment. Factors relevant to the auditor's professional judgment about whether a control, individually or in combination with others, is relevant to the audit may include such matters as the following:

- Materiality
- The significance of the related risk
- The institution's size
- The nature of the institution's business, including its organization and ownership characteristics
- The diversity and complexity of the institution's operations
- Applicable legal and regulatory requirements
- The circumstances and the applicable component of internal control
- The nature and complexity of the systems that are part of the institution's internal control, including the use of service organizations
- Whether and how a specific control, individually or in combination with other controls, prevents, or detects and corrects, material misstatements

5.63 Paragraph .A64 of AU-C section 315 states that the controls relating to operations and compliance objectives also may be relevant to an audit if they relate to data the auditor evaluates or uses in applying audit procedures. For example, controls pertaining to nonfinancial data that the auditor may use in analytical procedures, such as production statistics, or controls pertaining to detecting noncompliance with laws and regulations that may have a direct effect on the determination of material amounts and disclosures in the financial statements, such as compliance with income tax laws and regulations used to determine the income tax provision, may be relevant to an audit.

5.64 *IT considerations.* Financial institutions' operations are characterized by large volumes of transactions and, therefore, generally rely heavily on computers. AU-C section 315 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.

Considerations for Audits Performed in Accordance With PCAOB Standards[17]

PCAOB Staff Audit Practice Alert No. 11, *Considerations for Audits of Internal Control Over Financial Reporting* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400.11), highlights certain requirements of the auditing standards of the PCAOB in aspects of audits of internal control over financial reporting in which significant auditing deficiencies have been cited frequently in PCAOB inspection reports. Among other topics, the alert specifically addresses PCAOB standards regarding the consideration of IT in audits of internal control, including when testing controls that use system-generated data and reports and evaluating deficiencies in IT general controls.

5.65 Paragraph .A54 of AU-C section 315 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 online 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.)

5.66 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.

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[17] See footnote 2.

5.67 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-C section 402, *Audit Considerations Relating to an Entity Using a Service Organization* (AICPA, *Professional Standards*), addresses the user auditor's responsibility when auditing the financial statements of entities that obtain services that are part of its information system from another organization (see further discussion in paragraphs 5.120–.122).

5.68 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.[18]

5.69 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.

5.70 *Communication with those charged with governance*. AU-C section 260, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*), addresses the auditor's responsibility to communicate with those charged with governance in an audit of financial statements. Although this section applies regardless of an entity's governance structure or size, particular considerations apply when all of those charged with governance are involved in managing an entity. This section does not establish requirements regarding the auditor's communication with an entity's management or owners unless they are also charged with a governance role.

5.71 AU-C section 265, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*), addresses the auditor's responsibility to appropriately communicate to those charged with governance

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[18] The requirements for the auditor's use of a specialist are described in AU-C section 620, *Using the Work of an Auditor's Specialist* (AICPA, *Professional Standards*).

and management deficiencies in internal control that the auditor has identified in an audit of financial statements. In particular, AU-C section 265

- 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.

5.72 Paragraphs .11–.13 of AU-C section 265 state that the auditor should communicate in writing to those charged with governance on a timely basis significant deficiencies and material weaknesses identified during the audit, including those that were remediated during the audit. The auditor also should communicate to management at an appropriate level of responsibility, on a timely basis

a. in writing, significant deficiencies and material weaknesses that the auditor has communicated or intends to communicate to those charged with governance, unless it would be inappropriate to communicate directly to management in the circumstances.

b. in writing or orally, other deficiencies in internal control identified during the audit that have not been communicated to management by other parties and that, in the auditor's professional judgment, are of sufficient importance to merit management's attention. If other deficiencies in internal control are communicated orally, the auditor should document the communication.

The communication referred to should be made no later than 60 days following the report release date. However, paragraph .A15 of AU-C section 265 further explains that the communication is best made by the report release date because receipt of such communication may be an important factor in enabling those charged with governance to discharge their oversight responsibilities.

5.73 In accordance with paragraph .03 of AU-C section 265, nothing in AU-C section 265 precludes the auditor from communicating to those charged with governance or management other internal control matters that auditor has identified during the audit.

5.74 The appendix, "Examples of Circumstances That May Be Deficiencies, Significant Deficiencies, or Material Weaknesses," of AU-C section 265 includes examples of circumstances that may be deficiencies, significant deficiencies, or material weaknesses.

5.75 AU-C section 265 is not applicable if the auditor is engaged to perform an audit of internal control over financial reporting that is integrated with an audit of financial statements. In such circumstances, AU-C section 940, *An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements* (AICPA, *Professional Standards*), applies.

Risk Assessment and the Design of Further Audit Procedures

5.76 As discussed in paragraph 5.25, 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.

Identifying and Assessing the Risks of Material Misstatement

5.77 To provide a basis for designing and performing further audit procedures, paragraphs .26–.27 of AU-C section 315 state that the auditor should identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level for classes of transactions, account balances, and disclosures. 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, by considering the classes of transactions, account balances, and disclosures in the financial statements (see further discussion in paragraph 5.79);

b. assess the identified risks and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions;

c. relate the identified risks to what can go wrong at the relevant assertion level, taking account of relevant controls that the auditor intends to test; and

d. consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that could result in a material misstatement.

5.78 Paragraph .A108 of AU-C section 315 explains that the risks of material misstatement at the financial statement level refer to risks that relate pervasively to the financial statements as a whole and potentially affect many assertions. Risks of this nature are not necessarily risks identifiable with specific assertions at the class of transactions, account balance, or disclosure level. Rather, they represent circumstances that may increase the risks of material misstatement at the assertion level (for example, through management override of internal control). Financial statement level risks may be especially relevant to the auditor's consideration of the risks of material misstatement arising from fraud.

5.79 *Process of identifying risks of material misstatement*. Paragraph .A120 of AU-C section 315 explains that information gathered by performing risk assessment procedures, including the audit evidence obtained in evaluating the design of controls and determining whether they have been implemented, is used as audit evidence to support the risk assessment. The risk assessment determines the nature, timing, and extent of further audit procedures to be performed.

Risks that Require Special Audit Consideration

5.80 Paragraphs .28–.29 of AU-C section 315 state that as part of the risk assessment described in paragraph .26 of AU-C section 315 (see paragraph 5.77), the auditor should determine whether any of the risks identified are, in the auditor's professional judgment, a significant risk. In exercising this judgment, the auditor should exclude the effects of identified controls related to the risk. In addition, the auditor should consider at least

a. whether the risk is a risk of fraud;

b. whether the risk is related to recent significant economic, accounting, or other developments and, therefore, requires specific attention;

c. the complexity of transactions;

d. whether the risk involves significant transactions with related parties;

e. the degree of subjectivity in the measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty; and

f. whether the risk involves significant transactions that are outside the normal course of business for the entity or that otherwise appear to be unusual.

5.81 If the auditor has determined that a significant risk exists, paragraph .30 of AU-C section 315 states that the auditor should obtain an understanding of the entity's controls, including control activities, relevant to that risk and, based on that understanding, evaluate whether such controls have been suitably designed and implemented to mitigate such risks. See paragraphs 5.90 and 5.93 for discussion over further audit procedures pertaining to significant risks.

Designing and Performing Further Audit Procedures

5.82 AU-C section 330 addresses the auditor's responsibility to design and implement responses to the risks of material misstatement identified and assessed by the auditor in accordance with AU-C section 315 and to evaluate the audit evidence obtained in an audit of financial statements.

Overall Responses

5.83 Paragraph .05 of AU-C section 330 states that the auditor should design and implement overall responses to address the assessed risks of material misstatement at the financial statement level. Paragraph .A1 of AU-C section 330 states that overall responses to address the assessed risks of material misstatement at the financial statement level may include emphasizing to the audit team the need to maintain professional skepticism, assigning more experienced staff or those with specialized skills or using specialists, providing more supervision, incorporating additional elements of unpredictability in the selection of further audit procedures to be performed, or making general changes to the nature, timing, or extent of further audit procedures (for example, performing substantive procedures at period end instead of at an interim date or modifying the nature of audit procedures to obtain more persuasive audit evidence). 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 and provide more extensive supervision. See paragraphs 5.06–.09 for more guidance regarding the auditor's overall responses to audit risk.

5.84 Paragraphs .A2–.A3 of AU-C section 330 go on to explain that the assessment of the risks of material misstatement at the financial statement level and, thereby, the auditor's overall responses are affected by the auditor's understanding of the control environment. An effective control environment may allow the auditor to have more confidence in internal control and the reliability of audit evidence generated internally within the entity and, thus, for example, allow the auditor to conduct some audit procedures at an interim date rather than at the period-end. Deficiencies in the control environment, however, have the opposite effect (for example, the auditor may respond to an ineffective control environment by

- conducting more audit procedures as of the period-end rather than at an interim date,
- obtaining more extensive audit evidence from substantive procedures, and
- increasing the number of locations to be included in the audit scope).

Such considerations, therefore, have a significant bearing on the auditor's general approach (for example, an emphasis on substantive procedures [substantive approach] or an approach that uses tests of controls as well as substantive procedures [combined approach]).

Further Audit Procedures

5.85 Further audit procedures provide important audit evidence to support an audit opinion. These procedures consist of tests of controls and substantive tests. Paragraph .06 of AU-C section 330 states that the auditor should design and perform further audit procedures whose nature, timing, and extent are based on, and are responsive to, the assessed risks of material misstatement at the relevant assertion level.

5.86 In designing the further audit procedures to be performed, paragraph .07 of AU-C section 330 states that the auditor should

a. consider the reasons for the assessed risk of material misstatement at the relevant assertion level for each class of transactions, account balance, and disclosure, including

   i. the likelihood of material misstatement due to the particular characteristics of the relevant class of transactions, account balance, or disclosure (the inherent risk) and

   ii. whether the risk assessment takes account of relevant controls (the control risk), thereby requiring the auditor to obtain audit evidence to determine whether the controls are operating effectively (that is, the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing, and extent of substantive procedures), and

b. obtain more persuasive audit evidence the higher the auditor's assessment of risk.

5.87 *Tests of controls.* In accordance with paragraph .08 of AU-C section 330, the auditor should design and perform tests of controls to obtain sufficient appropriate audit evidence about the operating effectiveness of relevant controls if (*a*) the auditor's assessment of risks of material misstatement at the relevant assertion level includes an expectation that the controls are operating effectively (that is, the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing, and extent of substantive procedures)[19] or (*b*) when substantive procedures alone cannot provide sufficient appropriate audit evidence at the relevant assertion level. In accordance with paragraph .A21 of AU-C section 330, tests of controls are performed only on those controls that the auditor has determined are suitably designed to prevent, or detect and correct, a material misstatement in a relevant assertion. If substantially different controls were used at different times during the period under audit, each is considered separately.

5.88 Paragraph .A22 of AU-C section 330 states that the testing the operating effectiveness of controls is different from obtaining an understanding of and evaluating the design and implementation of controls. However, the same types of audit procedures are used. The auditor may, therefore, decide it is efficient to test the operating effectiveness of controls at the same time the auditor is evaluating their design and determining that they have been implemented.

5.89 Paragraph .A23 of AU-C section 330 states that although some risk assessment procedures 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.

5.90 *Timing of tests of controls over significant risks*. One or more significant risks normally arise on most audits.[20] Paragraph .15 of AU-C section 330 states that if the auditor plans to rely on controls over a risk the auditor has determined to be a significant risk, the auditor should test the operating effectiveness of those controls in the current period.

5.91 *Substantive procedures*. Irrespective 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 .18 of AU-C section 330.

5.92 Paragraph .21 of AU-C section 330 states that the auditor's substantive procedures should include audit procedures related to the financial statement closing process, such as

- agreeing or reconciling the financial statements with the underlying accounting records and
- examining material journal entries and other adjustments made during the course of preparing the financial statements.

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[19] Q&A section 8200.06, "The Meaning of Expectation of the Operating Effectiveness of Controls" (AICPA, *Technical Questions and Answers*), 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.

[20] According to paragraph .27 of AU-C section 240, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*), the auditor should treat those assessed risks of material misstatement due to fraud as significant risks. Paragraph .26 of AU-C section 240 states that there is a presumption that risks of fraud exist in revenue recognition. Paragraph .31 of AU-C section 240 states that the risk of management override of controls is present in all entities and is a risk of material misstatement due to fraud and thus, a significant risk. Thus, there are generally at least two significant risks in any financial statement audit.

Paragraph .A57 of AU-C section 330 states that the nature and extent of the auditor's examination of journal entries and other adjustments depends on the nature and complexity of the entity's financial reporting process and the related risks of material misstatement.

5.93 *Substantive procedures responsive to significant risks*. If the auditor has determined that an assessed risk of material misstatement at the relevant assertion level is a significant risk, paragraph .22 of AU-C section 330 states that the auditor should perform substantive procedures that are specifically responsive to that risk. When the approach to a significant risk consists only of substantive procedures, those procedures should include tests of details.

5.94 *Substantive analytical procedures*. AU-C section 520, *Analytical Procedures* (AICPA, *Professional Standards*), addresses the auditor's use of analytical procedures as substantive procedures (substantive analytical procedures). It also addresses the auditor's responsibility to perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion on the financial statements.

5.95 As explained in paragraphs .A2–.A3 of AU-C section 520, analytical procedures include the consideration of comparisons of the entity's financial information with, for example, comparable information for prior periods, anticipated results of the entity (such as, budgets or forecasts) or expectations of the auditor, or similar industry information. Analytical procedures also include consideration of relationships, like elements of financial information that would be expected to conform to a predictable pattern based on recent history of the entity and industry or between financial information and relevant nonfinancial information (such as, payroll costs to number of employees). When designing and performing analytical procedures, either alone or in combination with tests of details, as substantive procedures, paragraph .05 of AU-C section 520 states that the auditor should

- *a.* determine the suitability of particular substantive analytical procedures for given assertions, taking into account the assessed risks of material misstatement and tests of details, if any, for these assertions;
- *b.* evaluate the reliability of data from which the auditor's expectation of recorded amounts or ratios is developed, taking into account the source, comparability, and nature and relevance of information available and controls over preparation;
- *c.* develop an expectation of recorded amounts or ratios and evaluate whether the expectation is sufficiently precise (taking into account whether substantive analytical procedures are to be performed alone or in combination with tests of details) to identify a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated; and
- *d.* determine the amount of any difference of recorded amounts from expected values that is acceptable without further investigation and compare the recorded amounts, or ratios developed from recorded amounts, with the expectations.

5.96 Paragraphs .A13–.A14 of AU-C section 520 explain that different types of analytical procedures provide different levels of assurance. The determination of the suitability of particular substantive analytical procedures is influenced by the nature of the assertion and the auditor's assessment of the risk of material misstatement. Paragraph .A8 of AU-C section 520 states that the effectiveness and efficiency of a substantive analytical procedure in addressing risks of material misstatement 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, paragraph .A19 of AU-C section 520 notes that the auditor may consider testing the operating effectiveness of controls, if any, over the entity's preparation of information used by the auditor in performing the substantive analytical procedures in response to assessed risks. When such controls are effective, the auditor may have greater confidence in the reliability of the information and, therefore, in the results of analytical procedures. The operating effectiveness of controls over nonfinancial information may often be tested in conjunction with other tests of controls.

5.97 Paragraph .08 of AU-C section 520 states that when substantive analytical procedures have been performed, the auditor should include in the audit document the following:

a. The expectation referred to in paragraph .05*c* of AU-C section 520 (see paragraph 5.95*c*) and the factors considered in its development when that expectation or those factors are not otherwise readily determinable from the audit documentation

b. Results of the comparison referred to in paragraph .05*d* of AU-C section 520 (see paragraph 5.95*d*) of the recorded amounts, or ratios developed from recorded amounts, with the expectations

c. Any additional auditing procedures performed in accordance with paragraph .07 of AU-C section 520 relating to the investigation of fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount and the results of such additional procedures

Evaluating the Sufficiency and Appropriateness of Audit Evidence

5.98 Paragraph .28 of AU-C section 330 states the auditor should conclude whether sufficient appropriate audit evidence has been obtained. In forming a conclusion, 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.

Evaluation of Misstatements Identified During the Audit

5.99 Based on the results of substantive procedures, the auditor may identify misstatements in accounts or notes to the financial statements. AU-C section 450 addresses the auditor's responsibility to evaluate the effect of identified misstatements on the audit and the effect of uncorrected misstatements, if any, on the financial statements. Paragraphs .05–.12 of AU-C section 450 address specific requirements the auditor should perform in relation to accumulation of identified misstatements, consideration of identified misstatements as the audit progresses, communication and correction of misstatements, evaluating the effect of uncorrected misstatements,[21] and documentation.

5.100 The circumstances related to some misstatements may cause the auditor to evaluate them as material, individually or when considered together with other misstatements accumulated during the audit, even if they are below the materiality threshold for the financial statements as a whole. 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. Paragraph .A23 of AU-C section 450 provides circumstances that the auditor may consider relevant in determining whether misstatements are material.

5.101 AU-C section 700 addresses the auditor's responsibility in forming an opinion on the financial statements based on the evaluation of the audit evidence obtained. The auditor's conclusion, required by AU-C section 700, takes into account the auditor's evaluation of uncorrected misstatements, if any, on the financial statements, in accordance with AU-C section 450.

Audit Documentation

5.102 AU-C section 230, *Audit Documentation* (AICPA, *Professional Standards*), addresses the auditor's responsibility to prepare audit documentation for an audit of financial statements. The exhibit, "Audit Documentation Requirements in Other AU-C Sections," (see paragraph .A30 of AU-C section 230) lists other AU-C sections that contain specific documentation requirements and guidance. The specific documentation requirements of other AU-C sections do not limit the application of AU-C section 230. Law, regulation, or other standards may establish additional documentation requirements.

5.103 Paragraph .02 of AU-C section 230 states that audit documentation that meets the requirements of AU-C section 230 and the specific documentation requirements of other relevant AU-C sections provides

- *a.* evidence of the auditor's basis for a conclusion about the achievement of the overall objectives of the auditor;[22] and
- *b.* evidence that the audit was planned and performed in accordance with GAAS and applicable legal and regulatory requirements.

5.104 For purposes of GAAS, *audit documentation*, as defined in paragraph .06 of AU-C section 230, is the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached (terms such as *working papers* or *workpapers* are also sometimes used).

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[21] The SEC's *Codification of Staff Accounting Bulletins* 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 bulletin 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 topic also notes that an immaterial error on the balance sheet could be material on the income statement.

[22] Paragraph .12 of AU-C section 200.

Timely Preparation of Audit Documentation

5.105 Paragraph .07 of AU-C section 230 states that the auditor should prepare audit documentation on a timely basis. Paragraph .A3 of AU-C section 230 further explains that preparing sufficient and appropriate audit documentation on a timely basis throughout the audit helps to enhance the quality of the audit and facilitates the effective review and evaluation of the audit evidence obtained and conclusions reached before the auditor's report is finalized. Documentation prepared at the time such work is performed or shortly thereafter is likely to be more accurate than documentation prepared at a much later time.[23]

Documentation of the Audit Procedures Performed and Audit Evidence Obtained

5.106 Paragraphs .08–.12 of AU-C section 230 address the auditor's responsibilities regarding documentation of the audit procedures performed and audit evidence obtained including form, content, and extent of audit documentation. In accordance with paragraph .08 of AU-C section 230, the auditor should prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand

a. the nature, timing, and extent of the audit procedures performed to comply with GAAS and applicable legal and regulatory requirements; (Readers can find additional application and explanatory material in paragraphs .A8–.A9 of AU-C section 230)

b. the results of the audit procedures performed, and the audit evidence obtained; and

c. significant findings or issues arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions. (Readers can find additional application and explanatory material in paragraphs .A10–.A13 of AU-C section 230.)

As stated in paragraph .A5 of AU-C section 230, examples of audit documentation include audit plans, analyses, issues memorandums, summaries of significant findings or issues, letters of confirmation and representation, checklists, and correspondence (including e-mail) concerning significant findings or issues.

5.107 For audit procedures related to the inspection of significant contracts or agreements, paragraph .10 of AU-C section 230 states that the auditor should include abstracts or copies of those contracts or agreements in the audit documentation.

5.108 In addition to the requirements discussed previously, paragraphs .13–.14 of AU-C section 230 address further documentation requirements about

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[23] 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 GAAS, 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 10, *A Firm's System of Quality Control* (AICPA, *Professional Standards*). See also AU-C section 220, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards* (AICPA, *Professional Standards*).

departures from relevant requirements and matters arising after the date of the auditor's report.

Assembly and Retention of the Final Audit File

5.109 Paragraphs .15–.19 of AU-C section 230 address an auditor's responsibilities regarding assembly and retention of the final audit file. Paragraph .16 of AU-C section 230 states that the auditor should assemble the audit documentation in an audit file and complete the administrative process of assembling the final audit file on a timely basis, no later than 60 days following the report release date. After the documentation completion date, paragraph .17 of AU-C section 230 prohibits the auditor from deleting or discarding audit documentation of any nature before the end of the specified retention period. If it is necessary to modify existing audit documentation or add new audit documentation after the documentation date, paragraph .18 of AU-C section 230 requires the auditor to document the specific reasons for making the changes and when and by whom the changes were made and reviewed.

Using the Work of an Auditor's Specialist

5.110 AU-C section 620, *Using the Work of an Auditor's Specialist* (AICPA, *Professional Standards*), addresses the auditor's responsibilities relating to the work of an individual or organization possessing expertise in a field other than accounting or auditing when that work is used to assist the auditor in obtaining sufficient appropriate audit evidence (defined as an *auditor's specialist* for purposes of GAAS). An auditor's specialist may be either an internal specialist (who is a partner or staff, including temporary staff, of the auditor's firm or a network firm) or an external specialist.

5.111 AU-C section 620 does not address

- situations in which the engagement team includes a member or consults an individual or organization with expertise in a specialized area of accounting or auditing, which are addressed in AU-C section 220, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards* (AICPA, *Professional Standards*), and AU-C section 300,[24,25] or
- auditor's use of the work of an individual or organization possessing expertise in a field other than accounting or auditing, whose work in that field is used by the entity to assist the entity in preparing the financial statements (a management's specialist), which is addressed in AU-C section 500, *Audit Evidence* (AICPA, *Professional Standards*).[26]

5.112 In accordance with AU-C section 620, the objectives of the auditor are (*a*) to determine whether to use the work of an auditor's specialist and (*b*) if using the work of an auditor's specialist, to determine whether that work is adequate for the auditor's purposes. In reaching these objectives, the auditor should

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[24] Paragraphs .A10 and .A20–.A22 of AU-C section 220.

[25] Paragraph .12 of AU-C section 300, *Planning an Audit* (AICPA, *Professional Standards*).

[26] Paragraphs .A35–.A49 of AU-C section 500, *Audit Evidence* (AICPA, *Professional Standards*).

- determine the need for an auditor's specialist if expertise in a field other than accounting or auditing is necessary to obtain sufficient appropriate audit evidence.
- evaluate the competence, capabilities, and objectivity of the auditor's specialist.
- obtain a sufficient understanding of the field of expertise of the auditor's specialist to enable the auditor to (*a*) determine the nature, scope, and objectives of the work of the auditor's specialist for the auditor's purposes and (*b*) evaluate the adequacy of that work for the auditor's purposes.

5.113 Paragraph .09 of AU-C section 620 states that the auditor should evaluate whether the auditor's specialist has the necessary competence, capabilities, and objectivity for the auditor's purposes.

5.114 AU-C section 620 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. However, paragraph .09 of AU-C section 620 states that, in the case of an auditor's external specialist, the evaluation of objectivity should include inquiry regarding interests and relationships that may create a threat to the objectivity of the auditor's specialist. If the auditor believes that a relationship between the entity and the auditor's specialist might impair the objectivity of the auditor's specialist, paragraph .A22 of AU-C section 620 states that the auditor may perform additional procedures with respect to some or all of the assumptions, methods, or findings of the auditor's specialist to determine that the findings are reasonable or may engage another specialist for that purpose.

5.115 Paragraph .10 of AU-C section 620 states that the auditor should obtain a sufficient understanding of the field of expertise of the auditor's specialist to enable the auditor to

- determine the nature, scope, and objectives of the work of the auditor's specialist for the auditor's purposes and
- evaluate the adequacy of that work for the auditor's purposes.

Using the Work of a Management's Specialist

5.116 AU-C section 500 addresses the auditor's use of the work of an individual or organization possessing expertise in a field other than accounting or auditing, whose work in that field is used by the entity to assist the entity in preparing the financial statements (defined as a *management's specialist*).

5.117 Information regarding the competence, capabilities, and objectivity of a management's specialist may come from a variety of sources, such as knowledge of that specialist's qualifications, membership in a professional body or industry association, license to practice, or other forms of external recognition (a listing of additional sources is addressed in paragraph .A39 of AU-C section 500). 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. Further application and explanatory material regarding the reliability of information produced by a management's specialist is addressed in paragraphs .A35–.A49 of AU-C section 500.

5.118 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). If information to be used as audit evidence has been prepared using the work of a management's specialist, paragraph .08 of AU-C section 500 states that the auditor should, to the extent necessary, taking into account the significance of that specialist's work for the auditor's purposes,

a. evaluate the competence, capabilities, and objectivity of that specialist;

b. obtain an understanding of the work of that specialist; and

c. evaluate the appropriateness of that specialist's work as audit evidence for the relevant assertion.

Furthermore, paragraph .17 of 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" (AICPA, *Professional Standards*, AU-C sec. 9620 par. .01–.21), of AU-C section 620 states that, in some cases, the auditor may decide it necessary to contact the specialist to determine that the specialist is aware that his or her work will be used for evaluating the assertions in the financial statements.

5.119 The Audit Issues Task Force of the Auditing Standards Board issued Interpretation No. 1 of AU-C section 620.[27] 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 FASB ASC 860, *Transfers and Servicing*.

Processing of Transactions by Service Organizations

5.120 AU-C section 402 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 (for example, using a mortgage banker to service mortgages). Specifically, it expands on how the user auditor applies AU-C sections 315 and 330 in obtaining an understanding of the user entity, including internal control relevant to the audit, sufficient

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[27] 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" (AICPA, *Professional Standards*, AU-C sec. 9620 par. .01–.21), of AU-C section 620 has not been updated to reflect the issuance of FASB Statement No. 166, *Accounting for Transfers of Financial Assets*. FASB Statement No. 166 was incorporated into FASB ASC in FASB Accounting Standards Update (ASU) No. 2009-16, *Transfers and Servicing (Topic 860): Accounting for Transfers of Financial Assets*, and is discussed in FASB ASC 860, *Transfers and Servicing*.

In addition, this interpretation has not been updated for changes to the FDIC's safe harbor for financial assets transferred in connection with securitizations and participations. The FDIC's final amendments to the safe harbor, *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* (www.fdic.gov/news/news/press/2010/pr10216.html), were issued in September 2010. The safe harbor provides important protections for securitizations and participations by confirming that in the event of a bank failure, the FDIC would not try to reclaim loans transferred into such transactions.

In light of the issuance of FASB Statement No. 166 and the FDIC's changes to the safe harbor, the ASB is currently in the process of revising the interpretation. Auditors should be alert for such revisions; however, the guidance in this interpretation continues to be relevant.

to identify and assess the risks of material misstatement and in designing and performing further audit procedures responsive to those risks.

5.121 Paragraphs .03–.05 of AU-C section 402 state that services provided by a service organization are relevant to the audit of a user entity's financial statements when those services and the controls over them affect the user entity's information system, including related business processes, relevant to financial reporting. Although most controls at the service organization are likely to relate to financial reporting, other controls also may be relevant to the audit, such as controls over the safeguarding of assets. A service organization's services are part of a user entity's information system, including related business processes, relevant to financial reporting if these services affect any of the following:

- *a.* The classes of transactions in the user entity's operations that are significant to the user entity's financial statements;
- *b.* The procedures within both IT and manual systems by which the user entity's transactions are initiated, authorized, recorded, processed, corrected as necessary, transferred to the general ledger, and reported in the financial statements;
- *c.* The related accounting records, supporting information, and specific accounts in the user entity's financial statements that are used to initiate, authorize, record, process, and report the user entity's transactions. This includes the correction of incorrect information and how information is transferred to the general ledger; the records may be in either manual or electronic form;
- *d.* How the user entity's information system captures events and conditions, other than transactions, that are significant to the financial statements;
- *e.* The financial reporting process used to prepare the user entity's financial statements, including significant accounting estimates and disclosures; and
- *f.* Controls surrounding journal entries, including nonstandard journal entries used to record nonrecurring, unusual transactions, or adjustments.

The nature and extent of work to be performed by the user auditor regarding the services provided by a service organization depend on the nature and significance of those services to the user entity and the relevance of those services to the audit.

5.122 AU-C section 402 does not apply to services that are limited to processing an entity's transactions that are specifically authorized by the entity, such as the processing of checking account transactions by a bank or the processing of securities transactions by a broker (that is, when the user entity retains responsibility for authorizing the transactions and maintaining the related accountability). In addition, AU-C section 402 does not apply to the audit of transactions arising from an entity that holds a proprietary financial interest in another entity, such as a partnership, corporation, or joint venture, when the partnership, corporation, or joint venture performs no processing on behalf of the entity.

Consideration of Fraud in a Financial Statement Audit[28]

5.123 AU-C section 240 addresses the auditor's responsibilities relating to fraud in an audit of financial statements. Specifically, it expands on how AU-C sections 315 and 330 are to be applied regarding risks of material misstatement due to fraud.

5.124 Although fraud is a broad legal concept, for the purposes of GAAS, the auditor is primarily concerned with fraud that causes a material misstatement in the financial statements. In accordance with paragraph .03 of AU-C section 240, two types of intentional misstatements are relevant to the auditor:

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

Although the auditor may suspect or, in rare cases, identify the occurrence of fraud, the auditor does not make legal determinations of whether fraud has actually occurred.

5.125 Paragraph .A1 of AU-C section 240 states that fraud, whether fraudulent financial reporting or misappropriation of assets, involves incentive or pressure to commit fraud, a perceived opportunity to do so, and some rationalization of the act.

Professional Skepticism

5.126 Consistent with paragraph .15 of AU-C section 200, paragraph .12 of AU-C section 240 states that the auditor should maintain professional skepticism throughout the audit, recognizing the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience of the honesty and integrity of the entity's management and those charged with governance.

5.127 Paragraphs .A9–.A10 of AU-C section 240 states that maintaining professional skepticism requires an ongoing questioning of whether the information and evidence obtained suggests that a material misstatement due to fraud may exist. It includes considering the reliability of the information to be used as audit evidence and the controls over its preparation and maintenance when relevant. Although the auditor cannot be expected to disregard past experience of the honesty and integrity of the entity's management and those charged with governance, the auditor's professional skepticism is particularly important in considering the risk of material misstatement due to fraud because there may have been changes in circumstances.

5.128 When responses to inquiries of management, those charged with governance, or others are inconsistent or otherwise unsatisfactory (for example, vague or implausible), paragraph .14 of AU-C section 240 states that the auditor should further investigate the inconsistencies or unsatisfactory responses.

Discussion Among the Engagement Team

5.129 AU-C section 315 requires a discussion among the key engagement team members (see detailed discussion at paragraph 5.31). Paragraph .15 of AU-C section 240 states this discussion should include an exchange of ideas or brainstorming among the engagement team members about how and where

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[28] See footnote 21.

the entity's financial statements might be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting, and how assets of the entity could be misappropriated. The discussion should occur setting aside beliefs that the engagement team members may have that management and those charged with governance are honest and have integrity, and should, in particular, also address

a. known external and internal factors affecting the entity that may create an incentive or pressure for management or others to commit fraud, provide the opportunity for fraud to be perpetrated, and indicate a culture or environment that enables management or others to rationalize committing fraud;

b. the risk of management override of controls;

c. consideration of circumstances that might be indicative of earnings management or manipulation of other financial measures and the practices that might be followed by management to manage earnings or other financial measures that could lead to fraudulent financial reporting;

d. the importance of maintaining professional skepticism throughout the audit regarding the potential for material misstatement due to fraud; and

e. how the auditor might respond to the susceptibility of the entity's financial statements to material misstatement due to fraud.

Communication among the engagement team members about the risks of material misstatement due to fraud should continue throughout the audit, particularly upon discovery of new facts during the audit.

5.130 Paragraph .A12 of AU-C section 240 states that discussing the susceptibility of the entity's financial statements to material misstatement due to fraud with the engagement team

- provides an opportunity for more experienced engagement team members to share their insights about how and where the financial statements may be susceptible to material misstatement due to fraud.
- enables the auditor to consider an appropriate response to such susceptibility and to determine which members of the engagement team will conduct certain audit procedures.
- permits the auditor to determine how the results of audit procedures will be shared among the engagement team and how to deal with any allegations of fraud that may come to the auditor's attention during the audit.

5.131 In addition, paragraph .A13 of AU-C section 240 states the discussion may include the following matters:

- A consideration of management's involvement in overseeing employees with access to cash or other assets susceptible to misappropriation
- A consideration of any unusual or unexplained changes in behavior or lifestyle of management or employees that have come to the attention of the engagement team
- A consideration of the types of circumstances that, if encountered, might indicate the possibility of fraud

- A consideration of how an element of unpredictability will be incorporated into the nature, timing, and extent of the audit procedures to be performed
- A consideration of the audit procedures that might be selected to respond to the susceptibility of the entity's financial statements to material misstatement due to fraud and whether certain types of audit procedures are more effective than others
- A consideration of any allegations of fraud that have come to the auditor's attention

A number of factors may influence the extent of the discussion and how it may occur. For example, if the audit involves more than one location, there could be multiple discussions with team members in differing locations. Another factor in planning the discussions is whether to include specialists assigned to the audit team.

5.132 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.

Risk Assessment Procedures and Related Activities

5.133 When performing risk assessment procedures and related activities to obtain an understanding of the entity and its environment, including the entity's internal control, required by AU-C section 315, paragraph .16 of AU-C section 240 states that the auditor should perform the procedures in paragraphs .17–.24 of AU-C section 240 to obtain information for use in identifying the risk of material misstatement due to fraud. As part of this work, the auditor should perform the following procedures:

a. Hold fraud discussions with management, others within the entity, and those charged with governance (unless all those charged with governance are involved in managing the entity). See specific inquiries the auditor should make in paragraphs .17–.19 and .21 of AU-C section 240.

b. Obtain an understanding of how those charged with governance exercise oversight of management's process for identifying and responding to the risks of fraud in the entity and the internal control that management has established to mitigate these risks, unless all those charged with governance are involved in managing the entity. (See paragraphs .20 and .A21–.A23 of AU-C section 240.)

c. Evaluate whether unusual or unexpected relationships that have been identified (based on analytical procedures performed as part of risk assessment procedures) indicate risks of material misstatement due to fraud. (See paragraphs .22, .A24–.A26, and .A46 of AU-C section 240.)

d. Consider whether other information obtained by the auditor indicates risks of material misstatement due to fraud. (See further application guidance in paragraph .A27 of AU-C section 240.)

e. Evaluate whether the information obtained from the risk assessment procedures and related activities performed indicates that one or more fraud risk factors are present. (See paragraphs .24 and .A28–.A32 of AU-C section 240.)

Evaluation of Fraud Risk Factors

5.134 As indicated in paragraph 5.133*e*, the auditor may identify events or conditions that indicate incentives and pressures to perpetrate fraud, opportunities to carry out the fraud, or attitudes and rationalizations to justify a fraudulent action. Such events or conditions are referred to as *fraud risk factors*. Although fraud risk factors may not necessarily indicate the existence of fraud, paragraph .24 of AU-C section 240 states that they have often been present in circumstances in which frauds have occurred and, therefore, may indicate risks of material misstatement due to fraud.

5.135 Paragraph .A31 of AU-C section 240 states that the size, complexity, and ownership characteristics of the entity have a significant influence on the consideration of relevant fraud risk factors. Additional fraud risk factor considerations on large and smaller, less complex entities can be found in paragraphs .A31–.A32 of AU-C section 240.

5.136 Appendix A, "Examples of Fraud Risk Factors," of AU-C section 240 identifies examples of fraud risk factors that may be faced by auditors in a broad range of situations. 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.

Identification and Assessment of the Risks of Material Misstatement Due to Fraud

5.137 In accordance with AU-C section 315, paragraph .25 of AU-C section 240 states that the auditor should identify and assess the risks of material misstatement due to fraud at the financial statement level, and at the assertion level for classes of transactions, account balances, and disclosures.[29] The auditor's risk assessment should be ongoing throughout the audit, following the initial assessment.

5.138 Paragraph .26 of AU-C section 240 states that when identifying and assessing the risks of material misstatement due to fraud, the auditor should, based on a presumption that risks of fraud exist in revenue recognition, evaluate which types of revenue, revenue transactions, or assertions give rise to such risks. Paragraph .46 of AU-C section 240 specifies the documentation required when the auditor concludes that the presumption is not applicable in the circumstances of the engagement and, accordingly, has not identified revenue recognition as a risk of material misstatement due to fraud. (See paragraphs .A33–.A35 of AU-C section 240 for application guidance of fraud risks in revenue recognition.[30])

Considerations for Audits Performed in Accordance With PCAOB Standards[31]

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

[30] 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*.

[31] See footnote 2.

PCAOB Staff Audit Practice Alert No. 12, *Matters Related to Auditing Revenue in an Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400.12), highlights certain requirements of PCAOB standards relating to aspects of auditing revenue in which significant auditing deficiencies have been frequently observed by PCAOB Inspections staff. More specifically, the alert addresses, among other topics, responding to the risks of material misstatement due to fraud associated with revenue.

5.139 Paragraph .27 of AU-C section 240 states that the auditor should treat those assessed risks of material misstatement due to fraud as significant risks and, accordingly, to the extent not already done so, the auditor should obtain an understanding of the entity's related controls, including control activities, relevant to such risks, including the evaluation of whether such controls have been suitably designed and implemented to mitigate such fraud risks. (See paragraphs .A36–.A37 of AU-C section 240 for application guidance on identifying and assessing the risks of material misstatement due to fraud and understanding the entity's related controls.)

Responses to the Assessed Risks of Material Misstatement Due to Fraud

Overall Responses

5.140 In accordance with AU-C section 330, paragraphs .28–.29 of AU-C section 240 state that the auditor should determine overall responses to address the assessed risks of material misstatement due to fraud at the financial statement level. Accordingly, the auditor should

a. assign and supervise personnel, taking into account the knowledge, skill and ability of the individuals to be given significant engagement responsibilities and the auditor's assessment of the risks of material misstatement due to fraud for the engagement;

b. evaluate whether the selection and application of accounting policies by the entity, particularly those related to subjective measurements and complex transactions, may be indicative of fraudulent financial reporting resulting from management's effort to manage earnings, or a bias that may create a material misstatement; and

c. incorporate an element of unpredictability in the selection of the nature, timing, and extent of audit procedures.

See paragraphs .A38–.A42 of AU-C section 240 for additional application guidance on overall responses to the assessed risks of material misstatement due to fraud.

Audit Procedures Responsive to Assessed Risks of Material Misstatement Due to Fraud at the Assertion Level

5.141 In accordance with AU-C section 300, paragraph .30 of AU-C section 240 states that the auditor should design and perform further audit procedures whose nature, timing, and extent are responsive to the assessed risks of material misstatement due to fraud at the assertion level (See paragraphs .A43–.A46 for further application guidance.).

Audit Procedures Responsive to Risks Related to Management Override of Controls

5.142 Even if specific risks of material misstatement due to fraud are not identified by the auditor, paragraph .32 of AU-C section 240 states that a possibility exists that management override of controls could occur. Accordingly, the auditor should address the risk of management override of controls apart from any conclusions regarding the existence of more specifically identifiable risks by designing and performing audit procedures to

a. test the appropriateness of journal entries recorded in the general ledger and other adjustments made in preparation of the financial statements, including entries posted directly to financial statement drafts,

b. review accounting estimates for biases and evaluate whether the circumstances producing the bias, if any, represent a risk of material misstatement due to fraud, and

c. evaluate, for significant transactions that are outside the normal course of business for the entity or that otherwise appear to be unusual given the auditor's understanding of the entity and its environment and other information obtained during the audit, whether the business rationale (or lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriate of assets.

5.143 *Other audit procedures*. Paragraph .33 of AU-C section 240 states that the auditor should determine whether, in order to respond to the identified risks of management override of controls, the auditor needs to perform other audit procedures in addition to those specifically referred to previously (that is, when specific additional risks of management override exist that are not covered as part of the procedures performed to address the requirements in paragraph .32 of AU-C section 240.

Evaluation of Audit Evidence

5.144 Paragraphs .34–.37 and .A56–.A62 of AU-C section 240 provide requirements and application guidance for evaluating audit evidence. As stated in paragraph .34 of AU-C section 240, the auditor should evaluate, at or near the end of the audit, whether the accumulated results of auditing procedures, including analytical procedures, that were performed as substantive tests or when forming an overall conclusion, affect the assessment of the risks of material misstatement due to fraud made earlier in the audit or indicate a previously unrecognized risk of material misstatement due to fraud.

5.145 Paragraph .35 of AU-C section 240 states that, if the auditor identifies a misstatement, the auditor should evaluate whether such a misstatement is indicative of fraud. If such an indication exists, the auditor should evaluate the implications of the misstatement with regard to other aspects of the audit, particularly the auditor's evaluation of materiality, management and employee integrity, and the reliability of management representations, recognizing that an instance of fraud is unlikely to be an isolated occurrence. Furthermore, paragraph .36 of AU-C section 240 states that, if the auditor identifies a misstatement, whether material or not, and the auditor has reason to believe that it is, or may be, the result of fraud and that management (in particular, senior management) is involved, the auditor should reevaluate the assessment of the risks of material misstatement due to fraud and its resulting effect on the nature, timing, and extent of audit procedures to respond to the assessed risks. The auditor should also consider whether circumstances or conditions indicate possible collusion involving employees, management, or third parties when reconsidering the reliability of evidence previously obtained.

5.146 Paragraph .A60 of AU-C section 240 states that the implications of identified fraud depend on the circumstances. For example, an otherwise insignificant fraud may be significant if it involves senior management. In such circumstances, the reliability of evidence previously obtained may be called into question because there may be doubts about the completeness and truthfulness of representations made and genuineness of accounting records and documentation. There may also be a possibility of collusion involving employees, management, or third parties.

5.147 Paragraph .37 of AU-C section 240 states that if the auditor concludes that, or is unable to conclude whether, the financial statements are materially misstated as a result of fraud, the auditor should evaluate the implications for the audit. AU-C sections 450 and 700 address the evaluation and disposition of misstatements and the effect on the auditor's opinion in the auditor's report.

Auditor Unable to Continue the Engagement

5.148 Paragraph .38 of AU-C section 240 states that, if, as a result of identified fraud or suspected fraud, the auditor encounters circumstances that bring into question the auditor's ability to continue performing the audit, the auditor should

a. determine the professional and legal responsibilities applicable in the circumstances, including whether a requirement exists for the auditor to report to the person or persons who engaged the auditor or, in some cases, to regulatory authorities;

b. consider whether it is appropriate to withdraw from the engagement, when withdrawal is possible under applicable law or regulation; and

c. if the auditor withdraws

  i. discuss with the appropriate level of management and those charged with governance the auditor's withdrawal from the engagement and the reasons for the withdrawal, and

  ii. determine whether a professional or legal requirement exists to report to the person or persons who engaged the auditor or, in some cases, to regulatory authorities, the auditor's withdrawal from the engagement and the reasons for the withdrawal.

Given the nature of the circumstances and the need to consider the legal requirements, paragraph .A65 of AU-C section 240 states that the auditor may consider it appropriate to seek legal advice when deciding whether to withdraw from an engagement and in determining an appropriate course of action, including the possibility of reporting to regulators or others.[32] For additional

[32] AU-C section 510, *Opening Balances—Initial Audit Engagements, Including Reaudit Engagements* (AICPA, *Professional Standards*), provides guidance on communications with an auditor replacing the existing auditor.

application guidance, including examples of circumstances that may arise and bring into question the auditor's ability to continue performing the audit, see paragraphs .A63–.A65 of AU-C section 240.

Communications to Management and With Those Charged With Governance

5.149 Paragraph .39 of AU-C section 240 states that, if the auditor has identified a fraud or has obtained information that indicates that a fraud may exist, the auditor should communicate these matters on a timely basis to the appropriate level of management in order to inform those with primary responsibility for the prevention and detection of fraud of matters relevant to their responsibilities. As stated in paragraph .A67 of AU-C section 240, this is true even if the matter might be considered inconsequential (for example, a minor defalcation by an employee at a low level in the entity's organization). Unless all of those charged with governance are involved in managing the entity, paragraphs .40–.41 of AU-C section 240 state that, if the auditor has identified or suspects fraud involving (*a*) management, (*b*) employees who have significant roles in internal control, or (*c*) others, when the fraud results in a material misstatement in the financial statements, the auditor should communicate these matters to those charged with governance on a timely basis. If the auditor suspects fraud involving management, the auditor should communicate these suspicions to those charged with governance and discuss with them the nature, timing, and extent of audit procedures necessary to complete the audit. In addition, the auditor should communicate with those charged with governance any other matters related to fraud that are, in the auditor's professional judgment, relevant to their responsibilities. See paragraphs .A68–.A71 of AU-C section 240 for further application guidance concerning communications with those charged with governance.

Communications to Regulatory and Enforcement Authorities

5.150 If the auditor has identified or suspects a fraud, paragraph .42 of AU-C section 240 states that the auditor should determine whether the auditor has a responsibility to report the occurrence or suspicion to a party outside the entity. Although the auditor's professional duty to maintain the confidentiality of client information may preclude such reporting, the auditor's legal responsibilities may override the duty of confidentiality in some circumstances.

Documentation

5.151 Paragraphs .43–.46 of AU-C section 240 address requirements on certain items and events to be documented by the auditor in relation to assessed risks of material misstatement due to fraud.

Compliance With Laws and Regulations

5.152 AU-C section 250, *Consideration of Laws and Regulations in an Audit of Financial Statements* (AICPA, *Professional Standards*), addresses the auditor's responsibility to consider laws and regulations in an audit of financial statements. However, it does not apply to other assurance engagements in which the auditor is specifically engaged to test and report separately on compliance with specific laws and regulations.[33]

Responsibility for Compliance With Laws and Regulations

Responsibility of Management

5.153 In accordance with paragraph .03 of AU-C section 250, it is the responsibility of management, with the oversight of those charged with governance, to ensure that the entity's operations are conducted in accordance with the provisions of laws and regulations, including compliance with the provisions of laws and regulations that determine the reported amounts and disclosures in an entity's financial statements.

Responsibility of the Auditor

5.154 The requirements in AU-C section 250 are designed to assist the auditor in identifying material misstatement of the financial statements due to noncompliance with laws and regulations. However, paragraph .04 of AU-C section 250 recognizes that the auditor is not responsible for preventing noncompliance and cannot be expected to detect noncompliance with all laws and regulations. For purposes of discussion in AU-C section 250, the term *noncompliance* is defined as acts of omission or commission by the entity, either intentional or unintentional, which are contrary to the prevailing laws or regulations.

5.155 The auditor is responsible for obtaining reasonable assurance that the financial statements as a whole are free from material misstatement, whether caused by fraud or error.[34] In conducting an audit of financial statements, the auditor takes into account the applicable legal and regulatory framework. Because of the inherent limitations of an audit, an unavoidable risk exists that some material misstatements in the financial statements may not be detected, even though the audit is properly planned and performed in accordance with GAAS.[35] In the context of laws and regulations, the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for the reasons set forth in paragraph .05 of AU-C section 250. Paragraph .05 of AU-C section 250 further states that the further removed noncompliance is from the events and transactions reflected in the financial statements, the less likely the auditor is to become aware of, or recognize, the noncompliance.

5.156 Paragraph .06 of AU-C section 250 distinguishes the auditor's responsibilities regarding compliance with the following two categories of laws and regulations:

a. The provisions of those laws and regulations generally recognized to have a direct effect on the determination of material amounts and disclosures in the financial statements, such as tax and pension laws and regulations (see paragraph 5.157)

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[33] AU-C section 935, *Compliance Audits* (AICPA, *Professional Standards*), is applicable when an auditor is engaged, or required by law or regulation, to perform a compliance audit in accordance with GAAS, the standards for financial audits under *Government Auditing Standards*, and a governmental audit requirement that requires an auditor to express an opinion on compliance.

[34] Paragraph .12 of AU-C section 200.

[35] Paragraph .A49 of AU-C section 200.

b. The provisions of other laws and regulations that do not have a direct effect on the determination of the amounts and disclosures in the financial statements but compliance with which may be

i. fundamental to the operating aspects of the business,

ii. fundamental to an entity's ability to continue its business, or

iii. necessary for the entity to avoid material penalties

(for example, compliance with the terms of an operating license, regulatory solvency requirements, or environmental regulations); therefore, noncompliance with such laws and regulations may have a material effect on the financial statements (see paragraphs 5.158–.160).

The Auditor's Consideration of Compliance With Laws and Regulations

5.157 Paragraph .A9 of AU-C section 250 states that certain laws and regulations are well established, known to the entity and within the entity's industry or sector, and relevant to the entity's financial statements. These laws and regulations generally are directly relevant to the determination of material amounts and disclosures in the financial statements and readily evident to the auditor. They could include those that relate to, for example

- tax laws affecting accruals and the amount recognized as expense in the accounting period.
- certain laws and regulations placing 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.

For such laws and regulations, paragraph .13 of AU-C section 250 states that the auditor should obtain sufficient appropriate audit evidence regarding material amounts and disclosures in the financial statements that are determined by the provisions of those laws and regulations (see paragraph 5.156*a*).

Procedures to Identify Instances of Noncompliance—Other Laws and Regulations

5.158 As discussed in paragraphs .A12–.A14 of AU-C section 250, certain other laws and regulations may need particular attention by the auditor because they have a fundamental effect on the operations of the entity. Noncompliance with laws and regulations that have a fundamental effect on the operations of the entity may cause the entity to cease operations or call into question the entity's continuance as a going concern (for example, noncompliance with capital or investment requirements).

5.159 In addition, many laws and regulations relating principally to an institution's operating aspects do not directly affect the financial statements (their financial statement effect is indirect) and are not captured by the entity's information systems relevant to financial reporting. Their indirect effect may result from the need to disclose a contingent liability because of the allegation or determination of identified or suspected noncompliance. Those other laws or regulations may include those related to securities trading, occupational safety and health, food and drug administration, environmental protection, equal employment opportunities, and price-fixing or other antitrust violations.

5.160 For these other such laws and regulations, paragraph .14 of AU-C section 250 states that the auditor should perform the following audit procedures that may identify instances of noncompliance with other laws and regulations that may have a material effect on the financial statements (see paragraph 5.156*b*):

a. Inquiring of management and, when appropriate, those charged with governance about whether the entity is in compliance with such laws and regulations

b. Inspecting correspondence, if any, with the relevant licensing or regulatory authorities (additional application and explanatory material can be found at paragraph .A16 of AU-C section 250)

However, even when those procedures are performed, the auditor may not become aware of the existence of noncompliance unless there is evidence of noncompliance in the records, documents, or other information normally inspected in an audit of financial statements.

Noncompliance Brought to the Auditor's Attention By Other Audit Procedures

5.161 During the audit, paragraph .15 of AU-C section 250 states that the auditor should remain alert to the possibility that other audit procedures applied may bring instances of noncompliance or suspected noncompliance with laws and regulations to the auditor's attention. For example, paragraph .A17 of AU-C section 250 states that such audit procedures may include reading minutes; inquiring of the institution's management and in-house or external legal counsel concerning litigation, claims, and assessments; performing substantive tests of details of classes of transactions, account balances, or disclosures.

5.162 Further discussion regarding audit procedures when noncompliance is identified or suspected, reporting of identified or suspected noncompliance, and documentation requirements can be found in paragraphs .17–.28 of AU-C section 250.

Going-Concern Considerations[36]

5.163 AU-C section 570A, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*), addresses the auditor's responsibilities in an audit of financial statements with respect to evaluating whether there is substantial doubt about the entity's ability to continue as a going concern. This section applies to all audits of financial statements, regardless of whether the financial statements are prepared in accordance with a general purpose or a special purpose framework. This section does not apply to an audit of financial statements based on the assumption of liquidation (for example, when [*a*] an entity is in the process of liquidation, [*b*] the

[36] FASB ASU No. 2014-15, *Presentation of Financial Statements—Going Concern (Subtopic 205-40) (Topic 205): Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern*, issued in August 2014, requires management to assess an entity's ability to continue as a going concern by incorporating and expanding upon certain principles that are currently in U.S. auditing standards. Specifically, the amendments (1) provide a definition of the term *substantial doubt*, (2) require an evaluation every reporting period including interim periods, (3) provide principles for considering the mitigating effect of management's plans, (4) require certain disclosures when substantial doubt is alleviated as a result of consideration of management's plans, (5) require an express statement and other disclosures when substantial doubt is not alleviated, and (6) require an assessment for a period of one year after the date that the financial statements are issued (or available to be issued).

owners have decided to commence dissolution or liquidation, or [*c*] legal proceedings, including bankruptcy, have reached a point at which dissolution or liquidation is probable). 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.

> *Considerations for Audits Performed in Accordance With PCAOB Standards*[37]
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> PCAOB Staff Audit Practice Alert No. 13, *Matters Related to the Auditor's Consideration of a Company's Ability to Continue as a Going Concern* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400.13), addresses the professional standards applicable to the auditor's evaluation of a company's ability to continue as a going concern in light of recent changes to GAAP. The alert specifically highlights that in addition to adhering to the existing requirements in the PCAOB's interim auditing standard AS 2415, *Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *PCAOB Standards and Related Rules*), auditors should assess management's going concern evaluation in accordance with the requirements of the applicable financial reporting framework.

5.164 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 of this guide includes a discussion of regulatory capital requirements for banks and savings institutions and such requirements for credit unions are discussed in chapter 2 of this guide.

Evaluating Whether Substantial Doubt Exists

5.165 In accordance with paragraph .08 of AU-C section 570A, the auditor should evaluate whether there is substantial doubt about an entity's ability to continue as a going concern for a *reasonable period of time* (defined in AU-C section 570A as a period of time not to exceed one year beyond the date of the financial statements being audited) based on the results of the audit procedures.

5.166 When the applicable financial reporting framework includes a definition of *substantial doubt about an entity's ability to continue as a going concern*, Interpretation No. 1, "Definition of *Substantial Doubt About an Entity's Ability to Continue as a Going Concern*" (AICPA, *Professional Standards*, AU-C sec. 9570A par. 01–.02), of AU-C section 570A states that definition would be used by the auditor when applying the requirements of AU-C section 570A. Interpretation No. 2, "Definition of *Reasonable Period of Time*" (AICPA, *Professional Standards*, AU-C sec. 9570A par. 03–.05), of AU-C section 570A provides guidance on how an auditor should apply the term *reasonable period of time* when the applicable financial reporting framework requires management to evaluate whether there are conditions and events that raise substantial doubt for a period of time greater than one year from the date of the financial statements. Specifically, Interpretation No. 2 states that the auditor's assessment of

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[37] See footnote 2.

management's going concern evaluation would be for the same period of time as required by the applicable financial reporting framework.

Identifying Conditions or Events That Indicate Substantial Doubt Could Exist

5.167 As stated in paragraph .09 of AU-C section 570A, the auditor should consider whether the results of procedures performed during the course of 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. The auditor should consider the need 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.

5.168 Paragraph .A1 of AU-C section 570A states that it is not necessary to design audit procedures solely to identify conditions or 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. The results of audit procedures designed and performed to identify and assess risk in accordance with AU-C section 315, gather audit evidence in response to assessed risks in accordance with AU-C section 330, and complete the audit are expected to be sufficient for that purpose. The following are examples of procedures normally performed in audits of the financial statements of financial 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 stockholders, 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 loans maturing in less than one year and entity's ability to refinance or pay off the loan
- Review of reports of significant examinations and related communications between examiners and the institution
- Review of compliance with regulatory capital requirements

5.169 In performing such audit procedures as noted previously, paragraph .A2 of AU-C section 570A states that the auditor may identify information about certain conditions or 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. The significance of such conditions or events will depend on the circumstances, and some conditions or events 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

Considerations of Management's Plans When the Auditor Believes There Is Substantial Doubt

5.170 If, after considering the identified conditions or events in the aggregate, the auditor believes that there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, paragraph .10 of AU-C section 570A states that the auditor should obtain information about management's plans that are intended to mitigate the adverse effects of such conditions or events. The auditor should

a. assess whether it is likely that the adverse effects would be mitigated by management's plans for a reasonable period of time;

b. identify those elements of management's plans that are particularly significant to overcoming the adverse effects of the conditions or events and plan and perform procedures to obtain audit evidence about them, including, when applicable, considering the adequacy of support regarding the ability to obtain additional financing or the planned disposal of assets; and

c. assess whether it is likely that such plans can be effectively implemented.

5.171 When prospective financial information is particularly significant to management's plans, paragraph .11 of AU-C section 570A states that the auditor should request management to provide that information and should consider the adequacy of support for significant assumptions underlying that information. The auditor should give particular attention to assumptions that are

- material to the prospective financial information.
- especially sensitive or susceptible to change.
- inconsistent with historical trends.

The auditor's consideration should be based on knowledge of the entity, its business, and its management and should include (*a*) reading the prospective financial information and the underlying assumptions and (*b*) comparing prospective financial information from prior periods with actual results and comparing prospective information for the current period with results achieved to date. If the auditor becomes aware of factors, the effects of which are not reflected in such prospective financial information, the auditor should discuss those factors with management and, if necessary, request revisions of the prospective financial information.

Consideration of Financial Statement Effects

5.172 Paragraph .12 of AU-C section 570A states that when, after considering management's plans, the auditor concludes that there is substantial doubt about the entity'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. In considering the adequacy of disclosure, paragraph .A4 of AU-C section 570A states that some of the information that might be disclosed includes the following:

- Principal conditions or 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
- The possible effects of such conditions or events
- Management's evaluation of the significance of those conditions or 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

5.173 When the auditor concludes, primarily because of the auditor's consideration of management's plans, that substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time has been alleviated, paragraph .13 of AU-C section 570A states that the auditor should consider the need for, and evaluate the adequacy of, disclosure of the principal conditions or events that initially caused the auditor to believe there was substantial doubt. 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 of this guide for a discussion of necessary communications with regulators.) Chapter 23 of this guide includes an illustration of a report that includes such an emphasis-of-matter paragraph.

5.174 When the applicable financial reporting framework provides disclosure requirements related to management's evaluation of substantial doubt, Interpretation No. 4, "Consideration of Financial Statement Effects" (AICPA, *Professional Standards*, AU-C sec. 9570A par. 09–.10), of AU-C section 570A states that the auditor's assessment of the financial statement effects under AU-C section 570A would be based on the disclosure requirements of the applicable financial reporting framework.

Written Representations

5.175 If the auditor believes, before consideration of management's plans pursuant to paragraph .10 of AU-C section 570A (see paragraph 5.170), there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, paragraph .14 of AU-C section 570A states that the auditor should obtain written representations from management

a. regarding its plans that are intended to mitigate the adverse effects of conditions or events that indicate there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time and the likelihood that those plans can be effectively implemented, and *b.* that the financial statements disclose all the matters of which management is aware that are relevant to the entity's ability to continue as a going concern, including principal conditions or events and management's plans.

Consideration of the Effects on the Auditor's Report

5.176 Paragraphs .15–.16 of AU-C section 570A state that, 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 auditor should include an emphasis-of-matter paragraph[38] in the auditor's report to reflect that conclusion. 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. In a going concern emphasis-of-matter 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 going concern. Paragraph .A6 of AU-C section 570A provides an illustration of a going-concern emphasis-of-matter paragraph.

5.177 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.

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

Documentation

5.179 If the auditor believes, before consideration of management's plans pursuant to paragraph .10 of AU-C section 570A (see paragraph 5.170), there is substantial doubt about the ability of the entity to continue as a going concern for a reasonable period of time, paragraph .22 of AU-C section 570A states that the auditor should document the following:

- The conditions or events that led the auditor 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 to evaluate the significant elements of management's plans and evidence obtained.

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[38] Paragraphs 23.07–.13 of this guide address requirements concerning emphasis-of-matter paragraphs.

- 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 is 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 and, if applicable, the adequacy of disclosure of the principal conditions and events that initially caused the auditor to believe there was substantial doubt.
- The auditor's conclusion with respect to the effects on the auditor's report.

Going-Concern Considerations[39]

Statement on Auditing Standards (SAS) No. 132, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, AU-C sec. 570), addresses the auditor's responsibilities in the audit of financial statements relating to the entity's ability to continue as a going concern and the implications for the auditor's report. This SAS applies to all audits of a complete set of financial statements, regardless of whether the financial statements are prepared in accordance with a general purpose or a special purpose framework. As explained in paragraph A1 of SAS No. 132, the applicable financial reporting framework might contain explicit requirements regarding when the liquidation basis of accounting is appropriate. For example, FASB ASC requires that if and when the entity's liquidation becomes imminent financial statements should be prepared under the liquidation basis of accounting. Accordingly, this SAS does not apply to an audit of a complete set of general purpose financial statements prepared under the liquidation basis of accounting. 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.

> *Considerations for Audits Performed in Accordance With PCAOB Standards*[40]
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> PCAOB Staff Audit Practice Alert No. 13, *Matters Related to the Auditor's Consideration of a Company's Ability to Continue as a Going Concern* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400.13), addresses the professional standards applicable to the auditor's evaluation of a company's ability to continue as a going concern in light of recent changes to GAAP. The alert specifically highlights that in addition to adhering to the existing requirements in the PCAOB's interim auditing standard AS 2415,

[39] Statement on Auditing Standards (SAS) No. 132, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, AU-C sec. 570), was issued in February 2017. This SAS is effective for audits of financial statements for periods ending on or after December 15, 2017.

[40] See footnote 2.

Consideration of an Entity's Ability to Continue as a Going Concern (AICPA, *PCAOB Standards and Related Rules*), auditors should assess management's going concern evaluation in accordance with the requirements of the applicable financial reporting framework.

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 of this guide includes a discussion of regulatory capital requirements for banks and savings institutions and such requirements for credit unions are discussed in chapter 2 of this guide.

Risk Assessment Procedures and Related Activities

Conditions or Events That Raise Substantial Doubt About an Entity's Ability to Continue as a Going Concern

When performing risk assessment procedures as required by AU-C section 315, paragraph 12 of SAS No. 132 states that the auditor should consider whether there are conditions or events, considered in the aggregate, that raise substantial doubt about an entity's ability to continue as a going concern for a *reasonable period of time*.[41] In doing so, the auditor should determine whether management has performed a preliminary evaluation of whether such conditions or events exist:

a. If such an evaluation has been performed, the auditor should discuss the evaluation with management and determine whether management has identified conditions or events that raise substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time and, if so, understand management's plans to address them.

b. If such an evaluation has not yet been performed, the auditor should discuss with management the basis for the intended use of the going concern basis of accounting and inquire of management whether conditions or events exist that raise substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time.

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

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[41] For purposes of SAS No. 132, a *reasonable period of time* is defined as the period of time required by the applicable financial reporting framework or, if no such requirement exists, within one year after the date that the financial statements are issued (or within one year after the date that the financial statements are available to be issued, when applicable).

- Indications of strained relationships between management and regulatory authorities

As explained in paragraph A7 of SAS No. 132, the existence of one or more of these conditions or events does not establish that there is substantial doubt about the entity's ability to continue as a going concern. Similarly, the absence of these conditions or events does not establish that there is no substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time. Determining whether there is substantial doubt depends on an assessment of relevant conditions and events, in the aggregate, that are known and reasonably knowable at the date that the financial statements are issued (or at the date the financial statements are available to be issued, when applicable). An entity should weigh the likelihood and magnitude of the potential effects of the relevant conditions and events and consider their anticipated timing.

Remaining Alert Throughout the Audit for Audit Evidence About Conditions or Events

Paragraph 13 of SAS No. 132 states that the auditor should remain alert throughout the audit for audit evidence of conditions or events that raise substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time.

Management's Evaluation and Supporting Analysis, and the Auditor's Evaluation

Paragraph 14 of SAS No. 132 states that the auditor's evaluation should

a. address management's evaluation of whether there are conditions or events, considered in the aggregate, that raise substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time.

b. cover the same period as that used by management in its evaluation as required by the applicable financial reporting framework.

c. include consideration of whether management's evaluation includes all relevant information on which the auditor is aware as a result of the audit.

Period Beyond Management's Evaluation

In accordance with paragraph 15 of SAS No. 132, the auditor should inquire of management regarding its knowledge of conditions or events beyond the period of management's evaluation that may have an effect on the entity's ability to continue as a going concern.

Additional Audit Procedures When Events or Conditions Are Identified

Paragraph 16 of SAS No. 132 states that the auditor should obtain sufficient appropriate audit evidence to determine whether conditions and events identified, considered in the aggregate, raise substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time by performing additional audit procedures, including consideration of mitigating factors. The procedures should include the following:

a. Requesting management to make an evaluation when management has not yet performed an evaluation

b. Evaluating management's plans in relation to its going concern evaluation, with regard to whether it is probable that

i. management's plans can be effectively implemented and

ii. the plans would mitigate the relevant conditions or events that raise substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time

c. When the entity has prepared a cash flow forecast, and analysis of the forecast is a significant factor in evaluating management's plans,

i. evaluating the reliability of the underlying data generated to prepare the forecast and

ii. determining whether there is adequate support for the assumptions underlying the forecast, which includes considering contradictory audit evidence

d. Considering whether any additional facts or information have become available since the date on which management made its evaluation

Audit procedures for financial institutions that may be relevant to performing the requirements in paragraph 16 of SAS No. 132 include the following:

- Analyzing and discussing cash flow, profit, and other relevant forecasts with management
- Analyzing and discussing the entity's latest available interim financial statements
- Reading the terms of debentures and loan agreements and determining whether any have been breached
- Reading minutes of the meetings of shareholders, those charged with governance, and relevant committees, for reference to financial difficulties
- Inquiring of an entity's legal counsel regarding the existence of litigation and claims and the reasonableness of management's evaluations of their outcome and the estimate of their financial implications
- Performing audit procedures regarding subsequent events to identify those that either mitigate or exacerbate substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time
- 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 loans maturing in less than one year and entity's ability to refinance or pay off the loan
- Review of reports of significant examinations and related communications between examiners and the institution
- Review of compliance with regulatory capital requirements

Paragraphs A29–A30 of SAS No. 132 explain that evaluating management's plans may include performing audit procedures that the auditor considers necessary in the circumstances regarding management's plans for future action, including, for example, its plans to liquidate assets, borrow money or restructure debt, reduce or delay expenditures, or increase capital. In addition to the procedures required in paragraph 16c, the auditor may compare

a. the prospective financial information used in recent prior periods with historical results and

b. the prospective financial information used in the current period with results achieved to date.

Financial Support by Third Parties or the Entity's Owner-Manager

When management's plans include financial support by third parties or the entity's owner-manager (hereinafter referred to as "supporting parties") and such support is necessary in supporting management's assertions about the entity's ability to continue as a going concern for a reasonable period of time the auditor should obtain sufficient appropriate audit evidence about the following:

a. The intent of such supporting parties to provide the necessary financial support, including written evidence of such intent, and

b. The ability of such supporting parties to provide the necessary financial support

The failure to obtain written evidence required by item (*a*) constitutes a lack of sufficient appropriate audit evidence regarding the intent of the supporting parties to provide financial support. Therefore, the auditor should conclude that management's plans are insufficient to alleviate the determination that substantial doubt exists about the entity's ability to continue as a going concern for a reasonable period of time.

Written Representations

If the auditor believes, before consideration of management's plans pursuant to paragraph 16 of SAS No. 132, that substantial doubt exists about the entity's ability to continue as a going concern for a reasonable period of time, paragraph 18 of SAS No. 132 states that the auditor should request the following written representations from management:

a. A description of management's plans that are intended to mitigate the adverse effects of conditions or events that indicate there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time and the probability that those plans can be effectively implemented

b. That the financial statements disclose all the matters of which management is aware that are relevant to the entity's ability to continue as a going concern for a reasonable period of time, including principal conditions or events and management's plans

Auditor Conclusions

Use of the Going Concern Basis of Accounting

In accordance with paragraph 19 of SAS No. 132, the auditor should evaluate whether sufficient appropriate audit evidence has been obtained and conclude on the appropriateness of management's use of the going concern basis of accounting, when relevant, in the preparation of the financial statements.

Substantial Doubt About the Entity's Ability to Continue as a Going Concern

Based on the audit evidence obtained, paragraph 20 of SAS No. 132 states that the auditor should conclude whether in the auditor's judgment there are conditions or events, considered in the aggregate, that raise substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time.

Adequacy of Disclosures When Conditions or Events Have Been Identified and Substantial Doubt Has Not Been Alleviated

If the auditor concludes that management's use of the going concern basis of accounting is appropriate in the circumstances but substantial doubt exists about an entity's ability to continue as a going concern for a reasonable period of time, paragraph 21 of SAS No. 132 states that the auditor should evaluate the adequacy of the financial statement disclosures as required by the applicable financial reporting framework. As explained in paragraphs A41–A42 of SAS No. 132, some financial reporting frameworks provide requirements about management's responsibilities to evaluate whether substantial doubt exists about an entity's ability to continue as a going concern for a reasonable period of time and provide explicit requirements about financial statement disclosures. For example, under FASB ASC, if, after considering management's plans, substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time is not alleviated—that is, substantial doubt exists—the entity is required to include a statement in the notes to the financial statements indicating that there is substantial doubt about the entity's ability to continue as a going concern within one year after the date that the financial statements are issued (or within one year after the date the financial statements are available to be issued, when applicable). Additionally, the entity is required to disclose information that enables users of the financial statements to understand

a. principal conditions or events that raised substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time.

b. management's evaluation of the significance of those conditions or events in relation to the entity's ability to meets its obligations.

c. management's plans that are intended to mitigate the conditions or events that raise substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time.

Adequacy of Disclosures When Conditions or Events Have Been Identified But Substantial Doubt Has Been Alleviated by Management's Plans

If conditions or events, considered in the aggregate, have been identified that raise substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time but, based on the audit evidence obtained, the auditor concludes that substantial doubt has been alleviated by management's plans, paragraph 22 of SAS No. 132 states that the auditor should evaluate the adequacy of the financial statement disclosures required by the applicable financial reporting framework. For example, as explained in paragraph A45 of SAS No. 132, FASB ASC states that, if substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time is alleviated as a result of consideration of management's plans, an entity should disclose in a note to the financial statements information that enables users of the financial statements to understand all of the following (or should refer to similar information disclosed elsewhere in the footnotes):

a. Principal conditions or events that raised substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time (before consideration of management's plans)

b. Management's evaluation of the significance of those conditions or events in relation to the entity's ability to meets its obligations

c. Management's plans that alleviated substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time

Paragraphs A46–A47 of SAS No. 132 explain that the auditor's evaluation about whether the financial statements achieve fair presentation includes the consideration of the overall presentation, structure, and content of the financial statements and whether the financial statements, including the related notes, represent the underlying transactions and events in a manner that achieves fair presentation. Depending on the facts and circumstances, the auditor may determine that additional disclosures are necessary to achieve fair presentation. In the absence of disclosures explicitly required by the applicable financial reporting framework that address management's evaluation of the entity's ability to continue as a going concern for a reasonable period of time, the auditor may consider the disclosure guidance set out in paragraphs A42–A46 of SAS No. 132 in considering whether the financial statements are fairly presented.

The auditor may have to communicate with the regulator to assist with the auditor's assessment. (Refer to chapter 1 of this guide for a discussion of necessary communications with regulators.) Chapter 23 of this guide includes an illustration of a report that includes such an emphasis-of-matter paragraph.

Implications for the Auditor's Report

Use of Going Concern Basis of Accounting Is Inappropriate

If the financial statements have been prepared using the going concern basis of accounting but, in the auditor's judgment management's use of the going concern basis of accounting in the preparation of the financial statements is inappropriate, paragraph 23 of SAS No. 132 states that the auditor should express an adverse opinion.

Use of the Going Concern Basis of Accounting Is Appropriate But Conditions and Events Have Been Identified

Paragraph 24 of SAS No. 132 states that, if, after considering identified conditions or 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 auditor should include an emphasis-of-matter paragraph in the auditor's report.[42] Paragraphs A52–A53 of SAS No. 132 provide illustrations of going-concern emphasis-of-matter paragraphs.

If conditions or events, considered in the aggregate, have been identified that raise substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time but, based on the audit evidence obtained, the auditor concludes that substantial doubt has been alleviated by management's plans, paragraph A54 of SAS No. 132 explains that the auditor may include an emphasis-of-matter paragraph in accordance with AU-C section 706, *Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor's Report* (AICPA, *Professional Standards*), making reference to management's disclosures related to the conditions and events and management's plans related to those conditions and events. Paragraph A55 of SAS No. 132 provides an illustration of an emphasis-of-matter paragraph when management has disclosed (*a*) conditions or events, considered in the aggregate, that raised substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time; (*b*) its evaluation of the significant of those conditions or events, considered in the aggregate, in relation to the entity's ability to meets its obligations; and (*c*) that the substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time has been alleviated by management's plans.

As stated in paragraph 25 of SAS No. 132 the emphasis-of-matter paragraph about the entity's ability to continue as a going concern for a reasonable period of time should be expressed through the use of terms consistent with those included in the applicable financial reporting framework. In a going concern emphasis-of-matter paragraph, the auditor should not use conditional language concerning the existence of substantial doubt about the entity's ability to continue as going concern for a reasonable period of time.

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.

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

Adequate Disclosure About an Entity's Ability to Continue as a Going Concern Is Not Made in the Financial Statements

If adequate disclosure about an entity's ability to continue as a going concern for a reasonable period of time is not made in the financial statements, paragraph 26 of SAS No. 132 states that the auditor should express a qualified opinion or adverse opinion, as appropriate, in accordance with AU-C section 705.

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[42] Paragraphs 23.07–.13 of this guide address requirements concerning emphasis-of-matter paragraphs.

Management Unwilling to Perform or Extend Its Evaluation

If management is unwilling to perform or extend its evaluation to meet the period of time required by the applicable financial reporting framework when requested to do so by the auditor, paragraph 27 of SAS No. 132 states that the auditor should consider the implications for the auditor's report.

Documentation

If conditions or events are identified that, when considered in the aggregate, raise substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time before consideration of management's plans, paragraph 32 of SAS No. 132 states that the auditor should document the following:

a. The conditions or events that led the auditor to believe that there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time.

b. The elements of management's plans that the auditor considered to be particularly significant to overcoming the conditions or events, considered in the aggregate, that raise substantial doubt about the entity's ability to continue as a going concern, if applicable.

c. The auditing procedures performed to evaluate the significant elements of management's plans and evidence obtained, if applicable.

d. The auditor's conclusion regarding whether substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains or is alleviated. If substantial doubt remains, the auditor should also 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 should also document the conclusion as to the need for, and, if applicable, the adequacy of, disclosure of the principal conditions and events that initially caused the auditor to believe there was substantial doubt and management's plans that alleviated the substantial doubt.

e. The auditor's conclusion with respect to the effects on the auditor's report.

Written Representations

5.180 AU-C section 580, *Written Representations* (AICPA, *Professional Standards*), addresses the auditor's responsibility to obtain written representations from management and, when appropriate, those charged with governance in an audit of financial statements.

Written Representations as Audit Evidence

5.181 According to paragraphs .03–.04 of AU-C section 580, written representations are necessary information that the auditor requires in connection with the audit of the entity's financial statements. Accordingly, similar to responses to inquiries, written representations are audit evidence. Although written representations provide necessary audit evidence, they complement other auditing procedures and do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal. Furthermore, obtaining reliable written representations does not affect the nature or extent of other audit procedures that the auditor applies to obtain audit evidence about the fulfillment of management's responsibilities or about specific assertions.

Management From Whom Written Representations Are Requested

5.182 As explained in paragraph .A2 of AU-C section 580, written representations are requested from those 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, including the preparation and fair presentation of the financial statements. As such, in accordance with paragraph .09 of AU-C section 580, the auditor should request written representations from management with appropriate responsibilities for the financial statements and knowledge of the matters concerned.

5.183 Paragraph .A2 of AU-C section 580 further states that those individuals with overall responsibility may vary depending on the governance structure of the entity; however, management (rather than those charged with governance) is often the responsible party. Written representations may therefore be requested from the entity's chief executive officer and chief financial officer or other equivalent persons in entities that do not use such titles. In some circumstances, however, other parties, such as those charged with governance, also are responsible for the preparation and fair presentation of the financial statements.

Written Representations About Management's Responsibilities and Other Written Representations

5.184 Paragraphs .10–.18 of AU-C section 580 discuss matters the auditor should request management to provide written representation about such as preparation and fair presentation of the financial statements, information provided and completeness of transactions, fraud, laws and regulations, uncorrected misstatements, litigation an claims, estimates, related party transactions, and subsequent events. If, in addition to such required representations and those addressed in other AU-C sections,[43] the auditor determines that it is necessary to obtain one or more written representations to support other audit evidence relevant to the financial statements or one or more specific assertions in the financial statements, paragraph .19 of AU-C section 580 states that the auditor should request such other written representations.

5.185 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

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[43] As stated in paragraph .02 of AU-C section 580, *Written Representations* (AICPA, *Professional Standards*), exhibit D, "List of AU-C Sections Containing Requirements for Written Representations," lists other AU-C sections containing subject matter-specific requirements for written representations. The specific requirements for written representations of other AU-C sections do not limit the application of this section.

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.

5.186 Paragraph .A22 of AU-C section 580 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. Materiality may be different for different representations. A discussion of materiality may be included explicitly in the representation letter in either qualitative or quantitative terms. Materiality considerations do not apply to those representations that are not directly related to amounts included in the financial statements (for example, management's representations about the premise underlying the audit). In addition, because of the possible effects of fraud on other aspects of the audit, materiality would not apply to management's acknowledgment regarding its responsibility for the design, implementation, and maintenance of internal control to prevent and detect fraud.

Date of, and Period(s) Covered by, Written Representations

5.187 Paragraph .20 of AU-C section 580 states that the date of the written representations should be as of the date of the auditor's report on the financial statements. The written representations should be for all financial statements and period(s) referred to in the auditor's report.

Form of Written Representations

5.188 In accordance with paragraph .21 of AU-C section 580, the written representations should be in the form of a representation letter addressed to the auditor.

Doubt About the Reliability of Written Representations and Requested Written Representations Not Provided

5.189 Paragraph .25 of AU-C section 580 states that the auditor should disclaim an opinion on the financial statements in accordance with AU-C section 705 or withdraw from the engagement if

a. the auditor concludes that sufficient doubt exists about the integrity of management such that the written representations required by paragraphs .10–.11 of AU-C section 580 are not reliable or

b. management does not provide the written representations required by paragraphs .10–.11 of AU-C section 580.

Information Other Than Financial Statements

5.190 An institution may publish various documents that contain information in addition to audited financial statements and the auditor's report thereon. AU-C section 720, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*), addresses the auditor's responsibility with respect to other information in documents containing audited financial statements and the auditor's report thereon. In the absence of any separate requirement in the particular circumstances of the engagement, the auditor's opinion on the financial statements does not cover other information, and the auditor has no responsibility for determining whether such information is properly stated. This section establishes the requirement for the auditor to read the other information of which the auditor is aware because the credibility of the audited financial statements may be undermined by material inconsistencies between the audited financial statements and other information.

5.191 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-C section 725, *Supplementary Information in Relation to the Financial Statements as a Whole* (AICPA, *Professional Standards*), 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 section 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 section 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.

5.192 AU-C section 730, *Required Supplementary Information* (AICPA, *Professional Standards*), addresses the auditor's responsibility with respect to information that a designated accounting standards setter requires to accompany an entity's basic financial statements (hereinafter referred to as *required supplementary information*). In the absence of any separate requirement in the particular circumstances of the engagement, the auditor's opinion on the basic financial statements does not cover required supplementary information.

Certain Financial Reporting Matters

Disclosures of Certain Significant Risks and Uncertainties

5.193 FASB ASC 275-10-50-1[44] 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, including the activities in which the entity is currently engaged if principal operations have not commenced

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

c. Certain significant estimates

d. Current vulnerability due to certain concentrations

5.194 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 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.

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

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[44] See also paragraphs 1–2 of FASB ASC 825-10-55 for a discussion on concentrations involving loan product terms. The terms of certain loan products may increase a reporting entity's exposure to credit risk and thereby may result in a concentration of credit risk as that term is used in FASB ASC 825–10, either as an individual product type or as a group of products with similar features. Except as indicated in FASB ASC 825–10–50–22, FASB ASC 825–10–50–20 states that an entity should disclose all significant concentrations of credit risk arising from financial instruments, whether from an individual counterparty or groups of counterparties.

Certain Significant Estimates

5.196 As explained in FASB ASC 275-10-50-7, disclosures are required regarding estimates used in the determination of the carrying amounts of assets or liabilities or in disclosure of gain or loss contingencies, as described herein. FASB ASC 275-10-50-8 goes on to state that 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.

5.197 In accordance with FASB ASC 275-10-50-9, 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 also should include an estimate of the possible loss or range of loss, or state that such an estimate cannot be made.[45]

5.198 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.

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[45] 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 in FASB ASC 450-20–50–3 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

5.199 The following illustrates a paragraph that might be added to the illustrative disclosure in paragraph 5.198 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.[46]

5.200 The following illustrates a paragraph that might be added to the illustration in paragraph 5.198 to disclose an uncertainty that meets the 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.

5.201 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.

5.202 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 identifiable intangible assets (for example, depositor or borrower relationships)

5.203 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

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[46] 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.

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.[47] 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.

Current Vulnerability Due to Certain Concentrations

5.204 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 (as discussed in FASB ASC 855-10-25), 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.

5.205 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 of this guide, and elsewhere in this guide, FASB ASC 825, *Financial Instruments*, includes the disclosure provisions about concentrations of credit risk.[48]

5.206 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

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[47] 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.

[48] See footnote 44.

5.207 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.

5.208 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.

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

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

Segment Reporting

5.210 FASB ASC 280-10 provides guidance to public 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, *Segment Reporting*, for further discussion and detail regarding segment reporting requirements.

5.211 Per the FASB ASC glossary, a *public entity* is defined as a business entity or a not-for-profit entity that meets any of the following conditions:

- It has issued debt or equity securities or is 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).
- It is required to file financial statements with the SEC.
- It provides financial statements for the purpose of issuing any class of securities in a public market.

Regulation and Supervision of Depository Institutions

Introduction

5.212 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.[49]

5.213 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.

5.214 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

5.215 Paragraph .12 of AU-C section 315 indicates that auditors should obtain an understanding of relevant regulatory factors, including the applicable financial reporting framework. 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.

5.216 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.

5.217 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.

5.218 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

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[49] 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.

and to satisfy the credit needs of low- and moderate-income neighborhoods in institutions' local communities.

5.219 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.

5.220 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

5.221 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. 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.

5.222 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

5.223 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.

5.224 Federally insured financial institutions are required to have periodic full-scope, on-site examinations by the appropriate agency. In some cases the OCC 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.

5.225 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

5.226 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.

5.227 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.

5.228 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 Federal Reserve 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 five-point rating scale, with one being the highest possible rating.

Enforcement

5.229 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.

5.230 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 bank trading activities, 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.

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

5.232 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 million[50] 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.

5.233 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.

5.234 Due to the passage of Credit Union Membership Access Act of 1998 in 1998, the NCUA adopted stiffer net worth requirements and PCA regulations. Practitioners should understand these regulations and their effect on the credit union.

5.235 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.

5.236 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-National Credit Union

[50] Title 12 *U.S. Code* Section 1818(i)(2)(D).

Share Insurance Fund–insured credit union, the state regulator will usually involve the appropriate state or private insurer.

Planning

5.237 AU-C section 315 addresses the auditor's responsibility to identify and assess the risks of material misstatement in the financial statements through understanding the entity and its environment, including the entity's 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

5.238 AU-C section 240 addresses the auditor's responsibilities relating to fraud in an audit of financial statements. Specifically, it expands on how AU-C sections 315 and 330 are to be applied regarding risks of material misstatement due to 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.

5.239 In accordance with paragraph .A10 of AU-C section 250, the auditor's responsibility regarding misstatements resulting from noncompliance with laws and regulations having a direct effect on the determination of material amounts and disclosures in the financial statements is the same as that for misstatements caused by fraud or error. For purposes of AU-C section 250, *noncompliance* is defined as acts of omission or commission by the entity either intentional or unintentional, which are contrary to the prevailing laws or regulations. Such acts include transactions entered into by, or in the name of, the entity or on its behalf by those charged with governance, management, or employees. Noncompliance does not include personal misconduct (unrelated to the business activities of the entity) by those charged with governance, management, or employees of the entity.

Evaluation of Contingent Liabilities and Related Disclosures

5.240 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

5.241 Paragraphs 5.163–.179 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 PCA provisions of the FDI Act and the FCUA (see chapters 1 and 2 of this guide)

5.242 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 GAAP

5.243 General purpose financial statements are prepared in accordance with GAAP. Every national bank and savings and loan association, state member bank and state chartered savings and loan association, and insured state nonmember bank is required to file FFIEC Call Reports. Every federally insured credit union is required to file the NCUA 5300 Call Report. Call Reports (for example, FFIEC and NCUA) present an institution's financial condition and results of operations on a consolidated basis in accordance with 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 GAAP.

5.244 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 GAAP. Regulatory reporting topics noted herein are consistent with acceptable practices under GAAP. The Call Report 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 more detail, in the GAAP standards. Financial institutions are encouraged to discuss specific events and transactions not covered by GAAP or the guidance in the regulatory report instructions with their primary supervisory agency for more technical detail on the application of the GAAP accounting standards.

5.245 Appendix B, "Regulatory Reporting Matters—Interpretation and Reporting Related to U.S. GAAP," of this guide 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.

5.246 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 entry *allowance for loan and lease losses* in the "Glossary" section of the FFIEC's *Instructions for Preparation of Consolidated Reports of Condition and Income*, and the interagency policy statement on the ALLL.

5.247 Bank examiners will review the reasonableness of the range and management's best estimate within the range. The agencies find 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

5.248 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.

5.249 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 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 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.

5.250 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 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

5.251 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.

5.252 The auditor's attendance at other meetings between examiners and representatives of the institution is based on prior approval by the regulatory agency.

5.253 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 management.[51]

5.254 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. AU-C section 705 addresses how the form and content of the auditor's report is affected when the auditor expresses a modified opinion in the auditor's report. (For a detailed discussion on reports issued under the guidance of AU-C section 705, along with AU-C sections 700 and 706, *Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor's Report* [AICPA, *Professional Standards*], and related PCAOB requirements when performing integrated audits see chapter 23 of this guide.)

5.255 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.

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[51] 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.

5.256 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 should consider Interpretation No. 1, "Providing Access to or Copies of Audit Documentation to a Regulator" (AICPA, *Professional Standards*, AU-C sec. 9230 par. .01–.15), of AU-C section 230. The interpretation states when a regulator requests access to audit documentation pursuant to law, regulation, or audit contract, the auditor may take the following steps:

- Consider advising the client that the regulator has requested access to (and possibly copies of) the audit documentation and that the auditor intends to comply with such request.
- Make appropriate arrangements with the regulator for the review.
- Maintain control over the audit documentation.
- Consider submitting to the regulator a letter clarifying that an audit performed 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-C section 230.

In addition, the interpretation addresses situations in which an auditor has been requested by a regulator to provide access to the audit documentation 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.

5.257 Information in examination reports, inspection reports, and 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 of these types 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 identify 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.

Although fraud is a broad legal concept, for the purposes of GAAS, paragraph .03 of AU-C section 240, *Considerations of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*), states that the auditor is primarily concerned with fraud that causes a material misstatement in the 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.

Fraudulent Financial Reporting

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) the following:
   - *a.* High degree of competition or market saturation, accompanied by declining margins shown by the following:
     - 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 (ALLL)

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. Excessive pressure exists for management or operating personnel to meet financial targets established by those charged with governance, including incentive goals:

a. Unrealistically aggressive loan goals and lucrative incentive programs for loan originations, shown by the following, 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 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 party 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 predatory 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 ALLL

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 (DDAs)—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 write-offs

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

1. Known history of violations of securities laws or other laws and regulations, or claims against the entity, its senior management, or those charged with governance alleging fraud or violations of laws and regulations, such as the following:

   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, such as the following:
   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

Risk factors that relate to misstatements arising from the misappropriation of assets are also classified according to 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 when misstatements arising from misappropriation of assets occur. For example, ineffective monitoring of management and other deficiencies in internal control that are not effective may be present when 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

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 the following exist:
    - *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, misappropriation of assets may occur because the following exist:
    - *a.* Inadequate management oversight of employees responsible for assets, such as the following:
        - i. 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.

ii. 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.

iii. Lack of adherence or enforcement of vacation policy.

b. Inadequate job applicant screening and monitoring of employees, such as the following:

i. 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.

ii. 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 or independent checks, such as the following:

i. Lack of independent monitoring of activity in internal DDAs and correspondent bank accounts

ii. 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

iii. 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

iv. Lack of segregation of duties in the following areas:

(1) EFT—Origination, processing, confirmation, and recordkeeping

(2) 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.

(3) 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.)

(4) 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.)

(5) Fiduciary—Issuance, registration, transfer, cancellation, and recordkeeping

(6) Charged-off loan accounts and recoveries

(7) Dormant and inactive DDAs 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 re-underwritten 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 the following:

i. No verification of EFT initiation and authorization, including those instances in which bank employees initiate a transaction on a customer's behalf

ii. Frequent underwriting exceptions to board-established credit authorization limits

iii. Frequent instances of cash disbursements on loans that have not yet received all approvals or met all preconditions for funding

iv. 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 the following:

i. Lack of adequate physical security over the EFT operations area and customer records

ii. Failure to appropriately limit access to the vault to authorized employees acting within the scope of their job

iii. Lack of dual control over the vault, negotiable instruments (including travelers' checks and money orders), and blank-check stock

iv. Lack of accountability over negotiable instruments

k. Inadequate training of tellers and operations personnel regarding the following:

i. "Knowing your customer"

ii. Recognizing check fraud and kiting activities

iii. Controls over cash, negotiable instruments, and EFT

Attitudes and Rationalization

1. Disregard for the need for monitoring or reducing risks related to misappropriations of assets
2. Disregard for internal control over misappropriation of assets by overriding existing controls or by failing to take appropriate remedial action on known deficiencies in internal control
3. Behavior indicating displeasure or dissatisfaction with the entity or its treatment of the employee
4. Changes in behavior or lifestyle that may indicate assets have been misappropriated
5. The belief by some executives that their level of authority justifies a certain level of compensation and personal privileges
6. Tolerance of petty theft

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 the 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 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," of this guide. Other investments are discussed in chapter 12, "Other Assets, Other Liabilities, and Other Investments," of this guide. The fair value option for financial assets and liabilities under FASB ASC 825, *Financial Instruments*, is addressed in chapter 20, "Fair Value," of this guide.

CIPC 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. A discussion of cash equivalents can be found in paragraph 6.09.

Deposits With Other Financial Institutions

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

6.04 Many institutions also invest in nonnegotiable or negotiable certificates of deposit (CDs) of other depository institutions. These balances are generally interest bearing and insured up to $250,000[1] 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

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[1] 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 FDIC coverage limit applies per depositor, per insured depository institution, for each account ownership category.

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 FHLBs

6.06 Federal regulations require depository institutions to set aside specified amounts of cash as reserves against transaction accounts 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 (Federal Reserve) to effect monetary policy; by increasing or decreasing reserve requirements, the Federal Reserve can expand or contract the money supply. Depository institutions also may lend excess balances overnight and for short periods in the federal funds market.

Federal Funds Sold

6.07 Chapter 14, "Federal Funds and Repurchase Agreements," of this guide discusses federal funds and repurchase agreements, which can be either assets or liabilities, depending on which side of the transaction the institution participates.

Cash on Hand

6.08 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.

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). Other examples may include CDs.

6.10 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.

6.11 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 of this guide.

Classification of Cash Flows

Update 6-1 *Accounting and Reporting*: Statement of Cash Flows

FASB Accounting Standards Update (ASU) No. 2016-15, *Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments (a consensus of the Emerging Issues Task Force)*, issued in October 2016, is effective for fiscal years, including interim periods within those fiscal years, of a public business entity beginning after December 15, 2017. For all other entities, FASB ASU No. 2016-15 is effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years beginning after December 15, 2019. Early adoption is permitted, including adoption in an interim period. If an entity early adopts the amendments in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period. An entity that elects adoption must adopt all of the amendments in the same period.

FASB ASU No. 2016-15 addresses the following eight specific cash flow issues: Debt prepayment or debt extinguishment costs; settlement of zero-coupon debt instruments or other debt instruments with coupon interest rates that are insignificant in relation to the effective interest rate of the borrowing; contingent consideration payments made after a business combination; proceeds from the settlement of insurance claims; proceeds from the settlement of corporate-owned life insurance policies (including bank-owned life insurance policies); distributions received from equity method investees; beneficial interests in securitization transactions; and separately identifiable cash flows and application of the predominate principle.

This edition of the guide has not been updated to reflect changes as a result of this ASU, however, this section will be updated in a future edition. Readers are encouraged to consult the full text of this ASU on FASB's website at www.fasb.org.

6.12 FASB ASC 230, *Statement of Cash Flows*, presents standards 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.

Update 6-2 *Accounting and Reporting*: Restricted Cash

FASB ASU No. 2016-18, *Statement of cash Flows (Topic 230): Restricted Cash (a consensus of the Emerging Issues Task Force)*, issued in November 2016, is effective for fiscal years, including interim periods within those fiscal years, of a public business entity beginning after December 15, 2017.

For all other entities, FASB ASU No. 2016-18 is effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years beginning after December 15, 2019. Early adoption is permitted, including adoption in an interim period. If an entity early adopts the amendments in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period.

FASB ASU No. 2016-18 requires that a statement of cash flows explain the change during the period in total of cash, cash equivalents, and amount generally described as restricted cash or restricted cash equivalents. Therefore, amounts generally described as restricted cash and restricted cash equivalents should be included with cash and cash equivalents when reconciling the beginning-of-period and end-of-period total amounts shown on the statement of cash flows. This edition of the guide has not been updated to reflect changes as a result of this ASU, however, this section will be updated in a future edition. Readers are encouraged to consult the full text of this ASU on FASB's website at www.fasb.org.

6.13 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.

6.14 The cash equivalents policy is generally disclosed in the accounting policy footnote.

6.15 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.

Update 6-3 *Accounting and Reporting*: Credit Losses

FASB ASU No. 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*, issued in June 2016, is effective for fiscal years of public business entities that are SEC filers beginning after December 15, 2019, including interim periods within those fiscal years.

For all other public business entities, the amendments in FASB ASU No. 2016-13 are effective for fiscal years beginning after December 15, 2020, including interim periods within those fiscal years.

For all other entities, including not-for-profit entities and employee benefit plans within the scope of FASB ASC 960, *Plan Accounting—Defined Benefit Pension Plans*, through FASB ASC 965, *Plan Accounting—Health and Welfare Benefit Plans*, on plan accounting, FASB ASU No. 2016-13 is effective for fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021.

Early application is permitted for all entities as of the fiscal years beginning after December 15, 2018, including interim periods within those fiscal years.

FASB ASU No. 2016-13 creates FASB ASC 326, *Financial Instruments—Credit Losses*, to amend guidance on reporting credit losses for financial assets held at amortized cost basis and available-for-sale debt securities.

For financial assets held at amortized cost basis, FASB ASC 326 eliminates the probable initial recognition threshold in current U.S. generally accepted accounting principles (GAAP) and, instead, requires an entity to reflect its current estimate of all expected credit losses. The allowance for credit losses is a valuation account that is deducted from the amortized cost basis of the financial assets to present the net amount expected to be collected.

For available-for-sale debt securities, credit losses should be measured in a manner similar to current GAAP. However, FASB ASC 326 will require that credit losses be presented as an allowance rather than as a write-down.

FASB ASU No. 2016-13 affects entities holding financial assets and net investment in leases that are not accounted for at fair value through net income. The amendments affect loans, debt securities, trade receivables, net investments in leases, off-balance-sheet credit exposures, reinsurance receivables, and any other financial assets not excluded from the scope that have the contractual right to receive cash.

This edition of the guide has not been updated to reflect changes as a result of this ASU, however, this paragraph will be updated, as needed, in a future edition. Readers are encouraged to consult the full text of this ASU on FASB's website at www.fasb.org.

For more information on FASB ASU No. 2016-13, see appendix G, "Accounting for Financial Instruments," of this guide.

6.16 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.

6.17 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.

6.18 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.

6.19 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.

Update 6-4 *Accounting and Reporting*: Recognition and Measurement of Financial Assets and Financial Liabilities

FASB ASU No. 2016-01, *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*, issued in January 2016, is effective for fiscal years, and interim periods within those fiscal years, of a public business entity beginning after December 15, 2017.

For all other entities (including not-for-profit entities and employee benefit plans within the scope of FASB ASC 960 through FASB ASC 965 on plan accounting), FASB ASU No. 2016-01 is effective for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. Early application is permitted for all other entities as of the fiscal years beginning after December 15, 2017, including interim periods within those fiscal years.

All entities may adopt the presentation guidance in paragraphs 5–7 of FASB ASC 825-10-45 for financial statements of fiscal years or interim periods that have not yet been issued or that have not yet been made available for issuance. Furthermore, entities that are not public business entities may elect not to disclose the information about fair value of financial instruments required by the "General" subsection of FASB ASC 825-10-50 in financial statements of fiscal years or interim periods that have not yet been made available for issuance. Except as indicated previously in this paragraph, early application is not permitted.

FASB ASU No. 2016-01 addresses certain aspects of recognition, measurement, presentation, and disclosure of financial instruments and affects all entities that hold financial assets or owe financial liabilities. Among other provisions of the guidance, the amendments in this ASU supersede the guidance to classify equity securities with readily determinable fair values into different categories (that is, trading or available-for-sale) and require equity securities (including other ownership interests, such as partnerships, unincorporated joint ventures, and limited liability companies) to be measured at fair value with changes in the fair value recognized through net income. As such, upon the effective date of the amended guidance, an entity should classify cash flows from purchases and sales of equity securities on the basis of the nature and purpose for which it acquired the securities.

This edition of the guide has not been updated to reflect changes as a result of this ASU, however, this paragraph will be updated in a future edition. Readers are encouraged to consult the full text of this ASU on FASB's website at www.fasb.org.

For more information on FASB ASU No. 2016-01, see appendix G of this guide.

6.20 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*
Loan principal payments	Loan originations
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
* See footnote 1. ** Repos are addressed in chapter 14, "Federal Funds and Repurchase Agreements," of this guide.	

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

Financing Activities—*continued*

Cash Inflows	*Cash Outflows*
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 repurchase agreements (repos) and dollar-roll repos	Net decrease in repos and dollar-roll repos
	Dividends and other cash distributions to stockholders

6.21 *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.

Update 6-5 *Accounting and Reporting*: Leases

FASB ASU No. 2016-02, *Leases (Topic 842)*, issued in February 2016, is effective for fiscal years of a public business entity, a not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market, and an employee benefit plan that files financial statements with the SEC beginning after December 15, 2018, including interim periods within those fiscal years.

For all other entities, FASB ASU No. 2016-02 is effective for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2019.

Early application is permitted for all entities.

FASB ASU No. 2016-02 supersedes the lease requirements in FASB ASC 840, *Leases*, and creates FASB ASC 842, *Leases*, to establish the principles that lessees and lessors should apply to report useful information to users of financial statements about the amount, timing, and uncertainty of cash flows arising from a lease. FASB ASC 842 affects any entity that enters into a lease (as that term is defined in FASB ASU No. 2016-02), with some specified scope exceptions.

This edition of the guide has not been updated to reflect changes as a result of this ASU, however, this paragraph will be updated in a future edition. Readers are encouraged to consult the full text of this ASU on FASB's website at www.fasb.org.

For more information on FASB ASU No. 2016-02, see appendix F, "The New Leases Standard: FASB ASU No. 2016-02," of this guide.

6.22 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

6.23 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 fair 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 fair value or at the lower of cost or fair value in accordance with FASB ASC 948, *Financial Services—Mortgage Banking*.

Update 6-6 *Accounting and Reporting*: Recognition and Measurement of Financial Assets and Financial Liabilities

FASB ASU No. 2016-01, issued in January 2016, is effective for fiscal years, and interim periods within those fiscal years, of a public business entity beginning after December 15, 2017.

For all other entities (including not-for-profit entities and employee benefit plans within the scope of FASB ASC 960 through FASB ASC 965 on plan accounting), FASB ASU No. 2016-01 is effective for fiscal years beginning after December 15, 2018, and interim period within fiscal years beginning after December 15, 2019. Early application is permitted for all other entities as of the fiscal years beginning after December 15, 2017, including interim periods within those fiscal years.

All entities may adopt the presentation guidance in paragraphs 5–7 of FASB ASC 825-10-45 for financial statements of fiscal years or interim periods that have not yet been issued or that have not yet been made available for issuance. Furthermore, entities that are not public business entities may elect not to disclose the information about fair value of financial instruments required by the "General" subsection of FASB ASC 825-10-50 in financial statements of fiscal years or interim periods that have not yet been made available for issuance. Except as indicated previously in this paragraph, early application is not permitted.

FASB ASU No. 2016-01 addresses certain aspects of recognition, measurement, presentation, and disclosure of financial instruments. Among other provisions of the guidance, the amendments in this ASU supersede the guidance to classify equity securities with readily determinable fair values into different categories (that is, trading or available-for-sale) and require equity securities (including other ownership interests, such as partnerships, unincorporated joint ventures, and limited liability companies) to be measured at fair value with changes in the fair value recognized through net income. Accordingly, upon the effective date of the amended guidance, cash receipts and cash payments resulting from purchases and sales of equity securities accounted for in accordance with FASB ASC 321, *Investments—Equity Securities*, should be classified pursuant to FASB ASC 230 based on the nature and purpose for which the securities were acquired.

This edition of the guide has not been updated to reflect changes as a result of this ASU, however, this paragraph will be updated in a future edition. Readers are encouraged to consult the full text of this ASU on FASB's website at www.fasb.org.

For more information on FASB ASU No. 2016-01, see appendix G of this guide.

6.24 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

6.25 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

6.26 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.

6.27 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.

6.28 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

6.29 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

6.30 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.

6.31 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.

6.32 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 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.

6.33 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[2]

Objectives

6.34 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;

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[2] The auditing content in this guide focuses primarily on generally accepted auditing standards issued by the Auditing Standards Board and is applicable to audits of the financial statements of those entities not subject to the oversight authority of the PCAOB (that is, those audit reports not within the PCAOB's jurisdiction as defined by the Sarbanes-Oxley Act of 2002, as amended—hereinafter referred to as *nonissuers*). However, considerations for audits of entities subject to the oversight authority of the PCAOB (that is, those audit reports within the PCAOB's jurisdiction as defined by the Sarbanes-Oxley Act of 2002, as amended) may be discussed within this guide's chapter text. When such discussion is provided, the related paragraphs are designated with the following title: *Considerations for Audits Performed in Accordance With PCAOB Standards*.

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

6.35 In accordance with AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), the objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and relevant assertion levels through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement (as described in chapter 5, "Audit Considerations and Certain Financial Reporting Matters," of this guide). 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

6.36 AU-C section 315 addresses the auditor's responsibility to identify and assess the risks of material misstatement in the financial statements through understanding the entity and its environment, including the entity's internal control. Paragraphs .13–.14 of AU-C section 315 state that the auditor should obtain an understanding of internal control relevant to the audit and, in doing so, should evaluate the design of those controls and determine whether they have been implemented by performing procedures in addition to inquiry of the entity's personnel. (See chapter 5 of this guide for further discussion of the components of internal control.) To provide a basis for designing and performing further audit procedures, paragraph .26 of AU-C section 315 states that the auditor should identify and assess the risks of material misstatement at the financial statement level and the relevant assertion level for classes of transactions, account balances, and disclosures.

6.37 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," of this guide. 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.

6.38 AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*), addresses the auditor's responsibility to design and implement responses to the risks of material misstatement identified and assessed by the auditor in accordance with AU-C section 315 and to evaluate the audit evidence obtained in an audit of financial statements.

6.39 In accordance with paragraph .08 of AU-C section 330, the auditor should design and perform tests of controls to obtain sufficient appropriate audit evidence about the operating effectiveness of relevant controls if (*a*) the auditor's assessment of risks of material misstatement at the relevant assertion level includes an expectation that the controls are operating effectively or (*b*) 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

6.40 Possible tests of controls related to electronic funds transfers are discussed in chapter 13 of this guide.

Substantive Tests

6.41 Irrespective of the assessed risks of material misstatement, paragraph .18 of AU-C section 330 states that the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure, which for a financial institution would include cash and cash equivalents. In accordance with paragraph .A45 of AU-C section 330, this requirement reflects the facts that (*a*) the auditor's assessment of risk is judgmental and may not identify all risks of material misstatement and (*b*) inherent limitations to internal control exist, including management override.

6.42 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
- 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* as defined in the 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," of this guide.

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," of this guide.

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 are 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, credit loss, 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, credit loss, 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 (U.S. Treasury), as fiscal agent for the United States, routinely sells federal government debt securities called *treasuries or T-bills*. Backed by the full faith and credit of the United States, treasuries are generally considered the reference for the risk-free rate and 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 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 Board of Governors of the Federal Reserve System (Federal Reserve) 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 state or local 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," of this guide 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 other investments.

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 and Variable Interest Entities," and chapter 15, "Debt," of this guide 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 a credit allocation structure (for example, payout order of priority) or 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 (in synthetic structures), 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 *MBSs.* 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 represent 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 paragraphs, 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 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 any discount received or premium paid at acquisition. 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 a new, lower rate. Accordingly, expected prepayments must 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 U.S. Department of Veterans' Affairs. Prepayments are also dependent on availability of liquidity in the market; during the recession that begin in 2007, interest rates decreased as a result of market factors and the Federal Reserve's monetary policy, but prepayments did not increase as expected because financial institutions were approving less refinances than they would in a normalized market environment.

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 Yields on ARMs follow changes in stipulated interest rate indexes. This, and the fact that some ARMs may 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 MBSs.* Other MBSs add layers of complexity to the security structure to create investment classes that meet the needs of and are attractive to more 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 some 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 7.115 and beginning in paragraph 10.93 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 of this guide.

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. The term *tranche* refers to one of several related securities offered that are collateralized by the same group of assets. Tranches from the same offering usually have different risks, rewards, 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 products or other ABSs.

7.34 Investment classes that have a contractual right only to certain interest cash flows (interest classes), such as MBS IOs, are extremely interest-rate and prepayment sensitive and, therefore, carry the risk that the security holder's entire recorded investment could be lost. Investment classes weighted toward solely 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 because it often shows greater appreciation in value when interest rates increase and often 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 often 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 often 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 fair value of expected 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 and credit risk of other classes and to provide security holders with the potential for high yields. Residuals may earn high yields if prepayments and credit losses 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. They also represent the riskiest tranche of securities, as they are first in line to absorb credit losses, which is why they have the potential for high yields. As with POs and IOs, their fair values are dependent on the effect of discounting.

7.44 Typically residuals absorb credit losses. However, they could also absorb other risks such as interest rate risk and related prepayment risk. 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 often 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 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 can change 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 may 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 factors such as 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 structured 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 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 *TPSs*. 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 TPSs.* 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 earlier 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 during difficult credit environments. 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.

Transfers of Securities

7.62 *Short sales.* Short sales are trading activities in which an institution transfers securities it does not own, with the intention of buying or borrowing

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[1] Technical Questions & Answers section 2130.40, "Certificates of Deposit and FASB ASC 320" (AICPA, *Technical Questions and Answers*), addresses whether certificates of deposit fall within the scope of FASB *Accounting Standards Codification* (ASC) 320, *Investments—Debt and Equity Securities*.

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.

7.63 *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.

7.64 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.

7.65 *Repurchase and reverse repurchase agreements*. Sometimes an institution will enter into an agreement with a counterparty to sell (or purchase) securities and then buy (or sell) them back at a specified date. If the repurchase agreement is for the same or substantially similar securities, the transaction is not recorded as a sale (or purchase). Instead, the securities continue to be recorded as assets of the transferor and the transaction is recorded as a secured borrowing. Repurchase and reverse repurchase agreements are discussed further in chapter 14, "Federal Funds and Repurchase Agreements," of this guide.

Regulatory Matters

7.66 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.

7.67 *Banks and savings institutions.* 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 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.

7.68 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.

7.69 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.

7.70 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 qualified personnel who are independent of those initiating risk taking positions.

7.71 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.

7.72 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 7.67–.71. 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.

7.73 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 7.51–.60 for further discussion of other structure credit products.

7.74 The FDIC's *Risk Management Manual of Examination Policies* includes a subchapter titled "Securities and Derivatives" which references these interagency guidance documents.

7.75 On December 13, 1999, the federal banking agencies, including the Office of Thrift Supervision (OTS) (prior to its transfer of powers to the Office of the Comptroller of the Currency [OCC], the FDIC, and the Federal Reserve),[2]

[2] See chapter 1, "Industry Overview—Banks and Savings Institutions," of this guide for further discussion on the Office of Thrift Supervision transfer of powers.

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.

7.76 *Federal and state savings associations*. Thrift Bulletin (TB) 73a, *Investing in Complex Securities*, 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 can be found on the "Office of Thrift Supervision Thrift Bulletin" page at www.occ.gov and should be referred to for additional limitations and requirements for holding these securities. National banks and state nonmember banks are permitted to invest in trust preferred stock within certain limitations. (See OCC Interpretive Letter No. 777, April 8, 1997; FDIC FIL-16-99, February 16, 1999.) The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) did not change the prohibitions.

7.77 The Dodd-Frank Act authorized the FDIC to issue a final rule to establish standards of creditworthiness to replace previously used investment grade standards for corporate debt security investments held or acquired by savings associations. In July 2012, the FDIC's board of directors, through the issuance of FIL-34-2012, *Investments in Corporate Debt Securities by Savings Associations*, adopted the final rule *Permissible Investments for Federal and State Savings Associations: Corporate Debt Securities*. The final rule prohibits state and federal savings associations from acquiring or holding a corporate debt security when the security's issuer does not have an adequate capacity to meet all financial commitments under the security for the projected life of the security. In addition, the FDIC also issued final guidance that sets forth due diligence standards for determining the credit quality of a corporate debt security. Readers are encouraged to review the full text of the final rule and guidance in FIL-34-2012 from www.fdic.gov.

7.78 The Volcker rule of the Dodd-Frank Act, among other things, prohibits banks and other financial institutions from acquiring or retaining any ownership interests in or sponsorship of *covered funds* as defined in the rule. A recent focus has been on whether collateralized loan obligations (CLOs) qualify as covered funds. Although not exempt from the requirements, the Federal Reserve has extended the compliance deadline for CLOs by two years. See paragraph 7.86 for accounting considerations resulting from the Volcker rule.

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[3] The federal savings association requirements of corporate debt securities are set forth in Title 12 U.S. *Code of Federal Regulations* (CFR) Part 160.40 (Office of the Comptroller of Currency).

7.79 *Credit unions.* Federal regulations describe investments allowed for federal credit unions.[4,5] These regulations explicitly prohibit federal credit unions from (*a*) purchasing mortgage servicing rights as an investment, (*b*) investing in stripped MBSs or certain securities that represent interests in stripped MBSs, (*c*) purchasing residual interests in CMOs, REMICs, or small-business-related securities, and (*d*) engaging in adjusted trading or short sales.[6]

7.80 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.

7.81 In October 2010, the National Credit Union Administration 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 leveraged 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.[7]

Bank Accounting Advisory Series

7.82 The OCC's *Bank Accounting Advisory Series* (BAAS) is updated periodically to express the Office of the Chief Accountant's current views on accounting topics of interest to national banks and federal savings associations. Banks prepare their Consolidated Reports of Condition and Income using U.S. generally accepted accounting principles (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 GAAP, or OCC interpretations of regulatory capital requirements. Topic 1, "Investment Securities" of the BAAS includes interpretations on (*a*) investment in debt and equity securities and (*b*) other-than-temporary-impairment (OTTI). Readers are encouraged to view this publication under the "Publications—Bank Management" page at www.occ.gov.

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[4] For further discussion of regulations related to permissible investments, see 12 CFR 703.14.

[5] In January 2014, the National Credit Union Administration (NCUA) amended its investment regulations to permit federal credit unions to engage in limited derivatives activities for the purpose of mitigating interest rate risk (see 12 CFR 703.14[k]). NCUA derivatives regulations are set forth in 12 CFR 703 Subpart B.

[6] For further discussion of regulations related to prohibited investment activities and prohibited investments, see 12 CFR 703.15-.16.

[7] The requirements for corporate credit union investments and the investment action plan are set forth in 12 CFR 704.5 and 704.10.

Accounting and Financial Reporting

Update 7-1 *Accounting and Reporting*: Recognition and Measurement of Financial Assets and Financial Liabilities

FASB Accounting Standards Update (ASU) No. 2016-01, *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*, issued in January 2016, is effective for fiscal years, and interim periods within those fiscal years, of a public business entity beginning after December 15, 2017.

For all other entities (including not-for-profit entities and employee benefit plans within the scope of FASB ASC 960, *Plan Accounting—Defined Benefit Pension Plans*, through FASB ASC 965, *Plan Accounting—Health and Welfare Benefit Plans*, on plan accounting), FASB ASU No. 2016-01 is effective for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. Early application is permitted for all other entities as of the fiscal years beginning after December 15, 2017, including interim periods within those fiscal years.

All entities may adopt the presentation guidance in paragraphs 5–7 of FASB ASC 825-10-45 for financial statements of fiscal years or interim periods that have not yet been issued or that have not yet been made available for issuance. Furthermore, entities that are not public business entities may elect not to disclose the information about fair value of financial instruments required by the "General" subsection of FASB ASC 825-10-50 in financial statements of fiscal years or interim periods that have not yet been made available for issuance. Except as indicated previously in this paragraph, early application is not permitted.

FASB ASU No. 2016-01 addresses certain aspects of recognition, measurement, presentation, and disclosure of financial instruments and affects all entities that hold financial assets or owe financial liabilities. Among other provisions of the guidance, the amendments in this ASU supersede the guidance to classify equity securities with readily determinable fair values into different categories (that is, trading or available-for-sale) and require equity securities (including other ownership interests, such as partnerships, unincorporated joint ventures, and limited liability companies) to be measured at fair value with changes in the fair value recognized through net income (other than equity securities accounted for under the equity method of accounting or those that result in consolidation of an investee).

The amendments in this ASU also require an entity to present separately in other comprehensive income the portion of the total change in fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments.

This edition of the guide has not been updated to reflect changes as a result of this ASU, however, this section will be updated in a future edition. Readers are encouraged to consult the full text of this ASU on FASB's website at www.fasb.org.

For more information on FASB ASU No. 2016-01, see appendix G, "Accounting for Financial Instruments," of this guide.

© Update 7-2 *Accounting and Reporting*: Credit Losses

FASB ASU No. 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*, issued in June 2016, is effective for fiscal years of public business entities that are SEC filers beginning after December 15, 2019, including interim periods within those fiscal years.

For all other public business entities, the amendments in FASB ASU No. 2016-13 are effective for fiscal years beginning after December 15, 2020, including interim periods within those fiscal years. For all other entities, including not-for-profit entities and employee benefit plans within the scope of FASB ASC 960 through FASB ASC 965 on plan accounting, FASB ASU No. 2016-13 is effective for fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021.

Early application is permitted for all entities as of the fiscal years beginning after December 15, 2018, *including* interim periods within those fiscal years.

FASB ASU No. 2016-13 creates FASB ASC 326, *Financial Instruments—Credit Losses*, to amend guidance on reporting credit losses for financial assets held at amortized cost basis and available-for-sale debt securities.

For financial assets held at amortized cost basis, FASB ASC 326 eliminates the probable initial recognition threshold in current GAAP and, instead, requires an entity to reflect its current estimate of all expected credit losses. The allowance for credit losses is a valuation account that is deducted from the amortized cost basis of the financial assets to present the net amount expected to be collected.

For available-for-sale debt securities, credit losses should be measured in a manner similar to current GAAP. However, FASB ASC 326 will require that credit losses be presented as an allowance rather than as a write-down.

FASB ASU No. 2016-13 affects entities holding financial assets and net investment in leases that are not accounted for at fair value through net income. The amendments affect loans, debt securities, trade receivables, net investments in leases, off-balance-sheet credit exposures, reinsurance receivables, and any other financial assets not excluded from the scope that have the contractual right to receive cash.

This edition of the guide has not been updated to reflect changes as a result of this ASU, however, this section will be updated in a future edition. Readers are encouraged to consult the full text of this ASU on FASB's website at www.fasb.org.

For more information on FASB ASU No. 2016-13, see appendix G of this guide.

Introduction

7.83 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.[8] FASB ASC

[8] In accordance with FASB ASC 320-10-20, *equity securities* are defined as any security representing an ownership interest in an entity (for example, common, preferred, or other capital stock) or the right to acquire (for example, warrants, rights, and call options) or dispose of (for example,

(continued)

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.

7.84 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 gains and losses recorded in earnings at each subsequent reporting date. Chapter 20, "Fair Value," of this guide provides a summary of FASB ASC 825 but is not intended as a substitute for reading the guidance in FASB ASC 825. Investments in securities may contain embedded derivatives that, absent a fair value option election, could require bifurcation and separate accounting under FASB ASC 815.

7.85 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. Entities rarely transfer securities out of the held-to-maturity category because a single transfer may call into question management's intent and ability to hold the entire

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(footnote continued)

put options) an ownership interest in an entity at fixed or determinable prices. *Debt securities* are defined as securities that represent a creditor relationship with an entity, such as treasury securities or corporate bonds.

portfolio to maturity. FASB ASC 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.[9]

7.86 Compliance with the provisions of the Volcker rule (see paragraph 7.78) may have current accounting consequences. For example, entities should evaluate whether a positive intent and ability to hold held-to-maturity debt securities to maturity still exists. In addition, if it is more likely than not that an entity will be required to sell a debt security with a fair value that is less than its amortized cost, the manner in which impairment is recognized could be impacted.

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. 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 should classify as trading any retained MBSs 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 740-20-45-11b 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 320-10-25-5a 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

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[9] If the remaining held-to-maturity portfolio is tainted and reclassified to the available-for-sale classification, the length of the taint period under U.S. generally accepted accounting principles is not defined. The SEC recommended a two year time frame minimum for the tainting period. Refer to the guidance in the *Bank Accounting Advisory Series* Question 9 (December 2001) Topic 1A, "Investments in Debt and Equity Securities."

can be prepaid or otherwise settled in such a way that the holder of the security would not recover substantially all of its recorded 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, 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 of this guide for a summary of FASB ASC 820, *Fair Value Measurement*.

OTTI

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 7.126–.133 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 323-10-35 and 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 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 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-C section 501, *Audit Evidence—Specific Consideration for Selected Items* (AICPA, *Professional Standards*), and the SEC *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 220-10-45-1 requires an entity to report comprehensive income either in a single continuous financial statement or in two separate but consecutive financial statements. According to paragraphs 1A–1C of FASB ASC 220-10-45, an entity reporting comprehensive income in a single continuous financial statement should present its components in two sections: net income and other comprehensive income. If applicable, an entity should present in that financial statement a total amount for net income together with the components that make up net income, a total amount for other comprehensive income together with the components that make up other comprehensive income, and total comprehensive income. An entity reporting comprehensive income in two separate but consecutive statements should present components of and the total for net income in the statement of net income and components of and the total for other comprehensive income as well as total for comprehensive income in the statement of other comprehensive income, which should be presented immediately after the statement of net income. A reporting entity should begin the second statement with net income. An entity should present, either in a single continuous statement of comprehensive income or in a statement of net income and statement of other comprehensive income, all items that meet the definition of comprehensive income for the period in which those items are recognized. Components included in other comprehensive income should be classified based on their nature. For related guidance, see paragraphs 10A–10B of FASB ASC 220-10-45.

7.105 FASB ASC 220-10-45-15 requires that reclassification adjustments be made to avoid double counting of items in comprehensive income that are presented as part of net income for a period that also had been presented 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). Example 3 (see paragraphs 18–27 of FASB ASC 220-10-55) illustrates the presentation of reclassification adjustments in accordance with this paragraph.

7.106 FASB ASC 220-10-45-17 requires an entity to provide information about the effects on net income of significant amounts reclassified out of each component of accumulated other comprehensive income if those amounts all are required under other FASB ASC topics to be reclassified to net income in their entirety in the same reporting period. An entity should provide this information together, in one location, either (*a*) on the face of the financial statement where net income is presented or (*b*) as a separate disclosure in the notes to the financial statements. FASB ASC 220-10-45-17A describes the information requirements for presentation on the face of the statement where net income is presented, and FASB ASC 220-10-45-17B describes the information requirements for disclosure in the notes to the financial statements. FASB ASC 220-10-45-18B states that nonpublic entities are not required to meet the requirements in paragraphs 17–17B of FASB ASC 220-10-45 for interim reporting periods but are required to meet them for annual reporting periods.

Premiums and Discounts

7.107 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), together with the stated coupon on the security, represents the effective rate of interest on the security, thereby reflecting the security's market yield.

7.108 Dividend and interest income,[10] 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.

7.109 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 item (d) in FASB ASC 320-10-35-10. 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

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[10] 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 in accordance with applicable guidance as stated in FASB ASC 320-10-35-35.

FASB Accounting Standards Update (ASU) No. 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*, issued in June 2016, creates FASB ASC 326, *Financial Instruments—Credit Losses*, to amend guidance on reporting credit losses for assets held at amortized cost basis and available for sale debt securities. Update 7-2 provides further details on the amendments and effective date of ASU No. 2016-13.

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.

7.110 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 item (b) in FASB ASC 310-20-15-2. 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 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).

7.111 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.

Update 7-3 *Accounting and Reporting*: Premium Amortization on Purchased Callable Debt Securities

FASB ASU No. 2017-08, *Receivables—Nonrefundable Fees and Other Costs (Subtopic 310-20): Premium Amortization on Purchased Callable Debt Securities*, issued in March 2017, is effective for fiscal years, and interim periods within those fiscal years, of a public business entity beginning after December 15, 2018.

For all other entities, FASB ASU No. 2017-08 is effective for fiscal years beginning after December 15, 2019, and interim periods within those fiscal years beginning after December 15, 2020. Early adoption is permitted, including adoption in an interim period. If an entity early adopts the amendments in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period.

FASB ASU No. 2017-08 amends guidance on the amortization period of premiums on certain purchased callable debt securities. Specifically, the amendments shorten the amortization period of premiums on certain purchased callable debt securities to the earliest call date. The amendments affect all entities that hold investments in callable debt securities that have an amortized cost basis in excess of the amount that is repayable by the issuer at the earliest call date (that is, at a premium).

This edition of the guide has not been updated to reflect changes as a result of this ASU, however, this section will be updated in a future edition. Readers are encouraged to consult the full text of this ASU on FASB's website at www.fasb.org.

7.112 Certain ABSs may meet those conditions, and institutions may therefore consider estimates of prepayments in determining the amortization period for calculation of the constant effective yield.

7.113 In accordance with FASB ASC 310-20-35-26, 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.

Interest Income

7.114 Guidance for recognizing interest income on debt securities is included within FASB ASC 310-20, 320-10, 325-40, and 310-30. The appropriate model to apply depends on a number of factors including, but not limited to, the nature of the investment, its creditworthiness, and whether the asset was originated or purchased in the secondary market.

Consolidation

7.115 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 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 VIEs beginning in paragraph 10.93 of this guide.

Special Areas

7.116 The following paragraphs list several specialized accounting issues involving investments in securities.

7.117 *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.

7.118 *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

7.119 FASB ASC 860-10 establishes accounting and reporting standards for transfers and servicing of financial assets, according to FASB ASC 860-10-05-1. FASB ASC 860-10-05-6 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 of this guide for additional guidance regarding transfers and servicing of securities.

7.120 *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.[11]

7.121 *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 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

7.122 In accordance with item (a) in FASB ASC 320-10-55-2, any loan that was restructured as a security 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 310-40-40-8A for additional information.

7.123 FASB ASC 310-40 addresses measurement, derecognition, disclosure and implementation guidance issues concerning creditor's treatment of troubled debt restructurings. 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

[11] Chapter 10, "Transfers and Servicing and Variable Interest Entities," of this guide discusses accounting for transfers of loans that have not been previously securitized.

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," of this guide.

7.124 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

7.125 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 of this guide.

Financial Statement Presentation and Disclosure

7.126 *OTTIs*. 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.

7.127 FASB ASC 320-10-50 addresses disclosures about OTTIs 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.

7.128 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.

7.129 Maturity information may be combined in appropriate groupings, as stated in paragraphs 3 and 5 of FASB ASC 320-10-50. In complying with this requirement, financial institutions (see FASB ASC 942-320-50-1) should disclose the fair value and the net carrying amount (if different from fair value) of debt securities on the basis of at least the following four maturity groupings:

a. Within one year

b. After one year through five years

c. After five years through ten years

d. After ten years

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.

7.130 In accordance with FASB ASC 942-320-50-2, in complying with the disclosure requirements mentioned in paragraph 7.128, 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

7.131 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.

7.132 For all investments in an unrealized loss position, including those within the scope of FASB ASC 325-40, for which OTTI has not been recognized in earnings (including investments for which a portion of an OTTI has been recognized in other comprehensive income), FASB ASC 320-10-50-6 states that an entity should disclose all of the following items in its interim and annual financial statements:

a. As of each date for which a statement of financial position is presented, quantitative information aggregated by category of investment—each major security type that the entity discloses in accordance with FASB ASC 320-10 and cost-method investments—in tabular form:

  i. The aggregate related fair value of investments with unrealized losses

  ii. The aggregate amount of unrealized losses (that is, the amount by which amortized cost basis exceeds fair value)

b. As of the date of the most recent statement of financial position, additional information (in narrative form) that provides sufficient information to allow financial statements users to understand the quantitative disclosures and the information that the entity considered (both positive and negative) in reaching the conclusion that the impairment or impairments are not other than temporary. (The application of step 2 in FASB ASC 320-10-35-30 should provide insight into the entity's rationale for concluding that unrealized losses are not OTTIs. The disclosures required may be aggregated by investment categories, but individually significant unrealized losses generally should not be aggregated.) This disclosure could include all the following:

  i. The nature of the investment(s)

  ii. The cause(s) of the impairment(s)

  iii. The number of investment positions that are in an unrealized loss position

  iv. The severity and duration of the impairment(s)

  v. Other evidence considered by the investor in reaching its conclusion that the investment is not other-than-temporarily impaired, including, for example, any of the following:

1. Performance indicators of the underlying assets in the security, including default rates, delinquency rates, or percentage of nonperforming assets
2. Loan-to-collateral-value ratios
3. Third-party guarantees
4. Current levels of subordination
5. Vintage
6. Geographic concentration
7. Industry analyst reports
8. Sector credit ratings
9. Volatility of the security's fair value
10. Any other information that the investor considers relevant

7.133 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.

7.134 *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[12]

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

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[12] FASB ASC 740-20-45-2 requires that income tax expense or benefit for the year be allocated among continuing operations, discontinued operations, 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 [see chapter 16, "Income Taxes," of this guide]).

7.135 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 items (a)–(f) in FASB ASC 320-10-25-6. 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 320-10-50-10.

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[13]

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.

[13] The auditing content in this guide focuses primarily on generally accepted auditing standards issued by the Auditing Standards Board and is applicable to audits of the financial statements of those entities not subject to the oversight authority of the PCAOB (that is, those audit reports not within the PCAOB's jurisdiction as defined by the Sarbanes-Oxley Act of 2002, as amended—hereinafter referred to as *nonissuers*). However, considerations for audits of entities subject to the oversight authority of the PCAOB (that is, those audit reports within the PCAOB's jurisdiction as defined by the Sarbanes-Oxley Act of 2002, as amended) may be discussed within this guide's chapter text. When such discussion is provided, the related paragraphs are designated with the following title: *Considerations for Audits Performed in Accordance With PCAOB Standards*.

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.

Planning

7.139 In accordance with AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), the objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and relevant assertion levels through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement (see chapter 5 of this guide 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's understanding of the relationship between the interest-rate environment and the market values of securities might include review of the institution's asset/liability and other risk management policies, which 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. (See chapter 18, "Derivative Instruments: Futures, Forwards, Options, Swaps, and Other Derivative Instruments," of this guide.) Inquiry of a specialist could be considered by the auditor if a financial institution engaged in holding or trading such complex securities.

7.142 If the preparation of the financial statements involves the use of expertise in a field other than accounting, paragraph .A7 of AU-C section 620, *Using the Work of an Auditor's Specialist* (AICPA, *Professional Standards*), states that the auditor, who is skilled in accounting and auditing, may not possess the necessary expertise to audit those financial statements. The engagement partner is required by AU-C section 220, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards* (AICPA, *Professional Standards*), to be satisfied that the engagement team and any external auditor's specialists (defined in the auditing standards as an individual or organization possessing expertise in a field other than accounting or auditing, whose work in that field is used by the auditor to assist the auditor in obtaining sufficient appropriate audit evidence) who are not part of the engagement team, collectively, have the appropriate competence and capabilities to perform the audit engagement.[14] Further, the auditor is required by

[14] Paragraph .16 of AU-C section 220, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards* (AICPA, *Professional Standards*).

AU-C section 300, *Planning an Audit* (AICPA, *Professional Standards*), to ascertain the nature, timing, and extent of resources necessary to perform the engagement.[15] The auditor's determination of whether to use the work of an auditor's specialist, and, if so, when and to what extent, assists the auditor in meeting these requirements. As the audit progresses or as circumstances change, the auditor may need to revise earlier decisions about using the work of an auditor's specialist.

> *Considerations for Audits Performed in Accordance With PCAOB Standards*[16]
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> PCAOB Staff Audit Practice Alert No. 11, *Considerations for Audits of Internal Control Over Financial Reporting* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400.11), highlights certain requirements of the auditing standards of the PCAOB in aspects of audits of internal control over financial reporting in which significant auditing deficiencies have been cited frequently in PCAOB inspection reports. Specifically, the alert discusses, among other topics, using the work of others.

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 GAAP. In planning the audit, the independent auditor may consider reading the current year's interim financial statements, investment policy, and other financial information related to securities. The level of inherent risk for securities varies widely from institution to institution depending on, among other things, the nature and complexity of the securities and the extent and effectiveness of the institution's accounting and operational policies and procedures, as well as management's understanding and awareness of the risks. The following factors related to securities may, considered in the aggregate, indicate higher inherent risk:

- *a.* Significant concentrations of credit risk with one counterparty or within one geographic area
- *b.* Significant use of complex securities, particularly without relevant in-house expertise
- *c.* 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)

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[15] Item *e* in paragraph .08 of AU-C section 300, *Planning an Audit* (AICPA, *Professional Standards*).

[16] 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.

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 Controls

7.144 AU-C section 315 addresses the auditor's responsibility to identify and assess the risks of material misstatement in the financial statements through understanding the entity and its environment, including the entity's internal control. Paragraphs .13–.14 of AU-C section 315 state that the auditor should obtain an understanding of internal control relevant to the audit and, in doing so, should evaluate the design of those controls and determine whether they have been implemented by performing procedures in addition to inquiry of the entity's personnel. (See chapter 5 of this guide for further discussion of the components of internal control.) To provide a basis for designing and performing further audit procedures, paragraph .26 of AU-C section 315 states that the auditor should identify and assess the risks of material misstatement at the financial statement level and the relevant assertion level for 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, including other than temporary impairment; 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.)
- Management maintains frequent, open dialogue with any third-party investment advisors as to the company's strategy and how that impacts investment decisions.
- 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 AU-C section 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* (AICPA, *Professional Standards*), addresses the auditor's responsibilities relating to accounting estimates, including fair value accounting estimates and related disclosures, in an audit of financial statements. Specifically, it expands on how AU-C section 315; AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*); and other relevant AU-C sections are to be applied with regard to accounting estimates. It also includes requirements and guidance related to misstatements of individual accounting estimates and indicators of possible management bias.

7.149 When performing risk assessment procedures and related activities to obtain an understanding of the entity and its environment, including the entity's internal control, as required by AU-C section 315, paragraph .08 of AU-C section 540 states that the auditor should obtain an understanding of the following in order to provide a basis for the identification and assessment of the risks of material misstatement for accounting estimates:[17]

a. The requirements of the applicable financial reporting framework relevant to accounting estimates, including related disclosures.

b. How management identifies those transactions, events, and conditions that may give rise to the need for accounting estimates to be recognized or disclosed in the financial statements. In obtaining this understanding, the auditor should make inquiries of management about changes in circumstances that may give rise to new, or the need to revise existing, accounting estimates.

c. How management makes the accounting estimates and the inputs on which they are based, including

   i. the method(s), including, when applicable, the model, used in making the accounting estimate;

   ii. relevant controls;

   iii. whether management has used a specialist;

   iv. the assumptions underlying the accounting estimates;

   v. whether there has been or ought to have been a change from the prior period in the method(s) or assumption(s) for making the accounting estimates and, if so, why; and

   vi. whether and, if so, how management has assessed the effect of estimation uncertainty.

See paragraphs .A11–.A37 of AU-C section 540 for additional application guidance and other explanatory material as it relates to accounting estimate risk assessment procedures and related activities.

7.150 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, in accordance with paragraph .15 of AU-C section 240, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*), the engagement team should address the risk of management override of controls during the discussion among the key engagement team members.

7.151 AU-C section 330 addresses the auditor's responsibility to design and implement responses to the risks of material misstatement identified and assessed by the auditor in accordance with AU-C section 315 and to evaluate the audit evidence obtained in an audit of financial statements.

7.152 In accordance with paragraph .08 of AU-C section 330, the auditor should design and perform tests of controls to obtain sufficient appropriate audit evidence about the operating effectiveness of relevant controls if (*a*) the

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[17] Paragraphs .05–.06 and .12–.13 of AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*).

auditor's assessment of risks of material misstatement at the relevant assertion level includes an expectation that the controls are operating effectively or (*b*) 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), or attending a meeting of the board of directors or 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 reviewing supporting documentation; and
  - — testing recorded purchases of securities, including classification of the securities, prices, and entries used to record related amounts (for example, use of trade versus settlement date, treatment of commissions, and 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.

7.153 Many financial institutions outsource the determination of fair value measurements of investment securities to third party service organizations, such as a pricing service. AU-C section 402, *Audit Considerations Relating to an Entity Using a Service Organization* (AICPA, *Professional Standards*), 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. Specifically, it expands on how the user auditor applies AU-C sections 315 and 330 in obtaining an understanding of the user entity, including internal control relevant to the audit, sufficient to identify and assess the risks of material misstatement and in designing and performing further audit procedures responsive to those risks. If the user auditor plans to use a type 2 report as audit evidence that controls at the service organization are operating effectively, paragraph .17 of AU-C section 402 states that the user auditor should determine whether the service auditor's report provides sufficient appropriate audit evidence about the effectiveness of the controls to support the user auditor's risk assessment by

a. evaluating whether the type 2 report is for a period that is appropriate for the user auditor's purposes;

b. determining whether complementary user entity controls identified by the service organization are relevant in addressing the risks of material misstatement relating to the relevant assertions in the user entity's financial statements and, if so, obtaining an understanding of whether the user entity has designed and implemented such controls and, if so, testing their operating effectiveness;

c. evaluating the adequacy of the time period covered by the tests of controls and the time elapsed since the performance of the tests of controls; and

d. evaluating whether the tests of controls performed by the service auditor and the results thereof, as described in the service auditor's report, are relevant to the assertions in the user entity's financial statements and provide sufficient appropriate audit evidence to support the user auditor's risk assessment.

7.154 The auditor may also consider the following, which is not intended to be an all-inclusive list of considerations:

- 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, are 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

7.155 Irrespective of the assessed risks of material misstatement, paragraph .18 of AU-C section 330 states that the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure, which for a financial institution would include investments in debt and equity securities. In accordance with paragraph .A45 of AU-C section 330, this requirement reflects the facts that (*a*) the auditor's assessment of risk is judgmental and may not identify all risks of material misstatement and (*b*) inherent limitations to internal control exist, including management override.

7.156 AU-C section 501 addresses specific considerations by the auditor in obtaining sufficient appropriate audit evidence, in accordance with AU-C section 330; AU-C section 500, *Audit Evidence* (AICPA, *Professional Standards*); and other relevant AU-C sections, regarding, among other considerations, certain aspects of investments in securities and derivative instruments in an audit of financial statements. In addition, the companion AICPA Audit Guide *Special Considerations in Auditing Financial Instruments* specifically addresses derivatives and securities measured or disclosed at fair value, various methods for determining fair value as specified by GAAP, and evaluating audit evidence for the valuation assertion of derivatives and securities. Readers may consider this guidance when designing and performing substantive tests.

7.157 Paragraph .06 of AU-C section 540 states that the objective of the auditor is to obtain sufficient appropriate audit evidence about whether, in the context of the applicable financial reporting framework,

a. accounting estimates, including fair value accounting estimates, in the financial statements, whether recognized or disclosed, are reasonable; and

b. related disclosures in the financial statements are adequate.

7.158 Based on the assessed risks of material misstatement, paragraph .12 of AU-C section 540 states that the auditor should determine

a. whether management has appropriately applied the requirements of the applicable financial reporting framework relevant to the accounting estimate;

b. whether the methods for making the accounting estimates are appropriate and have been applied consistently; and

c. whether changes from the prior period, if any, in accounting estimates or the method for making them are appropriate in the circumstances.

7.159 In responding to the assessed risks of material misstatement, as required by AU-C section 330, paragraph .13 of AU-C section 540 states that the auditor should undertake one or more of the following, taking into account the nature of the accounting estimate:[18]

a. Determine whether events occurring up to the date of the auditor's report provide audit evidence regarding the accounting estimate.

b. Test how management made the accounting estimate and the data on which it is based. In doing so, the auditor should evaluate whether

   i. the method of measurement used is appropriate in the circumstances,

   ii. the assumptions used by management are reasonable in light of the measurement objectives of the applicable financial reporting framework, and

   iii. the data on which the estimate is based is sufficiently reliable for the auditor's purposes.

c. Test the operating effectiveness of the controls over how management made the accounting estimate, together with appropriate substantive procedures.

[18] Paragraphs .05–.06 of AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*).

d. Develop a point estimate or range to evaluate management's point estimate. For this purpose

i. if the auditor uses assumptions or methods that differ from management's, the auditor should obtain an understanding of management's assumptions or methods sufficient to establish that the auditor's point estimate or range takes into account relevant variables and to evaluate any significant differences from management's point estimate.

ii. if the auditor concludes that it is appropriate to use a range, the auditor should narrow the range, based on audit evidence available, until all outcomes within the range are considered reasonable.

7.160 In determining the matters identified in paragraph .12 of AU-C section 540 (see paragraph 7.158) or in responding to the assessed risks of material misstatement in accordance with paragraph .13 of AU-C section 540 (see paragraph 7.159), paragraph .14 of AU-C section 540 states that the auditor should consider whether specialized skills or knowledge with regard to one or more aspects of the accounting estimates are required in order to obtain sufficient appropriate audit evidence. Depending on the auditor's understanding of, and experience working with, the auditor's specialist or those other individuals with specialized skills or knowledge, paragraph .A107 of AU-C section 540 states that the auditor may consider it appropriate to discuss matters such as the requirements of the applicable financial reporting framework with the individuals involved to establish that their work is relevant for audit purposes.

7.161 *Auditing interests in trusts held by a third-party trustee and reported at fair value*. In circumstances in which the auditor determines that the nature and extent of auditing procedures should include verifying the existence and testing the measurement of investments held by a trust, simply receiving a confirmation from the trustee, either in aggregate or on an investment-by-investment basis, does not in and of itself constitute adequate audit evidence with respect to the requirements for auditing the fair value of interests in trusts under AU-C section 540. In addition, receiving confirmation from the trustee for investments in aggregate does not constitute adequate audit evidence with respect to the existence assertion. Receiving confirmation from the trustee on an investment-by-investment basis, however, typically would constitute adequate audit evidence with respect to the existence assertion. Also, in discussing obtaining an understanding of how management identifies the need for accounting estimates, paragraph .A15 of AU-C section 540 states that the preparation and fair presentation of the financial statements requires management to determine whether a transaction, an event, or a condition gives rise to the need to make an accounting estimate and that all necessary accounting estimates have been recognized, measured, and disclosed in the financial statements in accordance with the applicable financial reporting framework.

7.162 In circumstances in which the auditor is unable to audit the existence or measurement of interests in trusts at the financial statement date, the auditor should consider whether that scope limitation requires the auditor to either qualify his or her opinion or to disclaim an opinion, as discussed in AU-C section 705, *Modifications to the Opinion in the Independent Auditor's Report* (AICPA, *Professional Standards*).

7.163

Considerations for Audits Performed in Accordance With PCAOB Standards[19]

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. 400.02), 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 economic environment.

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. 400.04), informs auditors about potential implications of 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.

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[19] See footnote 16.

Chapter 8

Loans

FASB *Accounting Standards Codification* (ASC) 606, *Revenue from Contracts with Customers*

FASB ASC 606 is effective for annual reporting periods of a public business entity, a not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market, and an employee benefit plan that files or furnishes financial statements with or to the SEC beginning after December 15, 2017, including interim periods within that reporting period. Early application is permitted only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period.

For all other entities, FASB ASC 606 is effective for annual reporting periods beginning after December 15, 2018, and interim periods within annual periods beginning after December 15, 2019. Other entities may elect to adopt the standard earlier, however, only as of either

- an annual reporting period beginning after December 15, 2016, including interim periods within that reporting period, or
- an annual reporting period beginning after December 15, 2016, and interim periods within annual periods beginning one year after the annual reporting period in which an entity first applies the "Pending Content" that links to FASB ASC 606-10-65-1.

FASB ASC 606 provides a framework for revenue recognition and supersedes or amends several of the revenue recognition requirements in FASB ASC 605, *Revenue Recognition*, as well as guidance within the 900 series of industry-specific topics, including FASB ASC 942, *Financial Services—Depository and Lending*. The standard applies to any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets unless those contracts are within the scope of other standards (for example, insurance or lease contracts).

Readers are encouraged to consult the full text of FASB ASC 606 on FASB's website at www.fasb.org.

The AICPA has formed 16 industry task forces to assist in developing a new Audit and Accounting Guide on revenue recognition that provides helpful hints and illustrative examples for how to apply the new standard (guide available at www.aicpastore.com). Revenue recognition implementation issues identified by the Depository and Lending Institutions Revenue Recognition Task Force are available for informal comment, after review by the AICPA Financial Reporting Executive Committee, at the "Depository and Lending Institutions Revenue Recognition Task Force" page at aicpa.org.

Readers are encouraged to submit comments to revreccomments@aicpa.org.

For more information, see appendix E, "The New Revenue Recognition Standard: FASB ASC 606," of this guide.

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," of this guide). 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 and Variable Interest Entities," of this guide). 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, determine appropriate risk tolerance levels for each type of loan, set goals for portfolio growth or contraction, and establish limits on industry and geographic concentrations. The plan establishes the institution's credit underwriting standards. These underwriting standards should consider recently issued regulatory requirements. 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 make contractual loan payments and the fair value of any collateral pledged to secure the loan; 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 a credit strategy, defining target markets, and designing proper controls over credit initiation and 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, and also, in the case of fraud, the collateral does not exist. Further risks are 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.
- *Sovereign country 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.
- *Operational 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 Well-defined lending policies and comprehensive procedures for implementing such policies can contribute significantly to the institution's internal controls over financial reporting as they relate 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 as well as possession of tangible collateral such as jewelry or bearer bonds
- 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, or in the case of collateral-based lending the place of the collateral, 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 problem loans 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, a designated committee of 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, including the use of third party providers.

8.14 A 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 condition and determine the debt service coverage ratio.

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, 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 assess the LTV ratio and to identify deficiencies in collateral margins.

8.16 Loan reviews may identify weaknesses in the underwriting 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 that individual loans are impaired and need a loss accrual or may identify other factors relevant in assessing the allowance for loan and lease losses (ALLL), as discussed in chapter 9, "Credit Losses," of this guide.

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, performance guarantees, or trade financing), are agreements to lend a specified amount for a specified period (usually less than one year). Revolving credit agreements, which are also 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, the purpose of the loan, or other common risk characteristics. 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 or short term working capital loans or lines of credit, which are generally used by companies to finance the purchase of materials, inventory, or 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, an interest in the business, 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 or the Export-Import Bank. 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 a client ships the 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 typically are collateralized by accounts receivable and generally cannot exceed agreed percentages of the face values of those receivables. Such loans may also 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, the 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 (for example, automobile loans), may be originated directly with an institution's customers (direct paper) or acquired 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 the 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 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, and fees for usage may also be charged.

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, variable, or a combination of both. 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 nonpurchase related 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;

8.42 The Federal Housing Administration (FHA) insures and the U.S. 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 Chapters 4, "Industry Overview—Mortgage Companies," and 10 of this guide include further discussion on mortgage banking activities.

Lease Financing

Update 8-1 *Accounting and Reporting*: Leases

FASB Accounting Standards Update (ASU) No. 2016-02, *Leases (Topic 842)*, issued in February 2016, is effective for fiscal years of a public business entity, a not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market, and an employee benefit plan that files financial statements with the SEC beginning after December 15, 2018, including interim periods within those fiscal years.

For all other entities, FASB ASU No. 2016-02 is effective for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2019.

Early application is permitted for all entities.

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[1] The respective instructions for Schedule HC-R of the Board of Governors of the Federal Reserve System's (Federal Reserve's) *Consolidated Financial Statements for Holding Companies—FR Y-9C* or for Schedule RC-R of the Federal Financial Institutions Examination Council's Consolidated Reports of Condition and Income should be read in conjunction with the regulatory capital rules (for example, Title 12 U.S. *Code of Federal Regulations* [CFR] Part 217) issued by the reporting bank holding company and insured depository institution or primary federal supervisory authority for determination of the applicable risk weight. U.S. banking organizations are subject to the standardized or general capital rules and certain of these institutions also measure regulatory capital using qualified advanced approaches. For example, Item 4.a, *Residential mortgage exposures*, of Schedules HC-R Part II and RC-R Part II indicate that the 20 percent risk weight applies to residential loans secured by real estate including the carrying value of the guaranteed portion of held for sale (HFS) Federal Housing Administration and the U.S. Department of Veterans' Affairs mortgage loans included in closed end loans secured by first liens on 1–4 family residential properties. The 50 percent risk weight would apply for the unguaranteed portion of 1–4 family residential properties and multi-family (5 or more) residential properties if prudently underwritten. The 100 percent risk weight applies to the remaining loans.

FASB ASU No. 2016-02 supersedes the lease requirements in FASB ASC 840, *Leases*, and creates FASB ASC 842, *Leases*, to establish the principles that lessees and lessors should apply to report useful information to users of financial statements about the amount, timing, and uncertainty of cash flows arising from a lease. FASB ASC 842 affects any entity that enters into a lease (as that term is defined in FASB ASU No. 2016-02), with some specified scope exceptions.

This edition of the guide has not been updated to reflect changes as a result of this ASU, however, this section will be updated in a future edition. Readers are encouraged to consult the full text of this ASU on FASB's website at www.fasb.org.

For more information on FASB ASU No. 2016-02, see appendix F, "The New Leases Standard: FASB ASU No. 2016-02," of this guide.

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 8.140). 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 leasing*. 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 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 *Transactions and vendor leasing*. 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. Portions of loans for cross-border transactions are often guaranteed by the Export-Import Bank.

CRE 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 *CRE loans*. Such loans are usually secured by mortgages or other liens on the related real property such as an assignment of rents or a lien on the property, plant, and equipment within the 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 usually 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 commonly obtains long-term mortgage financing from the same or 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," of this guide.

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*, a group of institutions agrees to collectively provide a loan, with each institution being a direct creditor of the borrower for its portion 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 generally services the loan for the group, including disbursement of all funds and supervision of the perfection of legal interests in the underlying collateral. In some cases, an institution that is part of syndication may subsequently transfer via an assignment all or a portion of their share of the loan to another institution. If the borrower approves the assignment, the new institution becomes an official party to the lending agreement (for example, direct creditor to the borrower). 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. 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. The participating institutions have rights to their respective share of the cash flows from the original loan but do not become an official party to the loan agreement (for example, direct creditor). The borrower may not even be aware of the participation agreement.

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 FASB 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 of this guide.

Regulatory Matters

Real Estate Lending Standards

8.57 The Board of Governors of the Federal Reserve System (Federal Reserve), the OCC, and the 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 policies and practices.

8.60 On October 8, 1999, the federal banking agencies, including the Office of Thrift Supervision (OTS), prior to its transfer of powers to the federal banking agencies,[3] jointly issued the *Interagency Guidance on High Loan-to-Value*

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[2] See 12 CFR Part 34 (Office of the Comptroller of the Currency [OCC]); Part 208 (Federal Reserve); and Part 365 (FDIC).

[3] See chapter 1, "Industry Overview—Banks and Savings Institutions," of this guide for further discussion on the Office of Thrift Supervision transfer of powers.

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.

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 and bank holding companies, as well as their nonbank subsidiaries.

8.62 The federal banking agencies, along with 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,[4] 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 U.S. generally accepted accounting principles (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). Readers are encouraged to view the press release under the "Press Releases" page at www.ffiec.gov for additional information.

8.63 *Appraisals*. On December 10, 2010, the federal banking agencies, along with the NCUA, issued *Interagency Appraisal and Evaluation Guidelines*, which replaced the guidelines issued in 1994. These guidelines describe the elements of a sound program for conducting appraisals and evaluations in compliance with the agencies' appraisal regulations. The guidelines provide additional clarification for when a real estate appraisal and evaluation is required to support a real estate-related financial transaction. Further, they explain the minimum regulatory appraisal standards and the supervisory expectations for the development and content of an evaluation, which is permitted in certain situations in lieu of an appraisal. The guidelines build on the existing

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[4] See paragraphs 9.08–.09 of this guide for additional information regarding the classification of loans.

federal regulatory framework and reaffirm long-standing 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 that the programs are consistent with the guidelines. Readers are encouraged to access the guidance from any of the agencies' websites.

8.64 In January 2013, the federal banking agencies, along with the Consumer Financial Protection Bureau (CFPB), the Federal Housing Finance Agency, and the NCUA, issued a final rule *Appraisals for Higher-Priced Mortgage Loans* to establish new appraisal requirements for higher-priced mortgage loans. Higher-priced mortgages are those mortgages with an annual percentage rate that exceeds the average prime offer rate by a specified percentage.[5]

8.65 For higher-priced mortgage loans, the rule requires creditors to use a licensed or certified appraiser who prepares a written appraisal report based on a physical inspection of the interior of the property. The rule also requires creditors to disclose to applicants information about the purpose of the appraisal and provide consumers with a free copy of any appraisal report. If the seller acquired the property for a lower price during the prior six months and the price difference exceeds certain thresholds, creditors will have to obtain a second appraisal at no cost to the consumer. This requirement for higher-priced home-purchase mortgage loans is intended to address fraudulent property flipping by seeking to ensure that the value of the property legitimately increased.

8.66 The rule exempts several types of loans, such as qualified mortgages; temporary bridge loans and construction loans; loans for new manufactured homes; and loans for mobile homes, trailers, and boats that are dwellings. The rule also has exemptions from the second appraisal requirement to facilitate loans in rural areas and other transactions. Readers can access the full text of this final rule from any of the respective agencies' websites.

8.67 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 Regulations*) having a value greater than $250,000. The appraisal regulations do exempt certain real estate-related financial transactions from the appraisal requirement.[6] 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, the OCC and the FDIC use their supervisory authority to require problem federal and state savings associations and federal and state savings associations in troubled condition to obtain appraisals

[5] In December 2013, the Federal Reserve, the Consumer Financial Protection Bureau (CFPB), the FDIC, the Federal Housing Finance Agency, the National Credit Union Administration (NCUA), and the OCC issued a supplemental rule to the appraisals for higher-priced mortgage loans. The supplemental rule provides an exemption to loans of $25,000 or less and certain streamlined refinancings from the Dodd-Frank Wall Street Reform and Consumer Protection Act appraisal requirements. On January 1, 2015, the exemption threshold was adjusted to $25,500 through a final ruling issued by the OCC, the Federal Reserve, and the CFPB.

[6] See 12 CFR Part 34.43 (OCC); Part 225.63 (Federal Reserve); Parts 323.3 and 390.442 (FDIC); and Part 722.3 (NCUA).

for all real estate-related transactions over $100,000 (unless the transaction is otherwise exempt). The 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

8.68 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.[7] 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.

8.69 On March 26, 2001, the federal banking agencies, along with 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 the following:

> After 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 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).

8.70 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. Readers are encouraged to view the full text of this letter under the "Letters to Credit Unions—2009" page at www.ncua.gov.

Troubled Debt Restructurings

8.71 In April 2012, the OCC issued Bulletin OCC 2012-10, *Troubled Debt Restructurings: Supervisory Guidance on Accounting and Reporting*

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[7] See Federal Reserve Supervision and Regulation letter 00-8, *Revised Uniform Retail Credit Classification and Account Management Policy*, at www.federalreserve.gov.

Requirements, to national banks and federal savings associations to address many inquiries received from bankers and examiners on accounting and reporting requirements for troubled debt restructurings (TDRs), especially related to loan renewals and extensions of substandard commercial loans. The bulletin focuses on factors and key concepts to consider when evaluating loans for TDR designation and considerations for the appropriateness of accrual status and impairment analyses.

8.72 The bulletin specifically highlights that all substandard loans on accrual status that are renewed, extended, or otherwise modified should not automatically be considered TDRs. Rather, the institution needs to consider the totality of the transaction given the borrower's financial condition. As such, it is important for banks to establish an appropriate process for identification and analysis of TDRs and to document such an analysis. For example, the procedures should address the process for flagging a modified or renewed loan for review, considering factors to assess TDR status, designating responsibility for the TDR decision, and clearly documenting the facts and circumstances analyzed for each modification or renewal and the conclusion reached. Further guidance regarding TDRs that may assist when considering whether a loan modification or renewal is a TDR can be found in the interagency's *Policy Statement on Prudent Commercial Real Estate Loan Workouts* and the *BAAS*.

8.73 The bulletin further reminds banks that renewals, extensions, or modifications deemed to be TDRs must be evaluated for the appropriate impairment measurement under FASB ASC 310-10 to ensure that the ALLL and accrual status are appropriate and consistent with the Federal Financial Institutions Examination Council's (FFIEC's)*Instructions for Preparation of Consolidated Reports of Condition and Income*. The bulletin also addresses separate considerations that should be given when disclosing of a loan as a TDR and its evaluation under FASB ASC 310-10. Readers can access Bulletin OCC 2012-10 from the OCC website at www.occ.gov.

8.74 In October 2013, the federal banking agencies and the NCUA issued *Interagency Supervisory Guidance Addressing Certain Issues Related to Troubled Debt Restructurings*. The supervisory guidance for financial institutions[8] addresses certain issues related to the accounting treatment and regulatory credit risk grade or classification of commercial and residential real estate loans that have undergone TDRs. The document reiterates key aspects of previously issued regulatory guidance (such as the interagency *Policy Statement on Prudent Commercial Real Estate Loan Workouts*) and discusses the definition of *collateral-dependent loans* and the circumstances under which a charge-off is required for TDRs. Readers can access the full text of this guidance from any of the respective agencies' websites.

8.75 The FFIEC issued *Supplemental Instructions for September 2014 Call Reports* that address the accounting for subsequent restructurings of TDRs. Pursuant to this guidance, certain TDRs that are subsequently modified may no longer be considered to be TDRs if on the subsequent modification the borrower is no longer experiencing financial difficulties and no concession is

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[8] For purposes of this guidance, the term *financial institution* includes national banks, federal savings associations, and federal branches and agencies supervised by the OCC; state member banks, bank holding companies, savings and loan holding companies, and all other institutions for which the Federal Reserve is the primary federal supervisor; state nonmember banks, state savings associations, and insured state branches of foreign banks for which the FDIC is the primary federal supervisor; and federal credit unions and all other institutions for which the NCUA is the federal insurer.

granted to the borrower as a part of this modification. The subsequent modification must carry a market rate of interest for similar debt. Loans with principal forgiveness are considered to carry a continuing concession and therefore are not eligible for reconsideration of TDR status upon a subsequent modification. Loans that are no longer considered TDRs would be measured for impairment under FASB ASC 450-20.

Credit Card Lending

8.76 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 Memo 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. Readers are encouraged to visit the "OTS CEO Memos" page at www.occ.gov to review the full text of this memo.

8.77 For further information, on credit losses, see chapter 9 of this guide.

Nontraditional Mortgage Products

8.78 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

8.79 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.

Leveraged Lending

8.80 In March 2013, the federal banking agencies issued *Interagency Guidance on Leveraged Lending*. This guidance, which replaces the 2001 leveraged lending guidance, outlines high-level principles related to safe-and-sound leveraged lending activities, including underwriting considerations, assessing and documenting enterprise value, risk management expectations for credits awaiting distribution, stress-testing expectations, pipeline portfolio management, and risk management expectations for exposures held by the institution. This guidance applies to all financial institutions supervised by the federal banking agencies that engage in leveraged lending activities. The number of community banks with substantial involvement in leveraged lending is small; therefore, the agencies generally expect community banks to be largely unaffected by this guidance. In November 2014, the federal banking agencies subsequently released a frequently asked questions document to foster industry and examiner understanding of the 2013 leveraged lending guidance and to promote consistent application of the guidance in policy formulation, implementation, and regulatory supervisory assessments.

Income Recognition on Problem Loans

8.81 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.

8.82 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

8.83 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

8.84 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 CFPB 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

8.85 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.

8.86 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.

8.87 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

8.88 The OCCs *Bank Accounting Advisory Series* (BAAS) is updated periodically to express the Office of the Chief Accountant's current views on accounting topics of interest to national banks and federal savings associations. See further discussion of the BAAS in paragraph 7.82 of this guide. Topic 2, "Loans," of the BAAS includes interpretations and responses on (*a*) TDRs, (*b*) nonaccruals, (*c*) commitments, (*d*) origination fees and costs, (*e*) loans HFS, and (*f*) loan recoveries. Readers are encouraged to view this publication under the "Publications—Bank Management" page at www.occ.gov.

Accounting and Financial Reporting

Update 8-2 *Accounting and Reporting*: Credit Losses

FASB ASU No. 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*, issued in June 2016, is effective for fiscal years of public business entities that are SEC filers beginning after December 15, 2019, including interim periods within those fiscal years.

For all other public business entities, the amendments in FASB ASU No. 2016-13 are effective for fiscal years beginning after December 15, 2020, including interim periods within those fiscal years.

For all other entities, including not-for-profit entities and employee benefit plans within the scope of FASB ASC 960 through FASB ASC 965 on plan accounting, FASB ASU No. 2016-13 is effective for fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021.

Early application is permitted for all entities as of the fiscal years beginning after December 15, 2018, including interim periods within those fiscal years.

FASB ASU No. 2016-13 creates FASB ASC 326, *Financial Instruments—Credit Losses*, to amend guidance on reporting credit losses for financial assets held at amortized cost basis and available-for-sale debt securities.

For financial assets held at amortized cost basis, FASB ASC 326 eliminates the probable initial recognition threshold in current GAAP and, instead, requires an entity to reflect its current estimate of all expected credit losses. The allowance for credit losses is a valuation account that is deducted from the amortized cost basis of the financial assets to present the net amount expected to be collected.

For available-for-sale debt securities, credit losses should be measured in a manner similar to current GAAP. However, FASB ASC 326 will require that credit losses be presented as an allowance rather than as a write-down.

FASB ASU No. 2016-13 affects entities holding financial assets and net investment in leases that are not accounted for at fair value through net income. The amendments affect loans, debt securities, trade receivables, net investments in leases, off-balance-sheet credit exposures, reinsurance receivables, and any other financial assets not excluded from the scope that have the contractual right to receive cash.

This edition of the guide has not been updated to reflect changes as a result of this ASU, however, this section will be updated in a future edition. Readers are encouraged to consult the full text of this ASU on FASB's website at www.fasb.org.

For more information on FASB ASU No. 2016-13, see appendix G, "Accounting for Financial Instruments," of this guide.

8.89 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 of this guide 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 as well as chapter 10 of this guide for further guidance.

8.90 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*[9]), 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. In accordance with FASB ASC 948-310-40-1, after the securitization of a mortgage loan HFS

[9] With the other major financial instruments related projects completed, FASB has re-engaged in the hedging project. The objective of this project is to make targeted improvements to the hedge accounting model based on feedback received from preparers, auditors, users, and other stakeholders. For more information on FASB's recognition and measurement project titled Accounting for Financial Instruments—Hedging, see appendix G, "Accounting for Financial Instruments," of this guide.

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 should classify as trading any retained mortgage-backed securities 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.

8.91 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.

8.92 Mortgage and nonmortgage loans may qualify for application of the "Fair Value Option" subsections of FASB ASC 825-10 upon origination or purchase. The reason for such an election often is that the loan is being economically hedged with a derivative instrument that is required to be recorded at fair value. Application of the fair value option eliminates the need to qualify for hedge accounting. 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.

8.93 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. Factoring commissions under these arrangements should be recognized over the period of the loan contract in accordance with FASB ASC 310-20. 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.

8.94 FASB ASC 310-10-25-8 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.

Interest Income, Delinquency Fees, Prepayment Fees, and Rebates

8.95 Interest income on performing loans should be accrued and credited to interest income as it is earned, using the interest method.

8.96 Entities involved in transactions in which captive finance companies offer favorable financing to increase sales of related companies should account for such transactions under the guidance in FASB ASC 835-30. FASB ASC 835-30 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.

8.97 Delinquency fees are amounts debtors pay because of late payment on loans. Such fees are generally small and are intended to represent additional interest to compensate the lender for the time value and additional collection costs associated with delinquencies.

8.98 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.

8.99 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 item (*a*) in FASB ASC 310-20-35-18. Delinquency fees should be recognized in income when chargeable, assuming collectibility is reasonably assured.

8.100 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 item (*a*) in FASB ASC 310-20-35-18. 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

8.101 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. 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). Likewise, direct loan origination costs deferred in accordance with FASB ASC 310-20-25-2 should be recognized as a reduction in the yield of the loan except as set forth in FASB ASC 310-20-35-12 (for a TDR).[10] 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 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, in accordance with FASB ASC 310-20-35-26. Otherwise, the payment terms required by the loan contract should be used.

8.102 Direct loan origination costs must be deferred irrespective of the existence of related loan fees. As defined in the FASB ASC glossary, *direct loan*

[10] Paragraph 10.22 addresses the accounting guidance for loan origination fees and direct loan origination costs when a loan is held for resale.

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 lender for that loan. Unsuccessful loan origination efforts and other indirect costs, which include administrative costs, rent, depreciation, and all other occupancy and equipment costs, should be charged to expense as incurred, according to FASB ASC 310-20-25-3.

8.103 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.

8.104 FASB ASC 310-20 does not apply to fees and costs related to a commitment to originate, sell, or purchase loans that is accounted for as a derivative instrument under FASB ASC 815-10, as stated in item (d) in FASB ASC 310-20-15-3.

8.105 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.

8.106 FASB ASC 310-20-35-21 explains that certain loan agreements provide no scheduled payment terms (demand loans). Other loan agreements provide the borrower with the option to make multiple borrowings up to a specified maximum amount, to repay portions of previous borrowings, and then reborrow under the same contract (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 as an adjustment of yield 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 (or similar loan arrangements) 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.

8.107 Paragraphs 9–10 of FASB ASC 310-20-35 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 and modifications of the original debt instrument are more than minor. 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.

8.108 FASB ASC 310-20-35-11 states that a modification of a debt instrument should be considered more than minor under FASB ASC 310-20-35-10 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.

8.109 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[11]

8.110 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.[12]

8.111 FASB ASC 310-30 permits an entity the option to aggregate and pool loans possessing common risk characteristics that are acquired together or during the same fiscal quarter. The term *common risk characteristics* is

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[11] The AICPA issued Technical Questions and Answers sections 2130.09–.37 (AICPA, *Technical Questions and Answers*), which address accounting for certain loans or debt securities acquired in a transfer. For additional information visit the AICPA website at aicpa.org.

[12] Related financial reporting by liquidating banks is beyond the scope of this guidance. See FASB *Accounting Standards Codification* (ASC) 205-30 for guidance on when and how an entity should prepare its financial statements using the liquidation basis of accounting and describe the related disclosures that should be made.

defined in FASB ASC glossary as loans with similar credit risk (for example, evidenced by similar Fair Isaac Company scores, an automated rating process for credit reports) or risk ratings that share one or more predominant risk characteristics, such as financial asset type, collateral type, size, interest rate, date of origination, term, and geographic location. In other words, the pooling of loans is permitted to be done on the basis of as few as, but no less than, two common attributes with similar credit risk or risk ratings as one required element and predominant risk characteristics as to the other required element. For example, it would not be appropriate to aggregate loans based solely on the collateral type of the loans without regard to their credit risk profile or risk rating.

8.112 The guidance in 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. See also paragraph 19.20 of this guide for further discussion of the AICPA letter to the SEC addressing the scope of FASB ASC 310-30. 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 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. 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.

8.113 Upon completion of a transfer of a credit impaired loan, FASB ASC 310-30 requires that the investor (transferee) should recognize the acquired loans initially at fair value. Subsequently, the excess of all cash flows expected at acquisition over the investor's initial investment in the loan should be accreted as interest income on a level-yield basis over the life of the loan (defined as the *accretable yield* in the FASB ASC glossary), according to FASB ASC 310-30-35-2.

8.114 FASB ASC 310-30-45-1 requires that the amount of accretable yield not be displayed in the balance sheet. In addition, the loan's contractually required payments receivable in excess of the amount of its cash flows expected at acquisition (defined as the *nonaccretable difference* in 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.

8.115 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 subsequent measurement and accounting depends on whether the loans are accounted for as a debt security or are not accounted for as a debt security.

8.116 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.

8.117 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 (1) the excess of the revised cash flows expected to be collected, over (2) the sum of the initial investment, less (3) cash collected, less (4) other-than-temporary impairments, plus (5) the amount of yield accreted to date.

8.118 For loans not accounted for as a debt security, in accordance with FASB ASC 310-30-35-10, if, upon subsequent evaluation that is based on current information and events, it is probable that

a. 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 (in accordance with item (*b*)(*ii*), then the loan should be considered impaired for purposes of applying FASB ASC 450 or, if applicable, FASB ASC 310, *Receivables*.

b. 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 (1) the excess of the revised cash flows expected to be collected, over (2) the sum of the initial investment, less (3) cash collected, less (4) write-downs, plus (5) the amount of yield accreted to date.

8.119 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 item (a) in FASB ASC 310-30-35-10 (see paragraph 8.118).

8.120 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 expected to be collected. Increases in cash flows expected to be collected should be accounted for according to item (*b*) in FASB ASC 310-30-35-8 or item (*b*) in 310-30-35-10 (see paragraphs 8.117–.118). 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 item (*a*) in FASB ASC 310-30-35-8 and item (*a*) in 310-30-35-10 (see paragraphs 8.117–.118), 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.

8.121 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.

8.122 The prohibition of carrying over any valuation allowance previously recorded by the seller applies to the initial accounting of all loans acquired in a transfer that are within the scope of FASB ASC 310-30.

TDRs[13]

8.123 FASB ASC 310-40 addresses measurement, derecognition, disclosure, and implementation guidance issues concerning TDRs focused on the creditor's records. See paragraph 8.75 for a discussion on the FFIEC's *Supplemental Instructions for September 2014 Call Reports* that address the accounting for subsequent restructurings of TDRs.

8.124 For creditors, TDRs include certain modifications of terms of loans and receipt of assets from debtors in partial or full satisfaction of loans.

8.125 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

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[13] The 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 U.S. generally accepted accounting principles 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 *Accounting Standards Codification* (ASC) 310-10-35 and 310-40.

legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider.

8.126 *Creditor's concession determination.* According to 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 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.

8.127 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.

8.128 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.

8.129 *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 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 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.

8.130 *Restructuring Characteristics*. 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.

8.131 FASB ASC 310-40-15-9 further 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

8.132 *Modification of terms*. 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.

8.133 Item (*a*) in FASB ASC 320-10-55-2 clarifies that any loan that was restructured as a security 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). FASB 310-40-40-8A provides guidance on 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.

8.134 *Partial Satisfaction of a Receivable*. In accordance with FASB ASC 310-40-35-7, 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 except that, first, the assets received should be accounted for as prescribed in paragraphs 2–4 of FASB ASC 310-40-40 (see paragraph 8.135) and the recorded investment in the receivable should be reduced by the fair value less cost to sell of the assets received. If cash is received in a partial satisfaction of a receivable, the recorded investment in the receivable should be reduced by the amount of cash received.

8.135 *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 as-sets 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.

8.136 *Impairment*. 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.

8.137 *Foreclosed Assets in TDR*s. "Pending Content" in 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 8.134), paragraphs 2–4 of FASB ASC 310-40-40 and, if appropriate, FASB ASC 310-40-40-8 (see paragraph 8.138). See further discussion on the classification and measurement of certain government-guaranteed mortgage loans upon foreclosure in the "Foreclosed Assets" section of chapter 11 of this guide. For guidance on when a creditor should be considered to have received physical possession (resulting from an in-substance repossession or foreclosure) of residential real estate properly collateralizing a consumer mortgage loan, see FASB ASC 310-40-55-10A.

Update 8-3 *Accounting and Reporting*: Revenue From Contracts With Customers

FASB ASC 606 is effective for annual reporting periods of a public business entity, a not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market, and an employee benefit plan that files or furnishes financial statements with or to the SEC beginning after December 15, 2017, including interim periods within that reporting period. Early application is permitted only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period.

For all other entities, FASB ASC 606 is effective for annual reporting periods beginning after December 15, 2018, and interim periods within annual periods beginning after December 15, 2019. Other entities may elect to adopt the standard earlier, however, only as of either:

- An annual reporting period beginning after December 15, 2016, including interim periods within that reporting period, or
- An annual reporting period beginning after December 15, 2016, and interim periods within annual periods beginning one year after the annual reporting period in which an entity first applies the "Pending Content" that links to FASB ASC 606-10-65-1.

FASB ASC 606 provides a framework for revenue recognition and supersedes or amends several of the revenue recognition requirements in FASB ASC 605 as well as guidance within the 900 series of industry-specific topics. The standard applies to any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets unless those contracts are within the scope of other standards (for example, insurance or lease contracts).

Readers are encouraged to consult the full text of FASB ASC 606 on FASB's website at www.fasb.org.

For more information, see appendix E of this guide.

8.138 *Sale of Assets from a TDR*. 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 FASB ASC 835, *Interest*, 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.

Real Estate Investments

8.139 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 explained in FASB ASC 310-10-05-9, lenders may enter into ADC arrangements in which they have virtually the same risks and potential rewards as those of owners or joint venturers. Loans granted to acquire operating properties sometimes grant the lender a right to participate in expected residual profit from the sale or refinancing of the property. The expected residual profit may take the form of a percentage of the appreciation of the property determined at the maturity of the loan. If the lender is expected to receive over 50 percent of the expected residual profit from the project, item (a) in FASB ASC 310-10-25-27 states that the lender should account for income or loss from the arrangement as a real estate investment as specified in FASB ASC 970, *Real Estate—General*. See chapter 11 of this guide. Effective January 1, 2015, high volatility CRE loans carry a capital charge that is 50 percent higher than the capital charge for other CRE loans.

Lease Financing[14]

8.140 Accounting for leases by lessees and lessors is established in FASB ASC 840. 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

8.141 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.

8.142 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 any such sale are generally subject to similar repatriation restrictions.

8.143 In accordance with paragraph 1-2 of FASB ASC 942-310-30, *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. Because the secondary market for debt of financially troubled countries may be considered

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[14] This edition of the guide has not been updated to reflect the changes as a result of FASB Accounting Standards Update (ASU) No. 2016-02, *Leases (Topic 842)*, however, this discussion will be updated in a future edition. See Update 8-1 for further details on the amendments and effective date of FASB ASU No. 2016-02.

to be thin, it may not be the best indicator of the fair value of the equity investment or of net assets received. FASB ASC 942-310-30-3 provides factors to consider in measuring fair values of debt/equity swap transactions.

8.144 If amounts are received on a financially troubled country's loan on which the accrual of interest has been suspended, FASB ASC 942-310-35-2 notes that a determination should be made about whether the payment should be recorded as a reduction of the principal balance of the loan or as interest income.

Commitments

8.145 Paragraphs 69–71 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 (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). For the holder of a commitment to originate a loan (that is, the potential borrower), that 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.

8.146 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.

8.147 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.

8.148 Commitments to originate mortgage loans that will be HFS generally qualify as derivative instruments and 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.

8.149 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.

8.150 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.

8.151 FASB ASC 310-10-30-7 states that if a standby commitment is viewed under FASB ASC 310-10-25-6 as part of the normal production of loans, an entity should record loans purchased under the standby commitment 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.

8.152 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

8.153 *Loans and trade receivables*. FASB ASC 310-10-50-2 states that the summary of significant accounting policies should include the following:

- The basis for accounting for loans and trade receivables.
- 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.[15]
- The method used in determining the lower of cost or fair value of *nonmortgage* loans HFS (that is, aggregate or individual asset basis).[16]
- 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.

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[15] 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. As defined in 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 FASB ASC 860-20-35-2 for additional information.

[16] A similar requirement exists for mortgage loans HFS.

8.154 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.

8.155 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.

8.156 Except for credit card receivables, FASB ASC 310-10-50-4A requires that an entity 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.

8.157 *Nonaccrual and past due financing receivables*. FASB ASC 310-10-50-6 requires that a entity's 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)
- the policy for recording 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.

8.158 According to 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 in FASB ASC 310-10-50-7B.

8.159 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.

8.160 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 FASB ASC 310-30. 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 in FASB ASC 310-10-50-5B.

8.161 *Impaired loans*. See discussion on disclosure requirements of impaired loans in paragraph 9.54 of this guide.

8.162 *Credit quality*. According to 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 updated 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 in FASB ASC 310-10-50-27.

8.163 *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.

8.164 Paragraphs 2–3 of FASB ASC 310-40-50 explains 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 items (*a*) and (*c*) in FASB ASC 310-10-50-15 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 items (*a*) and (*c*) in FASB ASC 310-10-50-15 to all loans restructured in a TDR that meet the criteria in items (*a*) and (*b*) in FASB ASC 310-40-50-2.

8.165 For each period for which a statement of income is presented, FASB ASC 310-10-50-33 requires an entity to 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

8.166 For each period for which a statement of income is presented, FASB ASC 310-10-50-34 requires an entity to disclose 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

8.167 *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.

8.168 *Transfers of financial assets*. Accounting and financial reporting matters related to the sales or other dispositions of loans are addressed in chapter 10 of this guide.

8.169 *Lease financing*.[17] 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.

8.170 *Fair value option.* As of each date for which a statement of financial position is presented, item (*e*) in FASB ASC 825-10-50-28 states that 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.

8.171 For each period for which an income statement is presented, item (*c*) in FASB ASC 825-10-50-30 requires that entities disclose for loans and other receivables held as assets, for which the fair value option has been elected, both of the following:

- The estimated amount of gains or losses included in earnings during the period attributable to changes in instrument-specific credit risk
- How the gains or losses attributable to changes in instrument-specific credit risk were determined

8.172 *Concentrations of credit risk of all financial instruments*. 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 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

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[17] This edition of the guide has not been updated to reflect the changes as a result of FASB ASU No. 2016-02, however, this discussion will be updated in a future edition. See Update 8-1 for further details on the amendments and effective date of ASU No. 2016-02

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.

8.173 Information about loan products and terms of loan products that identifies the concentration may also be disclosed.

8.174 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.

8.175 *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 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

8.176 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.

8.177 *Related party disclosures*. 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. See paragraphs 5.38–.39 of this guide for Regulation O requirements regarding extension of credit to certain related parties.

8.178 *Guarantees*. 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 item (a) in FASB ASC 460-10-55-16. However, FASB ASC 460-10-55-2 provides 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 in 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.

8.179 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 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 under FASB ASC 460-10-25-4 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.

8.180 In accordance with paragraphs 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 in FASB ASC 450-20-30.

8.181 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

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[18]

Objectives

8.182 The primary objectives of audit procedures in the loan area are to obtain sufficient appropriate evidence that

[18] The auditing content in this guide focuses primarily on generally accepted auditing standards issued by the Auditing Standards Board and is applicable to audits of the financial statements of those entities not subject to the oversight authority of the PCAOB (that is, those audit reports not within the PCAOB's jurisdiction as defined by the Sarbanes-Oxley Act of 2002, as amended—hereinafter referred to as *nonissuers*). However, considerations for audits of entities subject to the oversight authority of the PCAOB (that is, those audit reports within the PCAOB's jurisdiction as defined by the Sarbanes-Oxley Act of 2002, as amended) may be discussed within this guide's chapter text. When such discussion is provided, the related paragraphs are designated with the following title: *Considerations for Audits Performed in Accordance With PCAOB Standards*.

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 of this guide);

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. credit commitments, letters of credit, guarantees, recourse provisions, and loans that collateralize borrowings are properly disclosed in the financial statements; and

i. transfers of loans have been properly accounted for as sales or secured borrowings under FASB ASC 860.

Planning

8.183 In accordance with AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), the objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and relevant assertion levels through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement (see chapter 5, "Audit Considerations and Certain Financial Reporting Matters," of this guide 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 of this guide for guidance.

8.184 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, or with a particular borrower or relationship of borrowers
- 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
- Additional charge-off of loans upon resolution exceeding the specific reserve established for impaired loans

Internal Control Over Financial Reporting and Possible Tests of Controls[19]

8.185 AU-C section 315 addresses the auditor's responsibility to identify and assess the risks of material misstatement in the financial statements through understanding the entity and its environment, including the entity's internal control. Paragraphs .13–.14 of AU-C section 315 state that the auditor should obtain an understanding of internal control relevant to the audit and, in doing so, should evaluate the design of those controls and determine whether they have been implemented by performing procedures in addition to inquiry of the entity's personnel. (See chapter 5 of this guide for further discussion of the components of internal control.) To provide a basis for designing and performing further audit procedures, paragraph .26 of AU-C section 315 states that the auditor should identify and assess the risks of material misstatement at the financial statement level and the relevant assertion level for classes of transactions, account balances, and disclosures.

8.186 An understanding of the internal control over the financial reporting of loans may 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.

8.187 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 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.

8.188 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

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[19] The FDIC's Financial Institution Letter-23-2009, *Annual Audit and Reporting Requirements: Final Amendments to Part 363*, 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 and appendix A, "FDI Act Reporting Requirements," of this guide and the FDIC website at www.fdic.gov.

AU-C section 940, *An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Financial Statements* (AICPA, *Professional Standards*), establishes requirements and provides guidance that applies only when an auditor is engaged to perform an audit of internal control over financial reporting that is integrated with an audit of financial statements.

- a reporting system that provides the institution with the information needed to manage the loan portfolio including monitoring of payment and past due status and credit quality.

8.189 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.

8.190 With respect to some risks, paragraph .31 of AU-C section 315 states that the auditor may judge that it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures. Such risks may relate to the inaccurate or incomplete recording of routine and significant classes of transactions or account balances, the characteristics of which often permit highly automated processing with little or no manual intervention. In such cases, the entity's controls over such risks are relevant to the audit, and the auditor should obtain an understanding of them. 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.
- Loans that were sold and are removed from the lender's balance sheet meet the requirements for removal under FASB ASC 860.
- 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.

8.191 *Loan files.* Complete and accurate loan files are an element of internal control over financial reporting. Paragraph 8.192 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.

8.192 Following are items a loan file may contain. The specific items contained in a loan file will vary based on the size, complexity, and type of loan. 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 (for example, borrower's board resolutions concerning loan approval) and date approval was granted
   - iv. Recent financial statements of borrower, guarantor, or both
   - v. Spreadsheets and other analyses of the financial situation of the borrower including analysis of debt service capability
   - vi. Credit agency reports and other account information reports, as well as direct trade creditor references
   - vii. Newspaper clippings about borrower
   - viii. Various other pertinent data, including the borrower's history and forecasts
   - ix. Correspondence
   - x. 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

xi. 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

8.193 For commercial loans, the credit 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.

8.194 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.

8.195 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.

8.196 Specific procedures the auditor may consider performing to test the operating effectiveness of controls for loans include

- inspecting loan documents, including sales and participation agreements, 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
  - — 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; and
  - — loans sold meet the conditions in FASB ASC 860 for removal from the lender's balance sheet.
- 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 performing a review of concentration reports (such as loans to one borrower, in a particular region, or in a specific industry) and related-party loan reports.
- reviewing internal audit, loan review, and examination reports to identify control weaknesses and exceptions.
- observing or otherwise obtaining evidence that 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).

See paragraph 8.220 for procedures around controls identified at a service organization.

8.197 *Credit card activities.* If 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 to the extent the auditor considers such internal control relevant to the audit. 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 charge-offs may be appropriate
- Test charge-off history and compare to reserve levels

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.

8.198 To the extent the institution relies on other entities for some processing activities, the auditor should refer to the guidance in AU-C section 402, *Audit Considerations Relating to an Entity Using a Service Organization* (AICPA, *Professional Standards*).

Substantive Tests

8.199 Irrespective of the assessed risks of material misstatement, paragraph .18 of AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*), states that the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure, which for a financial institution would include loans. In accordance with paragraph .A45 of AU-C section 330, this requirement reflects the facts that (*a*) the auditor's assessment of risk is judgmental and may not identify all risks of material misstatement and (*b*) inherent limitations to internal control exist, including management override.

8.200 Paragraph .06 of AU-C section 330 states that the auditor should design and perform further audit procedures whose nature, timing, and extent are based on, and are responsive to, the assessed risks of material misstatement at the relevant assertion level.

8.201 *Analytical procedures.* AU-C section 520, *Analytical Procedures* (AICPA, *Professional Standards*), addresses the auditor's use of analytical procedures as substantive procedures (substantive analytical procedures). See chapter 5 of this guide for additional guidance regarding analytical procedures.

8.202 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
- 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

8.203 In accordance with item *a* in paragraph .05 of AU-C section 520, when designing and performing analytical procedures, either alone or in combination with tests of details, as substantive procedures in accordance with AU-C section 330,[20] the auditor should determine the suitability of particular substantive analytical procedures for given assertions, taking into account the assessed risks of material misstatement and tests of details, if any, for these assertions. Analytical procedures may be used to help assess risk and identify areas that may require additional audit procedures. 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 with a sufficient level of precision 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).

8.204 In accordance with item *b* in paragraph .05 of AU-C section 520, when designing and performing analytical procedures, either alone or in combination with tests of details, as substantive procedures in accordance with AU-C section 330,[21] the auditor should evaluate the reliability and completeness of data from which the auditor's expectation of recorded amounts or ratios is developed, taking into account the source, comparability, and nature and relevance of information available and controls over preparation. System generated information should be tested for completeness and accuracy. Paragraph .A19 of AU-C section 520 further explains that the auditor may consider testing the operating effectiveness of controls, if any, over the entity's preparation of information used by the auditor in performing substantive analytical procedures in response to assessed risks. When such controls are effective, the auditor may have greater confidence in the reliability of the information and, therefore, in the results of analytical procedures. The operating effectiveness of controls over nonfinancial information may often be tested in conjunction with other tests of controls. Further requirements on the auditor's evaluation of data reliability can be found in paragraph .09 of AU-C section 500, *Audit Evidence* (AICPA, *Professional Standards*).

8.205 When designing substantive analytical procedures, the auditor also might evaluate the risk of management override of controls. As part of this

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[20] Paragraph .18 of AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*).

[21] See footnote 20.

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.

8.206 For significant risks of material misstatement, it is unlikely that audit evidence obtained from substantive analytical procedures alone will be sufficient.

8.207 *Subsidiary records.* In accordance with paragraph .21 of AU-C section 330, the auditor's substantive procedures should include audit procedures relating to the financial statement closing process, such as agreeing or reconciling financial statement balances, including loan principal balances and related accounts (accrued interest receivable, unearned discount, and net deferred loan fees and costs), with the underlying accounting records (trial balance, general ledger, and other subsidiary records). The auditor should test significant reconciling items.

8.208 *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-C section 530, *Audit Sampling* (AICPA, *Professional Standards*),[22] and AU-C section 320, *Materiality in Planning and Performing an Audit* (AICPA, *Professional Standards*). Readers may also refer to the AICPA Audit Guide *Audit Sampling* that provides guidance to help auditors apply audit sampling in accordance with AU-C section 530. Guidance on the timing of audit procedures is included in AU-C section 330.[23]

8.209 AU-C section 505, *External Confirmations* (AICPA, *Professional Standards*), addresses the auditor's use of external confirmation procedures to obtain audit evidence, in accordance with the requirements of AU-C sections 320 and 500.

8.210 When using external confirmation procedures, item (c) in paragraph .07 of AU-C section 505 states that the auditor should maintain control over external confirmation requests, including designing the confirmation requests, determining that requests are properly directed to the appropriate confirming party and providing for responses being directly to the auditor. Paragraphs .A4–.A5 of AU-C section 505 further explain that the design of a confirmation request may directly affect the confirmation response rate and the reliability and nature of the audit evidence obtained from responses. In addition, a factor to consider when designing confirmation requests is the ability of the intended confirming party to confirm or provide the requested information. 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.

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[22] See footnote 11.

[23] See footnote 11.

8.211 Auditors may use either positive or negative requests to confirm loans. However, paragraph .15 of AU-C section 505 states that negative confirmations provide less persuasive audit evidence than positive confirmations. Accordingly, the auditor should not use negative confirmation requests as the sole substantive audit procedure to address an assessed risk of material misstatement at the assertion level, unless all of the following are present:

a. The auditor has assessed the risk of material misstatement as low and has obtained sufficient appropriate audit evidence regarding the operating effectiveness of controls relevant to the assertion.

b. The population of items subject to negative confirmation procedures comprises a large number of small, homogeneous account balances, transactions, or conditions.

c. A very low exception rate is expected.

d. The auditor is not aware of circumstances or conditions that would cause recipients of negative confirmation requests to disregard such requests.

Positive confirmation procedures might be appropriate 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.

8.212 *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.

8.213 When inspecting loan documents, the auditor may test the physical existence and read 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.

8.214 While inspecting loan documents, the auditor should keep in mind the audit objectives discussed in chapter 9 of this guide. For example, reading the financial 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.

8.215 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.

8.216 *Construction loans.* Audit procedures should be responsive to the assessed risk related 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.

8.217 *Lease financing.* When confirming basic lease terms, the confirmation requests typically would 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 accordance with FASB ASC 840.[24]

8.218 *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-C section 402 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. Statement on Standards for Attestation Engagements No. 16,[25] 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. It complements AU-C section 402 in that reports prepared in accordance with this section may provide appropriate evidence under AU-C section 402.

8.219 Paragraph .A24 of AU-C section 402 states that a type 1 or type 2 report (as defined in AU-C section 402) may assist the user auditor in obtaining

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[24] See paragraph 8.140.

[25] The AICPA Guide *Reporting on an Examination of Controls at a Service Organization Relevant to User Entities' Internal Control Over Financial Reporting (SOC 1®)* contains information for practitioners reporting on controls at a service organization that affect user entities' internal control over financial reporting. Also, the AICPA Guide *Reporting on Controls at a Service Organization Relevant to Security, Availability, Processing Integrity, Confidentiality, or Privacy (SOC 2®)* summarizes the three SOC engagements and provides detailed guidance on planning, performing, and reporting on SOC 2 engagements.

a sufficient understanding to identify and assess the risks of material misstatement of the user entity's financial statements. A type 1 report, however, does not provide any evidence of the operating effectiveness of the relevant controls.

8.220 When the user auditor's risk assessment includes an expectation that controls at the service organization are operating effectively, paragraph .16 of AU-C section 402 states that the user auditor should obtain audit evidence about the operating effectiveness of those controls from one or more of the following procedures:

a. Obtaining and reading a type 2 report, if available

b. Performing appropriate tests of controls at the service organization

c. Using another auditor to perform tests of controls at the service organization on behalf of the user auditor

If the user auditor believes that the service auditor's report may not provide sufficient appropriate audit evidence (for example, if a service auditor's report does not contain a description of the service auditor's tests of controls and results thereof), paragraph .A38 of AU-C section 402 further explains that the user auditor may supplement his or her understanding of the service auditor's procedures and conclusions by contacting the service organization through the user entity to request a discussion with the service auditor about the scope and results of the service auditor's work. Also, if the user auditor believes it is necessary, the user auditor may contact the service organization through the user entity to request that the service auditor perform procedures at the service organization, or the user auditor may perform such procedures. Further guidance for a user auditor can be found in AU-C section 402.

8.221 *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 and the amounts can be predicted with a sufficient level of precision, 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 8.201–.206, the effectiveness of such analytical procedures may vary.

8.222 *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.

8.223 *Balance sheet classification of loans.* Depending on the auditor's assessment of the risks of material misstatement, 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.

8.224 *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.

8.225 *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.

8.226 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. Based on the auditor's assessment of the risks of material misstatement, the auditor should consider whether to send confirmations to the borrower on any undisbursed loan balances.

8.227 *TDRs*. The auditor should consider performing procedures to determine whether management has appropriately identified all TDRs, whether the accrual status is appropriate, whether they have been accounted for in conformity with FASB ASC 310-40, and whether management has appropriately measured impairment for TDRs under FASB ASC 310-10. 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 [see paragraph 8.137]). Auditors should also consider whether the entities have appropriate tracking and reporting processes in place to address disclosure requirements applicable to TDRs.

8.228 In addition, auditors should consider reviewing substandard or watch-listed loans that have been renewed at terms similar to the original loan because these loans may involve borrowers that are experiencing some level of financial difficulty and, because of the deterioration in the loan's credit quality, may not otherwise qualify for the terms as offered in the renewal agreement. In these instances, the institution may have granted a concession because the interest rate for such a renewal is not indicative of a market rate, and, therefore, the renewal under such terms is a strong indicator that the loan should be accounted for as a TDR. In such cases, auditors should consider whether the institutions have appropriately documented their conclusions regarding TDR status and appropriately accounted for renewals of this nature. When the practical expedient for collateral dependent loans is not elected, the auditor may also want to review the assumptions of projected cash flows utilized in impairment measurements to determine the reasonableness of the estimates because this will drive the allocated allowance for such loans.

8.229 *Valuation*. 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. In accordance with paragraph .06 of AU-C section 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* (AICPA, *Professional Standards*), the objective of the auditor is to obtain sufficient appropriate audit evidence about whether, in the context of the applicable financial reporting framework, accounting estimates including fair value accounting estimates in the financial statements, whether recognized or disclosed, are reasonable and related disclosures in the financial statements are adequate. AU-C section 540 provides relevant guidance. AU-C section 620, *Using the Work of an Auditor's Specialist* (AICPA, *Professional Standards*), addresses the auditor's responsibilities relating to the work of an individual or organization possessing expertise in a field other than accounting or auditing when that work is used to assist the auditor in obtaining sufficient appropriate audit evidence. AU-C section 620 does not address the auditor's use of the work of an individual or organization possessing expertise in a field other than accounting or auditing, whose work in that field is used by the entity to assist the entity in preparing the financial statements (a management's specialist), which is addressed in AU-C section 500.

8.230

Considerations for Audits Performed in Accordance With PCAOB Standards[26]

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. 400.02), 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. 4, *Auditor Considerations Regarding Fair Value Measurements, Disclosures, and Other-Than-Temporary Impairments* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400.04), 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*)

[26] 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.

audits of financial statements, including integrated audits; (*c*) disclosures; and (*d*) auditor reporting considerations.

PCAOB Staff Audit Practice Alert No. 7, *Auditor Considerations of Litigation and Other Contingencies Arising From Mortgage and Other Loan Activities* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400.07), 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

Update 9-1 *Accounting and Reporting*: Credit Losses

FASB Accounting Standards Update (ASU) No. 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*, issued in June 2016, is effective for fiscal years of public business entities that are SEC filers beginning after December 15, 2019, including interim periods within those fiscal years.

For all other public business entities, the amendments in FASB ASU No. 2016-13 are effective for fiscal years beginning after December 15, 2020, including interim periods within those fiscal years.

For all other entities, including not-for-profit entities and employee benefit plans within the scope of FASB *Accounting Standards Codification* (ASC) 960, *Plan Accounting—Defined Benefit Pension Plans* through FASB ASC 965, *Plan Accounting—Health and Welfare Benefit Plans* on plan accounting, FASB ASU No. 2016-13 is effective for fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021.

Early application is permitted for all entities as of the fiscal years beginning after December 15, 2018, *including* interim periods within those fiscal years.

FASB ASU No. 2016-13 creates FASB ASC 326, *Financial Instruments—Credit Losses*, to amend guidance on reporting credit losses for financial assets held at amortized cost basis and available-for-sale debt securities.

For financial assets held at amortized cost basis, FASB ASC 326 eliminates the probable initial recognition threshold in current U.S. generally accepted accounting principles (GAAP) and, instead, requires an entity to reflect its current estimate of all expected credit losses. The allowance for credit losses is a valuation account that is deducted from the amortized cost basis of the financial assets to present the net amount expected to be collected.

For available-for-sale debt securities, credit losses should be measured in a manner similar to current GAAP. However, FASB ASC 326 will require that credit losses be presented as an allowance rather than as a write-down.

FASB ASU No. 2016-13 affects entities holding financial assets and net investment in leases that are not accounted for at fair value through net income. The amendments affect loans, debt securities, trade receivables, net investments in leases, off-balance-sheet credit exposures, reinsurance receivables, and any other financial assets not excluded from the scope that have the contractual right to receive cash.

This edition of the guide has not been updated to reflect changes as a result of this ASU, however, this chapter will be updated in a future edition. Readers are encouraged to consult the full text of this ASU on FASB's website at www.fasb.org.

For more information on FASB ASU No. 2016-13, see appendix G, "Accounting for Financial Instruments," of this guide.

Introduction

9.01 Financial institutions accept and manage significant amounts of credit risk. Declines in the value of 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 are incurred as of the balance sheet date. Chapter 8, "Loans," of this guide discusses the various types of loans institutions make or purchase, the lending process and related controls, financial reporting for loans, and the audit procedures for loans.

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. Although liabilities related to credit losses associated with such off-balance-sheet financial instruments are not part of the allowance for loan losses, institutions' processes for evaluation and estimation of credit losses may include consideration of credit risk associated with those off-balance-sheet financial instruments, especially when the counterparty to an off-balance-sheet financial 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 financial instruments.

9.03 Careful planning, risk assessment and execution of audit procedures related to credit losses is essential due to the significance of the allowance for loan losses and related provision to institutions' financial statements and to 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.

Management's Methodology

9.04 Management is responsible for estimating credit losses using a methodology that results in an estimate that is in accordance with GAAP. Management has a responsibility for developing, maintaining, and documenting a comprehensive, systematic, and consistently applied process for determining the allowance for loan losses. To fulfill that responsibility, management should ensure controls are in place to consistently estimate the allowance for loan losses using a methodology that results in an estimate that is in accordance with GAAP, and that complies with the institution's stated policies and procedures, and relevant supervisory guidance. 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; current conditions existing at the balance sheet date; and realistic courses of action that management expects to take.

9.05 An institution's methodology for estimating credit losses should be well documented, with clear explanations of the supporting analyses and rationale. An institution's methodology for 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 methodologies, there are certain common elements included in any effective methodology. They include, subject to materiality considerations,

a. a detailed and regular analysis of the loan portfolio and off-balance-sheet financial instruments with credit risk;

b. procedures for timely identification of problem credits;

c. consistent use and application;

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 exposures;

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 with oversight by appropriate levels of management, and, when appropriate, board committees;

i. current, relevant, and reliable data;

j. good documentation with clear explanations of the supporting analyses and rationale;

k. identification of all subsequent events that provide additional evidence about conditions that existed at the balance sheet date;

l. segregation of loans purchased or acquired such that an appropriate allowance for loan losses is recorded for deterioration in cash flows on loans scoped into FASB ASC 310-30 (purchased credit impaired);

m. segregation of troubled loans that have been modified such that an appropriate allowance for loan losses is recorded for loans scoped into FASB ASC 310-40 (troubled debt restructurings by creditors); and

n. consideration of the particular risks in the organization structure, underwriting or loan administration practices, where applicable.

9.06 Allowance methodologies 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 all of the essential elements of an effective methodology because they do not involve a detailed analysis of an institution's particular credit exposures or consider the current economic environment. The allowance documentation should include a conclusion as well as the basis for conclusion on the appropriateness and reasonableness of the resulting point estimate.

9.07 The components of the loan portfolio and their related allowance for loan losses might have different risks, for instance if those components relate to different credit exposures, and the components of the allowance for loan losses are determined using different methodologies, or are subject to different accounting requirements. As discussed in the following paragraph, financial institutions have traditionally identified loans that are to be evaluated for collectibility by dividing the loan portfolio into different segments. Loans with similar risk characteristics are generally grouped and evaluated together. The defining risk characteristics of each segment may include different combinations of such factors as risk classification or rating, past-due status, type of loan, collateral, vintage, geographic regions, FICO scores, loan-to-value ratios, and lines of business. Appropriate segmentation provides for a more accurate assessment of the estimated loss in the portfolio by differentiating loss rates based on common risk factors.

9.08 A key element of most methodologies for estimating credit losses related to commercial loans is a risk classification process that involves categorizing loans into risk categories or ratings. The categorization should be based on relevant information about the ability of borrowers to service the debt, such as current financial information, historical payment experience, credit documentation, public information, current trends, and the value of collateral, including its ability to generate cash flows. Many institutions classify loans using a risk rating system that incorporates as its most serious categories the supervisory classification system as follows:[1]

substandard. Assets classified as substandard are inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Assets 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. Doubtful is a transitional asset classification category; loans classified doubtful typically have a pending short term event that will provide evidence of the confirmed loss amount.

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 asset has absolutely no recovery or salvage value but, rather, that it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be effected in the future.

9.09 Some loans are listed as special mention.[2] Such loans have 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. However, these loans do generally represent an elevated collection risk for the institution and the method of estimating credit losses should consider the elevated collection risk accordingly.

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[1] Uniform Agreement on the Classification and Appraisal of Securities Held by Depository Institutions, October 29, 2013.

[2] Interagency Statement on the Supervisory Definition of Special Mention Assets, June 10, 1993.

9.10 Examples of potential weaknesses are

- poor underwriting or loan administration 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 (if relevant) about the borrower or guarantors, including stale financial information or lack of current collateral valuations.
- economic or market conditions existing at the balance sheet date that may affect the borrower's ability to meet scheduled repayments in the future. These may be evidenced by adverse profitability, liquidity, or leverage trends in the borrower's financial statements.

9.11 The supervisory ratings special mention, substandard, doubtful, and loss identify different degrees of credit weakness. Credits that are not covered by these definitions are "pass" credits, for which no formal supervisory definition exists (for example, supervisory ratings do not distinguish among loans within the pass category). However, more precise monitoring of credit risk allows for better allowance estimates and enhances early warning and portfolio management. It is difficult to manage risk prospectively without some stratification of the pass ratings. The number of pass ratings an institution will find useful depends on the complexity of the portfolio and the objectives of the risk rating system. Less complex, community banks may find that a few pass ratings are sufficient to differentiate the risk among their pass-rated credits. Larger, more complex institutions will generally require the use of a larger number of pass ratings to achieve their risk identification and portfolio management objectives.

9.12 Although the Board of Governors of the Federal Reserve System (Federal Reserve), the FDIC, and the Office of the Comptroller of the Currency (OCC) do not require institutions to adopt identical classification definitions, institutions should classify their assets using a system that can be easily reconciled with the supervisory classification system. The lack of an effective classification system may be considered to be an unsafe and unsound practice by regulators.

Loan Reviews

9.13 *Loan review function.* An effective loan review function should include internal controls to promptly identify loans with potential credit weaknesses and trends that affect the collectibility of the portfolio. Loan credit analyses performed by loan review focus on determining whether the loans are properly classified or rated according to their relative 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 the contractual terms and conditions of the loan. 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, (*c*) estimates of current fair values of collateral, and (*d*) other information affecting the borrower's ability to repay. Borrower and guarantor financial statements are generally reviewed for weaknesses 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 fair value less costs to sell is greater than the amount owed. Loan file contents are generally reviewed for completeness and conformity with the institution's written policies for loan file documentation. The nature of the loan review system may vary based on an institution's size, complexity, loan types and management practices. Some institutions outsource the loan review function to an independent third party, although the loan review function always remains a responsibility of management. Regardless of the structure, the lack of an effective loan review function may be considered to be an unsafe and unsound practice by regulators. The absence of an effective loan review function may also be an indicator of a significant deficiency or a material weakness, as defined in paragraph .07 of AU-C section 265, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*).

9.14 Foreign loans should be reviewed and require special consideration because of the transfer risk associated with cross-border lending. Transfer risk is the possibility that an asset cannot be serviced in the currency of payment because of a lack of, or restraint on the availability of, needed foreign exchange in the country of the obligor. 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 for loan losses is necessary based on the assessment of probable losses in accordance with GAAP.

9.15 Loan evaluations performed by management for the purpose of risk rating and measurement of impairment (and tests of such by auditors to the extent they are performed as part of the audit engagement) should avoid the following:

- *Inadequate appraisals of collateral.* 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 or collateral sensitive to cyclical fluctuations or who demonstrate significant growth or changes in operating philosophy and markets. 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 value of the property will likely decline, diminishing the protection afforded by the collateral. 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.

- *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 of the institution 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 and loan officer 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.

Loans Individually Evaluated for Impairment

9.16 After segmenting the loan portfolio into groups of loans with similar risk characteristics, loans that are not recognized as being impaired in the individual loan impairment analyses, based on the definition, normally would be evaluated and measured for impairment on a collective basis. Institutions will further identify certain loans to be assessed for individual loan impairment. Loans that are generally assessed for individual impairment include large loans, and loans with especially heightened risk profiles, for example, certain risk categories. The individual loan impairment analyses may be performed by loan officers subject to review by a loan review function or may be performed by a credit risk management function. An individual loan is deemed to be impaired when it is probable that the creditor will be unable to collect all the contractual interest and principal payments as scheduled in the loan agreement. Loans that are recognized as being impaired cannot be further evaluated and measured for impairment on a collective basis, regardless of whether such loans result in an impairment loss or not. For this reason it is important to distinguish between an assessment that concludes a loan is not impaired, and a loan that is impaired but that does not need any allowance or write down.

Loans Collectively Evaluated for Impairment

9.17 Loans not evaluated for impairment individually are included in groups (or pools) of homogeneous loans and evaluated for impairment on a collective basis. 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 current trends and conditions. The time period used for determining the historical loss rate is often referred to as the *look-back period*. The look-back period should be reasonable, supported, and consistently applied. However, the look-back period should not be static; rather, it should be revised (either shortened or lengthened) as changes occur in the portfolio and its credit quality. The look-back period should be the period that best reflects losses inherent in the current portfolio. The look-back period may differ by segment, as the economic cycle and current conditions may be different for different types of loans. The look-back period impacts the extent of qualitative adjustments made to the historical loss rates because the degree of comparability of the look-back period to the current period will generally vary. For example, during upswings or downswings in the credit cycle a longer look-back period may be less representative of the current environment and therefore may require higher levels of qualitative or environmental factor adjustments than may be necessary for a shorter look-back period. Generally, management should determine the historical loss rate for each group of loans with similar risk characteristics based on the institution's own loss experience for loans in that group. Methods for calculating loss rates include average historical net charge-off rates, migration analysis (including roll rate analysis), and loss estimation models. The method used by an institution will depend on considerations such as the size of the institution and the nature, scope, and risk of its lending activities. Although historical loss experience provides a reasonable starting point for the analysis of loss rates, historical losses (or even recent trends in losses) do not by themselves form a sufficient basis to estimate the appropriate level of the allowance for loan losses. Management should also consider those qualitative or environmental factors that are likely to cause estimated credit losses associated with the institution's existing portfolio to differ from historical loss experience. Qualitative or environmental factors can include, but are not limited to,

- changes in the volume and severity of past due loans, the volume of nonaccrual loans, and the volume and severity of adversely classified or graded loans;
- changes in the nature and volume of the portfolio and in the terms of loans;
- changes in lending policies and procedures, including changes in underwriting standards and collection, charge-off and recovery practices not considered elsewhere in estimating credit losses;
- changes in the experience, ability, and depth of lending management and other relevant staff;
- changes in international, national, regional, and local economic and business conditions and developments that affect the collectibility of the portfolio, including the condition of various market segments;
- the existence and effect of any concentrations of credit risk and changes in the level of such concentrations;

- changes in the quality of the institution's loan review system;
- changes in the value of underlying collateral for collateral-dependent loans; and
- the effect of other external factors, such as competition and legal and regulatory requirements on the level of estimated credit losses in the institution's existing portfolio.

9.18 Qualitative adjustments may address limitations of the quantitative analysis of the allowance for loan losses based on historical loss experience and serves as a bridge for the difference between (*a*) conditions prevailing in the current credit environment compared to the environment in the look-back period and (*b*) the credit profile of the of an entity's current loan portfolio compared to the credit profile of the portfolio in the look-back period. Identification of relevant qualitative and environmental factor adjustments depends on an understanding of the composition of the portfolio, the lending profile of the institution, market area and current economic conditions and how these elements are or are not captured in the quantitative model. When qualitative adjustments are used, they should be supported by reliable evidence. The quantitative and qualitative analyses should interact with each other to ensure that the allowance for loan losses is appropriate and reflects credit losses incurred as of the balance sheet date.

Estimating Overall Credit Losses

9.19 Careful judgment must be applied in assessing the risks as well as other relevant factors for each segment of loans to estimate the allowance amount to be recorded. Depending on the method used to measure impairment, collective or individual, institutions should follow the appropriate accounting guidance when estimating allowance levels (see paragraphs 9.38–.40). The approach for determination of the allowance should be well documented and applied consistently from period to period, as stated in FASB ASC 310-10-35-4c.

9.20 In addition to the standards outlined previously, SEC Staff Accounting Bulletin (SAB) No. 102, *Selected Loan Loss Allowance Methodology and Documentation Issues*, and the 2006 Federal Financial Institutions Examination Council (FFIEC) *Interagency Policy Statement on the Allowance for Loan and Lease Losses* provides further guidance regarding documentation requirements related to the allowance for loan losses.

9.21 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, estimated credit losses on off-balance-sheet financial instruments should be reported separately as liabilities and not as part of the allowance for loan losses (see paragraph 9.56).

9.22 Management should consider its overall allowance for loan losses and the liability for other credit exposures to be appropriate in accordance with 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 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 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 (FASB *Accounting Standards Codification* [ASC] 460, *Guarantees*)			
Other			
Total liability for credit instruments and other credit exposures		$	$

* 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 *Accounting Standards Codification* (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 portfolio.

‡ This category includes loans evaluated for impairment in conformity with FASB ASC 310-10-35.

(continued)

(table footnote continued)

|| 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 that are collectively evaluated for impairment.

** This category comprises large groups of all other loans 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 FASB ASC 815 is captured by the fair value measurement of the instrument.

(2) Refer to FASB ASC 820, *Fair Value Measurement*, and FASB ASC 825, *Financial Instruments*, in chapter 20, "Fair Value," of this guide.

Regulatory Matters

9.23 The Federal Reserve, the FDIC, the OCC (collectively, the federal banking agencies), and the Office of Thrift Supervision's (prior to its transfer of powers to the federal banking agencies)[3] *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 GAAP. In particular, the guidance focuses on the documentation the staff normally would expect registrants to prepare and maintain in support of the ALLL.

9.24 Guidance was provided to examiners in the federal banking agencies' December 12, 2006, joint issuance *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*,[4] which 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

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[3] See chapter 1, "Industry Overview—Banks and Savings Institutions," of this guide for further discussion on the Office of Thrift Supervision transfer of powers.

[4] *Federal Register* Vol. 71, No. 238 [12 December 2006], pp. 74585–74588.

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.

9.25 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, along with the National Credit Union Administration (NCUA). This statement revised the 1993 policy statement on the ALLL to ensure consistency with 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 responsibilities 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, along with the NCUA, also issued 16 frequently asked questions to assist institutions in complying with GAAP and ALLL supervisory guidance. (See the entry *allowance for loan and lease losses*, in the "Glossary" section of the FFIEC's *Instructions for Preparation of Consolidated Reports of Condition and Income*, for additional information.)

9.26 On March 17, 2008, the FDIC issued Financial Institution Letter (FIL)-22-2008, *Managing Commercial Real Estate Concentrations in a 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.

9.27 On August 3, 2009, the FDIC issued 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 9.25) 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.

9.28 In January 2012, the federal banking agencies and the NCUA issued *Interagency Supervisory Guidance on Allowance for Loan and Lease Losses Estimation Practices for Loans and Lines of Credit Secured by Junior Liens on 1-4 Family Residential Properties*. This guidance reiterates key GAAP concepts and supervisory guidance related to the ALLL and loss estimation practices. For institutions that hold a significant junior lien portfolio, the guidance addresses the responsibilities of management in estimating the allowance and examiners' review of management's assessment. Although the discussion is specifically tailored in evaluating junior liens, the concepts and principles contained apply to estimating the ALLL for all types of loans. Readers can access the guidance from any of the federal banking agencies' websites.

9.29 The FDIC released FIL-49-2015, *Advisory on Effective Risk Management Practices for Purchased Loans and Purchased Loan Participations*, in November 2015, to update information contained in the *FDIC Advisory on Effective Credit Risk Management Practices for Purchased Loan Participations* (initially issued September 2012 through FIL-38-2012). The update advisory addresses purchased loans and loan participations and reminds FDIC-supervised institutions of the importance of underwriting and administering loan purchases and loan participations in the same diligent manner as if the loans were directly originated by the purchasing institution. The advisory also reminds FDIC-supervised institutions that third party arrangements to facilitate the purchase of loans and participations should be managed by an effective third-party risk management process. The advisory goes on to outline recommended practices relating to (*a*) policy guidelines for purchased loans and participations, (*b*) independent credit and collateral analysis, (*c*) profit analysis, (*d*) loan purchase and participation agreements, (*e*) ability to transfer sell, or assign interest, (*f*) due diligence and monitoring of purchased loans and participations in out-of-territory or unfamiliar markets, (*g*) due diligence of third parties, (*h*) financial reporting, (*i*) audit, (*j*) board approval and reporting, (*k*) and Bank Secrecy Act/Anti-Money Laundering. Readers can access FIL-49-2015 from the FDIC website at www.fdic.gov.

9.30 Effective March 30, 1993, the federal banking agencies established the *Interagency Policy Statement on Documentation for Loans to Small- and Medium-sized Businesses and Farms* 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. To qualify for the exemption, each loan may not exceed the lesser of $900,000 or 3 percent of the institution's total capital, and the aggregate value of the loans may not exceed 20 percent of an institution's total capital. 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 GAAP of loan loss allowances. (See paragraph 9.97.)

9.31 The OCC's *Bank Accounting Advisory Series* (BAAS) is updated periodically to express the Office of the Chief Accountant's current views on accounting topics of interest to national banks and federal savings associations. See further discussion of the BAAS in paragraph 7.82 of this guide. Topic 4, "Allowance for Loan and Lease Losses," includes interpretations and responses related to the ALLL. Readers are encouraged to view this publication under the "Publications—Bank Management" page at www.occ.gov.

9.32 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 entry *nonaccrual status* in the "Glossary" section of the FFIEC's *Instructions for Preparation of Consolidated Reports of Condition and Income*. See also appendix B, "Regulatory Reporting Matters—Interpretation and Reporting Related to U.S. GAAP," 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 9.31.)

9.33 Management should provide auditors access to 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," of this guide.

Credit Unions

9.34 Federal credit unions are required by Part 702 of the NCUA 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.

9.35 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 under GAAP.

9.36 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 Interpretive Ruling and Policy Statement (IRPS) 02-3, *Allowance for Loan and Lease Losses Methodologies and Documentation for Federally-Insured Credit Unions*, through Letter to Credit Unions No. 02-CU-09, *Allowance for Loan and Lease Losses*. The IRPS provides guidance on the design and implementation of ALLL methodologies and supporting documentation practices. Furthermore, it recognizes that credit unions should adopt methodologies and documentation practices that are appropriate for their size and complexity. As a follow up to IRPS 02-3, the NCUA issued Letter to Credit Unions No. 03-CU-01, *Loan Charge-Off Guidance*, to provide guidance on the systematic charge off on uncollectible loans. Although the application of the NCUA's methods may or may not result in substantially the same allowance as management's estimate for the allowance, management should report an allowance in the financial statements prepared under GAAP that is appropriate in accordance with GAAP to cover all estimated losses incurred at the statement-of-financial-condition date in the loan portfolio.

9.37 The NCUA also issued Accounting Bulletin No. 06-01 to distribute an interagency advisory addressing the ALLL (see paragraph 9.25 for further discussion on the advisory). 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

Sources of Applicable Guidance

9.38 FASB ASC 310-10 and FASB ASC 450-20 are the primary sources of guidance on accounting for the allowance for loan losses. 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). In addition, see FASB ASC 310-40 which addresses loans subject to troubled debt restructurings, and which can interact with the guidance on impaired loans.

9.39 Paragraphs 12–40 of FASB ASC 310-10-35 provide specific guidance on measurement and disclosure for 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).

9.40 The "General" subsection of 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 (see paragraph 9.39). Paragraphs 33–36 of FASB ASC 310-10-35 also address the interaction between FASB ASC 310-10-35 and FASB ASC 450-20.

Allowance for Loan Losses

9.41 The following provides an overview of 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 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. 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.

9.42 The allowance for loan losses should be appropriate in accordance with 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.

9.43 The act of lending money generally is not the event that causes asset impairment, and future losses should not be provided for at the time loans are made. Credit losses are provided for when the events have occurred that cause the losses or loan impairment (for example, loss of employment, disability, or bankruptcy). 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.

9.44 *Loans that are identified for evaluation or that are individually considered impaired.* FASB ASC 310-10-35 provides guidance on measurement and disclosure of loans that are identified for evaluation and that are individually deemed to be impaired through a three-step process of identifying loans for evaluation (paragraphs 14–15 of FASB ASC 310-10-35), assessing whether a loan is impaired (paragraphs 16–19 of FASB ASC 310-10-35), and measurement of impairment if a loan is deemed impaired (paragraphs 20–36 of FASB ASC 310-10-35). In accordance with 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.

9.45 Paragraphs 20–36 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.

9.46 FASB ASC 310-10-35-22 states that when a loan is impaired (see paragraphs 16–17 of FASB ASC 310-10-35), a creditor should measure impairment based on the present value of expected future cash flows 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 the FASB ASC glossary, a *collateral-dependent loan* is a loan for which the repayment is expected to be provided solely by the underlying collateral. Generally, repayment of an impaired loan would be expected to be provided solely by the sale or continued operation of the underlying collateral if cash flows from all other available sources (including guarantors) are expected to be no more than nominal.

9.47 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.

Loss Contingencies

9.48 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.

9.49 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.

9.50 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, the accrual should be the amount that appears to be a better estimate than any other estimate within the range or the minimum amount in the range if no amount within the range is a better estimate than any other amount.

9.51 The following are 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

Financial Statement Presentation and Disclosure of Loan Impairment and Allowance for Credit Losses

9.52 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 (for example, the loss is confirmed). 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. Financial institutions typically credit the allowance for loan losses for recoveries, which, in combination with the practice of frequently reviewing the adequacy of the allowance for loan losses, results in the same credit to earnings, albeit in an indirect manner.

9.53 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 GAAP—that is, management should verify that the allowance is appropriate to cover incurred losses in accordance with GAAP as of the balance sheet date. Thus, the primary measurement focus is on the appropriateness of the balance of the allowance and the liabilities, rather than on the resulting provision charged to income.

9.54 *Impaired loans*. 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 ASC 310-40-50 for disclosure information about an impaired loan that has been restructured in a troubled debt restructuring involving a modification of terms.)

9.55 *Loans acquired with deteriorated credit quality*. FASB ASC 310-30-50 provides disclosure guidance regarding loans with evidence of deterioration of credit quality since origination that are 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, as explained in FASB ASC 310-30-05-1. Paragraphs 8.110–.122 of this guide provide additional information regarding loans and debt securities acquired with deteriorated credit quality.

9.56 *Off-balance-sheet credit exposures*. 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 separately 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 refer 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 20, "Fair Value," of this guide for a summary of FASB ASC 825, *Financial Instruments*.

9.57 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 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 FASB ASC 310-10-50-11B, an entity should disclose all of the following by portfolio segment:[5]

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 of 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 to allowance accounting policies or methodology on the current period loss provision

e. The amount of any significant purchases of financing receivables during each reporting period

f. The amount of any significant sales of financing receivables or reclassifications of financing receivables 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

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*

See paragraph 8.163 for additional disclosures related to credit quality that are required pursuant to FASB ASC 310-10-50.

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 lessors' net investments in leveraged leases.

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[5] According to the FASB *Accounting Standards Codification* (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.

9.59 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*. In accordance with 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.

9.61 *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 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.

Auditing[6]

Objectives

9.62 The primary objectives of audit procedures for credit losses are to obtain sufficient appropriate evidence that

a. the allowance for loan losses and liability for other credit exposures are appropriate in accordance with GAAP to cover the amount of probable credit losses inherent in the loan portfolio and off-balance-sheet financial instruments, respectively, at the balance sheet date;

b. credit losses and other items, such as loan charge-offs and recoveries, have been included in the financial statements at appropriate amounts and in the appropriate reporting periods; and

c. disclosures are adequate.

The auditor generally achieves those objectives by testing management's estimates of the allowance based on available and relevant information regarding loan collectibility. The auditor could also develop an independent estimate as more fully discussed in paragraph 9.79. The auditor is not responsible for

[6] The auditing content in this guide focuses primarily on generally accepted auditing standards (GAAS) issued by the Auditing Standards Board and is applicable to audits of the financial statements of those entities not subject to the oversight authority of the PCAOB (that is, those audit reports not within the PCAOB's jurisdiction as defined by the Sarbanes-Oxley Act of 2002, as amended—hereinafter referred to as *nonissuers*). However, considerations for audits of entities subject to the oversight authority of the PCAOB (that is, those audit reports within the PCAOB's jurisdiction as defined by the Sarbanes-Oxley Act of 2002, as amended) may be discussed within this guide's chapter text. When such discussion is provided, the related paragraphs are designated with the following title: *Considerations for Audits Performed in Accordance With PCAOB Standards*.

estimating the amount of the allowance or ascertaining the collectibility of each, or any, specific loan included in an institution's loan portfolio.

Planning and Risk Assessment

9.63 In accordance with AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), the objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and relevant assertion levels through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement (as described in chapter 5 of this guide). 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.

9.64 AU-C section 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* (AICPA, *Professional Standards*), addresses the auditor's responsibilities relating to accounting estimates, including fair value accounting estimates and related disclosures, in an audit of financial statements. Specifically, it expands on how AU-C sections 315; 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*); and other relevant AU-C sections are to be applied with regard to accounting estimates. It also includes requirements and guidance related to misstatements of individual accounting estimates and indicators of possible management bias.

> *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 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.
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> PCAOB Staff Audit Practice Alert No. 11, *Considerations for Audits of Internal Control Over Financial Reporting* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400.11), highlights certain requirements of the auditing standards of the PCAOB in aspects of audits of internal control over financial reporting in which significant auditing deficiencies have been cited frequently in PCAOB inspection reports. Specifically, this alert discusses the following topics:
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> - Risk assessment and the audit of internal control
> - Selecting controls to test

- Testing management review controls
- IT considerations, including system-generated data and reports
- Roll-forward of controls tested at an interim date
- Using the work of others
- Evaluating identified control deficiencies

9.65 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 allowance for loan losses, 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 the audit procedures. One example would be audit procedures over loan reviews. 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.

9.66 Another important consideration in obtaining an understanding of the entity and its environment is whether an institution's loan review and internal audit functions can be considered in the audit plan by the auditor, and permit the auditor to modify the nature, timing, and extent of procedures to be performed. Discussions with loan review and internal audit staff can provide the auditor with information concerning loan customers, related-party transactions, and account histories that may not be readily available elsewhere. Also, because the internal audit function is involved in evaluating accounting systems and control activities (as discussed in chapter 8 of this guide), it can provide the auditor with important control process descriptions and results of testing that are helpful in understanding internal control. Chapter 5 of this guide discusses consideration of the internal audit function.

9.67 Paragraph .A120 of AU-C section 315 states that information gathered by performing risk assessment procedures, including the audit evidence obtained in evaluating the design of controls and determining whether they have been implemented, is used as audit evidence to support the risk assessment. The risk assessment determines the nature, timing, and extent of further audit procedures to be performed. As a part of the risk assessment with respect to the allowance for loan losses, the auditor should 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, charge-off, collection, and recovery policies and procedures;
- loan documentation and compliance exceptions reports;
- loans with repayment terms structured (or restructured) such that collectability problems and concerns may not be evident until payments come due, such as construction loans with interest reserves included in the loan commitment amount;
- local, national, and international economic and environmental conditions;
- experience, competence, and depth of lending management and staff;
- results of regulatory examinations;
- discussions of significant lending activities included in board and loan committee minutes;
- related-party lending;
- organizational structure; and
- management information systems.

Individual components of the allowance for loan losses might have different risks (for example, components that reflect different credit exposures, are determined using different methodologies, or are subject to different accounting requirements). As a result, the risk assessment process should involve challenging management's methodology and process, including factors such as portfolio segmentation, look-back periods, loss emergence periods, qualitative factors, and other criteria and metrics used to estimate the allowance for loan losses.

Internal Control Over Financial Reporting and Possible Tests of Controls

9.68 AU-C section 315 addresses the auditor's responsibility to identify and assess the risks of material misstatement in the financial statements through understanding the entity and its environment, including the entity's internal control. Paragraphs .13–.14 of AU-C section 315 state that the auditor should obtain an understanding of internal control relevant to the audit and, in doing so, should evaluate the design of those controls and determine whether they have been implemented by performing procedures in addition to inquiry of the entity's personnel. (See chapter 5 of this guide for further discussion of the components of internal control.) To provide a basis for designing and performing further audit procedures, paragraph .26 of AU-C section 315 states that the auditor should identify and assess the risks of material misstatement at the financial statement level and the relevant assertion level for classes of transactions, account balances, and disclosures.

9.69 Effective controls related to estimating the allowance for loan losses may reduce the likelihood of material misstatement of the allowance for loan losses. The auditor should obtain an understanding of (*a*) how management developed the allowance for loan losses, (*b*) how the process has changed from prior periods, and (*c*) 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:

- *Control environment, including 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.
- *Controls over the completeness and accuracy of data used, including the 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. Management should have controls over the completeness and accuracy of underlying data used in formulating the allowance estimate, such as segmented portfolio balances, loan risk classifications or ratings, charge-offs, delinquencies, and exceptions to underwriting standards.
- *Controls over loan risk ratings.* There may be multiple controls or elements of controls that operate over the appropriateness of loan risk ratings to mitigate the risk of using inaccurate ratings in formulating the allowance estimate. The controls should be designed such that the risk rating used for purposes of the allowance estimate is subject to review by a party other than the individual responsible for assigning the rating. The following are examples of controls that address the appropriateness of loan risk ratings; this is not intended to be an all-inclusive list:
  - — *Independent loan reviews.* Loan reviews should be conducted by competent personnel who are independent of the underwriting, supervision, and collections functions.

Alternatively, an independent loan review function may be outsourced to a competent third party. Although the specific lines of reporting for the loan review function often will depend on the complexity of the institution's organizational structure, 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, including the appropriateness of individual loan risk ratings used in the allowance estimate. The loan review function should be designed to address considerations such as (*a*) risk assessment, including the determination of which groups of loans will be covered through credit file reviews by independent loan review in the current year; (*b*) selection of individual loans within those loan groups for review in the current year; (*c*) overall credit file review plan for the current year; (*d*) frequency of credit file reviews; (*e*) definition of *loan risk rating exceptions*; and (*f*) use of credit file review results. The sample of loans selected for review should be representative and unbiased.

— The loan review function ordinarily conducts a series of activities, including but not limited to

- conducting a risk assessment of the segmented risk rated loan portfolios;
- preparing a loan file review plan;
- determining the frequency of loan reviews;
- monitoring risk assessment considerations to determine whether the loan review plan should be updated;
- defining loan risk rating exceptions;
- selecting a risk-based sample of loans for review and evaluating whether the assigned loan risk rating is appropriate;
- evaluating the appropriateness of the assigned loan risk rating for loans for which a loan review was performed;
- concluding whether the loan review results are appropriate and representative of the entire risk rated loan population, thereby mitigating the risk of inappropriate loan risk ratings in the population of risk rating loans in the current year; and
- communicating loan review results to management for consideration in the allowance estimate for the current year.

— *Other reviews of loan risk ratings.* In addition to independent loan reviews, institutions may have one or more controls that are relevant to the accuracy of loan risk ratings.

Such controls may take different forms and vary from institution to institution. For example, an institution may subject loans with risk ratings to a formal review at least annually to ensure the ratings are accurate and up to date. In that regard, the responsible loan officer may be required to conduct and document a review of each loan that includes, among other things, a formal reassessment of the accuracy of the loan's risk rating. The loan officer's reassessment may then be subjected to a secondary review. The secondary annual review functions as a control over risk ratings assigned to all loans with such ratings, including groups of loans that are not covered by the scope of the independent loan review function in the current year.

- *Controls over the loss estimation process.* A loss estimation process for individually impaired loans and groups of other loans 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;
  - — documenting current economic conditions that differ from conditions that prevailed in the prior periods used to determine historical loss rates, and justification for specific adjustments to historical loss rates; and
  - — accumulating the component needs of the allowance and provision amounts.

Controls over the loss estimation process include review controls over the judgments within the allowance estimate, as well as controls over the completeness and accuracy of underlying data used in the operation of the review control. These also include controls over models used in the estimation process.

- *Adequate review and approval of the allowance estimates by the individuals specified in management's written ALLL policy (or other documents that describe the ALLL methodology).* This includes
  - — review of sources of relevant information;
  - — review of development of assumptions and methodologies (for example, historical loss experience, including the look-back period and loss emergence period, and qualitative adjustment factors);
  - — review of reasonableness of assumptions, methodologies, and resulting estimates, including metrics, thresholds, or criteria to identify outliers or exceptions;
  - — consideration of the need to use the work of specialists (such as appraisers or construction specialists);

- — consideration of changes in previously established methods to arrive at the allowance; and
- — review of accuracy of data and calculations.

- *Back-testing and validation of prior estimates related to the allowance with subsequent results to assess the reliability of the process used to develop the allowance, including controls over the back-testing process.*
- *Controls over the 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 have become delinquent or that have been restructured or charged off subsequent to the balance sheet date were impaired as of the balance sheet date.
  - — Updated appraisal information received subsequent to the balance sheet date.
  - — Independent loan review results received subsequent to the balance sheet date.
  - — Regulatory examination results received subsequent to the balance sheet date.

9.70 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.

9.71 AU-C section 330 addresses the auditor's responsibility to design and implement responses to the risks of material misstatement identified and assessed by the auditor in accordance with AU-C section 315 and to evaluate the audit evidence obtained in an audit of financial statements.

9.72 In accordance with paragraph .08 of AU-C section 330, the auditor should design and perform tests of controls to obtain sufficient appropriate audit evidence about the operating effectiveness of relevant controls if (*a*) the auditor's assessment of risks of material misstatement at the relevant assertion level includes an expectation that the controls are operating effectively or (*b*) substantive procedures alone do not provide sufficient appropriate audit evidence at the relevant assertion level. The auditor may consider performing procedures such as the following to test the effectiveness of internal control over financial reporting in the area of credit losses:

- Review and challenge the design of the institution'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.

- Test the controls over identifying and reporting classified and 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 senior management and an appropriate board committee review and monitor past due loans, watch list loans, classified loans, and assigned risk ratings.
- Test application controls and related general IT controls, including system interfaces and account mapping, for all relevant systems.
- Test the controls over completeness and accuracy of the underlying data used in the allowance process, including the preparation of the periodic past due, watch list, and classified loans reports.
- Test the controls over how 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 controls over the completeness and accuracy of loans between the trial balance and the applicable report.
- Examine evidence that the institution has an independent loan review function to review and evaluate loan officer analyses of significant loans, including the accuracy of the risk ratings.
- Examine evidence of secondary review of the loan officers' periodic loan risk ratings.
- Review the institution's documentation that analyzes each component of the allowance for loan 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 flows for one or more impaired loans.
- Read minutes of meetings of the board or loan committee for evidence of the periodic review and approval of the appropriateness in accordance with GAAP of the allowance for loan losses based on appropriate documentation.

There may be more than one control that addresses the assessed risk of material misstatement to a particular relevant assertion for the ALLL; and therefore the combination of controls would prevent, or detect, a material misstatement.

9.73 Management review controls may be higher-level or process-level controls and usually involve a member of management reviewing information contained in documents, reports, or other information produced by the entity, including variance reports, exception reports, or detailed calculations supporting financial statement balances or disclosures. Management review controls also may relate to significant management estimates or judgments incorporated into the allowance process, such as independent loan review and management review of qualitative or environmental factors and adjustments to the historical loss experience. The design of management review controls includes metrics, thresholds, or other criteria to identify outliers or exceptions and should involve the appropriate level of precision to ensure that the controls would detect a material misstatement.

9.74 Ordinarily, it is expected that a management review control is performed using information produced by the entity. When testing controls that are dependent on information produced by the entity (for example, system generated or management prepared reports), the auditor should test controls over the completeness and accuracy of that information.

Substantive Tests

9.75 Irrespective of the assessed risks of material misstatement, paragraph .18 of AU-C section 330 states that the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure, which for a financial institution would include credit losses. In accordance with paragraph .A45 of AU-C section 330, this requirement reflects the facts that (i) the auditor's assessment of risk is judgmental and may not identify all risks of material misstatement and (ii) inherent limitations to internal control exist, including the potential for management override.

9.76 Based on the assessed risks of material misstatement, paragraph .12 of AU-C section 540 states that the auditor should determine

a. whether management has appropriately applied the requirements of the applicable financial reporting framework relevant to the accounting estimate (in this instance, the allowance for loan losses) and

b. whether the methods for making the accounting estimates are appropriate and have been applied consistently and whether changes from the prior period, if any, in accounting estimates or the method for making them are appropriate in the circumstances.

9.77 In responding to the assessed risks of material misstatement, as required by AU-C section 330, paragraph .13 of AU-C section 540 states that the auditor should undertake one or more of the following, taking into account the nature of the accounting estimate:

a. Determine whether events occurring up to the date of the auditor's report provide audit evidence regarding the allowance for loan losses.

b. Test how management made the accounting estimate of the allowance for loan losses and the data on which it is based. In doing so, the auditor should evaluate whether

  i. the method of measurement used is appropriate in the circumstances,

  ii. the assumptions used by management are reasonable in light of the measurement objectives of the applicable financial reporting framework (see further discussion in paragraph 9.80), and

  iii. the data on which the allowance is based are sufficiently reliable for the auditor's purposes.

c. Test the operating effectiveness of the controls over how management made the accounting estimate of the allowance for loan losses, together with the appropriate substantive procedures.

d. Develop a point estimate or range to evaluate management's point estimate. For this purpose

i. if the auditor uses assumptions or methods that differ from management's, the auditor should obtain an understanding of management's assumptions or methods sufficient to establish that the auditor's point estimate or range takes into account relevant variables and to evaluate any significant differences from management's point estimate.

ii. if the auditor concludes that is it appropriate to use a range, the auditor should narrow the range, based on audit evidence available, until all outcomes within the range are considered reasonable.

9.78 Generally, the most effective audit strategy for the allowance for loan losses is to test management's methodology and process. This strategy may include

- testing the extent to which data used in formulating the accounting estimate of the allowance for loan losses is accurate, complete, and relevant and whether the estimate has been properly determined using such data and management assumptions;
- considering the source, relevance, and reliability of external data or information, including that received from external experts engaged by management to assist in making the accounting estimate;
- determining how management has taken into account the effect of events, transactions, and changes in circumstances occurring between the date that the accounting estimate or inputs to the estimate were determined and the reporting date (for example, a valuation by an independent appraiser made prior to the reporting date);
- recalculating the accounting estimate and reviewing information about the estimate for internal consistency;
- considering management's review and approval processes for the accounting estimate; and
- determining consistency of the resulting estimate with applicable GAAP.

9.79 In accordance with paragraph .A81 of AU-C section 540, the assumptions on which accounting estimates, such as the allowance for loan losses, are based may reflect what management expects will be the outcome of specific objectives and strategies. In such cases, the auditor may perform audit procedures to evaluate the reasonableness of such assumptions by considering, for example, whether the assumptions are consistent with

- the general economic environment and the entity's economic circumstances.
- the plans of the entity.
- assumptions made in prior periods, if relevant.
- the experience of, or previous conditions experienced by, the entity to the extent this historical information may be considered representative of future conditions or events. For example, compare current year charge-offs with prior period estimated losses to determine the historical reliability of prior period estimates.

- other assumptions used by management relating to the financial statements.

9.80 The auditor may test key factors and assumptions such as those that are

- significant to the estimate of the amount of the allowance for loan losses, such as
  - — the effectiveness of the institution's internal control related to loans and the allowance for loan losses (the design and operating effectiveness of controls may impact the nature, timing, and extent of substantive procedures);
  - — portfolio segmentation based on similar credit risk characteristics;
  - — look-back period used to calculate the historical loss component of the allowance;
  - — loss emergence period used to calculate the historical loss component of the allowance (this period is typically defined as the period of time from the event that triggers a loss to the charge-off or confirmation of the loss);
  - — 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 loan review and internal audit functions;
  - — the effects of changes in lending policies and procedures, including those for underwriting, credit monitoring, collection, and charge-offs 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 charge-offs, 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.

9.81 For accounting estimates (such as the allowance for loan losses) that give rise to significant risks, in addition to other substantive procedures performed to meet the requirements of AU-C section 330, the auditor should evaluate the following:[7]

a. How management has considered alternative assumptions or outcomes and why it has rejected them or how management has otherwise addressed estimation uncertainty in making the accounting estimate

b. Whether the significant assumptions used by management are reasonable

c. When relevant to the reasonableness of the significant assumptions used by management or the appropriate application of the applicable financial reporting framework, management's intent to carry out specific courses of action and its ability to do so

If, in the auditor's professional judgment, management has not addressed adequately the effects of estimation uncertainty on the accounting estimates that give rise to significant risks, the auditor should, if considered necessary, develop a range with which to evaluate the reasonableness of the accounting estimate.

9.82 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 recorded liability for such other credit exposures.

9.83 When information included in reports prepared by management is used in the performance of 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.

9.84 In determining the matters identified in paragraph .12 of AU-C section 540 (see paragraph 9.76) or in responding to the assessed risks of material misstatement in accordance with paragraph .13 of AU-C section 540 (see paragraph 9.77), paragraph .14 of AU-C section 540 states that the auditor should consider whether specialized skills or knowledge with regard to one or more

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[7] Paragraph .18 of AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*).

aspects of the allowance for loan losses is required in order to obtain sufficient appropriate audit evidence.

9.85 AU-C section 620, *Using the Work of an Auditor's Specialist* (AICPA, *Professional Standards*), addresses the auditor's responsibilities relating to the work of an individual or organization possessing expertise in a field other than accounting or auditing when that work is used to assist the auditor in obtaining sufficient appropriate audit evidence. 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 risks that require special knowledge and expertise of the types of collateral supporting the loan.

9.86 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.

9.87 Loans to developing countries are another example of instances in which the auditor may obtain 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.

9.88 For impaired collateral-dependent loans, the specific allowance 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 an example of using a management specialist as contemplated by paragraph .08 of AU-C section 500, *Audit Evidence* (AICPA, *Professional Standards*). Refer to chapter 11, "Real Estate Investments, Real Estate Owned, and Other Foreclosed Assets," of this guide for audit procedures over appraisals.

9.89 In accordance with paragraphs .09–.10 and .12 of AU-C section 620, the auditor should evaluate whether the auditor's specialist has the necessary competence, capabilities, and objectivity for the auditor's purposes. In the case of an auditor's external specialist, the evaluation of objectivity should include inquiry regarding interests and relationships that may create a threat to the objectivity of the auditor's specialist. Furthermore, the auditor should obtain a sufficient understanding of the field of expertise of the auditor's specialist to enable the auditor to

a. determine the nature, scope, and objectives of the work of the auditor's specialist for the auditor's purposes and

b. evaluate the adequacy of that work for the auditor's purposes.

Further application and explanatory material regarding the competence, capabilities, and objectivity, as well as understanding the field of expertise, of the auditor's specialist can be found in paragraphs .A15–.A24 of AU-C section 620.

9.90 The auditor should evaluate the adequacy of the work of the auditor's specialist for the auditor's purposes, including

a. the relevance and reasonableness of the findings and conclusions of the auditor's specialist and their consistency with other audit evidence.

b. if the work of the auditor's specialist involves the use of significant assumptions and methods,

  i. obtaining an understanding of those assumptions and methods and

  ii. evaluating the relevance and reasonableness of those assumptions and methods in the circumstances, giving consideration to the rationale and support provided by the specialist, and in relation to the auditor's other findings and conclusions.

c. if the work of the auditor's specialist involves the use of source data that is significant to the work of the auditor's specialist, the relevance, completeness, and accuracy of that source data.

9.91 If the auditor determines that the work of the auditor's specialist is not adequate for the auditor's purposes, paragraph .13 of AU-C section 620 states that the auditor should

a. agree with the auditor's specialist on the nature and extent of further work to be performed by the auditor's specialist or

b. perform additional audit procedures appropriate to the circumstances (such as selecting and hiring another specialist).

9.92 *Large groups of loans.* For loans that are pooled for purposes of measuring 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 charge-off and nonaccrual policies 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.

9.93 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 assessing the collectibility of such loans as a group rather than the collectibility 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 charge off experience may not be sufficient in itself but could be considered in light of consistent application of loan policies, and current economic conditions at the balance sheet date.

9.94 *Individually evaluated loans.* In contrast to large groups of smaller balance homogeneous loans, an evaluation of larger balance loans (for example, commercial loans) generally requires a more detailed review because of the loan size and the fact that the type of borrower, the purpose of the loan, and the timing of cash flows may be dissimilar from loan to loan. More important, a relatively small number of credit losses on larger balance loans can significantly affect the appropriateness of the allowance in accordance with GAAP. In these circumstances, the auditor will generally select and review in detail a number of those loans. The auditor's review of loans may be performed as a dual purpose test (test of controls and substantive attribute test).

9.95 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 may include 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 effective in identifying and classifying problem credits.

9.96 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.

9.97 The exemption of certain loans from examiner review and criticism pursuant to the March 30, 1993, regulatory policy (see paragraph 9.30) 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 institution's exempt portfolio could be material to its financial statements. An auditor's assessment of management assertions about the allowance for loan 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.

9.98 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 examination 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		*Institution's In-House*	
classification	*Amount*	*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 of collateral in accordance with U.S. generally accepted accounting principles 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, charge-off, or both and management's supporting rationale:

____

IX. Auditor's Summary ____________________

X. Conclusion (including the amount and basis for auditor's estimated loss exposure) ____________________

____

9.99 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 controls.

9.100 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 accountant or prepared internally by the borrower may be useful.

9.101 *Collateral review.* Assessment of collateral is important to the classification or grading of the loan portfolio as well as the measurement of credit losses when the loan, individually evaluated for impairment, is deemed collateral dependent. 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 appraisal.

9.102 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 potential accounting consequences of collateral arrangements under FASB ASC 860, *Transfers and Servicing*.

9.103 *Personal guarantees.* 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.

9.104 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.

9.105 *Participation.* Management should have the information necessary to authorize, monitor, and review participation loans and to estimate any related allowance for loan losses. The collectibility of participation loans (whether at the lead institution or at a participating institution) is normally evaluated in light of the entire amount of the loan, not just of the share held by the institution. Accordingly, the participating institution should supplement documentation by the lead institution with its own investigation and credit analysis. The participating institution should not rely 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.

9.106 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.

9.107 *Charge-offs and recoveries.* The auditor should test the propriety of charge-offs and recoveries. Substantive detail testing in this area may be minimized if tests of controls and analytical procedures on charge-offs and recoveries are performed.

9.108 *Analytical procedures.* AU-C section 520, *Analytical Procedures* (AICPA, *Professional Standards*), addresses the auditor's use of analytical procedures as substantive procedures (substantive 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.

9.109 *Conclusions.* In accordance with paragraph .18 of AU-C section 540, the auditor should evaluate, based on the audit evidence, whether the allowance for loan losses in the financial statements is either reasonable in the context of the applicable financial reporting framework or is misstated. Based on the audit evidence obtained, paragraph .A122 of AU-C section 540 goes on to state that the auditor may conclude that the evidence points to an accounting estimate of the allowance that differs from management's point estimate. When the audit evidence supports a point estimate, the difference between the auditor's point estimate and management's point estimate constitutes a misstatement. When the auditor has concluded that using the auditor's range provides sufficient appropriate audit evidence, a management point estimate that lies outside the auditor's range would not be supported by audit evidence. In such cases, the misstatement is no less than the difference between management's point estimate and the nearest point of the auditor's range. (Note that this only applies to situations in which the auditor has chosen to test the reasonableness of the institution's allowance for loan losses by independently developing a point estimate or range, as opposed to testing how management made the accounting estimate, in accordance with paragraph .13 of AU-C section 540. AU-C section 450, *Evaluation of Misstatements Identified During the Audit* (AICPA, *Professional Standards*), provides guidance on distinguishing misstatements for purposes of the auditor's evaluation of the effect of uncorrected misstatements on the financial statements. With regard to accounting estimates, a misstatement, whether caused by fraud or error, may arise as a result of

- misstatements about which no doubt exists (factual misstatements).
- differences arising from management's judgments concerning accounting estimates that the auditor considers unreasonable or the selection or application of accounting policies that the auditor considers inappropriate (judgmental misstatements).
- the auditor's best estimate of misstatements in populations involving the projection of misstatements identified in audit samples to the entire population from which the samples were drawn (projected misstatements).

In some cases involving accounting estimates, a misstatement could arise as a result of a combination of these circumstances, making separate identification difficult or impossible.

9.110 If the auditor deems the financial information inadequate, the auditor may discuss the situation with an appropriate member of management. In accordance with paragraph .A38 of AU-C section 260, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*), this discussion may clarify facts and issues and give management an opportunity to provide further information and explanations. For example, the discussion may include missing information that 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. In accordance with paragraph .12 of AU-C section 260, the auditor should communicate with those charged with governance[8] significant difficulties, if any, encountered during the audit (for example, appropriate financial information in accordance with GAAP that is not available for significant loans). In some circumstances, paragraph .A26 of AU-C section 260 explains that such difficulties may constitute a scope limitation that leads to a modification of the auditor's opinion.

9.111 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.

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[8] For purposes of GAAS, *those charged with governance* are defined as the person(s) or organization(s) with responsibility for overseeing the strategic direction of the entity and the obligations related to the accountability of the entity. This includes overseeing the financial reporting process. They may include management personnel, for example, executive members of a governance board or an owner-manager.

Chapter 10

Transfers and Servicing and Variable Interest Entities

Gray shaded text in this chapter reflects guidance issued but not yet effective as of the date of this guide, July 1, 2017, but becoming effective on or prior to December 31, 2017, exclusive of any option to early adopt ahead of the mandatory effective date. Unless otherwise indicated, all unshaded text reflects guidance that was already effective as of the date of this guide.

Update 10-1 *Accounting and Reporting*: Credit Losses

FASB Accounting Standards Update (ASU) No. 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*, issued in June 2016, is effective for fiscal years of public business entities that are SEC filers beginning after December 15, 2019, including interim periods within those fiscal years.

For all other public business entities, the amendments in FASB ASU No. 2016-13 are effective for fiscal years beginning after December 15, 2020, including interim periods within those fiscal years.

For all other entities, including not-for-profit entities and employee benefit plans within the scope of FASB Accounting Standards Codification (ASC) 960, *Plan Accounting—Defined Benefit Pension Plans*, through FASB ASC 965, *Plan Accounting—Health and Welfare Benefit Plans*, on plan accounting, FASB ASU No. 2016-13 is effective for fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021.

Early application is permitted for all entities as of the fiscal years beginning after December 15, 2018, including interim periods within those fiscal years.

FASB ASU No. 2016-13 creates FASB ASC 326, *Financial Instruments—Credit Losses*, to amend guidance on reporting credit losses for financial assets held at amortized cost basis and available-for-sale debt securities.

For financial assets held at amortized cost basis, FASB ASC 326 eliminates the probable initial recognition threshold in current U.S. generally accepted accounting principles (GAAP) and, instead, requires an entity to reflect its current estimate of all expected credit losses. The allowance for credit losses is a valuation account that is deducted from the amortized cost basis of the financial assets to present the net amount expected to be collected.

For available-for-sale debt securities, credit losses should be measured in a manner similar to current GAAP. However, FASB ASC 326 will require that credit losses be presented as an allowance rather than as a write-down.

FASB ASU No. 2016-13 affects entities holding financial assets and net investment in leases that are not accounted for at fair value through net income. The amendments affect loans, debt securities, trade receivables, net investments in leases, off-balance-sheet credit exposures, reinsurance receivables, and any other financial assets not excluded from the scope that have the contractual right to receive cash.

This edition of the guide has not been updated to reflect changes as a result of this ASU, however, this chapter will be updated in a future edition. Readers are encouraged to consult the full text of this ASU on FASB's website at www.fasb.org.

For more information on FASB ASU No. 2016-13, see appendix G, "Accounting for Financial Instruments," of this guide.

Introduction

10.01 This chapter discusses transfers of financial assets and servicing of financial assets (including mortgage banking) and variable interest entities (VIEs) which are often used to facilitate a transfer of financial assets. Common transfers of financial assets for financial institutions include whole loan sales, loan participations, asset securitizations, securities lending transactions, repurchase agreements, and banker's acceptances. Such transfers may result in the seller having continuing involvement with the transferred financial assets, such as servicing rights, guarantees, retained interests in the assets, indemnity clauses, representations and warranties, or beneficial interests in securitized assets. Repurchase agreements are discussed in further detail in chapter 14, "Federal Funds and Repurchase Agreements," of this guide.

10.02 Financial institutions often have mortgage banking activities that 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 sold outright through whole loan sales or pooled and securitized. Access to the secondary mortgage market is an important source of liquidity for banks and savings institutions. Many institutions have deposit bases that are indexed to variable rates and, therefore, are particularly sensitive to interest-rate risk. Financial institutions with long term, fixed-rate assets funded with variable-rate deposit bases may incur losses in a rising interest-rate environment. Therefore, sales of mortgage loans and, in some cases, servicing rights and retained beneficial interests in the secondary market are an important source of funds to many institutions, supplemented by income streams from servicing and other fees. 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 government-sponsored entities (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 U.S. Department of Veterans' Affairs. 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," of this guide describes ABS transactions and considerations for investors in ABSs.) Many entities are also active in the secondary market as issuers, investors, servicers, and financial guaranty companies.

10.04 When mortgage loans are originated for sale, the process includes not only finding an investor but also identifying loans that fit the investor's requirements, including underwriting criteria. Mortgage loans originated for sale normally must comply with specific standards governing documentation, appraisal, mortgage insurance, loan terms, and borrower qualifications. Investors typically review key loan terms and 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 retain the loans in its 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. These obligations typically arise from the representations and warranties included in 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 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 in the secondary market.

Asset-Backed Securitizations

10.06 Securitization is often utilized by lending institutions to diversify funding sources. It 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 seller will retain the servicing rights for the loans sold to the trust and often retains a subordinated interest in the trust, which serves as a credit enhancement to the asset-backed certificates. Such structures provide companies the opportunity to obtain funding at competitive levels given the structural characteristics of securitization vehicles.

Loan Participations and Loan Syndications

10.07 In certain situations, a customer's borrowing needs may exceed its bank's legal lending limits or its self-imposed counterparty limits. To accommodate such a customer, the bank may share the credit risk with other banks through a loan participation. A *loan participation*, as defined in the FASB 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 banks 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 service the loan and is the lender of record. 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.[1] A loan participation is in the scope of FASB ASC 860, *Transfers and Servicing*. In contrast,

[1] Under 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) participations, 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 qualify for sale accounting and, instead, must be reported as secured borrowings.

a *loan syndication*, as defined in the FASB ASC glossary, is a transaction in which several lenders share in lending to a single borrower. In a loan syndication, each lender loans a specific amount to the borrower and has the right to repayment from the borrower. A loan syndication is not a transfer of financial assets because each participant in a syndication is a lender of record, and therefore the transaction is not in the scope of FASB ASC 860. The "Glossary" section of the Federal Financial Institutions Examination Council's *Instructions for Preparation of Consolidated Reports of Condition and Income* provides guidance that may assist in distinguishing between a loan participation and a loan syndication.

Loan Servicing

10.08 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 unpaid principal balance of the 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 arising from failure to abide by the terms of the servicing agreement. The servicer also may be required to advance funds to investors if there are shortfalls in the cash collected due to default by the underlying borrowers. These loans may have been originated by the servicer institution itself or by other financial institutions. When servicing mortgages for government entities (for example, Ginnie Mae) and GSEs (for example, Fannie Mae, Freddie Mac), institutions must meet certain minimum net-worth requirements and comply with the GSEs' servicing standards. Inability to meet the requirements may result in termination of the servicing contracts.

Regulatory Matters

10.09 The Office of the Comptroller of the Currency (OCC), the FDIC, and the Board of Governors of the Federal Reserve System (Federal Reserve) (collectively, 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, including the Office of Thrift Supervision (OTS) (prior to its transfer of powers to the OCC, the FDIC, and the Federal Reserve),[2] 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

[2] See chapter 1, "Industry Overview—Banks and Savings Institutions," of this guide for further discussion on the Office of Thrift Supervision transfer of powers.

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. On December 20, 2013, the Federal Reserve issued *Risk Transfer Considerations When Assessing Capital Adequacy—Supplemental Guidance on Consolidated Supervision Framework for Large Financial Institutions*, an advisory that provides guidance on how certain risk transfer transactions, such as securitizations, affect assessments of capital adequacy at large financial institutions. Readers are encouraged to view this guidance under the "Banking Information and Regulation—Supervision and Regulation Letters" page at www.federalreserve.gov.

10.11 On February 25, 2003, the federal banking agencies, including the OTS, 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.

10.12 On May 3, 2005, the federal banking agencies, including the OTS, and the 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.

10.13 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 accounting standards (that is, FASB Statement Nos. 166, *Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140* [FASB ASU No. 2009-16, *Transfers and Servicing (Topic 860): Accounting for Transfers of Financial Assets*], and 167, *Amendments to FASB Interpretation No. 46(R)* [FASB ASU No. 2009-17, *Consolidations (Topic 810): Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities*]) 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.

10.14 See chapter 9, "Credit Losses," of this guide for regulatory matters related to loan and lease losses and nontraditional mortgage products and chapter 8, "Loans," of this guide for regulatory matters related to commercial and residential mortgages.

10.15 The OCC's *Bank Accounting Advisory Series* (BAAS) is updated periodically to express the Office of the Chief Accountant's current views on accounting topics of interest to national banks and federal savings associations. See further discussion of the BAAS in paragraph 7.82 of this guide. Topic 9, "Income and Expense Recognition," of the BAAS includes interpretations on accounting for transfers of financial assets and servicing. Readers are encouraged to view this publication under the "Publications—Bank Management" page at www.occ.gov.

Accounting and Financial Reporting[3]

Mortgage Loans and MBSs Held for Sale

10.16 FASB ASC 948, *Financial Services—Mortgage Banking*, includes accounting and reporting guidance applicable to mortgage banking entities and entities that engage in certain mortgage banking activities.

10.17 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 should 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.

10.18 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.

10.19 The valuation allowance addressed in paragraph 10.18 is not the same as the allowance for credit losses and thus the change should not be recognized in the provision for credit losses.

10.20 Many mortgage banking entities apply the fair value option to loans under FASB ASC 825, *Financial Instruments*. 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

[3] Guidance on matters related to fair value measurements and disclosures are provided in chapter 20, "Fair Value," of this guide and should be considered in connection with references to fair value in this chapter.

Option" subsections. See chapter 20, "Fair Value," of this guide for a summary of FASB ASC 825.

10.21 The fair value of mortgage loans and MBSs HFS should be measured by type of loan, as explained in FASB ASC 948-310-35-3. At a minimum, the fair value of residential (one- to four-family dwellings) and commercial mortgage loans should be measured separately. 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 measured 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 fair value in the principal market or, in the absence of a principal market, in the most advantageous market (see paragraphs 5–6C of FASB ASC 820-10-35). That determination relies on the principles in FASB ASC 820, *Fair Value Measurement*, and would include consideration of the following:

   i. Market prices and yields sought by market participants in the principal or most advantageous market.

   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.

10.22 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. However, for loans subject to the fair value option as discussed in paragraph 10.20, such amounts are recognized in the income statement immediately.

10.23 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. The fair value of loan commitments accounted for as derivative instruments should include the inherent value of servicing, in accordance with SEC Staff Accounting Bulletin No. 109, "Written Loan Commitments Recorded at Fair Value Through Earnings" (codified in FASB ASC 815-10-S99-1).

10.24 FASB ASC 948-310-30-4 states that mortgage loans transferred from loans HFS to long-term-investment classification should be measured at the lower of cost or fair value on the date of transfer.

10.25 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

10.26 FASB ASC 860 establishes accounting and reporting standards for transfers and servicing of financial assets. FASB ASC 860-10-05-6 provides examples of the various types of transfers to which FASB ASC 860 applies, which include but are not limited to securitizations, factoring arrangements, transfers of receivables with recourse, securities lending transactions, repurchase agreements, loan participations, and banker's acceptances.

10.27 FASB ASC 860 establishes accounting and reporting standards for transfers and servicing of financial assets, as well as establishes the accounting for transfers of servicing rights. Transfers of financial assets often occur in which the transferor has some continuing involvement either with the assets transferred or with the transferee. Transfers of financial assets with continuing involvement raise issues about the circumstances under which the transfers should be considered as sales of all or part of the assets or as secured borrowings and about how transferors and transferees should account for sales and secured borrowings. *Continuing involvement* is defined in FASB ASC 860-10-20 and includes, but is not limited to, servicing rights, guarantees, retained interests in the loans, or beneficial interests in securitized assets.

10.28 The objective of the derecognition guidance in FASB ASC 860-10-40 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* (as defined in the FASB ASC glossary) 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 its parent's involvements with the transferred financial assets in applying FASB ASC 860-10-40-5.

10.29 According to FASB ASC 860-10-40-4D, 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*. 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.

10.30 FASB ASC 860-10-40-6A provides guidance on the characteristics of a participating interest. Critical for qualifying as a participating interest is that the transferee receives from the date of the transfer a proportionate (pro rata) ownership interest in an entire financial asset.

10.31 According to FASB ASC 860-10-40-4E, 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 FASB ASC 860-10-40-5 (see paragraph 10.32). 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 not individually meet the *participating interest* definition, FASB ASC 860-10-40-5 (see paragraph 10.32) should be applied to the entire financial asset once all portions have been transferred.

10.32 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 [see discussion of paragraphs 18–18C of FASB ASC 860-10-55 in paragraphs 10.35–.38]). 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 item (b) in FASB ASC 860-10-40-5 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 the transferred financial assets before their maturity (see paragraphs 23–25 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).

10.33 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 derecognition guidance in FASB ASC 860-20-40 and guidance on recognition of any assets obtained and liabilities incurred in FASB ASC 860-20-25. 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).

10.34 Paragraphs 16–18 of FASB ASC 860-10-05 provide background on securities lending transactions and paragraphs 19–21 of FASB ASC 860-10-05 provide background on repurchase agreements. Implementation guidance related to the application of FASB ASC 860 to repurchase agreements and securities lending transactions is discussed in paragraphs 51–56B of FASB ASC 860-10-55. Implementation guidance related to the application of FASB ASC 860 to wash sales is discussed in FASB ASC 860-10-55-57.

10.35 *Isolation of transferred financial assets.* Paragraphs 18–25A of FASB ASC 860-10-55 provide implementation guidance related to the isolation condition in item (a) in FASB ASC 860-10-40-5.

10.36 In the context of U.S. bankruptcy laws, a true sale opinion from an attorney is often required to support a conclusion that transferred financial assets are isolated from the transferor, any of its consolidated affiliates included in the financial statements being presented, and its creditors. In addition, a nonconsolidation opinion is often required if the transfer is to an affiliated entity. In the context of U.S. bankruptcy laws,

a. a true sale opinion is an attorney's conclusion that the transferred financial assets have been sold and are beyond the reach of the transferor's creditors and that a court *would* conclude that the transferred financial assets *would not* be included in the transferor's bankruptcy estate.

b. a nonconsolidation opinion is an attorney's conclusion that a court *would* recognize that an entity holding the transferred financial assets exists separately from the transferor. Additionally, a nonconsolidation opinion is an attorney's conclusion that a court *would not* order the substantive consolidation of the assets and liabilities of the entity holding the transferred financial assets and the assets and liabilities of the transferor (and its consolidated affiliates included in the financial statements being presented) in the event of the transferor's bankruptcy or receivership.

10.37 A legal opinion may not be required if a transferor has a reasonable basis to conclude that the appropriate legal opinion(s) would be given if requested. For example, the transferor might reach a conclusion without consulting an attorney if either of the following conditions exist:

a. The transfer is a routine transfer of financial assets that does not result in any continuing involvement by the transferor.

b. The transferor had experience with other transfers with similar facts and circumstances under the same applicable laws and regulations.

10.38 For entities that are subject to other possible bankruptcy, conservatorship, or other receivership procedures (for example, banks subject to receivership by the FDIC in the United States or other jurisdictions), judgments about whether transferred financial assets have been isolated should be made in relation to the powers of bankruptcy courts or trustees, conservators, or receivers in those jurisdictions.

Sale of Financial Assets

10.39 *Sale of a participating interest*. Upon completion of a transfer of a participating interest that satisfies the conditions in FASB ASC 860-10-40-5 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 values at the date of the transfer:

  i. The participating interest(s) sold

  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

10.40 *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 860-10-40-5 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 asset 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.

10.41 *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)

10.42 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.

10.43 *Transferee recognition and measurement of assets obtained and liabilities incurred in a sale of financial assets*. In accordance with FASB ASC 860-20-25-3 and FASB ASC 860-20-30-2, the transferee should recognize and initially measure all assets obtained (including any participating interest[s] obtained) and any liabilities incurred at fair value.

10.44 *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.

Transfers of Loans With Recourse

10.45 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.

10.46 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 item (a) in FASB ASC 860-10-55-46. 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 item (c)(4) in FASB ASC 860-10-40-6A, does not meet the requirements of a participating interest and should be accounted for as a secured borrowing, as stated in item (b) in FASB ASC 860-10-55-46. The form and nature of recourse may have a bearing on legal isolation (see further discussion in paragraph 10.35).

Servicing Assets and Liabilities

10.47 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

10.48 Servicing rights are significant assets for some institutions. They have value in addition to the servicing fee to be received because of the servicer's ability to invest the "float" that results from payments that are received from borrowers but are not immediately passed on to the investors in the loans.

Additionally, intrinsic value components of servicing rights may include ancillary income, such as late-payment charges and prepayment charges. Servicing rights can be purchased or sold either separately or as part of a loan. Loans sold along with the respective servicing rights are commonly referred to as *servicing retained*, whereas loans sold apart from the respective servicing rights are commonly referred to as *serving released*.

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 FASB ASC 860-50-25-2.

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 to subsequently measure servicing assets and servicing liabilities by using either the amortization method or the fair value measurement method 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 item (a) in FASB ASC 860-50-35-3. However, at the beginning of each year, for servicing assets and liabilities measured at amortized cost, an entity may make an irrevocable decision to subsequently measure a class of servicing assets or liabilities at fair value. If this election is made the cumulative effect adjustment should be recorded to retained earnings at the beginning of the year.

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 More recently, there has been an increase in bulk transfers of servicing (such as sales of servicing rights from one servicer to another). That activity has been driven by several factors, including changes in bank regulatory capital requirements for mortgage servicing rights and changes in the tax treatment of certain servicing cash flows.

10.57 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 to 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.

10.58 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 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.

10.60 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.

10.61 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.

10.62 Paragraphs 7–9 of FASB ASC 860-50-40 provide additional guidance on sales of servicing rights with a subservicing contract.

10.63 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. There are difficulties in measuring the amount of the gain if the sales price is based on a participation in future payments and there is no specified upper limit on the computed sales price. The transferor of mortgage servicing rights should consider all available information, including the amount of gain that would be recognized if the servicing rights were to be sold outright for a fixed cash price.

10.64 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.

10.65 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

10.66 Paragraphs 2–3 of FASB ASC 860-30-05 state that 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, 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).

10.67 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).

10.68 *Cash Collateral*. Paragraphs 3–4 of FASB ASC 860-30-25 state that all cash collateral should be recorded as an asset by the party receiving it (the secured party), together with a liability for the obligation to return it to the payer (obligor), whose asset is a receivable. Cash collateral used, for example, in securities lending transactions (see paragraphs 16–18 of FASB ASC 860-10-05) should be derecognized by the obligor and recognized by the secured party, not as collateral but rather as proceeds of either a sale or a borrowing.

10.69 *Noncash Collateral*. 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 obligor (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 obligor (transferor) should continue to carry the collateral as its asset, and the secured party (transferee) should not recognize the pledged asset.

Loans Not Previously HFS

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, including the OTS 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 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.

Financial Statement Presentation

10.75 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.

10.76 FASB ASC 310-10-50-3 states that if major categories of loans or trade receivables are not presented separately in the balance sheet (see

FASB ASC 310-10-45-2), they should be disclosed 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.

10.77 As explained in FASB ASC 230-10-45-21, 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 fair value or at the lower of cost or fair value. For example, mortgage loans HFS are required to be reported at the lower of cost or fair 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 item (a) in FASB ASC 230-10-45-12.

Update 10-2 *Accounting and Reporting*: Statement of Cash Flows

FASB ASU No. 2016-15, *Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments*, issued in October 2016, is effective for fiscal years, including interim periods within those fiscal years, of a public business entity beginning after December 15, 2017.

For all other entities, FASB ASU No. 2016-15 is effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years beginning after December 15, 2019. Early adoption is permitted, including adoption in an interim period. If an entity early adopts the amendments in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period. An entity that elects adoption must adopt all of the amendments in the same period.

FASB ASU No. 2016-15 addresses the following eight specific cash flow issues: Debt prepayment or debt extinguishment costs; settlement of zero-coupon debt instruments or other debt instruments with coupon interest rates that are insignificant in relation to the effective interest rate of the borrowing; contingent consideration payments made after a business combination; proceeds from the settlement of insurance claims; proceeds from the settlement of corporate-owned life insurance policies (including bank-owned life insurance policies; distributions received from equity method investees; beneficial interests in securitization transactions; and separately identifiable cash flows and application of the predominate principle.

This edition of the guide has not been updated to reflect changes as a result of this ASU, however, this section will be updated in a future edition. Readers are encouraged to consult the full text of this ASU on FASB's website at www.fasb.org.

10.78 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.

10.79 FASB ASC 948-310-50-1 requires an entity to disclose the method used in determining the lower of cost or fair value of mortgage loans HFS (that is, aggregate or individual loan basis).

10.80 In addition, see chapter 18, "Derivative Instruments: Futures, Forwards, Options, Swaps, and Other Derivative Instruments," of this guide for accounting and financial reporting of derivative instruments recognized in connection with mortgage banking activities.

10.81 FASB ASC 825-10-45 addresses financial statement presentation if the fair value option is elected for mortgage loans HFS.

Financial Statement Disclosure

10.82 FASB ASC 860 provides disclosure requirements for transfers and servicing of financial assets, including sales of financial assets, secured borrowings 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. Those objectives are to provide financial statement users with an understanding of all of the following:

- *a*. A transferor's continuing involvement, if any, with transferred financial assets
- *b*. The nature of any restrictions on assets reported by an entity in its statement of financial position that relate to a transferred financial asset, including the carrying amounts of those assets
- *c*. How servicing assets and servicing liabilities are reported under FASB ASC 860-50
- *d*. For both of the following, how the transfer of financial assets affects an entity's financial position, financial performance, and cash flows:
  - i. Transfers accounted for as sales, if a transferor has continuing involvement with the transferred financial asset
  - ii. Transfers of financial assets accounted for as secured borrowing

The specific disclosures required by FASB ASC 860 are minimum requirements, and an entity may need to supplement the required disclosures depending on (*a*) the facts and circumstances of a transfer, (*b*) the nature of an entity's continuing involvement with the transferred financial assets, or (*c*) the effect of an entity's continuing involvement on the transferor's financial position, financial performance, and cash flows.

10.83 *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 item (a) in FASB ASC 860-30-25-5 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.

10.84 To provide an understanding of the nature and risks of short-term collateralized financing obtained through repurchase agreements, securities lending transactions, and repurchase-to-maturity transactions, that are accounted for as secured borrowings at the reporting date, FASB ASC 860-30-50-7 states that an entity should disclose the following information for each interim and annual period about the collateral pledged and the associated risks to which the transferor continues to be exposed after the transfer:

a. A disaggregation of the gross obligation by the class of collateral pledged. An entity should determine the appropriate level of disaggregation and classes to be presented on the basis of the nature, characteristics, and risks of the collateral pledged. Total borrowings under those agreements should be reconciled to the amount of the gross liability for repurchase agreements and securities lending transactions disclosed in accordance with item (a) in FASB ASC 210-20-50-3 before any adjustments for offsetting. Any difference between the amount of the gross obligation disclosed under this paragraph and the amount disclosed in accordance with item (a) in FASB ASC 210-20-50-3 should be presented as reconciling item(s).

b. The remaining contractual maturity of the repurchase agreements, securities lending transactions, and repurchase-to-maturity transactions. An entity should use judgment to determine an appropriate range of maturity intervals that would convey an understanding of the overall maturity profile of the entity's financing agreements.

c. A discussion of the potential risks associated with the agreements and related collateral pledged, including obligations arising from a decline in the fair value of the collateral pledged and how those risks are managed.

10.85 *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.

10.86 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

10.87 According to FASB ASC 860-50-50-4, all of the following should be disclosed for servicing assets and servicing liabilities measured subsequently under the amortization method in item (a) in FASB ASC 860-50-35-1:

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.

10.88 *Sales of financial assets disclosure requirements*. For securitizations, asset-backed financing arrangements, and similar transfers that are 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.

10.89 According to FASB ASC 860-20-50-4, 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:

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 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 item (c)(2) in FASB ASC 860-20-50-3).

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 *c* 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.

10.90 To provide an understanding of the nature of the transactions, the transferor's continuing exposure to the transferred financial assets, and the presentation of the components of the transaction in the financial statements, FASB ASC 860-20-50-4D states that an entity should disclose the following for outstanding transactions at the reporting date that meet the scope guidance in paragraphs 4A–4B of FASB ASC 860-20-50 by type of transaction (for example, repurchase agreement, securities lending transaction, and sale and total return swap) (except for those transactions that are excluded from the scope, as described in FASB ASC 860-20-50-4C):[4]

a. The carrying amount of assets derecognized as of the date of derecognition:
  i. If the amounts that have been derecognized have changed significantly from the amounts that have been derecognized in prior periods or are not representative of the activity throughout the period, a discussion of the reasons for the change should be disclosed.

b. The amount of gross cash proceeds received by the transferor for the assets derecognized as of the date of derecognition.

c. Information about the transferor's ongoing exposure to the economic return on the transferred financial assets:
  i. As of the reporting date, the fair value of assets derecognized by the transferor.
  ii. Amounts reported in the statement of financial position arising from the transaction (for example, the carrying value or fair value of forward repurchase agreements or swap contracts). To the extent that those amounts are captured in the derivative disclosures presented in accordance with FASB ASC 815-10-50-4B, an entity should provide a cross-reference to the appropriate line item in that disclosure.
  iii. A description of the arrangements that result in the transferor retaining substantially all of the exposure to the

[4] In accordance with the scope guidance addressed in paragraphs 4A–4C of FASB ASC 860-20-50, this disclosure requirement applies to transactions accounted for as a sale that comprise both a transfer of financial assets to a transferee and an agreement entered into in contemplation of the initial transfer with the transferee that results in the transferor retaining substantially all of the exposure to the economic return on the transferred financial asset throughout the term of the transaction. These transactions include both of the following types:

a. Transfers of financial assets with an agreement to repurchase the transferred financial asset (or a substantially-the-same financial asset) before maturity at a fixed or determinable price that will be settled in a form other than the return of the transferred financial asset (for example, the transaction is cash-settled).

b. Transfers of financial assets with an agreement that requires that the transferor retain substantially all of the exposure to the economic return on the transferred financial asset (for example, a sale with a total return swap).

The following items are excluded from the scope of this disclosure requirement:

a. Transfers of financial assets with an agreement to purchase another financial asset that is not substantially the same as the initial transferred financial asset in accordance with item (a) in FASB ASC 860-10-40-24, for example, a dollar roll transaction accounted for as a sale because the financial asset to be purchased is not substantially the same as the initially transferred financial assets in accordance with item (a) in FASB ASC 860-10-40-24.

b. Securitizations, asset-backed financing arrangements, and similar transfers, in which both the transfer is accounted for as a sale and the transferor has continuing involvement with the transferred financial assets, that are subject to the disclosures in paragraphs 3–4 of FASB ASC 860-20-50.

economic return on the transferred financial assets and the risks related to those arrangements.

10.91 In addition, see chapter 18 of this guide for disclosures required for derivative instruments recognized in connection with mortgage banking activities.

10.92 FASB ASC 820-10-50 and FASB ASC 825-10-50 provide additional guidance related to fair value disclosures.

VIEs[5]

10.93 Financial institutions use securitization vehicles to pool and repackage mortgage loans, credit card loans and other assets. They also use asset-backed commercial paper conduits and collateralized debt and loan obligation vehicles to issue equity and debt to investor. Other common investment vehicles used by financial institutions include partnerships for low income housing or historic rehabilitation. These vehicles should be evaluated to determine if they are VIEs. 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 of that legal entity and is not required to provide disclosures for that legal entity under FASB ASC 810-10 "Variable Interest Entities" subsections.[6]

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[5] Many paragraphs in FASB ASC 810-10 are labeled as "Pending Content" and relate to FASB Accounting Standards Update (ASU) No. 2009-17, *Consolidations (Topic 810): Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities*. Although labeled as "Pending Content," this guidance is applicable for many entities except those that qualify for the deferral in FASB ASU No. 2010-10, *Consolidation (Topic 810): Amendments to Certain Investment Funds*. In February 2015, FASB issued ASU No. 2015-02, *Consolidation (Topic 810): Amendments to the Consolidation Analysis*. Among other provisions, the amendments in this ASU rescind the indefinite deferral in FASB ASU No. 2010-10 and provide a scope exception from FASB ASC 810, *Consolidation*, for reporting entities with interests in legal entities that are required to comply with or operate in accordance with requirements similar to those in Rule 2a-7 of the Investment Company Act of 1940 for registered money market funds. See footnote 7 for further details on the effective date of ASU No. 2015-02. Readers should carefully review the transition guidance in FASB ASC 810-10-65-2 associated with "Pending Content" to determine the applicability.

[6] FASB ASU No. 2010-02, *Consolidation (Topic 810): Accounting and Reporting for Decreases in Ownership of a Subsidiary—a Scope Clarification*, added a scope exception for deconsolidation/derecognition of sales of in-substance real estate. Emerging Issues Task Force (EITF) Issue No. 10-E, "Accounting for Deconsolidation of a Subsidiary That Is In-Substance Real Estate," highlighted a concern for in-substance real estate in which there is an event or circumstance other than a sale in which an entity may be required to deconsolidate in-substance real estate because the reporting entity has lost a controlling financial interest but the reporting entity would not be able to derecognize the in-substance asset under the guidance in FASB ASC 360-20. FASB ASU No. 2011-10, *Property, Plant, and Equipment (Topic 360): Derecognition of in Substance Real Estate—a Scope Clarification (a consensus of the FASB Emerging Issues Task Force)*, codified the consensus in EITF Issue No. 10-E and resolved diversity in practice by clarifying that when a parent (reporting entity) ceases to have a controlling financial interest (as described in FASB ASC 810-10) in a subsidiary that is in-substance real estate as a result of default on the subsidiary's nonrecourse debt, the reporting entity should apply the guidance in FASB ASC 360-20 to determine whether it should derecognize the in-substance real estate. Further, on the basis of the feedback received, the EITF recommended that the FASB chairman add a project to its agenda to address lenders' accounting in situations in which a borrower ceases to have a controlling financial interest in an in-substance real estate entity because of a default on its nonrecourse debt. After considering the recommendation of the EITF and the comments received on FASB ASU No. 2011-10, the FASB chairman added the research project titled Clarifying the Definition of a Business (formerly Application of Asset- or Entity-Based Guidance to Nonfinancial

(continued)

10.94 Per the FASB ASC glossary, a *variable interest* is defined as an investment or other interest that will absorb portions of a VIE's expected losses or receive 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 10.98). 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 16–41 of FASB ASC 810-10-55 describe various types of variable interests and explain in general how they may affect the determination of the primary beneficiary of a VIE.

10.95 "Pending Content" in paragraphs 37–38 of FASB ASC 810-10-55 provides detailed guidance in determining whether fees paid to a legal entity's decision maker or service provider constitute a variable interest.

10.96 The VIE guidance in FASB ASC 810-10 explains how to identify 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.

10.97 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 GAAP.

Considerations for Private Companies that Elect to use Standards as Issued by the Private Company Council

FASB ASU No. 2014-07, *Consolidation (Topic 810): Applying Variable Interest Entities Guidance to Common Control Leasing Arrangements (a consensus of the Private Company Council)*, permits a private company lessee (the reporting entity) to elect an alternative not to apply VIE guidance to a lessor entity if the following criteria are met:

(footnote continued)

Assets in an Entity) to FASB's agenda to explore the broader issue of determining when an entity that substantially consists of nonfinancial assets should be accounted for as an in-substance asset or as an entity.

In February 2017, FASB issued ASU No. 2017-05, *Other Income—Gains and Losses from the Derecognition of Nonfinancial Assets (Subtopic 610-20): Clarifying the Scope of Asset Derecognition Guidance and Accounting for Partial Sales of Nonfinancial Assets*, clarifying the scope of nonfinancial asset guidance in FASB ASC 610-20. The amendments also clarify the derecognition of all businesses and nonprofit activities (except those related to conveyances of oil and gas mineral rights or contracts with customers) should be accounted for in accordance with the derecognition and deconsolidation guidance in FASB ASC 810-10. The amendments also provide guidance on accounting for what often are referred to as partial sales of nonfinancial assets within the scope of FASB ASC 610-20 and contributions of nonfinancial assets to a joint venture or other noncontrolled investee.

FASB ASU No. 2017-05 is effective at the same time as the amendments in FASB ASU No. 2014-09 and an entity is required to apply the amendments in this ASU at the same time that it applies the amendments in FASB ASU No. 2014-09. Readers are encouraged to consult the full text of this ASU on FASB's website at www.fasb.org.

- The private company lessee and the lessor legal entity are under common control.
- The private company lessee has a lease arrangement with the lessor legal entity.
- Substantially all activities between the private company lessee and the lessor legal entity are related to leasing activities (including supporting leasing activities) between those two entities.
- If the private company lessee explicitly guarantees or provides collateral for any obligation of the lessor legal entity related to the asset leased by the private company, then the principal amount of the obligation at inception of such guarantee or collateral arrangement does not exceed the value of the asset leased by the private company from the lessor legal entity.

In accordance with FASB ASC 810-10-15-17B, the accounting alternative is an accounting policy election that, when elected, should be applied by a private company lessee to all current and future lessor entities under common control that meet the criteria for applying this approach. If any of the criteria for applying the alternative cease to be met, a private company should apply the VIE guidance at the date of change on a prospective basis.

VIE Determination

10.98 According to "Pending Content" in FASB ASC 810-10-15-14, a legal entity should be subject to consolidation under the VIE guidance subsections of FASB ASC 810, *Consolidation*, 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:

   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 810-10-25 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. The investors do not have the power through voting rights or similar rights if no owners hold voting rights or similar rights (such as those of a common shareholder in a corporation or a general partner in a partnership). Legal entities that are not controlled by the holder of a majority voting interest because of noncontrolling shareholder veto rights, as discussed in paragraphs 2–14 of FASB ASC 810-10-25, are not VIEs if the shareholders as a group have the power to control the entity and the equity investment meets the other requirements of the "Variable Interest Entities" subsections. *Kick-out rights* or *participating rights*, as defined in the FASB ASC glossary, held by the holders of the equity investment at risk should not prevent interests other than the equity investment from having this characteristic unless a single equity holder (including its related parties and de facto agents) has the unilateral ability to exercise such rights. Alternatively, interests other than the equity investment at risk that provide the holders of those interests with kick-out rights or participating rights should not prevent the equity holders from having this characteristic unless a single reporting entity (including its related parties and de facto agents) has the unilateral ability to exercise those rights. A decision maker also should not prevent the equity holders from having this characteristic unless the fees paid to the decision maker represent a variable interest based on paragraphs 37–38 of FASB ASC 810-10-55.

   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.

   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.

If interests other than the equity investment at risk provide the holders of that investment with the characteristics of a controlling financial interest or if interests other than the equity investment at risk prevent the equity holders from having the necessary characteristics, the entity is a VIE.

c. The equity investors as a group also are considered to lack the characteristics in item *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.

According to "Pending Content" in FASB ASC 810-10-15-14, a legal entity should be subject to consolidation under the VIE guidance subsections of FASB ASC 810, 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:

   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 810-10-25 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.

(1) For legal entities other than limited partnerships, investors lack the power through voting rights or similar rights if no owners hold voting rights or similar rights (such as those of a common shareholder in a corporation). Legal entities that are not controlled by the holder of a majority voting interest because of noncontrolling shareholder veto rights (participating rights), as discussed in paragraphs 2–14 of FASB ASC 810-10-25, are not VIEs if the holders of the equity investment at risk as a group have the power to control the entity and the equity investment meets the other requirements of the "Variable Interest Entities" subsections. If no owners hold voting rights or similar rights (such as those of a common shareholder in a corporation) over the activities of a legal entity that most significantly impact the entity's economic performance, kick-out rights or participating rights, as defined in the FASB ASC glossary, held by the holders of the equity investment at risk should not prevent interests other than the equity investment from having this characteristic unless a single equity holder (including its related parties and de facto agents) has the unilateral ability to exercise such rights. Alternatively, interests other than the equity investment at risk that provide the holders of those interests with kick-out rights or participating rights should not prevent the equity holders from having this characteristic unless a single reporting entity (including its related parties and de facto agents) has the unilateral ability to exercise those rights. A decision maker also should not prevent the equity holders from having this characteristic unless the fees paid to the decision maker represent a variable interest based on paragraphs 37–38 of FASB ASC 810-10-55.

(2) For limited partnerships, partners lack that power if neither items (a) nor (b), discussed subsequently, exists. The guidance in this subparagraph does not apply to entities in industries (see FASB ASC 910-810-45-1 and FASB ASC 932-810-45-1) in which it is appropriate for a general partner to use the pro rata method of consolidation for its investment in a limited partnership (see FASB ASC 810-10-45-14).

(a) A simple majority or lower threshold of limited partners (including a single limited partner) with equity at risk is able to exercise substantive kick-out rights (according to their voting interest entity definition) through voting interests over the general partner(s). For purposes of evaluating this threshold, a general partner's kick-out rights held through voting interests should not be included. Kick-out rights through voting interests held by entities under common control with the general partner or other parties acting on behalf of the general partner also should not be included.

(b) Limited partners with equity at risk are able to exercise substantive participating rights (according to their voting interest entity definition) over the general partner(s).

(c) For purposes of items (a) and (b), evaluation of the substantiveness of participating rights and kick-out rights should be based on the guidance included in paragraphs 2–14C of FASB ASC 810-10-25-2.[7]

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.

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.

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[7] FASB ASU No. 2015-02 was issued in February 2015. The amendments are effective for public business entities for fiscal years, and for interim periods within those fiscal years, beginning after December 15, 2015. For all other entities, the amendments in this ASU are effective for fiscal years beginning after December 15, 2016, and for interim periods within fiscal years beginning after December 15, 2017. Early adoption is permitted, including adoption in an interim period. If an entity early adopts the amendments in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period. A reporting entity may apply the amendments in this ASU using a modified retrospective approach by recording a cumulative-effect adjustment to equity as of the beginning of the fiscal year of adoption. A reporting entity also may apply the amendments retrospectively.

FASB ASU No. 2015-02 affects reporting entities that are required to evaluate whether they should consolidate certain legal entities. All legal entities are subject to reevaluation under the revised consolidation model.

Readers are encouraged to read the full text of the ASU, available at www.fasb.org. Readers should apply the appropriate guidance based on their facts and circumstances.

If interests other than the equity investment at risk provide the holders of that investment with the characteristics of a controlling financial interest or if interests other than the equity investment at risk prevent the equity holders from having the necessary characteristics, the entity is a VIE.

c. The equity investors as a group also are considered to lack the characteristics in item *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.

Reconsideration of VIE Status

10.99 A legal entity that previously was not subject to the VIE guidance presented in FASB ASC 810-10 should not become subject to it 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

Primary Beneficiary Evaluation

10.100 In accordance with "Pending Content" in paragraphs 38–38A of FASB ASC 810-10-25, 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

In accordance with "Pending Content" in paragraphs 38–38A of FASB ASC 810-10-25, 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–38J of FASB ASC 810-10-25.[8] 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

10.101 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. "Pending Content" in FASB ASC 810-10-25-43 provides guidance on related parties and de facto agents. In situations 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 "Pending Content" in 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

[8] See footnote 7.

"Pending Content" in paragraphs 42–44B of FASB ASC 810-10-25 address the effect of related parties on the primary beneficiary determination.[9]

10.102 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 significant 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.

Financial Statement Presentation and Disclosure Requirements

10.103 "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

10.104 The principal objectives of the required disclosure in FASB ASC 810-10 are to provide financial statement users with an understanding of all of the following:

a. The significant judgments and assumptions made by a reporting entity in determining whether it must consolidate a VIE or disclose information about its involvement in a VIE

b. The nature of restrictions on a consolidated VIE's assets and on the settlement of its liabilities reported by a reporting entity in its statement of financial position, including the carrying amounts of such assets and liabilities

c. The nature of, and changes in, the risks associated with a reporting entity's involvement with the VIE

d. How a reporting entity's involvement with the VIE affects the reporting entity's financial position, financial performance, and cash flows

Considerations for Private Companies that Elect to use Standards as Issued by the Private Company Alternative

Under the private company accounting alternative, a private company lessee would not be required to provide the VIE disclosures about the lessor entity. Rather, in accordance with FASB ASC 810-10-50-2AD, the private company lessee would disclose the following information:

- The amount and key terms of liabilities (for example, debt, environmental liabilities, and asset retirement obligations) recognized by the lessor legal entity that expose the private company lessee to providing financial support to the legal entity. For example, a private company lessee exposed to debt of the legal entity should disclose

[9] See footnote 7.

information such as the amount of debt, interest rate, maturity, pledged collateral, and guarantees associated with the debt.

- A qualitative description of circumstances (for example, certain commitments and contingencies) not recognized in the financial statements of the lessor legal entity that expose the private company lessee to providing financial support to the legal entity.

In applying this disclosure guidance, FASB ASC 810-10-50-2AE states that a private company lessee should consider exposures through implicit guarantees. The determination as to whether an implicit guarantee exists is based on facts and circumstances. The facts and circumstances include, but are not limited to, whether there is an economic incentive for the private company lessee to act as a guarantor or to make funds available, such actions have happened in similar situations in the past, and the private company lessee acting as a guarantor or making funds available would be considered a conflict of interest or illegal.

In accordance with FASB ASC 810-10-50-2AF, the disclosures under this alternative are required in combination with the disclosures required by other guidance (for example, FASB ASC 460, *Guarantees*, FASB ASC 850, *Related Party Disclosures*, and FASB ASC 840, *Leases*). Those disclosures could be combined in a single note or by including cross-references within the notes to the financial statements.

10.105 *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 required by FASB ASC 810, the primary beneficiary should disclose all of the following:

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

10.106 *Disclosure requirements for a holder of a variable interest in a VIE that is not the primary beneficiary.* "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.

A VIE may issue voting equity interests, and the entity that holds a majority voting interest also may be the primary beneficiary of the VIE. If so, the disclosures in this paragraph are not required.

10.107 *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 49–54 of FASB ASC 810-10-25 provide guidance on how to determine whether a reporting entity has an implicit variable interest in a VIE.

10.108 *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 variable interest and

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.

10.109 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.

Auditing[10]

Objectives

10.110 Audit objectives and procedures for loan origination and underwriting are discussed in chapter 8 of this guide. Audit objectives and procedures for securities, including MBSs, are addressed in chapter 7 of this guide. The primary audit objectives in this area are to obtain sufficient appropriate evidence that

a. loans HFS exist and the institution has the right to them;

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, including through repurchase agreements and securitizations, 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 retained or obtained 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. representations and warranty liabilities, recourse obligations and other liabilities assumed as a result of a transfer of a financial asset accounted for as a sale are measured appropriately initially and on an ongoing basis;

h. transfers of servicing rights have been properly accounted for as sales or secured borrowings;

i. servicing rights are properly measured upon and subsequent to initial recognition, including key assumptions such as prepayment speeds, discount rates and market cost-to-service;

j. derivatives are properly identified, valued, recorded and disclosed;

k. the entity has complied with the disclosure objectives and requirements for transfers of financial assets in FASB ASC 860 for all transfers of financial assets and other applicable disclosures in other FASB ASC topics;

l. the entity has identified a complete population of VIEs in which it has variable interests and arrived at the appropriate conclusion as to whether each should be consolidated; and

m. the entity has complied with the disclosure objectives and requirements for VIEs in FASB ASC 810.

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[10] The auditing content in this guide focuses primarily on generally accepted auditing standards issued by the Auditing Standards Board (ASB) and is applicable to audits of the financial statements of those entities not subject to the oversight authority of the PCAOB (that is, those audit reports not within the PCAOB's jurisdiction as defined by the Sarbanes-Oxley Act of 2002, as amended—hereinafter referred to as *nonissuers*). However, considerations for audits of entities subject to the oversight authority of the PCAOB (that is, those audit reports within the PCAOB's jurisdiction as defined by the Sarbanes-Oxley Act of 2002, as amended) may be discussed within this guide's chapter text. When such discussion is provided, the related paragraphs are designated with the following title: *Considerations for Audits Performed in Accordance With PCAOB Standards*.

Planning

10.111 In accordance with AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), the objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and relevant assertion levels through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement (as described in chapter 5, "Audit Considerations and Certain Financial Reporting Matters," of this guide). 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, the extent of continuing involvement with the transferred assets, and the nature of obligations incurred

c. Inquire about the processes, procedures, and controls employed by the entity at both the time of transfer and thereafter for recognition, measurement, and disclosures related to the transfer and servicing of assets

10.112 To obtain an understanding of mortgage banking activities in which the institution is engaged, the auditor may inquire about how the mortgage banking activities relate to management's objectives for managing interest-rate risk and enhancing liquidity. The auditor may also inquire about the reporting systems used by management to account for mortgage banking activities and may 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.

10.113 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 U.S. 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 and evaluate the risk of material misstatement of the financial statements that could result from the entity's mortgage banking activities including the institution's servicing systems controls over investor and escrow accounts (for example, for taxes and insurance or loan principal and interest) and the potential for contingent liabilities associated with noncompliance with investor-servicing requirements.

10.114 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 SEC Regulation AB or the *Uniform Single Attestation Program for Mortgage Bankers*. These agreements may require confirmation of the loans being serviced under specific contracts.

Internal Control Over Financial Reporting and Possible Tests of Controls

10.115 AU-C section 315 addresses the auditor's responsibility to identify and assess the risks of material misstatement in the financial statements through understanding the entity and its environment, including the entity's internal control. Paragraphs .13–.14 of AU-C section 315 state that the auditor should obtain an understanding of internal control relevant to the audit (such as mortgage loans HFS, participations sold, and individually significant securitization transactions) and, in doing so, should evaluate the design of those controls and determine whether they have been implemented by performing procedures in addition to inquiry of the entity's personnel. (See chapter 5 of this guide for further discussion of the components of internal control.) To provide a basis for designing and performing further audit procedures, paragraph .26 of AU-C section 315 states that the auditor should identify and assess the risks of material misstatement at the financial statement level and the relevant assertion level for classes of transactions, account balances, and disclosures.

10.116 The discussions of internal control activities in chapters 8–9 of this guide are also relevant to loan transfers and mortgage banking activities.

10.117 *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 transferred with continuing involvement are properly identified to determine whether sale or secured borrowing treatment is appropriate;
- review of ongoing valuation of outstanding derivatives;
- 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;
- procedures are established and reviewed for distinguishing loans HFS from those held for investment;
- procedures and systems are established to ensure that reconsideration of VIEs takes place on an ongoing basis;
- procedures to review investments and interests of the entity for VIE considerations;
- procedures to review the assumptions used in the accounting for servicing rights, including review of data inputs for accuracy, review of reasonableness of assumptions by a qualified person and review of the models used to calculate estimates; and

- review of recourse obligation and evaluation of potential liabilities.

10.118 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;
- procedures in place to engage counsel to provide a legal opinion when deemed necessary to support the assertion that transferred financial assets have been legally isolated from the transferor;
- 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 complete and accurate; and
- 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.

10.119 AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*), addresses the auditor's responsibility to design and implement responses to the risks of material misstatement identified and assessed by the auditor in accordance with AU-C section 315 and to evaluate the audit evidence obtained in an audit of financial statements.

10.120 In accordance with paragraph .08 of AU-C section 330, the auditor should design and perform tests of controls to obtain sufficient appropriate audit evidence about the operating effectiveness of relevant controls if (*a*) the auditor's assessment of risks of material misstatement at the relevant assertion level includes an expectation that the controls are operating effectively or (*b*) 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 reconciliation of payment amounts to income, principal, escrow, and service fee accounts;
- testing custodial account reconciliations and supporting documentation to assess whether 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 management's policies; and
- examining controls over loan documentation. (See chapter 8 of this guide.)

10.121 The following are examples of tests of controls that may be used by the auditor to ensure that internal control over financial reporting of mortgage banking activities are operating effectively:

- Review accounting policy manual updates and consultations.
- Review of valuation of outstanding derivatives.
- Examine applicable loan sale and servicing agreements for appropriate review and approval.
- 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.
- Examine reconciliations of cash receipts and payments to custodial accounts and servicing fees to the general ledger.
- Examine and assess management's valuation of servicing rights, including the controls over data inputs, review of assumptions and model utilized.
- Test management's process for identifying VIEs, evaluating whether VIEs should be consolidations and identifying reconsideration events for VIEs.
- Examine and assess management's impairment analysis for servicing rights, if applicable, including management's stratification of the portfolio for the impairment analysis.
- Examine evidence of management's review of financial statements and footnotes to ensure that all required disclosures are included.
- Review of recourse obligations and potential liabilities to be recognized.

Substantive Tests

10.122 Irrespective of the assessed risks of material misstatement, paragraph .18 of AU-C section 330 states that the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure, which for a financial institution may include transfers of loans and mortgage banking activities. In accordance with paragraph .A45 of AU-C section 330, this requirement reflects the facts that (*a*) the auditor's assessment of risk is judgmental and may not identify all risks of material misstatement and (*b*) inherent limitations to internal control exist, including management override.

10.123 Paragraph .06 of AU-C section 330 states that the auditor should design and perform further audit procedures whose nature, timing, and extent are based on, and responsive to, the assessed risks of material misstatement at the relevant assertion level. Examples of 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 held for investment, 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.)
- Assessing 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 financial asset transfers during the period and examining contracts to evaluate whether sale-versus-secured borrowing treatment and servicing assets and liabilities have been recognized properly. 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 ASC 860-10-40" (AICPA, *Professional Standards*, AU-C sec. 9620 par. .01–.21), of AU-C section 620, *Using the Work of an Auditor's Specialist*, 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.[11]
- Recalculating a sample of financial asset sale transactions to test gains or losses by testing the valuation of assets retained and liabilities assumed and vouching payments received for those transactions.

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[11] 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 ASC 860-10-40" (AICPA, *Professional Standards*, AU-C sec. 9620 par. .01–.21), of AU-C section 620, *Using the Work of an Auditor's Specialist*, has not been updated to reflect the issuance of FASB Statement No. 166, *Accounting for Transfers of Financial Assets*. FASB Statement No. 166 was incorporated into FASB ASC in FASB ASU No. 2009-16, *Transfers and Servicing (Topic 860): Accounting for Transfers of Financial Assets*, and is discussed in FASB ASC 860, *Transfers and Servicing*.

In addition, this interpretation has not been updated for changes to the FDIC's safe harbor for financial assets transferred in connection with securitizations and participations. The FDIC's final amendments to the safe harbor, *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* (www.fdic.gov/news/news/press/2010/pr10216.html), were issued in September 2010. The safe harbor provides important protections for securitizations and participations by confirming that in the event of a bank failure, the FDIC would not try to reclaim loans transferred into such transactions.

In light of the issuance of FASB Statement No. 166 and the FDIC's changes to the safe harbor, the AICPA's ASB is currently in the process of revising this interpretation. Auditors should be alert for such revisions; however, the guidance in this interpretation continues to be relevant.

- Analytically projecting service fees for comparison to such expectations with service fee revenues reported in operating income for the period.
- Analytically assessing gain on sale to the volume of loans sold and comparing this to auditor expectations.
- Assessing 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, assessing the assumptions used in the valuation process, considering their current reasonableness, and evaluating the effect of changes in assumptions on impairment or fair value measurement. Key assumptions include prepayment speeds, discount rates, cost-to-service and ancillary income.
- Analyzing prepayment data used by management to calculate the fair 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 management estimates.
- Evaluating the reasonableness of cost-to-service assumptions used to calculate the fair value of servicing rights, considering that a fair value should consider a market participant's cost-to-service rather than the institution's internal cost-to-service.
- Analytically assessing the ancillary income assumptions used to calculate the fair value of servicing rights.
- Analytically assessing the amount of initial servicing rights and ending servicing rights in relation to the related loan balances at those respective dates to auditor expectations.
- Evaluating the method of amortizing servicing rights, if applicable, including key assumptions like the methodology for stratification of the portfolio for impairment purposes.
- Evaluating the appropriateness of the liability for recourse obligations. Loan sale or 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, investor, or trustee.

- Reviewing legal documents (such as bylaws and servicing agreements) for securitization trusts and other VIEs to determine that consolidation or nonconsolidation is appropriate.
- Obtaining legal opinions for securitizations derecognized from the balance sheet.
- Reviewing financial statements and footnotes to determine that all required disclosures have been made.

Chapter 11

Real Estate Investments, Real Estate Owned, and Other Foreclosed Assets

FASB *Accounting Standards Codification* (ASC) 606, *Revenue from Contracts with Customers*

FASB ASC 606 is effective for annual reporting periods of a public business entity, a not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market, and an employee benefit plan that files or furnishes financial statements with or to the SEC beginning after December 15, 2017, including interim periods within that reporting period. Early application is permitted only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period.

For all other entities, FASB ASC 606 is effective for annual reporting periods beginning after December 15, 2018, and interim periods within annual periods beginning after December 15, 2019. Other entities may elect to adopt the standard earlier, however, only as of either

- an annual reporting period beginning after December 15, 2016, including interim periods within that reporting period, or
- an annual reporting period beginning after December 15, 2016, and interim periods within annual periods beginning one year after the annual reporting period in which an entity first applies the "Pending Content" that links to FASB ASC 606-10-65-1.

FASB ASC 606 provides a framework for revenue recognition and supersedes or amends several of the revenue recognition requirements in FASB ASC 605, *Revenue Recognition*, as well as guidance within the 900 series of industry-specific topics, including FASB ASC 942, *Financial Services—Depository and Lending*. The standard applies to any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets unless those contracts are within the scope of other standards (for example, insurance or lease contracts).

Readers are encouraged to consult the full text of FASB ASC 606 on FASB's website at www.fasb.org.

The AICPA has formed 16 industry task forces to assist in developing a new Audit and Accounting Guide on revenue recognition that provides helpful hints and illustrative examples for how to apply the new standard (guide available at www.aicpastore.com). Revenue recognition implementation issues identified by the Depository and Lending Institutions Revenue Recognition Task Force are available for informal comment, after review by the AICPA Financial Reporting Executive Committee, at the "Depository and Lending Institutions Revenue Recognition Task Force" page at aicpa.org.

Readers are encouraged to submit comments to revreccomments@aicpa.org.

For more information, see appendix E, "The New Revenue Recognition Standard: FASB ASC 606," of this guide.

Introduction

11.01 Generally, the largest component of real estate owned (REO), also known as other real estate owned (OREO), by lenders is assets taken in full or partial settlement of troubled loans through foreclosure or receiving physical possession of real estate property collateralizing a loan. 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.[1] Once a bank obtains physical possession of the collateral, the real estate is included in REO. Physical possession of residential real estate property collateralizing a consumer mortgage loan occurs either when the creditor obtains legal title to the residential real estate property through foreclosure, even if the borrower has redemption rights whereby it can legally reclaim the real estate property for a period of time, or upon completion of a deed in lieu of foreclosure or similar legal agreement under which the borrower conveys all interest in the residential real estate property to the creditor to satisfy that loan. The deed in lieu of foreclosure or similar legal agreement is completed when agreed upon terms and conditions have been satisfied by both the borrower and the creditor. 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.

Real Estate Investments

11.03 Some institutions make direct and indirect equity investments in real estate projects. Direct and indirect equity investment activities exclude OREO acquired in any manner for debts previously contracted and are limited by 12 USC 29 and Regulation H, 12 CFR Part 208.

Regulatory Matters

11.04 As explained in the entry *foreclosed assets* in the "Glossary" section of the Federal Financial Institutions Examination Council's *Instructions for Preparation of Consolidated Reports of Condition and Income*, certain provisions of Statement of Position No. 92-3, *Accounting for Foreclosed Assets*, (rescinded with the issuance of FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long Lived Assets*, [codified in FASB ASC 360, *Property, Plant, and Equipment*]) are not present in FASB ASC 360, but the application of these provisions represents prevalent practice in the banking industry and is 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 entry *foreclosed assets* in the "Glossary" section of the Federal Financial Institutions Examination Council's *Instructions*

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[1] FASB Accounting Standards Update (ASU) No. 2014-04, *Receivables—Troubled Debt Restructurings by Creditors (Subtopic 310-40): Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure (a consensus of the FASB Emerging Issues Task Force)*, clarifies when a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan.

for Preparation of Consolidated Reports of Condition and Income. The instructions explain that

- for purposes of these reports, foreclosed assets (other than residential real estate property collateralizing a consumer mortgage loan) include loans where the bank, as creditor, has received physical possession of a borrower's assets, regardless of whether formal foreclose proceedings take place. The timing of physical possession is also explained.
- 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 initially measure this asset at its fair value less cost to sell. This fair value (less cost to sell, if applicable) of the asset received in full satisfaction of the loan becomes the "cost" of the asset. Cost to sell includes items like estimated sales commissions on the sale of the property.
- an asset received in partial satisfaction of a loan should be initially measured at its fair value less cost to sell and the recorded amount of the loan should be reduced by the fair value (less cost to sell, if applicable) of the asset at the time of restructuring, foreclosure, or repossession.
- after foreclosure, each foreclosed real estate asset (including any real estate for which the bank receives physical possession) 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. This determination must be made on an asset-by-asset basis.

11.05 Voluntary direct investments in real estate are generally limited for national banks, as described in Title 12 U.S. *Code of Federal Regulations* (CFR) Part 7.100. State member banks may invest in real estate only with the prior approval of the Board of Governors of the Federal Reserve System (Federal Reserve) as described in Regulation H. For REO acquired through foreclosure, the maximum allowable holding period is generally five years from the date of a bank receiving legal title, unencumbered by any redemption period applicable, to the property. A bank may request an extension not to exceed an additional five years, if (1) the institution has made a good faith attempt to dispose of the real estate within the five-year period, or (2) disposal within the five-year period would be detrimental to the institution, and the holding period regulatory guidance applies to all OREO properties the bank holds legal title to, even if the property has been written down to a recorded amount of zero.

11.06 *Foreclosure management.* In July 2012, the Federal Reserve issued guidance to address a lender's decision to discontinue foreclosure proceedings. The objective of the guidance is to emphasize the importance of appropriate risk management practices and controls in connection with a decision not to complete foreclosure proceedings after they have been initiated. Responsibilities of management include the following:

- *Communication with borrowers*. Supervised banking organizations should use all means possible to provide the previously described notification to affected borrowers, particularly those who prematurely vacated their homes based on the servicers' initial communications regarding foreclosure actions.

- *Notification to local authorities*. Supervised banking organizations should ensure that their procedures include reasonable efforts to notify appropriate state or local government authorities of the organization's decision not to pursue a foreclosure, including complying with applicable state or local government notification requirements.
- *Obtaining and monitoring collateral values*. Supervised banking organizations should have a process for obtaining the best practicable information on the collateral value of a residential property that may be subject to foreclosure and for updating this information on a regular basis.

Readers can access this guidance in Supervision and Regulation (SR) letter 12-11/Consumer Affairs (CA) letter 12-10, *Guidance on a Lender's Decision to Discontinue Foreclosure Proceedings*, from the Federal Reserve website at www.federalreserve.gov.

11.07 In April 2013, the Federal Reserve issued guidance on sound business practices for residential mortgage servicing that Federal Reserve supervised financial institutions are expected to address in their collections, loss mitigation, and foreclosure processing functions. The guidance confirms the minimum standards that all regulated institutions are expected to adopt in prioritizing and handling borrowers' files with imminent risk of foreclosure. These minimum review criteria are intended to ensure a level of consistency across servicers and should be used to determine whether a scheduled foreclosure sale should be postponed, suspended, or cancelled because of critical foreclosure defects in the borrower's file. Readers can access this guidance in SR letter 13-9/CA letter 13-6, *Minimum Standards for Prioritization and Handling Borrower Files with Imminent Scheduled Foreclosure Sale*, from the Federal Reserve website at www.federalreserve.gov.

11.08 *Disposal of problem assets through exchanges*. In December 2011, the Federal Reserve issued SR letter 11-15, *Disposal of Problem Assets through Exchanges*. The guidance addresses the risks involved in asset exchanges, the associated risk management considerations for institutions, and the supervisory considerations for examiners. The guidance also provides a detailed example of an asset exchange transaction. The example highlights the potential risks associated specifically with transactions that may reduce problem assets in the short term but, because of a lack of appropriate, up-front due diligence, may result in heightened risks over the longer term. Readers can access the guidance in SR letter 11-15 from the Federal Reserve website at www.federalreserve.gov.

11.09 *Rental of Residential OREO Properties*. In April 2012, the Federal Reserve issued SR letter 12-5/CA letter 12-2, *Policy Statement on Rental of Residential OREO Properties*, (policy statement) to remind banking organizations and examiners that the Federal Reserve's regulations and policies permit the rental of OREO properties as part of an orderly disposition strategy within statutory and regulatory limits. The policy statement applies to state member banks, bank holding companies, nonbank subsidiaries of bank holding companies, savings and loan holding companies, nonthrift subsidiaries of savings and loan holding companies, and U.S. branches and agencies of foreign banking organizations (collectively, banking organizations).

11.10 While the general policy of the Federal Reserve is that banking organizations should make good-faith efforts to dispose of OREO properties at the earliest practicable date. The policy statement indicates that banking organizations may rent one- to four-family residential OREO properties without having to demonstrate continuous active marketing of the properties, provided that suitable policies and procedures are followed.

11.11 Key risk management considerations for banking organizations that engage in the rental of residential OREO include compliance with holding-period requirements for OREO, compliance with landlord-tenant and associated requirements, and accounting for OREO assets in accordance with U.S. generally accepted accounting principles (GAAP). Residential OREO is typically treated as a substandard asset as defined by the interagency classification guidelines. However, residential properties with leases in place and demonstrated cash flow from rental operations sufficient to generate a reasonable rate of return should generally not be classified.

11.12 The policy statement also establishes specific supervisory expectations for banking organizations that undertake large-scale residential OREO rentals (generally, 50 properties or more available for rent). Such organizations should have formal policies and procedures governing the operation and administration of OREO rental activities, including property-specific rental plans, policies and procedures for compliance with applicable laws and regulations, a risk management framework, and oversight of third-party property managers. For more information, readers can access SR letter 12-5/CA letter 12-3 from the Federal Reserve website at www.federalreserve.gov.

11.13 *OREO management*. In June 2012, the Federal Reserve issued SR letter 12-10/CA letter 12-9, *Questions and Answers for Federal Reserve-Regulated Institutions Related to the Management of Other Real Estate Owned (OREO)*, to clarify existing policies and promote prudent practices for the management of an institution's OREO assets. Topics covered in the question and answer document include transferring an asset to OREO, reporting treatment and classification, appraisal concepts, ongoing property management, operational and legal issues, and sale and transfer of OREO. Readers can access SR letter 12-10/CA letter 12-9 from the Federal Reserve website at www.federalreserve.gov.

11.14 *Appraisals*. All OREO whether actively marketed or not actively marketed, should be reviewed quarterly and supported by appropriate policies, procedures, and documentation to support appraised value. Readers should refer to the discussion beginning in paragraph 8.63 of this guide for regulatory guidance addressing appraisals. A bank is required to monitor the appraisal value of each parcel of OREO property in accordance with GAAP and regulatory guidance. Further discussion on ongoing appraisal requirements for OREO can also be found in 12 (CFR) Part 34.85(a)(2).

11.15 *Bank Accounting Advisory Series (BAAS)*. The Office of the Comptroller of the Currency's BAAS is updated periodically to express the Office of the Chief Accountant's current views on accounting topics of interest to national banks and federal savings associations. See further discussion of the BAAS in paragraph 7.82 of this guide. Topic 5, "OREO and Other Assets," of the BAAS includes interpretations and responses related to OREO (for example, when a bank should derecognize a loan collateralized by property other than residential real estate, such as a commercial real estate loan and an auto loan.) In addition, Topic 2 A, "Troubled Debt Restructuring," includes discussion on when discharged debt should not to be reported as OREO and classification and measurement guidance under GAAP for government guaranteed mortgage loans upon a bank's foreclosure of the property that collateralizes the loan. Readers are encouraged to view this publication under the "Publications—Bank Management" page at www.occ.gov.

Accounting and Financial Reporting

Foreclosed Assets

Update 11-1 *Accounting and Reporting*: Revenue From Contracts With Customers

FASB ASC 606 is effective for annual reporting periods of a public business entity, a not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market, and an employee benefit plan that files or furnishes financial statements with or to the SEC beginning after December 15, 2017, including interim periods within that reporting period. Early application is permitted only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period.

For all other entities, FASB ASC 606 is effective for annual reporting periods beginning after December 15, 2018, and interim periods within annual periods beginning after December 15, 2019. Other entities may elect to adopt the standard earlier, however, only as of either

- an annual reporting period beginning after December 15, 2016, including interim periods within that reporting period, or
- an annual reporting period beginning after December 15, 2016, and interim periods within annual periods beginning one year after the annual reporting period in which an entity first applies the "Pending Content" that links to FASB ASC 606-10-65-1.

FASB ASC 606 provides a framework for revenue recognition and supersedes or amends several of the revenue recognition requirements in FASB ASC 605 as well as guidance within the 900 series of industry-specific topics. The standard applies to any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets unless those contracts are within the scope of other standards (for example, insurance or lease contracts). Under FASB ASC 606, in addition to other criteria to determine whether a contract exists, the bank must assess collectability to determine if a contract exists. If collection is not deemed probable, then the consideration received from the customer is recognized as a liability.

Readers should be aware that the sale of OREO is within the scope of FASB ASC 606 and FASB ASC 610, *Other Income*.

Readers are encouraged to consult the full text of FASB ASC 606 on FASB's website at www.fasb.org.

For more information, see appendix E of this guide.

Update 11-2 *Accounting and Reporting*: Credit Losses

FASB Accounting Standards Update (ASU) No. 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*, issued in June 2016, is effective for fiscal years of public business entities that are SEC filers beginning after December 15, 2019, including interim periods within those fiscal years.

For all other public business entities, the amendments in FASB ASU No. 2016-13 are effective for fiscal years beginning after December 15, 2020, including interim periods within those fiscal years.

For all other entities, including not-for-profit entities and employee benefit plans within the scope of FASB ASC 960, *Plan Accounting—Defined Benefit Pension Plans*, through FASB ASC 965, *Plan Accounting—Health and Welfare Benefit Plans*, FASB ASU No. 2016-13 is effective for fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021.

Early application is permitted for all entities as of the fiscal years beginning after December 15, 2018, including interim periods within those fiscal years.

FASB ASU No. 2016-13 creates FASB ASC 326, *Financial Instruments—Credit Losses*, to amend guidance on reporting credit losses for financial assets held at amortized cost basis and available-for-sale debt securities.

For financial assets held at amortized cost basis, FASB ASC 326 eliminates the probable initial recognition threshold in current GAAP and, instead, requires an entity to reflect its current estimate of all expected credit losses. The allowance for credit losses is a valuation account that is deducted from the amortized cost basis of the financial assets to present the net amount expected to be collected.

For available-for-sale debt securities, credit losses should be measured in a manner similar to current GAAP. However, FASB ASC 326 will require that credit losses be presented as an allowance rather than as a write-down.

FASB ASU No. 2016-13 affects entities holding financial assets and net investment in leases that are not accounted for at fair value through net income. The amendments affect loans, debt securities, trade receivables, net investments in leases, off-balance-sheet credit exposures, reinsurance receivables, and any other financial assets not excluded from the scope that have the contractual right to receive cash.

This edition of the guide has not been updated to reflect changes as a result of this ASU, however, this section will be updated in a future edition. Readers are encouraged to consult the full text of this ASU on FASB's website at www.fasb.org.

For more information on FASB ASU No. 2016-13, see appendix G, "Accounting for Financial Instruments," of this guide.

11.16 FASB ASC 310-40-40 applies to the initial measurement of a foreclosed property (including when the creditor receives physical possession of the debtor's assets, regardless of whether formal foreclosure proceedings take place). Paragraphs 2–3 of FASB ASC 310-40-40 provide that a creditor that receives real estate or other assets from a debtor in full satisfaction of a receivable should record the asset received at fair value at the time of the restructuring. If the long-lived asset received will be sold, those assets should be recorded at their fair value less cost to sell, as that term is used in FASB ASC 360-10-35-43. In addition, FASB ASC 310-40-35-7 provides that an asset received in partial satisfaction of a receivable combined with a modification of the debt should account for the asset received as prescribed in paragraphs 2–4 of FASB ASC 310-40-40 (fair value less cost to sell if the asset received will be sold) and reduce the recorded investment in the receivable by a corresponding amount.

11.17 Further, "Pending Content" in FASB ASC 310-40-40-6 explains that, except in the circumstances described in FASB ASC 310-40-40-6A (see paragraph 11.18), 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 (see paragraph 11.16), paragraphs 2–4 of FASB ASC 310-40-40 (see paragraph 11.16), and if appropriate, FASB ASC 310-40-40-8. See paragraphs 7A–7B of FASB ASC 310-40-40 for the classification and measurement of certain government-guaranteed mortgage loans. For guidance on when a creditor should be considered to have received physical possession (resulting from an in substance repossession or foreclosure) of residential real estate properly collateralizing a consumer mortgage loan, see FASB ASC 310-40-55-10A.

11.18 The guidance in FASB ASC 310-40-40-7 (see paragraph 11.19) applies to initial measurement of a foreclosed property in a transaction having all of the following characteristics:

a. A sale of real estate was financed by the seller.

b. The buyer's initial investment was not sufficient for recognition of profit under the full accrual method.

c. The seller met the conditions of FASB ASC 970-605 to record a sale and recognized profit on the installment or cost recovery method.

d. Subsequently, the buyer defaulted on the mortgage to the seller.

e. The seller forecloses on the property.

f. At the time of foreclosure, the fair value of the property is less than the seller's gross receivable but greater than the seller's net receivable, that is, the principal and interest receivable less the deferred profit on the sale and related allowances.

11.19 At the time of foreclosure, foreclosed property meeting the characteristics of FASB ASC 310-40-40-6A (see paragraph 11.18) should be recorded at the lower of the net amount of the receivable or fair value of the property, in accordance with FASB ASC 310-40-40-7. 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.

11.20 In accordance with "Pending Content" in paragraphs 7A–7B of FASB ASC 310-40-40, a guaranteed mortgage loan receivable should be derecognized and a separate other receivable be recognized upon foreclosure (that is, when a creditor receives physical possession of real estate property collateralizing a mortgage loan in accordance with the guidance in FASB ASC 310-40-40-6 (see paragraph 11.17) if the following conditions are met:

- The loan has a government guarantee that is not separable from the loan before foreclosure.
- At the time of foreclosure, the creditor has the intent to convey the real estate property to the guarantor and make a claim on the guarantee, and the creditor has the ability to recover under the claim.
- At the time of foreclosure, any amount of the claim that is determined on the basis of the fair value of the real estate is fixed.

Upon foreclosure, the separate other receivable should be measured based on the amount of the loan balance (principal and interest) expected to be recovered from the guarantor.

11.21 FASB ASC 310-10-35-32 establishes guidance on the accounting for loans when foreclosure is probable and 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.

Financial Statement Presentation and Disclosure

11.22 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. In accordance with FASB ASC 310-10-50-11, an entity should also disclose the carrying amount of foreclosed residential real estate properties held at the reporting date as a result of obtaining physical possession in accordance with FASB ASC 310-40-40-6 (see paragraph 11.17) and FASB ASC 310-40-55-10A.

Accounting and Reporting for Long-Lived Assets to Be Disposed of by Sale

11.23 FASB ASC 360-10-05-4 states that 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 and disclosures about the impairment or disposal of long-lived assets and disposals of individually significant components of an entity.

11.24 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.

11.25 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.

11.26 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.

11.27 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.

11.28 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.

Financial Statement Presentation and Disclosure

11.29 "Pending Content" in FASB ASC 360-10-45-5 states that a gain or loss recognized (see FASB ASC 610-20 on the sale or transfer of a nonfinancial asset) on the sale of a long-lived asset (disposal group) that is not a discontinued operation 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.

11.30 FASB ASC 360-10-45-14 states that a long-lived asset classified as HFS (but not qualifying for presentation as a discontinued operation in the statement of financial position in accordance with FASB ASC 205-20-45-10) should be presented separately in the statement of financial position of the current period. 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 presented on the face of the statement of financial position or disclosed in the notes to the financial statements (see FASB ASC 360-10-50-3 in paragraph 11.31*e*).

11.31 For any period in which a long-lived asset (disposal group) either has been disposed of or is classified as HFS (see FASB ASC 360-10-45-9 in paragraph 11.24), FASB ASC 360-10-50-3 states that an entity should disclose the following information in the notes to the financial statements:

a. A description of the facts and circumstances leading to the disposal or expected disposal.

b. The expected manner and timing of that disposal.

c. The gain or loss recognized in accordance with paragraphs 37–45 of FASB ASC 360-10-35 and FASB ASC 360-10-40-5.

d. If not separately presented on the face of the statement where net income is reported, the caption in the statement where net income is reported that includes the gain or loss.

e. If not separately presented on the face of the statement of financial position, the carrying amounts of the major classes of assets and liabilities included as part of a disposal group classified as HFS. Any loss recognized on the disposal group classified as HFS in accordance with paragraphs 37–45 of FASB ASC 360-10-35 and FASB ASC 360-10-40-5 should not be allocated to the major classes of assets and liabilities of the disposal group.

f. If applicable, the segment(s) in which the long-lived asset (disposal group) is reported under FASB ASC 280, *Segment Reporting*.

11.32 In addition to the disclosures in FASB ASC 360-10-50-3 (see paragraph 11.31), FASB ASC 360-10-50-3A states that if a long-lived asset (disposal group) includes an individually significant component of an entity that either has been disposed of or is classified as HFS (see FASB ASC 360-10-45-9 in paragraph 11.24) and does not qualify for presentation and disclosure as a discontinued operation (see FASB ASC 205-20 on discontinued operations), a public business entity and a not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market should disclose the information in item (*a*). All other entities should disclose the information in item (*b*).

a. For a public business entity and a not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market, both of the following:

1. The pretax profit or loss of the individually significant component of an entity for the period in which it is disposed of or is classified as HFS and for all prior periods that are presented in the statement where net income is reported calculated in accordance with paragraphs 6–9 of FASB ASC 205-20-45
2. If the individually significant component of an entity includes a noncontrolling interest, the pretax profit or loss attributable to the parent for the period in which it is disposed of or is classified as HFS and for all prior periods that are presented in the statement where net income is reported

b. For all other entities, both of the following:

1. The pretax profit or loss of the individually significant component of an entity for the period in which it is disposed of or is classified as HFS calculated in accordance with paragraphs 6–9 of FASB ASC 205-20-45
2. If the individually significant component of an entity includes a noncontrolling interest, the pretax profit or loss attributable to the parent for the period in which it is disposed of or is classified as HFS

Accounting and Reporting for Long-Lived Assets to Be Held and Used

11.33 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.

11.34 Paragraphs 16–36 of FASB ASC 360-10-35 address how long-lived assets or asset groups that are intended to be held and used in an entity's business should be reviewed for impairment. 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. 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), as stated in FASB ASC 360-10-35-17. 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 (see FASB ASC 360-10-35-33) or under development (see FASB ASC 360-10-35-34). In accordance with FASB ASC 360-10-35-29, 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.

11.35 FASB ASC 360-10-35-17 goes on to state 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 grouping long-lived assets classified as held and used.

11.36 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 (see paragraphs 31–32 of FASB ASC 360-10-35). However, any change in the accounting method for the asset resulting from that review should be made only after applying FASB ASC 360-10.

11.37 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.

Financial Statement Presentation and Disclosure

11.38 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.

11.39 As required by 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

Real Estate Investments

11.40 The "General" subsections of FASB ASC 970, *Real Estate—General*, provide accounting guidance concerning various forms of real estate investments. FASB ASC contains several topics for real estate due to differing accounting treatment for various real estate subindustries.

11.41 The "Acquisition, Development, and Construction" subsections of FASB ASC 310-10 provide guidance for determining whether a lender should account for an acquisition, development, and construction (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. In an ADC arrangement in which the lender participates in expected residual profit, in addition to the lender's participation in expected residual profit, FASB ASC 310-10-25-19 outlines certain characteristics that would suggest that the risks and rewards of the arrangement are similar to those associated with an investment in real estate or joint venture.

Financial Statement Presentation and Disclosure

11.42 FASB ASC 310-10-45-15 states that 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.

Sale of Real Estate Assets[2]

Update 11-3 ***Accounting and Reporting*****: Revenue From Contracts With Customers**

FASB ASC 606 is effective for annual reporting periods of a public business entity, a not-for-profit entity that has issued, or is a conduit bond obligor for,

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[2] FASB ASU No. 2010-02, *Consolidation (Topic 810): Accounting and Reporting for Decreases in Ownership of a Subsidiary—a Scope Clarification*, added a scope exception for deconsolidation/derecognition of sales of in-substance real estate. Emerging Issues Task Force (EITF) Issue No. 10-E, "Accounting for Deconsolidation of a Subsidiary That Is In-Substance Real Estate," highlighted a concern for in-substance real estate in which there is an event or circumstance other than a sale in which an entity may be required to deconsolidate in-substance real estate because the reporting entity has lost a controlling financial interest but the reporting entity would not be able to derecognize the in-substance asset under the guidance in FASB *Accounting Standards Codification* (ASC) 360-20. FASB ASU No. 2011-10, *Property, Plant, and Equipment (Topic 360): Derecognition of in Substance Real Estate—a Scope Clarification (a consensus of the FASB Emerging Issues Task Force)*, codified the consensus in EITF Issue No. 10-E and resolved diversity in practice by clarifying that when a parent (reporting entity) ceases to have a controlling financial interest (as described in FASB ASC 810-10) in a subsidiary that is in-substance real estate as a result of default on the subsidiary's nonrecourse debt, the reporting entity should apply the guidance in FASB ASC 360-20 to determine whether it should derecognize the in-substance real estate. Further, on the basis of the feedback received, the EITF recommended that the FASB chairman add a project to its agenda to address lenders' accounting in situations in which a borrower ceases to have a controlling financial interest in an in-substance real estate entity because of a default on its nonrecourse debt. After considering the recommendation of the EITF and the comments received on FASB ASU No. 2011-10, the FASB chairman added the research project titled Clarifying the Definition of a Business (formerly Application of Asset- or Entity-Based Guidance to Nonfinancial Assets in an Entity) to FASB's agenda to explore the broader issue of determining when an entity that substantially consists of nonfinancial assets should be accounted for as an in-substance asset or as an entity.

In February 2017, FASB issued ASU No. 2017-05, *Other Income—Gains and Losses from the Derecognition of Nonfinancial Assets (Subtopic 610-20): Clarifying the Scope of Asset Derecognition Guidance and Accounting for Partial Sales of Nonfinancial Assets*, clarifying the scope of nonfinancial asset guidance in FASB ASC 610-20. The amendments also clarify the derecognition of all businesses and nonprofit activities (except those related to conveyances of oil and gas mineral rights or contracts with customers) should be accounted for in accordance with the derecognition and deconsolidation guidance in FASB ASC 810-10. The amendments also provide guidance on accounting for what often are referred to as partial sales of nonfinancial assets within the scope of FASB ASC 610-20 and contributions of nonfinancial assets to a joint venture or other noncontrolled investee.

FASB ASU No. 2017-05 is effective at the same time as the amendments in FASB ASU No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, and an entity is required to apply the amendments in this ASU at the same time that it applies the amendments in FASB ASU No. 2014-09. Readers are encouraged to consult the full text of this ASU on FASB's website at www.fasb.org.

securities that are traded, listed, or quoted on an exchange or an over-the-counter market, and an employee benefit plan that files or furnishes financial statements with or to the SEC beginning after December 15, 2017, including interim periods within that reporting period. Early application is permitted only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period.

For all other entities, FASB ASC 606 is effective for annual reporting periods beginning after December 15, 2018, and interim periods within annual periods beginning after December 15, 2019. Other entities may elect to adopt the standard earlier, however, only as of either:

- An annual reporting period beginning after December 15, 2016, including interim periods within that reporting period, or
- An annual reporting period beginning after December 15, 2016, and interim periods within annual periods beginning one year after the annual reporting period in which an entity first applies the "Pending Content" that links to FASB ASC 606-10-65-1.

FASB ASC 606 provides a framework for revenue recognition and supersedes or amends several of the revenue recognition requirements in FASB ASC 605 as well as guidance within the 900 series of industry-specific topics. The standard applies to any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets unless those contracts are within the scope of other standards (for example, insurance or lease contracts). Under FASB ASC 606, in addition to other criteria to determine whether a contract exists, the bank must assess collectability to determine if a contract exists. If collection is not deemed probable, then the consideration received from the customer is recognized as a liability.

Readers are encouraged to consult the full text of FASB ASC 606 on FASB's website at www.fasb.org.

For more information, see appendix E of this guide.

Update 11-4 *Accounting and Reporting*: Leases

FASB ASU No. 2016-02, *Leases (Topic 842)*, issued in February 2016, is effective for fiscal years of a public business entity, a not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market, and an employee benefit plan that files financial statements with the SEC beginning after December 15, 2018, including interim periods within those fiscal years.

For all other entities, FASB ASU No. 2016-02 is effective for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2019.

Early application is permitted for all entities.

FASB ASU No. 2016-02 supersedes the lease requirements in FASB ASC 840, *Leases*, and creates FASB ASC 842, *Leases*, to establish the principles that lessees and lessors should apply to report useful information to users of financial statements about the amount, timing, and uncertainty of cash flows arising from a lease. FASB ASC 842 affects any entity that enters into a lease (as that term is defined in FASB ASU No. 2016-02), with some specified scope exceptions.

This edition of the guide has not been updated to reflect changes as a result of this ASU, however, this section will be updated in a future edition. Readers are encouraged to consult the full text of this ASU on FASB's website at www.fasb.org.

For more information on FASB ASU No. 2016-02, see appendix F, "The New Leases Standard: FASB ASU No. 2016-02," of this guide.

11.43 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.

11.44 FASB ASC 360-20-40 presents the real estate derecognition guidance 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 an institution is selling discrete real estate projects, it may need to consider whether the projects would be considered a disposal of a component of an entity that represents a strategic shift that has (or will have) a major effect on an entity's operations and financial results and accordingly may need to be reported as a discontinued operation in accordance with paragraphs 1A–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

Update 11-5 *Accounting and Reporting*: Revenue From Contracts With Customers

FASB ASC 606 is effective for annual reporting periods of a public business entity, a not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market, and an employee benefit plan that files or furnishes financial statements with or to the SEC beginning after December 15, 2017, including interim periods within that reporting period. Early application is permitted only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period.

For all other entities, FASB ASC 606 is effective for annual reporting periods beginning after December 15, 2018, and interim periods within annual periods beginning after December 15, 2019. Other entities may elect to adopt the standard earlier, however, only as of either

- an annual reporting period beginning after December 15, 2016, including interim periods within that reporting period, or
- an annual reporting period beginning after December 15, 2016, and interim periods within annual periods beginning one year after the annual reporting period in which an entity first applies the "Pending Content" that links to FASB ASC 606-10-65-1.

FASB ASC 606 provides a framework for revenue recognition and supersedes or amends several of the revenue recognition requirements in FASB ASC 605 as well as guidance within the 900 series of industry-specific topics. The standard applies to any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets unless those contracts are within the scope of other standards (for example, insurance or lease contracts). Under FASB ASC 606, in addition to other criteria to determine whether a contract exists, the bank must assess collectability to determine if a contract exists. If collection is not deemed probable, then the consideration received from the customer is recognized as a liability.

Readers are encouraged to consult the full text of FASB ASC 606 on FASB's website at www.fasb.org.

For more information, see appendix E of this guide.

11.45 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.

11.46 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.

11.47 Paragraphs 8–12 of FASB ASC 970-340-25 address the accounting for costs incurred on real estate for property taxes and insurance, costs of amenities, and incidental operations. 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 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.

11.48 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

11.49 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.

11.50 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

11.51 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.

11.52 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.

11.53 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.

11.54 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.[3]

Auditing[4]

Objectives

11.55 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, are properly recorded, 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;

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[3] FASB ASU No. 2015-02, *Consolidation (Topic 810): Amendments to the Consolidation Analysis*, was issued in February 2015. The amendments are effective for public business entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2016, and for interim periods within those fiscal years beginning after December 15, 2017. Early adoption is permitted, including adoption in an interim period. If an entity early adopts the amendments in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period. A reporting entity may apply the amendments in this ASU using a modified retrospective approach by recording a cumulative-effect adjustment to equity as of the beginning of the fiscal year of adoption. A reporting entity also may apply the amendments retrospectively.

The amendments in this ASU affect reporting entities that are required to evaluate whether they should consolidate certain legal entities. All legal entities are subject to reevaluation under the revised consolidate model.

Readers are encouraged to read the full text of the ASU, available at www.fasb.org. Readers should apply the appropriate guidance based on their facts and circumstances.

[4] The auditing content in this guide focuses primarily on generally accepted auditing standards issued by the Auditing Standards Board and is applicable to audits of the financial statements of those entities not subject to the oversight authority of the PCAOB (that is, those audit reports not within the PCAOB's jurisdiction as defined by the Sarbanes-Oxley Act of 2002, as amended—hereinafter referred to as *nonissuers*). However, considerations for audits of entities subject to the oversight authority of the PCAOB (that is, those audit reports within the PCAOB's jurisdiction as defined by the Sarbanes-Oxley Act of 2002, as amended) may be discussed within this guide's chapter text. When such discussion is provided, the related paragraphs are designated with the following title: *Considerations for Audits Performed in Accordance With PCAOB Standards*.

e. sales of assets, including the recognition of gains and losses, have been recognized; and

f. appropriate disclosures have been made.

Planning

11.56 In accordance with AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatements* (AICPA, *Professional Standards*), the objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and relevant assertion levels through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement (as described in chapter 5, "Audit Considerations and Certain Financial Reporting Matters," of this guide). In obtaining that understanding, the auditor might 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
- Appraisals in unstable market conditions

Internal Control Over Financial Reporting and Possible Tests of Controls

11.57 AU-C section 315 addresses the auditor's responsibility to identify and assess the risks of material misstatement in the financial statements through understanding the entity and its environment, including the entity's internal control. Paragraphs .13–.14 of AU-C section 315 state that the auditor should obtain an understanding of internal control relevant to the audit (such as, individually significant real estate in-vestments, REO and other foreclosed assets) and, in doing so, should evaluate the design of those controls and determine whether they have been implemented by performing procedures in addition to inquiry of the entity's personnel. (See chapter 5 of this guide for further discussion of the components of internal control.) To provide a basis for designing and performing further audit procedures, paragraph .26 of AU-C section 315 states that the auditor should identify and assess the risks of material misstatement at the financial statement level and the relevant assertion level for classes of transactions, account balances, and disclosures.

11.58 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.

11.59 AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*), addresses the auditor's responsibility to design and implement responses to the risks of material misstatement identified and assessed by the auditor in accordance with AU-C section 315 and to evaluate the audit evidence obtained in an audit of financial statements.

11.60 In accordance with paragraph .08 of AU-C section 330, the auditor should design and perform tests of controls to obtain sufficient appropriate audit evidence about the operating effectiveness of relevant controls if (*a*) the auditor's assessment of risks of material misstatement at the relevant assertion level includes an expectation that the controls are operating effectively or (*b*) substantive procedures alone do not provide sufficient appropriate audit evidence at the relevant assertion level. Internal control 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;
  - — review and monitoring of marketing efforts;
  - — nature and amount of facilitating financing;
  - — revenue recognition;
  - — estimates of 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.
- accounting for dispositions, including whether derecognition (sale) and profit recognition are appropriate.

Substantive Tests

11.61 Irrespective of the assessed risks of material misstatement, paragraph .18 of AU-C section 330 states that the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure, which for a financial institution would include real estate investments, REO, and other foreclosed assets. In accordance with paragraph .A45 of AU-C section 330, this requirement reflects the facts that (*a*) the auditor's assessment of risk is judgmental and may not identify all risks of material misstatement and (*b*) inherent limitations to internal control exist, including management override.

11.62 *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.

11.63 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. The auditor may also evaluate appraisals performed close to a period end that may not be timely processed and included in the entity's records.

11.64 Estimates of the fair value of real estate assets are necessary to account for such assets. AU-C section 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosure* (AICPA, *Professional Standards*), addresses the auditor's responsibilities related to accounting estimates, including fair value accounting estimates and related disclosures, in an audit of financial statements. Specifically, it expands on how AU-C section 315, AU-C section 330, and other relevant AU-C sections are to be applied with regard to accounting estimates. It also includes requirements and guidance related to misstatements of individual accounting estimates and indicators of possible management bias.

11.65 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-C section 500, *Audit Evidence* (AICPA, *Professional Standards*), addresses the auditor's use of the work of an individual or organization possessing expertise in a field other than accounting or auditing whose work in that field is used by the entity to assist the entity in preparing the financial statements (defined as a *management's specialist*).

11.66 If information to be used as audit evidence has been prepared using the work of a management's specialist, paragraph .08 of AU-C section 500 states that the auditor should, to the extent necessary, taking into account the significance of that specialist's work for the auditor's purposes,

a. evaluate the competence, capabilities, and objectivity of that specialist;

b. obtain an understanding of the work of that specialist; and

c. evaluate the appropriateness of that specialist's work as audit evidence for the relevant assertion.

11.67 Information regarding the competence, capabilities, and objectivity of a management's specialist may come from a variety of sources, such as knowledge of that specialist's qualifications, membership in a professional body or industry association, license to practice, or other forms of external recognition (a listing of additional sources is addressed in paragraph .A39 of AU-C section 500). Further application and explanatory material regarding the reliability of information produced by a management's specialist is addressed in paragraphs .A35–.A49 of AU-C section 500.

11.68 As addressed in the preceding paragraphs, 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. 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;
- appraised values should be based on current market conditions and must be discounted for costs to complete and sell; and
- the estimated selling prices should reflect the expectations of a sale in the reasonably near future—not in an indefinite future period.

11.69 In periods of declining real estate values, management might consider implementing policies and procedures that address

- its process for evaluating appraisals that are not as of the balance sheet date to determine whether an adjustment to the appraised value is needed to reflect declines in fair value that are not reflected in the appraisals.
- circumstances in which an updated appraisal should be obtained and the process for obtaining an updated appraisal.

Depending on materiality and level of inherent risk the auditor may also engage its own experts to review appraisals obtained by management or perform independent appraisals of collateral.

11.70 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.

11.71 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.

11.72 *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

Update 12-1 *Accounting and Reporting*: Leases

FASB Accounting Standards Update (ASU) No. 2016-02, *Leases (Topic 842)*, issued in February 2016, is effective for fiscal years of a public business entity, a not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market, and an employee benefit plan that files financial statements with the SEC beginning after December 15, 2018, including interim periods within those fiscal years.

For all other entities, FASB ASU No. 2016-02 is effective for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2019.

Early application is permitted for all entities.

FASB ASU No. 2016-02 supersedes the lease requirements in FASB *Accounting Standards Codification* (ASC) 840, *Leases*, and creates FASB ASC 842, *Leases*, to establish the principles that lessees and lessors should apply to report useful information to users of financial statements about the amount, timing, and uncertainty of cash flows arising from a lease. FASB ASC 842 affects any entity that enters into a lease (as that term is defined in FASB ASU No. 2016-02), with some specified scope exceptions.

This edition of the guide has not been updated to reflect changes as a result of this ASU, however, this chapter will be updated in a future edition. Readers are encouraged to consult the full text of this ASU on FASB's website at www.fasb.org.

For more information on FASB ASU No. 2016-02, see appendix F, "The New Leases Standard: FASB ASU No. 2016-02," of this guide.

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 line item:

- Accrued interest receivable (see chapter 7, "Investments in Debt and Equity Securities," of this guide for a discussion on securities and chapter 8, "Loans," of this guide for a discussion on loans)
- Premises and equipment, net
- Other real estate, such as foreclosed assets (see chapter 11, "Real Estate Investments, Real Estate Owned, and Other Foreclosed Assets," of this guide for a discussion on real estate investments, real estate owned, and other foreclosed assets)

- Servicing assets (SAs) (see chapter 10, "Transfers and Servicing and Variable Interest Entities," of this guide 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
- Indemnification assets arising from contractual indemnities provided in business combinations
- Goodwill
- Customers' liabilities on acceptances
- Deferred tax assets (see chapter 16, "Income Taxes," of this guide)
- Investments in equity securities that are not readily marketable (which meet definition of a security in FASB 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," of this guide)
- Bank, or credit union, owned life insurance
- Loans to executives for collateralized split-dollar life insurance agreements
- Prepaid pension assets

Update 12-2 *Accounting and Reporting*: Recognition and Measurement of Financial Assets and Financial Liabilities

FASB ASU No. 2016-01, *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*, issued in January 2016, is effective for fiscal years, and interim periods within those fiscal years, of a public business entity beginning after December 15, 2017.

For all other entities (including not-for-profit entities and employee benefit plans within the scope of FASB ASC 960, *Plan Accounting—Defined Benefit Pension Plans* through FASB ASC 965, *Plan Accounting—Health and Welfare Benefit Plans* on plan accounting), FASB ASU No. 2016-01 is effective for fiscal years beginning after December 15, 2018, and interim period within fiscal years beginning after December 15, 2019. Early application is permitted for all other entities as of the fiscal years beginning after December 15, 2017, including interim periods within those fiscal years.

All entities may adopt the presentation guidance in paragraphs 5–7 of FASB ASC 825-10-45 for financial statements of fiscal years or interim periods that have not yet been issued or that have not yet been made available for issuance. Furthermore, entities that are not public business entities may elect not to disclose the information about fair value of financial instruments required by the "General" subsection of FASB ASC 825-10-50 in financial statements of fiscal years or interim periods that have not yet been made available for issuance. Except as indicated previously in this paragraph, early application is not permitted.

FASB ASU No. 2016-01 addresses certain aspects of recognition, measurement, presentation, and disclosure of financial instruments and affects all entities that hold financial assets or owe financial liabilities. Among other provisions of the guidance, the amendments in this ASU supersede the guidance to classify equity securities with readily determinable fair values into different categories (that is, trading or available-for-sale) and require equity securities (including other ownership interests, such as partnerships, unincorporated joint ventures, and limited liability companies) to be measured at fair value with changes in the fair value recognized through net income (other than equity securities accounted for under the equity method of accounting or those that result in consolidation of an investee).

The amendments in this ASU also require an entity to present separately in other comprehensive income the portion of the total change in fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments.

This edition of the guide has not been updated to reflect changes as a result of this ASU, however, this discussion will be updated in a future edition. Readers are encouraged to consult the full text of this ASU on FASB's website at www.fasb.org.

For more information on FASB ASU No. 2016-01, see appendix G, "Accounting for Financial Instruments," of this guide.

12.02 Other liabilities frequently include the following:

- Accounts payable
- Accrued interest payable (see chapter 13, "Deposits," of this guide 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, Net

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. Although goodwill is an intangible asset, the term *intangible assets* is used to refer to intangible assets other than goodwill, which 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).

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," of 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 permits federal credit unions to purchase, hold, and dispose of only that property which is necessary or incidental to their operations. Part 701.36 of the National Credit Union Administration (NCUA) regulations establishes occupancy and disposal requirements for acquired and abandoned premises, and prohibits certain transactions (such as, acquiring real property from certain related parties).[1]

12.12 As noted in chapter 17, "Equity and Disclosures Regarding Capital Matters," in 2013, the U.S. Banking regulators issued a final rule for U.S. adoption of the Basel III regulatory capital framework. Basel III includes a more stringent definition of capital and all intangible assets, other than mortgage servicing rights, are fully deducted from capital (net of associated deferred tax liabilities) after the current phase-in period which began on January 1, 2015 and will be fully phased-in January 1, 2018. Specific to mortgage servicing rights, under the revised capital rule any amount above 10 percent of a firm's common equity tier 1 capital must be deducted from common equity tier 1 capital. Starting January 1, 2018, any amount of the threshold items that is not deducted from common equity tier 1 capital will be risk weighted at 250 percent (an increase from 100 percent). In addition, any amount of mortgage servicing assets, certain deferred tax assets arising from temporary differences, and significant investments in the capital of unconsolidated financial institutions in the form of common stock above 15 percent of a firm's common equity tier 1 capital must also be deducted from common equity tier 1 capital.

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[1] In July 2015, the National Credit Union Administration issued a final rule to amend its regulation governing federal credit union ownership of fixed assets. Among other amendments, the regulation eliminated a provision in the prior fixed assets rule that established a 5 percent aggregate limit on investments in fixed assets for federal credit union's with $1 million or more in assets.

12.13 Both national banks, federal savings associations, and state member banks are limited as to the amount of their investments in bank premises. National bank and federal savings association limitations are set forth in Title 12 U.S. *Code of Federal Regulations* (CFR) Part 5.37 *Banks and Banking*, *U.S. Code* 12, Section 371d. State member bank limitations are set forth in 12 CFR 208.21.

12.14 See paragraph 10.10 of this guide for information on interagency guidelines on asset securitization.

12.15 The Office of the Comptroller of the Currency's *Bank Accounting Advisory Series* (BAAS) is updated periodically to express the Office of the Chief Accountant's current views on accounting topics of interest to national banks and federal savings associations. See further discussion of the BAAS in paragraph 7.82 of this guide. Topic 10B, "Intangible Assets," includes interpretations related to intangible assets. Readers are encouraged to view this publication under the "Publications—Bank Management" page at www.occ.gov.

Accounting and Financial Reporting

Premises and Equipment, Net

12.16 Financial institutions account for premises and equipment in the same way that commercial entities account for property and equipment (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 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.

12.17 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.

12.18 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.

12.19 Premises and equipment held for use, including capital leases, need to be tested for recoverability whenever indicators of impairment are present. Paragraph 12.59 provides further guidance on impairment of long-lived assets.

12.20 Consolidation of subsidiaries that own premises and equipment should occur in accordance with FASB ASC 810, *Consolidation*.

12.21 In accordance with FASB ASC 810-10-15-3, all reporting entities should apply the guidance in FASB ASC 810 to determine whether and how to consolidate another entity and apply the applicable subsections of FASB

ASC 810-10. The "Variable Interest Entities" subsections of FASB ASC 810-10 clarify the application of the "General" subsections 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,[2] 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.

12.22 FASB ASC 840-40 provides guidance on how to account for sale-leaseback transactions and various sale-leaseback matters.

12.23 FASB ASC 350-40 provides guidance on accounting for the cost of computer software developed or obtained for internal use and for determining 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.[3]

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[2] Many paragraphs in FASB *Accounting Standards Codification* (ASC) 810-10 are labeled as "Pending Content" and relate to FASB Accounting Standards Update (ASU) No. 2009-17, *Consolidations (Topic 810): Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities*. Although labeled as "Pending Content," this guidance is applicable for many entities except those that qualify for the deferral in FASB ASU No. 2010-10, *Consolidation (Topic 810): Amendments for Certain Investment Funds*. In February 2015, FASB issued ASU No. 2015-02, *Consolidation (Topic 810): Amendments to the Consolidation Analysis*. Among other provisions, the amendments in this ASU rescind the indefinite deferral in FASB ASU No. 2010-10 and provide a scope exception from FASB ASC 810, *Consolidation*, for reporting entities with interests in legal entities that are required to comply with or operate in accordance with requirements similar to those in Rule 2a-7 of the Investment Company Act of 1940 for registered money market funds. FASB ASU No. 2015-02 is effective for public business entities for fiscal years, and for interim periods within those fiscal years, beginning after December 15, 2015. For all other entities, the amendments in this ASU are effective for fiscal years beginning after December 15, 2016, and for interim periods within fiscal years beginning after December 15, 2017. Early adoption is permitted, including adoption in an interim period. If an entity early adopts the amendments in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period. A reporting entity may apply the amendments in this ASU using a modified retrospective approach by recording a cumulative-effect adjustment to equity as of the beginning of the fiscal year of adoption. A reporting entity also may apply the amendments retrospectively. Readers should carefully review the transition guidance in FASB ASC 810-10-65-2 associated with the "Pending Content" to determine the applicability.

[3] FASB ASU No. 2015-05, *Intangibles—Goodwill and Other—Internal-Use Software (Subtopic 350-40): Customer's Accounting for Fees Paid in a Cloud Computing Arrangement*, provides guidance to customers about whether a cloud computing arrangement includes a software license. If a cloud computing arrangement includes a software license, then the customer should account for the software license element of the arrangement consistent with the acquisition of other software licenses. If a cloud computing arrangement does not include a software license, the customer should account for the arrangement as a service contract. The guidance will not change U.S. generally accepted accounting principles for a customer's accounting for service contracts. In addition, the guidance in this ASU supersedes FASB ASC 350-40-25-16. Consequently, all software licenses within the scope of FASB ASC 350-40 will be accounted for consistent with other licenses of intangible assets.

Readers are encouraged to consult the full text of the ASU on FASB's website at www.fasb.org.

Update 12-3 *Accounting and Reporting*: Goodwill Impairment

FASB ASU No. 2017-04, *Intangibles—Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment*, issued in January 2017, is effective for a public business entity that is a U.S. SEC filer for its annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2019. A public business entity that is not an SEC filer should adopt the amendments in this ASU for its annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2020.

For all other entities, including not-for-profit entities, FASB ASU No. 2017-04 is effective for their annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2021.

Early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017.

FASB ASU No. 2017-04 removes the second step of the two-step goodwill impairment test. An entity will apply a one-step quantitative test and record the amount of goodwill impairment as the excess of a reporting unit's carrying amount over its fair value, not to exceed the total amount of goodwill allocated to the reporting unit. The new guidance does not amend the optional qualitative assessment of goodwill impairment.

This edition of the guide has not been updated to reflect changes as a result of this ASU, however, this paragraph will be updated in a future edition. Readers are encouraged to consult the full text of this ASU on FASB's website at www.fasb.org.

12.24 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.

12.25 *Operating leases.* An *operating lease*, from the perspective of a lessor, is a lease that meets the conditions in item (d) in FASB ASC 840-10-25-43 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.

12.26 *State credit unions.* Because the NCUA eliminated the 5 percent aggregate limit on investments in fixed assets for federal credit unions with

$1 million or more in assets, state credit unions in some instances may still have limits on the amount they can invest in fixed assets.

FHLB or FRB Stock

Update 12-4 *Accounting and Reporting*: Recognition and Measurement of Financial Assets and Financial Liabilities

FASB ASU No. 2016-01, issued in January 2016, is effective for fiscal years, and interim periods within those fiscal years, of a public business entity beginning after December 15, 2017.

For all other entities (including not-for-profit entities and employee benefit plans within the scope of FASB ASC 960 through FASB ASC 965 on plan accounting), FASB ASU No. 2016-01 is effective for fiscal years beginning after December 15, 2018, and interim period within fiscal years beginning after December 15, 2019. Early application is permitted for all other entities as of the fiscal years beginning after December 15, 2017, including interim periods within those fiscal years.

All entities may adopt the presentation guidance in paragraphs 5–7 of FASB ASC 825-10-45 for financial statements of fiscal years or interim periods that have not yet been issued or that have not yet been made available for issuance. Furthermore, entities that are not public business entities may elect not to disclose the information about fair value of financial instruments required by the "General" subsection of FASB ASC 825-10-50 in financial statements of fiscal years or interim periods that have not yet been made available for issuance. Except as indicated previously in this paragraph, early application is not permitted.

FASB ASU No. 2016-01 addresses certain aspects of recognition, measurement, presentation, and disclosure of financial instruments and affects all entities that hold financial assets or owe financial liabilities. Among other provisions of the guidance, the amendments in this ASU supersede the guidance to classify equity securities with readily determinable fair values into different categories (that is, trading or available-for-sale) and require equity securities (including other ownership interests, such as partnerships, unincorporated joint ventures, and limited liability companies) to be measured at fair value with changes in the fair value recognized through net income (other than equity securities accounted for under the equity method of accounting or those that result in consolidation of an investee).

The amendments in this ASU also require an entity to present separately in other comprehensive income the portion of the total change in fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments.

This edition of the guide has not been updated to reflect changes as a result of this ASU, however, this section will be updated in a future edition. Readers are encouraged to consult the full text of this ASU on FASB's website at www.fasb.org.

For more information on FASB ASU No. 2016-01, see appendix G of this guide.

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 SEC. 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, because of the oversight role exercised by regulators in the process of budgeting and approving dividends.

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

> **Update 12-5 *Accounting and Reporting*: Goodwill Impairment**
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> FASB ASU No. 2017-04, issued in January 2017, is effective for a public business entity that is a U.S. SEC filer for its annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2019. A public business entity that is not an SEC filer should adopt the amendments in this ASU for its annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2020.
>
> For all other entities, including not-for-profit entities, FASB ASU No. 2017-04 is effective for their annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2021.
>
> Early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017.
>
> FASB ASU No. 2017-04 removes the second step of the two-step goodwill impairment test. An entity will apply a one-step quantitative test and record the amount of goodwill impairment as the excess of a reporting unit's carrying amount over its fair value, not to exceed the total amount of goodwill allocated to the reporting unit. The new guidance does not amend the optional qualitative assessment of goodwill impairment.
>
> This edition of the guide has not been updated to reflect changes as a result of this ASU, however, this paragraph will be updated in a future edition. Readers are encouraged to consult the full text of this ASU on FASB's website at www.fasb.org.

12.35 *Goodwill*. FASB ASC 350-20 addresses financial accounting and reporting for goodwill subsequent to its acquisition and for the cost of internally developing 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.) FASB ASC 350-20-35-2 states that impairment is the condition that exists when the carrying amount of goodwill exceeds its implied fair value. The first step of the goodwill impairment test compares the estimated fair value of the identified reporting units with their carrying amount, including goodwill. If the estimated fair value of the reporting unit is less than the carrying value, the second step must be performed to determine the implied fair value of the reporting unit's goodwill and the amount of goodwill impairment, if any. The implied fair value of goodwill is determined as if the reporting unit were being acquired in a business combination. FASB ASC 350-20-35-3 states that an entity may first assess qualitative factors,[4] as described in paragraphs 3A–3G of FASB ASC 350-20-35

[4] In accordance with FASB ASC 350-20-35B, an entity has an unconditional option to bypass the qualitative assessment for any reporting unit in any period and proceed directly to performing the first step of the goodwill impairment test. An entity may resume performing the qualitative assessment in any subsequent period.

(see paragraphs 12.36–.38), to determine whether it is necessary to perform the two-step goodwill impairment test discussed in paragraphs 4–19 of FASB ASC 350-20-35. The entity should consider its specific facts and circumstances when determining whether to utilize the qualitative assessment. If determined to be necessary, the two-step impairment test should be used to identify potential goodwill impairment and measure the amount of a goodwill impairment loss to be recognized (if any).

> ***Considerations for Private Companies That Elect to Use Standards as Issued by the Private Company Council***
>
> FASB ASU No. 2014-02, *Intangibles—Goodwill and Other (Topic 350): Accounting for Goodwill (a consensus of the Private Company Council)*, permits a private company to subsequently amortize goodwill on a straight-line basis over a period of 10 years, or less if the company demonstrates that another useful life is more appropriate. It also permits a private company to apply a simplified impairment model to goodwill.

12.36 In performing the qualitative assessment to evaluate whether it is more likely than not (that is, a likelihood of more than 50 percent) that the fair value of a reporting unit is less than its carrying amount, an entity should assess relevant events and circumstances. Examples of such events and circumstances include the following:[5]

- *a.* Macroeconomic conditions such as a deterioration in general economic conditions, limitations on accessing capital, fluctuations in exchange rates, or other developments in equity and credit markets
- *b.* Industry and market considerations such as deterioration in the environment in which an entity operates, an increased competitive environment, a decline in market-dependent multiples or metrics (consider in both absolute terms and relative to peers), a change in the market for an entity's products or services, or a regulatory or political development
- *c.* Cost factors such as increases in raw materials, labor, or other costs that have a negative effect on earnings and cash flows
- *d.* Overall financial performance such as negative or declining cash flows or a decline in actual or planned revenue or earnings compared with actual and projected results of relevant prior periods
- *e.* Other relevant entity-specific events such as changes in management, key personnel, strategy, or customers; contemplation of bankruptcy; or litigation
- *f.* Events affecting a reporting unit such as a change in the composition or carrying amount of its net assets, a more-than-likely-than-not expectation of selling or disposing of all, or a portion, of a reporting unit, the testing for recoverability of a significant asset group within a reporting unit, or recognition of a goodwill impairment loss in the financial statements of a subsidiary that is a component of a reporting unit

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[5] The examples included are not all-inclusive, and an entity should consider other relevant events and circumstances that affect the fair value or carrying amount of a reporting unit in determining whether to perform the first step of the goodwill impairment test. None of these individual examples of events and circumstances are intended to represent standalone events or circumstances that necessarily require an entity to perform the first step of the goodwill impairment test.

g. If applicable, a sustained decrease in share price (consider in both absolute terms and relative to peers)

12.37 An entity should consider the extent to which each of the adverse events and circumstances identified could affect the comparison of a reporting unit's fair value with its carrying amount. An entity should place more weight on the events and circumstances that most affect a reporting unit's fair value or the carrying amount of its net assets. An entity also should consider positive and mitigating events and circumstances that may affect its determination of whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If an entity has a recent fair value calculation for a reporting unit, it also should include as a factor in its consideration the difference between the fair value and the carrying amount in reaching its conclusion about whether to perform the first step of the goodwill impairment test. An entity should evaluate, on the basis of the weight of evidence, the significance of all identified events and circumstances in the context of determining whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount. Also, the existence of positive and mitigating events and circumstances is not intended to represent a rebuttable presumption that an entity should not perform the first step of the goodwill impairment test.

12.38 If, after assessing the totality of events or circumstances, an entity determines that it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, then the first and second steps of the goodwill impairment test are unnecessary. Conversely, if an entity determines that it is more likely than not that the fair value of a reporting unit is less than its carrying amount, then the entity should perform the first step of the two-step goodwill impairment test.

12.39 *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 of this guide discuss intangible assets acquired in connection with a business combination.

12.40 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.

12.41 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.

12.42 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.

12.43 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.

12.44 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.

12.45 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.

12.46 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 15–16 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, FASB ASC 350-30-35-17 states that the asset should be tested for impairment in accordance with paragraphs 18–19 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.

12.47 Paragraphs 18–19 of FASB ASC 350-30-35 state that an intangible asset that is not subject to amortization should be tested for impairment annually and more frequently if events or changes in circumstances indicate that it is more likely than not that the asset is impaired. An entity may first perform a qualitative assessment, as described in paragraphs 18A–18F of FASB ASC 350-30-35, to determine whether it is necessary to perform the quantitative impairment test. An entity has an unconditional option to bypass the qualitative assessment for any indefinite-lived intangible asset in any period and proceed directly to performing the quantitative impairment test. An entity may resume performing the qualitative assessment in any subsequent period. The quantitative impairment test for an indefinite-lived intangible asset should consist of a comparison of the fair value of the intangible asset with its carrying amount. If the carrying amount of an intangible asset exceeds its fair value, an entity should recognize an impairment loss in an amount equal to the excess. After an impairment loss is recognized, the adjusted carrying amount of the intangible asset should be its new accounting basis. In accordance with FASB ASC 350-30-35-20, subsequent reversal of a previously recognized impairment loss is prohibited.

12.48 *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. At each subsequent reporting date, FASB ASC 805-20-35-4 requires the acquirer to 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, except as noted in FASB ASC 805-20-35-4B, and, for an indemnification asset that is not subsequently measured at its fair value, management's assessment of the collectability of the indemnification asset.

12.49 *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.

12.50 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. For guidance on reporting discontinued operations, see FASB ASC 205-20. FASB ASC 350-30-50 and 350-20-50 provide additional disclosure requirements for intangible assets and goodwill, respectively.

Exit or Disposal Activities

12.51 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.

12.52 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

12.53 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.

12.54 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.

12.55 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 item (a) in FASB ASC 410-20-15-2. 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.

12.56 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

12.57 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

12.58 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

12.59 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 item (a) in FASB ASC 360-10-15-4. See chapter 11 of this guide for the requirements of FASB ASC 360-10.

NCUSIF Deposit

12.60 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 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.

12.61 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.

12.62 The refundability of NCUSIF deposits should be reviewed for impairment, as stated in item (a) in FASB ASC 942-325-35-4. 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.

12.63 Item (b) in FASB ASC 942-325-35-4 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.

12.64 Item (c) in FASB ASC 942-325-35-4 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.

12.65 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.

12.66 On May 20, 2009, the Helping Families Save Their Homes Act of 2009 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 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

12.67 *CUSOs.*[6] 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.

12.68 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 invest up to 1 percent of the credit union's unimpaired capital and surplus. Credit unions can also lend up to an additional 1 percent. This loan authority is independent and separate from the 1 percent investment authority. 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 investment in or loan to the CUSO must also be accounted for in accordance with GAAP.

12.69 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

[6] See Title 12 U.S. *Code of Federal Regulations* Part 712.

- Travel agency
- Trust and trust-related services
- Real estate brokerage services
- Non-CUSO service providers
- Credit card loan origination
- Payroll processing services

12.70 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.

12.71 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.

12.72 A majority-owned subsidiary is an entity separate from the institution and may be a VIE 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 810-10 clarify the application of the "General" subsections 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 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.[7]

Contributed Assets

12.73 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

[7] See footnote 2.

to their members; some credit unions are staffed exclusively by volunteers. In addition, credit unions occasionally receive contributions of assets of material value.

12.74 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.

12.75 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.

12.76 A reporting entity should measure the fair value of an asset using 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 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[8]

Objectives

12.77 *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;

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[8] The auditing content in this guide focuses primarily on generally accepted auditing standards (GAAS) issued by the Auditing Standards Board and is applicable to audits of the financial statements of those entities not subject to the oversight authority of the PCAOB (that is, those audit reports not within the PCAOB's jurisdiction as defined by the Sarbanes-Oxley Act of 2002, as amended—hereinafter referred to as *nonissuers*). However, considerations for audits of entities subject to the oversight authority of the PCAOB (that is, those audit reports within the PCAOB's jurisdiction as defined by the Sarbanes-Oxley Act of 2002, as amended) issuers in accordance with PCAOB standards may be discussed within this guide's chapter text. When such discussion is provided, the related paragraphs are designated with the following title: *Considerations for Audits Performed in Accordance With PCAOB Standards*.

b. the assets are properly classified, valued, 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.

12.78 *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

12.79 In accordance with AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), the objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and relevant assertion levels through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement (as described in chapter 5, "Audit Considerations and Certain Financial Reporting Matters," of this guide). 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
- The use of unobservable inputs and higher degree of estimation uncertainty in the goodwill or intangible impairment test
- 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

12.80 AU-C section 315 addresses the auditor's responsibility to identify and assess the risks of material misstatement in the financial statements through understanding the entity and its environment, including the entity's internal control. Paragraphs .13–.14 of AU-C section 315 state that the auditor should obtain an understanding of internal control relevant to the audit and, in doing so, should evaluate the design of those controls and determine whether they have been implemented by performing procedures in addition to inquiry of the entity's personnel. (See chapter 5 of this guide for further discussion of the components of internal control.) To provide a basis for designing and performing further audit procedures, paragraph .26 of AU-C section 315 states that the auditor should identify and assess the risks of material misstatement at the financial statement level and the relevant assertion level for classes of transactions, account balances, and disclosures.

12.81 AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*), addresses the auditor's responsibility to design and implement responses to the risks of material misstatement identified and assessed by the auditor in accordance with AU-C section 315 and to evaluate the audit evidence obtained in an audit of financial statements.

12.82 In accordance with paragraph .08 of AU-C section 330, the auditor should design and perform tests of controls to obtain sufficient appropriate audit evidence about the operating effectiveness of relevant controls if (*a*) the auditor's assessment of risks of material misstatement at the relevant assertion level includes an expectation that the controls are operating effectively or (*b*) 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

12.83 Irrespective of the assessed risks of material misstatement, paragraph .18 of AU-C section 330 states that 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 .A45 of AU-C section 330, this requirement reflects the fact that (*a*) the auditor's assessment of risk is judgmental and may not identify all risks of material misstatement and (*b*) inherent limitations to internal control exist, including management override.

12.84 *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.

12.85 *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.

12.86 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.

12.87 *Intangible assets and goodwill.* AU-C section 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* (AICPA, *Professional Standards*), addresses the auditor's responsibilities relating to accounting estimates, including fair value accounting estimates and related disclosures, in an audit of financial statements. Specifically, it expands on how AU-C section 315, AU-C section 330, and other relevant AU-C sections are to be applied with regard to accounting estimates. It also includes requirements and guidance related to misstatements of individual accounting estimates and indicators of possible management bias. In accordance with paragraph .06 of AU-C section 540, the objective of the auditor is to obtain sufficient appropriate audit evidence about whether, in the context of the applicable financial reporting framework, (*a*) accounting estimates, including fair value accounting estimates, in the financial statements, whether recognized or disclosed, are reasonable and (*b*) related disclosures in the financial statements are adequate.

12.88 Paragraphs .12–.13 of AU-C section 540 states that based on the assessed risks of material misstatement, the auditor should determine (*a*) whether management has appropriately applied the requirements of the applicable financial reporting framework relevant to the accounting estimate and (*b*) whether the methods for making the accounting estimates are appropriate and have been applied consistently and whether changes from the prior period, if any, in accounting estimates or the method for making them are appropriate in the circumstances. In responding to the assessed risks of material misstatement, as required by AU-C section 330, the auditor should undertake one or more of the following, taking into account the nature of the accounting estimate:

a. Determine whether events occurring up to the date of the auditor's report provide audit evidence regarding the accounting estimate.

b. Test how management made the accounting estimate and the data on which it is based. In doing so, the auditor should evaluate whether

i. the method of measurement used is appropriate in the circumstances,

ii. the assumptions used by management are reasonable in light of the measurement objectives of the applicable financial reporting framework, and

iii. the data on which the estimate is based is sufficiently reliable for the auditor's purposes.

c. Test the operating effectiveness of the controls over how management made the accounting estimate, together with appropriate substantive procedures.

d. Develop a point estimate or range to evaluate management's point estimate.[9] For this purpose,

i. if the auditor uses assumptions or methods that differ from management's, the auditor should obtain an understanding of management's assumptions or methods sufficient to establish that the auditor's point estimate or range[10] takes into account relevant variables and to evaluate any significant differences from management's point estimate.

ii. if the auditor concludes that it is appropriate to use a range, the auditor should narrow the range, based on audit evidence available, until all outcomes within the range are considered reasonable.

In relation to intangible assets and goodwill, the auditor might consider such key factors and assumptions as 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, paragraph .14 of AU-C section 540 states that the auditor should consider whether specialized skills or knowledge with regard to one or more aspects of the accounting estimates is required in order to obtain sufficient appropriate audit evidence.

Considerations for Audits Performed in Accordance With PCAOB Standards

The second note in paragraph .A5 of AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*), discusses the inherent limitations of internal control. Because fair value determinations often involve subjective judgments by management, this may affect the nature of controls that are capable of being implemented, including the possibility of management override of controls. The auditor considers the inherent limitations of internal control in such circumstances in assessing control risk.

Paragraph .47 of AS 2502, *Auditing Fair Value Measurements and Disclosures* (AICPA, *PCAOB Standards and Related Rules*), states that

[9] For purposes of GAAS, *management's point estimate* is defined as the amount selected by management for recognition or disclosure in the financial statements as an accounting estimate.

[10] For purposes of GAAS, an *auditor's point estimate* or *auditor's range* is defined as the amount or range of amounts, respectively, derived from audit evidence for use in evaluating the recorded or disclosed amount(s).

the auditor should evaluate the sufficiency and competence of the audit evidence obtained from auditing fair value measurements and disclosures as well as the consistency of that evidence with other audit evidence obtained and evaluated during the audit. The auditor's evaluation of whether the fair value measurements and disclosures in the financial statements are in conformity with GAAP is performed in the context of the financial statements taken as a whole (see paragraphs .12–.18 and .24–.27 of AS 2810, *Evaluating Audit Results* [AICPA, *PCAOB Standards and Related Rules*]).

12.89 *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," of this guide.)

12.90 *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

12.91 *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.

Chapter 13

Deposits

FASB *Accounting Standards Codification* (ASC) 606, *Revenue from Contracts with Customers*

FASB ASC 606 is effective for annual reporting periods of a public business entity, a not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market, and an employee benefit plan that files or furnishes financial statements with or to the SEC beginning after December 15, 2017, including interim periods within that reporting period.

Early application is permitted only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period. For all other entities, FASB ASC 606 is effective for annual reporting periods beginning after December 15, 2018, and interim periods within annual periods beginning after December 15, 2019. Other entities may elect to adopt the standard earlier, however, only as of either

- an annual reporting period beginning after December 15, 2016, including interim periods within that reporting period, or
- an annual reporting period beginning after December 15, 2016, and interim periods within annual periods beginning one year after the annual reporting period in which an entity first applies the "Pending Content" that links to FASB ASC 606-10-65-1.

FASB ASC 606 provides a framework for revenue recognition and supersedes or amends several of the revenue recognition requirements in FASB ASC 605, *Revenue Recognition*, as well as guidance within the 900 series of industry-specific topics, including FASB ASC 942, *Financial Services—Depository and Lending*. The standard applies to any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets unless those contracts are within the scope of other standards (for example, insurance or lease contracts).

Readers are encouraged to consult the full text of FASB ASC 606 on FASB's website at www.fasb.org.

The AICPA has formed 16 industry task forces to assist in developing a new Audit and Accounting Guide on revenue recognition that provides helpful hints and illustrative examples for how to apply the new standard (guide available at www.aicpastore.com). Revenue recognition implementation issues identified by the Depository and Lending Institutions Revenue Recognition Task Force are available for informal comment, after review by the AICPA Financial Reporting Executive Committee, at the "Depository and Lending Institutions Revenue Recognition Task Force" page at aicpa.org.

Readers are encouraged to submit comments to revreccomments@aicpa.org.

For more information, see appendix E, "The New Revenue Recognition Standard: FASB ASC 606," of this guide.

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 nontransaction). A description of various deposit products follows. These descriptions may not correspond to regulatory designations under the Board of Governors of the Federal Reserve System (Federal Reserve) Regulation D.

Demand Deposits[1]

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.

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), 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

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[1] Under Regulation D, demand deposit accounts (DDAs) and negotiable order of withdrawal (NOW) accounts are types of transaction accounts. Historically, DDAs could not be interest-bearing under federal regulation, whereas NOW accounts may bear interest.

Section 627 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) permits insured depository institutions (IDIs) to pay interest on DDAs. In response to this provision of the Dodd-Frank Act, the FDIC released Financial Institution Letter 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 noninterest-bearing transaction account (issued May 2011).

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 IRC 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 paragraph 15.18 of this guide.)

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 brokered deposit account type known as the Certificate of Deposit Account Registry Service (CDARS) program has become more prevalent. With CDARS, an investor who wishes to buy CDs in excess of the 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 that 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[2] (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 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

[2] Interagency guidance issued by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the FDIC, and the National Credit Union Administration, addresses the risks and accounting treatment associated with overdraft protection programs.

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[3]

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," of this guide.)

13.34 *Banks and savings institutions.* Section 29 of the Federal Deposit Insurance Act (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," of this guide). 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 an 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 [FIL]-69-2009, *Process for Determining If An Institution Subject to Interest-Rate Restrictions is Operating in a High-Rate Area*, dated December 4, 2009.)

[3] In January 2015, the FDIC issued *Guidance on Identifying, Accepting, and Reporting Brokered Deposits—Frequently Asked Questions* to address frequently asked questions on such topics as identifying brokered deposits, accepting deposits, listing services, interest rate restrictions, and other brokered deposit-related matters. In November 2015, the FDIC updated the document in response to further inquiries and comments. For further information, readers can access the guidance on the FDIC website at www.fdic.gov.

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 (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 GAAP basis. However, the Call Report is not structured for GAAP presentation and disclosure and shows deposits in a separate category, not in equity or liabilities. To the National Credit Union Administration (NCUA), the Call Report deals specifically with recognition and measurement for GAAP rather than presentation and disclosure.

13.40 As discussed further in paragraph 13.64, supervisory committees of federal credit unions are required to perform a verification of member's accounts.

Accounting and Financial Reporting[4]

13.41 FASB ASC 942-405-25-3 states that the institution's liability for deposits originates and should be recognized at the time deposits are received rather than when the institution collects the funds. Checks that are deposited by customers and that are in the process of collection and are currently not available for withdrawal (deposit float) should be recorded as assets and liabilities. Deposits should not be recorded based solely on collections.

13.42 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 statement of financial condition, as stated in FASB ASC 942-405-25-4. Paragraphs 3–4 of FASB ASC 942-405-45 address presentation guidance related to member deposits and respective interest payable on those deposit accounts. 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. 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 should not be 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

[4] In June 2010, the AICPA issued Technical Questions and Answers (Q&A) section 2130.38, "Certificates of Deposit and FASB ASC 820, *Fair Value Measurements and Disclosures*"; Q&A section 2130.39, "Balance Sheet Classification of Certificates of Deposit"; and Q&A section 2130.40, "Certificates of Deposit and FASB ASC 320" (AICPA, *Technical Questions and Answers*). Q&A section 2130.38 addresses whether certificates of deposit (CDs) are within the scope of the disclosure requirements of FASB *Accounting Standards Codification* (ASC) 820, *Fair Value Measurement*. Q&A section 2130.39 addresses where in a classified balance sheet an entity should report a CD. Q&A section 2130.40 addresses whether a CD is within the scope of FASB ASC 320, *Investments—Debt and Equity Securities*.

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 all of the following:

a. The aggregate amount of time deposit accounts (including CDs) in denominations that meet or exceed the FDIC insurance limit 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 accordance with FASB ASC 470-10-50-1)

b. The amount of deposits of related parties at the balance sheet date (in accordance with FASB ASC 850, *Related Party Disclosures*)

13.46 In accordance with FASB ASC 825, *Financial Instruments*, the fair value of deposits should also be disclosed. In estimating the fair value of deposit liabilities, FASB ASC 942-470-50-1 states that 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.

Update 13-1 *Accounting and Reporting*: Recognition and Measurement of Financial Assets and Financial Liabilities

FASB Accounting Standards Update (ASU) No. 2016-01, *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*, issued in January 2016, is effective for fiscal years, and interim periods within those fiscal years, of a public business entity beginning after December 15, 2017.

For all other entities (including not-for-profit entities and employee benefit plans within the scope of FASB ASC 960 through FASB ASC 965 on plan accounting), FASB ASU No. 2016-01 is effective for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. Early application is permitted for all other entities as of the fiscal years beginning after December 15, 2017, including interim periods within those fiscal years.

All entities may adopt the presentation guidance in paragraphs 5–7 of FASB ASC 825-10-45 for financial statements of fiscal years or interim periods that have not yet been issued or that have not yet been made available for issuance. Furthermore, entities that are not public business entities may elect not to disclose the information about fair value of financial instruments required by the "General" subsection of FASB ASC 825-10-50 in financial statements of fiscal years or interim periods that have not yet been made available for issuance. Except as indicated previously in this paragraph, early application is not permitted.

FASB ASU No. 2016-01 addresses certain aspects of recognition, measurement, presentation, and disclosure of financial instruments and affects all entities that hold financial assets or owe financial liabilities. Among other provisions of the guidance, the conclusions reached in paragraph BC137 of FASB ASU No. 2016-01 explain that the difficulties of determining the fair value of demand deposit liabilities supported not requiring disclosure of fair value, either parenthetically or in the notes, and as such, upon the effective date of this guidance, demand deposit liabilities are exempt from an entity's requirement to disclose the fair value of financial liabilities.

This edition of the guide has not been updated to reflect changes as a result of this ASU, however, this paragraph will be updated in a future edition. Readers are encouraged to consult the full text of this ASU on FASB's website at www.fasb.org.

For more information on FASB ASU No. 2016-01, see appendix G, "Accounting for Financial Instruments," of this guide.

Auditing[5]

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-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), the objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and relevant assertion levels through understanding the entity and

[5] The auditing content in this guide focuses primarily on generally accepted auditing standards (GAAS) issued by the Auditing Standards Board and is applicable to audits of the financial statements of those entities not subject to the oversight authority of the PCAOB (that is, those audit reports not within the PCAOB's jurisdiction as defined by the Sarbanes-Oxley Act of 2002, as amended—hereinafter referred to as *nonissuers*). However, considerations for audits of entities subject to the oversight authority of the PCAOB (that is, those audit reports within the PCAOB's jurisdiction as defined by the Sarbanes-Oxley Act of 2002, as amended) may be discussed within this guide's chapter text. When such discussion is provided, the related paragraphs are designated with the following title: *Considerations for Audits Performed in Accordance With PCAOB Standards*.

its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement (as described in chapter 5 of this guide). 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 paragraphs .A36 and .A44 of AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards* (AICPA, *Professional Standards*), audit risk is a function of the risks of material misstatement (consisting of inherent risk and control risk) and detection risk. (A detailed discussion on audit risk can be found in chapter 5 of this guide.) The assessment of risks is a matter of professional judgment, rather than a matter capable of precise measurement. The assessment of the risks of material misstatement may be expressed in quantitative terms, such as in percentages, or in nonquantitative terms. In any case, the need for the auditor to make appropriate risk assessments is more important than the different approaches by which they may be made. 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-C section 315 addresses the auditor's responsibility to identify and assess the risks of material misstatement in the financial statements through understanding the entity and its environment, including the entity's internal control. Paragraphs .13–.14 of AU-C section 315 state that the auditor should obtain an understanding of internal control relevant to the audit and, in doing so, should evaluate the design of those controls and determine whether they have been implemented by performing procedures in addition to inquiry of the entity's personnel. (See chapter 5 of this guide for further discussion of the components of internal control.) To provide a basis for designing and performing further audit procedures, paragraph .26 of AU-C section 315 states that the auditor should identify and assess the risks of material misstatement at the financial statement level and the relevant assertion level for classes of transactions, account balances, and disclosures.

13.51 AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*), addresses the auditor's responsibility to design and implement responses to the risks of material misstatement identified and assessed by the auditor in accordance with AU-C section 315 and to evaluate the audit evidence obtained in an audit of financial statements.

13.52 Effective internal control (as it relates to financial reporting of deposits) provides 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 paragraph .15 of AU-C section 315, the auditor should obtain an understanding of the control environment. As part of obtaining this understanding, the auditor should evaluate whether (*a*) management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behavior and (*b*) the strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control and whether those other components are not undermined by deficiencies in the control environment. 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 In accordance with paragraph .08 of AU-C section 330, the auditor should design and perform tests of controls to obtain sufficient appropriate audit evidence about the operating effectiveness of relevant controls if (*a*) the

auditor's assessment of risks of material misstatement at the relevant assertion level includes an expectation that the controls are operating effectively or (*b*) 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 Irrespective of the assessed risks of material misstatement, paragraph .18 of AU-C section 330 states that the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure, which for a financial institution would include deposits. In accordance with paragraph .A45 of AU-C section 330, this requirement reflects the facts that (*a*) the auditor's assessment of risk is judgmental and may not identify all risks of material misstatement and (*b*) inherent limitations to internal control exist, including management override.

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.* In accordance with paragraph .21 of AU-C section 330, the auditor's substantive procedures should include audit procedures relating to the financial statement closing process, such as agreeing or reconciling financial statement balances, including deposit balances and related accounts (accrued interest payable), with the underlying accounting records (trial balance, general ledger, and other subsidiary records). 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*. Paragraph .A8 of AU-C section 500, *Audit Evidence* (AICPA, *Professional Standards*), states that corroborating information obtained from a source independent of the entity may increase the assurance that the auditor obtains from audit evidence that is generated internally, such as evidence existing within the accounting records, minutes of meetings, or a management representation. AU-C section 505, *External Confirmations* (AICPA, *Professional Standards*), addresses the auditor's use of external confirmation procedures to obtain audit evidence, in accordance with the requirements of AU-C sections 330 and 500.

13.60 Confirmation of deposits provides evidence about existence and valuation (accuracy), but it may not provide evidence about other assertions. Paragraph .15 of AU-C section 505 states that negative confirmations provide less persuasive audit evidence than positive confirmations. Accordingly, the auditor should not use negative confirmation requests as the sole substantive audit procedure to address an assessed risk of material misstatement at the assertion level, unless all of the following are present:

a. The auditor has assessed the risk of material misstatement as low and has obtained sufficient appropriate audit evidence regarding the operating effectiveness of controls relevant to the assertion.

b. The population of items subject to negative confirmation procedures comprises a large number of small, homogeneous account balances, transactions, or conditions.

c. A very low exception rate is expected.

d. The auditor is not aware of circumstances or conditions that would cause recipients of negative confirmation requests to disregard such requests.

13.61 According to paragraph .A5 of AU-C section 505, factors to consider when designing confirmation requests include the following:

- The assertions being addressed.
- Specific identified risks of material misstatement, including fraud risk.
- The layout and presentation of the confirmation request.
- Prior experience on the audit or similar engagements.
- The method of communication (for example, in paper form or by electronic or other medium).
- Management's authorization or encouragement to the confirming parties to respond to the auditor. Confirming parties may only be willing to respond to a confirmation containing management's authorization.

13.62 Refer to AU-C section 505 for additional guidance on the confirmation process. Refer to AU-C sections 530, *Audit Sampling*, and 320, *Materiality in Planning and Performing an Audit* (AICPA, *Professional Standards*), 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-C section 530. Guidance on the timing of audit procedures is included in AU-C section 330.

13.63 In the case of each nonresponse,[6] paragraph .12 of AU-C section 505 states that the auditor should perform alternative procedures to obtain relevant and reliable audit evidence. (See paragraphs .A24–.A27 of AU-C section 505 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.

13.64 *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. Part 715.8(b) of the NCUA's 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 statistical sampling method that provides for random selection that is expected to be representative of the population from which the sample was selected with an equal chance of selecting each item in the population, which will allow the auditor to test sufficient accounts in both number and scope on which to base conclusions concerning management's financial reporting objectives. The auditor should also perform alternative procedures if evidence provided by confirmations alone is not sufficient. (According to paragraph .08 of AU-C section 530, the auditor should select items for the sample in such a way that the auditor can reasonable expect the sample to be representative of the relevant population and likely to provide the auditor with a reasonable basis for conclusion about the population.)
- For independent, licensed, CPAs, the additional option of sampling members' accounts using nonstatistical sampling methods consistent with applicable GAAS may be chosen as long as 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,

[6] For purposes of GAAS, *nonresponse* is defined as a failure of the confirming party to respond, or fully respond, to a positive confirmation request or a confirmation request returned undelivered.

CPAs will be responsible for documenting their sampling procedures, and providing evidence to the NCUA, if requested, that the method used is consistent with applicable GAAS.)

13.65 *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.

13.66 *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 might 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.

13.67 *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.

13.68 *Other analytical procedures.* AU-C section 520, *Analytical Procedures* (AICPA, *Professional Standards*), addresses the auditor's use of analytical procedures as substantive procedures (substantive analytical procedures). Paragraph .05 of AU-C section 520 states that when designing and performing analytical procedures, either alone or in combination with tests of details, as substantive procedures in accordance with AU-C section 330,[7] the auditor should

a. determine the suitability of particular substantive analytical procedures for given assertions, taking into account the assessed risks of material misstatement and tests of details, if any, for these assertions. (For example, 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 with rates that change frequently during a financial reporting period, it is normally difficult to develop expectations to be used in analyzing yields on deposits.)

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[7] Paragraph .18 of AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*).

b. evaluate the reliability of data from which the auditor's expectation of recorded amounts or ratios is developed, taking into account the source, comparability, and nature and relevance of information available and controls over preparation.

c. develop an expectation of recorded amounts or ratios and evaluate whether the expectation is sufficiently precise (taking into account whether substantive analytical procedures are to be performed alone or in combination with tests of details) to identify a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated.

d. determine the amount of any difference of recorded amounts from expected values that is acceptable without further investigation as required by paragraph .07 of AU-C section 520 and compare the recorded amounts, or ratios developed from recorded amounts, with the expectations.

13.69 As discussed in item *a* in paragraph 13.68, it is normally difficult to develop sufficiently precise expectations to be used in analyzing yields on deposits. 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). Analytical review procedures that the auditor may apply in the deposit area include analysis and evaluation of the following:

- Comparison of the percentage of deposit growth during the period with historical percentages
- Comparison of the average deposit account balances during the period with those of prior periods
- Changes in the relative composition of deposits from period to period
- Comparison of the amounts and percentage ratio of dormant accounts to total deposits with those of prior periods
- Comparison of deposit interest rates with those prevailing in the institution's marketing area for the same periods

However, 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.

13.70 Paragraph .A7 of AU-C section 520 states that the auditor's substantive procedures to address the assessed risk of material misstatement for relevant assertions may be tests of details, substantive analytical procedures, or a combination of both. The decision about which audit procedures to perform, including whether to use substantive analytical procedures, is based on the auditor's professional judgment about the expected effectiveness and efficiency of the available audit procedures to reduce the assessed risk of material misstatement to an acceptably low level. Further guidance on the auditor's use of analytical procedures as substantive procedures is provided in AU-C section 520. AU-C section 315 addresses the use of analytical procedures as risk assessment procedures, and AU-C section 330 addresses the nature, timing, and extent of audit procedures in response to assessed risks; these audit procedures may include substantive analytical procedures. In addition, see analytical procedures discussion within paragraphs 5.94–.97 of this guide for further guidance on designing and performing substantive analytical procedures.

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 System 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*).

Repos

14.04 A *repurchase agreement*, as stated in the FASB *Accounting Standards Codification* (ASC) glossary, refers to an agreement under which the transferor (repo party) transfers a financial asset to a transferee (repo counterparty or reverse party) in exchange for cash and concurrently agrees to reacquire that financial asset at a future date for an amount equal to the cash exchanged plus or minus a stipulated interest factor. Instead of cash, other securities or letters of credit sometimes are exchanged. Some repos call for repurchase of financial assets that need not be identical to the financial assets transferred. A repo may be accounted for either as a collateralized borrowing or a sale, depending on the terms of the contract. See discussion beginning in paragraph 14.27 for further details.

14.05 A *repurchase agreement accounted for as a collateralized borrowing*, as stated in the FASB ASC glossary, refers to a transaction 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.[1] A repo accounted for as a collateralized borrowing is a repo that does not qualify for sale accounting under FASB ASC 860, *Transfers and Servicing*. The payable under a repo accounted for as a collateralized borrowing 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 accounted for as a collateralized borrowing*, 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 accounted for as a collateralized borrowing 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.[2]

14.06 The FASB ASC glossary defines a *repurchase-to-maturity transaction* as a repo in which the settlement date of the agreement to repurchase a transferred financial asset is at the maturity date of that financial asset and the agreement would not require the transferor to reacquire the financial asset.

14.07 Most repos involve obligations of the federal government or its agencies, but other financial instruments, such as commercial paper, banker's acceptances, negotiable certificates of deposit, and non-agency mortgage-backed securities (MBSs) 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, insurance companies, investment funds, and customers (retail repo). Maturities of such agreements are flexible and generally vary from 1 day to 270 days.

14.08 *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.

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[1] A seller-borrower represents a seller of securities and borrower of funds, whereas a buyer-lender represents a buyer of securities and a lender of funds.

[2] Broker-dealers and depository institutions (and accordingly, 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*.

- 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-roll 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.

14.09 The dollar roll transactions are typically found in the To Be Announced section of the primary issuance markets for agency MBSs.

14.10 In a fixed coupon dollar-roll, the securities repurchased are generally priced to result in substantially the same yield. In addition, the seller-borrower retains control over the future economic benefits of the securities sold and assumes no additional market risk.

14.11 In a yield-maintenance agreement, the securities repurchased may have a different stated interest rate from that of the securities sold and are generally priced to result in different yields as specified in the agreement.[3] The seller-borrower surrenders control over the future economic benefits of the securities sold and assumes additional market risk. Yield-maintenance agreements may contain *par cap*[4] provisions that could significantly alter the economics of the transactions.

14.12 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 separate forward purchase of securities. For agreements involving existing securities collateralized by dissimilar pools, those transactions are accounted for as sales and forward purchases of securities.

14.13 *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. Overnight repos are often used as a source of short-term financing, and rolled over on a daily basis by agreement between the counterparties.

14.14 *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

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[3] The price-spread relationship between securities with different contractual interest rates does not move in tandem. The existence of yield and price disparities provides opportunities for the buyer-lender to deliver, within the terms of the agreement, certificates providing the greatest benefit to the buyer-lender.

[4] A *par cap* provision limits the repurchase price to a stipulated percentage of the face amount of the certificate. Fixed-coupon agreements do not contain par cap provisions.

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.

14.15 *Business risk.* Business risks associated with repos arise from the contractual and economic complexities inherent in certain of these transactions and 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 a contract's terms may also result in improper accounting treatment of the transaction (that is, as a sale and forward purchase or as a secured borrowing).

14.16 *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 market price of nongovernment securities can also be caused by changes in credit spreads and liquidity in the market. Price changes affect the margin in a transaction and may create a need for the seller-borrower to transfer additional securities or return cash.

14.17 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 seller-borrowers and their relative bargaining strengths. Haircuts generally range from a fraction of 1 percent to 4 percent or 5 percent but may be higher in certain instances.

14.18 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

14.19 *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.

14.20 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.

14.21 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 (including re-hypothecations), 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.

14.22 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.

14.23 *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.

14.24 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.)

14.25 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.[5] 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

14.26 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

14.27 FASB ASC 860 establishes accounting and reporting standards for transfers and servicing of financial assets. As addressed in FASB ASC 860-10-05-6, transfers of financial assets take many forms, including but not limited to, repos. Paragraphs 19–21 of FASB ASC 860-10-05 provide an overview of repos. Paragraphs 51–56B of FASB ASC 860-10-55 provide implementation guidance for accounting for repos.

14.28 If the conditions in FASB ASC 860-10-40-5 are met, FASB ASC 860-10-55-55 states that 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.

14.29 In accordance with FASB ASC 860-10-55-51 repos and securities lending transactions that do not meet all the criteria in FASB ASC 860-10-40-5 should be treated as secured borrowings.

14.30 FASB ASC 860-10-55-51A goes on to state that under certain agreements to repurchase transferred financial assets before their maturity, the transferor maintains effective control over the transferred financial assets. If

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[5] 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 (the 1934 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 1934 Act and provides a number of exemptions.

effective control is maintained or the transaction qualifies for the repurchase-to-maturity transaction exception, the agreement is accounted for as a secured borrowing. If effective control is not maintained or the repurchase-to-maturity transaction exception is not met, the transaction would be assessed under the other derecognition conditions in FASB ASC 860-10-40-5 to determine if the transferred financial asset should be derecognized and accounted for as a sale.

14.31 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 item (c)(1) in FASB ASC 860-10-40-5, 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 14.32).

b. The agreement is to repurchase or redeem the financial assets before maturity, at a fixed or determinable price.

c. The agreement is entered into contemporaneously with, or in contemplation of, the transfer.

14.32 Item (a) in FASB ASC 860-10-40-24 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.

14.33 In accordance with item (a) in FASB ASC 860-10-55-35, the exchange of pools of single-family loans would not meet the criteria in item (a)(1) in FASB ASC 860-10-40-24 (see item (a) in paragraph 14.32) because the mortgages making up the pool do not have the same primary obligor and would therefore not be considered substantially the same.

14.34 Item (b) in FASB ASC 860-10-55-35 explains that 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 would not meet the identical form and type criterion (see item [b] in paragraph 14.32).

14.35 In accordance with item (c) in FASB ASC 860-10-55-35, an example that would not meet the criterion addressed in item *c* in paragraph 14.32 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 because differences in the expected remaining lives of the certificates result in different market yields.

14.36 Related to item *f* in paragraph 14.32, participants in the MBSs market have established parameters for what is considered acceptable delivery. As stated in item (a)(6) in FASB ASC 860-10-40-24, these specific standards are defined by the Securities Industry and Financial Markets Association (SIFMA) 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 SIFMA.

14.37 *Repurchase financings.* A *repurchase financing*, as defined in the FASB ASC glossary, is a repo that relates to a previously transferred financial asset between the same counterparties (or consolidated affiliates of either counterparty) that is entered into contemporaneously with, or in contemplation of, the initial transfer. In transactions involving a contemporaneous transfer of a financial asset and a repurchase financing of that transferred financial asset with the same counterparty, FASB ASC 860-10-40-4C states that a transferor and transferee should separately account for the initial transfer of the financial asset and the related repo.

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 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. 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 210-20-45-2. According to FASB ASC 210-20-45-11, notwithstanding the condition in item (c) in FASB ASC 210-20-45-1, which requires an intent to net-settle the instruments' cash flows, an entity may, but is not required to, offset amounts recognized as payables under repos accounted for as collateralized borrowings and amounts recognized as receivables under reverse repos accounted for as collateralized borrowings if all the following conditions are met:

a. The repos and reverse repos are executed with the same counterparty.

b. The repos and reverse repos have the same explicit settlement date specified at the inception of the agreement.

c. The repos and reverse repos are executed in accordance with a master netting arrangement.

d. The securities underlying the repos and reverse repos exist in book entry form and can be transferred only by means of entries in the records of the transfer system operator or securities custodian.

Book entry securities meeting the criterion in this paragraph exist only as items in accounting records maintained by a transfer system operator. This requirement does not preclude offsetting securities held in book entry form solely because other securities of the same issue exist in other forms.

e. The repos and reverse repos will be settled on a securities transfer system that operates in the manner described in paragraphs 14–17 of FASB ASC 210-20-45, and the entity must have associated banking arrangement in place as described in those paragraphs. Cash settlements for securities transferred should be made under established banking arrangements that provide that the entity will need available cash on deposit only for any net amounts that are due at the end of the business day. It must be probable that the associated banking arrangements will provide sufficient daylight overdraft or other intraday credit at the settlement date for each of the parties. The term *probable* is used in FASB ASC 210-20 consistent with its use in FASB ASC 450-20-25-1 to mean that a transaction or event is likely to occur.

f. The entity intends to use the same account at the clearing bank or other financial institution at the settlement date in transacting both the cash inflows resulting from the settlement of the reverse repo and the cash outflows in settlement of the offsetting repo.

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 FASB ASC 210-20-50-1 establishes the scope of the disclosure requirements in FASB ASC 210-20-50. The disclosures apply to both of the following:

a. Recognized derivative instruments accounted for in accordance with FASB ASC 815, *Derivatives and Hedging* (including bifurcated embedded derivatives), repos accounted for as collateralized borrowings and reverse repos, and securities borrowing and securities lending transactions that are offset in accordance with either FASB ASC 210-20-45 or FASB ASC 815-10-45

b. Recognized derivative instruments accounted for in accordance with FASB ASC 815 (including bifurcated embedded derivatives), repos and reverse repos, and securities borrowing and securities lending transactions that are subject to an enforceable master netting arrangement or similar agreement, irrespective of whether they are offset in accordance with either FASB ASC 210-20-45 or FASB ASC 815-10-45

14.41 Paragraphs 2–3 of FASB ASC 210-20-50 state that an entity should disclose information to enable users of its financial statements to evaluate the effect or potential effect of netting arrangements on its financial position for recognized assets and liabilities within the scope of the preceding paragraph. This includes the effect or potential effect of rights of setoff associated with an entity's recognized assets and recognized liabilities that are in the scope of FASB ASC 210-20-50 disclosure requirements. To meet these objectives, an entity should disclose at the end of the reporting period the following quantitative information separately for assets and liabilities that are in scope:[6]

a. The gross amounts of those recognized assets and those recognized liabilities

b. The amounts offset in accordance with the guidance in FASB ASC 210-20-45 and FASB ASC 815-10-45 to determine the net amounts presented in the statement of financial position

c. The net amounts presented in the statement of financial position

d. The amounts subject to an enforceable master netting arrangement or similar agreement[7] not otherwise included in item *b*:

  i. The amounts related to recognized financial instruments and other derivative instruments that either management makes an accounting policy election not to offset or do not meet some or all of the guidance in either FASB ASC 210-20-45 or FASB ASC 815-10-45

  ii. The amounts related to financial collateral (including cash collateral).

e. The net amount after deducting the amounts in item *d* from the amounts in item *c*.

14.42 *Disclosures.* FASB ASC 860 requires certain disclosures about transfers and servicing of financial assets. See chapter 10, "Transfers and Servicing and Variable Interest Entities," of this guide for additional information regarding the particular disclosures.

14.43 Item (a) in FASB ASC 860-30-50-1A requires an entity that has entered into repos or securities lending transactions to disclose its policy for requiring collateral or other security.

14.44 To provide an understanding of the nature and risks of short-term collateralized financing obtained through repos, securities lending transactions, and repurchase-to-maturity transactions, that are accounted for as secured borrowings at the reporting date, FASB ASC 860-30-50-7 states that an entity should disclose the following information for each interim and annual period about the collateral pledged and the associated risks to which the transferor continues to be exposed after the transfer:

a. A disaggregation of the gross obligation by the class of collateral pledged. An entity should determine the appropriate level of disaggregation and classes to be presented on the basis of the nature, characteristics, and risks of the collateral pledged. Total borrowings under those agreements should be reconciled to the amount of the gross liability for repos and securities lending transactions disclosed in accordance with item (a) in FASB ASC 210-20-50-3 before any adjustments for offsetting. Any difference between the

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[6] FASB *Accounting Standards Codification* (ASC) 210-20-50-4 states that this information should be presented in tabular format, separately for assets and liabilities, unless another format is more appropriate. The total amount disclosed in accordance with FASB ASC 210-20-50-3(d) for an instrument should not exceed the amount disclosed in accordance with FASB ASC 210-20-50-3(c) for that instrument.

[7] In accordance with FASB ASC 210-20-50-5, an entity should provide a description of the rights of setoff associated with an entity's recognized assets and recognized liabilities subject to an enforceable master netting arrangement or similar agreement, including the nature of those rights.

amount of the gross obligation disclosed under this paragraph and the amount disclosed in accordance with item (a) in FASB ASC 210-20-50-3 should be presented as reconciling item(s).

b. The remaining contractual maturity of the repos, securities lending transactions, and repurchase-to-maturity transactions. An entity should use judgment to determine an appropriate range of maturity intervals that would convey an understanding of the overall maturity profile of the entity's financing agreements.

c. A discussion of the potential risks associated with the agreements and related collateral pledged, including obligations arising from a decline in the fair value of the collateral pledged and how those risks are managed.

14.45 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. The concentrations-of-credit-risk disclosures apply to debt securities and loans.

14.46 The balance sheet classification noncash collateral by the seller-borrower depends on whether the buyer-lender has the right to sell or repledge the collateral under the agreement. If there is a right to sell or repledge the collateral, FASB 860-30-45-1 requires the seller-borrower to classify those assets separately from assets not so encumbered (for example, as security pledged to creditors). See paragraphs 10.66–.69 of this guide for further discussion.

14.47 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.

Auditing[8]

Objectives

14.48 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;

[8] The auditing content in this guide focuses primarily on generally accepted auditing standards issued by the Auditing Standards Board and is applicable to audits of the financial statements of those entities not subject to the oversight authority of the PCAOB (that is, those audit reports not within the PCAOB's jurisdiction as defined by the Sarbanes-Oxley Act of 2002, as amended—hereinafter referred to as *nonissuers*). However, considerations for audits of entities subject to the oversight authority of the PCAOB (that is, those audit reports within the PCAOB's jurisdiction as defined by the Sarbanes-Oxley Act of 2002, as amended) issuers in accordance with PCAOB standards may be discussed within this guide's chapter text. When such discussion is provided, the related paragraphs are designated with the following title: *Considerations for Audits Performed in Accordance With PCAOB Standards*.

c. repos and dollar rolls are appropriately accounted for as sales or secured borrowings based upon whether 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, including classification of collateral on the balance sheet;

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 securities 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 footnote disclosures are adequate; and

l. events of default are appropriately disclosed and any related fees are properly accrued; and

m. amounts that have been offset in the statement of financial position meet the criteria for netting set forth in FASB ASC 210.

Planning

14.49 In accordance with AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), the objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and relevant assertion levels through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement (as described in chapter 5, "Audit Considerations and Certain Financial Reporting Matters," of this guide). 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.

14.50 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.

14.51 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.

14.52 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.

14.53 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 guidance for user auditors is provided in AU-C section 402, *Audit Considerations Relating to an Entity Using a Service Organization* (AICPA, *Professional Standards*), and for service auditors is provided in AT-C section 320, *Reporting on an Examination of Controls at a Service Organization Relevant to User Entities' Internal Control Over Financial Reporting* (AICPA, *Professional Standards*).[9] If, in accordance with paragraph .16*a* of AU-C section 402, the user auditor plans to use a type 2 report as audit evidence that controls at the

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[9] The AICPA Guide *Reporting on an Examination of Controls at a Service Organization Relevant to User Entities' Internal Control Over Financial Reporting (SOC 1®)*, contains information for practitioners reporting on controls at a service organization that affect user entities' internal control over

(continued)

service organization are operating effectively, paragraph .17 of AU-C section 402 states that the user auditor should determine whether the service auditor's report provides sufficient appropriate audit evidence about the effectiveness of the controls to support the user auditor's risk assessment by

a. evaluating whether the type 2 report is for a period that is appropriate for the user auditor's purposes;

b. determining whether complementary user entity controls identified by the service organization are relevant in addressing the risks of material misstatement relating to the relevant assertions in the user entity's financial statements and, if so, obtaining an understanding of whether the user entity has designed and implemented such controls and, if so, testing their operating effectiveness;

c. evaluating the adequacy of the time period covered by the tests of controls and the time elapsed since the performance of the tests of controls; and

d. evaluating whether the tests of controls performed by the service auditor and the results thereof, as described in the service auditor's report, are relevant to the assertions in the user entity's financial statements and provide sufficient appropriate audit evidence to support the user auditor's risk assessment.

Internal Control Over Financial Reporting and Possible Tests of Controls

14.54 AU-C section 315 addresses the auditor's responsibility to identify and assess the risks of material misstatement in the financial statements through understanding the entity and its environment, including the entity's internal control. Paragraphs .13–.14 of AU-C section 315 state that the auditor should obtain an understanding of internal control relevant to the audit (see examples of controls over financial reporting of federal funds and repo transactions in paragraph 14.55) and, in doing so, should evaluate the design of those controls and determine whether they have been implemented by performing procedures in addition to inquiry of the entity's personnel. (See chapter 5 of this guide for further discussion of the components of internal control.) To provide a basis for designing and performing further audit procedures, paragraph .26 of AU-C section 315 states that the auditor should identify and assess the risks of material misstatement at the financial statement level and the relevant assertion level for classes of transactions, account balances, and disclosures.

14.55 Examples of controls over financial reporting of federal funds and repo transactions are as follows:

- The institution has formal, written policies that specify the types of securities that can be sold or repurchased under repos.
- Formal policies and procedures are in place to provide that repo transactions are executed in accordance with written contracts

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(footnote continued)

financial reporting. Also, the AICPA Guide *Reporting on Controls at a Service Organization Relevant to Security, Availability, Processing Integrity, Confidentiality, or Privacy (SOC 2®)* summarizes the three SOC engagements and provides detailed guidance on planning, performing, and reporting on SOC 2® engagements.

that describe the rights and obligations of the parties and that offsetting is applied only where appropriate based on the underlying contracts.

- 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. The reconciliations are reviewed by supervisory personnel.
- 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.

Chapter 7, "Investments in Debt and Equity Securities," and chapter 15, "Debt," of this guide discuss related control issues for investments and borrowings, respectively.

14.56 AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*), addresses the auditor's responsibility to design and implement responses to the risks of material misstatement identified and assessed by the auditor in accordance with AU-C section 315 and to evaluate the audit evidence obtained in an audit of financial statements.

14.57 In accordance with paragraph .08 of AU-C section 330, the auditor should design and perform tests of controls to obtain sufficient appropriate audit evidence about the operating effectiveness of relevant controls if (*a*) the

auditor's assessment of risks of material misstatement at the relevant assertion level includes an expectation that the controls are operating effectively or (*b*) 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 and subject to supervisory review.
- Review supporting documentation for transactions, and consider whether only authorized individuals entered into or otherwise executed those transactions on behalf of the institution and that these components of the transactions were appropriately reviewed by supervisory personnel.
- Review management's control over the appropriateness of the accounting for repo transactions, including the determination of sale or secured borrowing treatment, application of netting, recording the difference between the selling price and repurchase price as interest expense and determining whether interest expense is properly recorded on other borrowings, such as federal funds purchased. Obtain evidence that supervisory personnel reviewed the recording of the transaction.[10]
- Review the latest audited financial statements of the counterparties and other available reports, such as reports on internal control or special-purpose reports by the dealer's accountant, to determine whether the dealer has net capital in excess of statutory requirements.

14.58 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

14.59 Irrespective of the assessed risks of material misstatement, paragraph .18 of AU-C section 330 states that the auditor should design and perform

[10] These procedures also could be performed to provide substantive evidence.

substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure. In accordance with paragraph .A45 of AU-C section 330, this requirement reflects the facts that (*a*) the auditor's assessment of risk is judgmental and may not identify all risks of material misstatement and (*b*) inherent limitations to internal control exist, including management override.

14.60 *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, and that when such securities are sold or re-hypothecated, a liability to return them is recorded by the original buyer-lender. The auditor should also examine the underlying contracts and (*a*) assess whether the criteria for offsetting assets and liabilities have been met (in cases where netting has been applied) and (*b*) 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.

14.61 *Confirmation.* Paragraph .A8 of AU-C section 500, *Audit Evidence* (AICPA, *Professional Standards*), states that corroborating information obtained from a source independent of the entity may increase the assurance that the auditor obtains from audit evidence that is generated internally, such as evidence existing within the accounting records, minutes of meetings, or a management representation. The auditor could consider confirming the amount and all significant terms of federal funds transactions 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.

14.62 The auditor should consider the need to assess the counterparty's ability to complete the transaction by performing other procedures, such as testing the subsequent completion of the transaction for transactions that are completed after period-end but before the issuance of the financial statements, 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.

14.63 *Auditing interests in trusts held by a third-party trustee and reported at fair value.* In circumstances in which the auditor determines that the nature and extent of auditing procedures should include verifying the existence and testing the measurement of investments held by a trust simply receiving a confirmation from the trustee, either in aggregate or on an investment by investment basis, does not in and of itself constitute adequate audit evidence with respect to the requirements for auditing the fair value of the interest in trust under AU-C section 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* (AICPA, *Professional Standards*). In addition, receiving conformation from the trustee for investments in aggregate does not constitute adequate audit evidence with respect to the existence assertion. Receiving confirmation from the trustee on an investment-by-investment basis, however, typically would constitute adequate audit evidence with respect to the existence assertion. Also, in discussing obtaining an understanding of how management identifies the need for accounting estimates, paragraph .A15 of AU-C section 540 states that the preparation and fair presentation of the financial statements requires management to determine whether a transaction, an event, or a condition gives rise to the need to make an accounting estimate and that all necessary accounting estimates have been recognized, measured, and disclosed in the financial statements in accordance with the applicable financial reporting framework.

14.64 In circumstances in which the auditor is unable to audit the existence or measurement of interests in trusts at the financial statement date, the auditor should consider whether that scope limitation requires the auditor to either qualify his or her opinion or to disclaim an opinion, as discussed in AU-C section 705, *Modifications to the Opinion in the Independent Auditor's Report* (AICPA, *Professional Standards*).

14.65 *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.

14.66 *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 fair 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 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.

14.67 *Analytical procedures.* Chapters 7 and 15 of this guide discuss analytical procedures that may also be applied in this area.

14.68 *Tests of fair value disclosures.* AU-C section 540 addresses the auditor's responsibilities relating to accounting estimates, including fair value accounting estimates and related disclosures, in an audit of financial statements. Specifically, it expands on how AU-C section 315, AU-C section 330, and other relevant AU-C sections are to be applied with regard to accounting estimates. It also includes requirements and guidance related to misstatements of individual accounting estimates and indicators of possible management bias. AU-C section 501, *Audit Evidence—Specific Considerations for Selected Items* (AICPA, *Professional Standards*), addresses specific considerations by the auditor in obtaining sufficient appropriate audit evidence, in accordance with AU-C sections 330, AU-C section 500, and other relevant AU-C sections, regarding certain aspects of (*a*) investments in securities and derivative instruments; (*b*) inventory; (*c*) litigation, claims, and assessments involving the entity; and (*d*) segment information in an audit of financial statements.

> *Considerations for Audits Performed in Accordance With PCAOB Standards*
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> The second note to paragraph .A5 of AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*), discusses the inherent limitations of internal control. Because fair value determinations often involve subjective judgments by management, this may affect the nature of controls that are capable of being implemented, including the possibility of management override of controls. The auditor considers the inherent limitations of internal control in such circumstances in assessing control risk.
>
> Paragraph .47 of AS 2502, *Auditing Fair Value Measurements and Disclosures* (AICPA, *PCAOB Standards and Related Rules*), states that the auditor should evaluate the sufficiency and competence of the audit evidence obtained from auditing fair value measurements and disclosures as well as the consistency of that evidence with other audit evidence obtained and evaluated during the audit. The auditor's evaluation of whether the fair value measurements and disclosures in the financial statements are in conformity with U.S. generally accepted accounting principles is performed in the context of the financial statements taken as a whole (see paragraphs .12–.18 and .24–.27 of AS 2810, *Evaluating Audit Results* [AICPA, *PCAOB Standards and Related Rules*]).

14.69 *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 accounted for as sales on a test basis.

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 accept 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 assets, such as 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 priorities of repayment, which become especially significant when solvency becomes questionable.

15.04 Internal 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 debt 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 the issuer's financial condition as measured by 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 institutions 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[2] rating.

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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.

[2] In accordance with Title 12 U.S. *Code of Federal Regulations* Part 16.2, *investment grade* means that the issuer of a security has an adequate capacity to meet financial commitments under the security for the projected life of the asset or exposure. An issuer has an adequate capacity to meet financial commitments if the risk of default by the obligor is low and full and timely repayment of principal and interest is expected.

Long Term Debt

15.06 The most common long term debt funding sources are debentures and notes. Institutions also may have long term mortgages, obligations and commitments under capital leases, and mandatorily redeemable preferred stock, 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 preferred or 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) 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 (repos) are discussed in chapter 14, "Federal Funds and Repurchase Agreements," of this guide.

15.11 *Federal funds purchased.* Federal funds purchased are discussed in chapter 14 of this guide.

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 repos 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 FHLB 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 needs. A discounting transaction is technically a note to the Federal Reserve Bank 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 Bank. 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 callable and non-callable advances of varying maturities from their district FHLBs. FHLB advances often are secured through pledges of loans or securities. Paragraph 15.73 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, which 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 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 contain 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 *MBBs.* MBBs are any borrowings (other than those from an FHLB) collateralized in whole or in part by one or more real estate loans. MBBs typically have the following characteristics:

a. Fixed maturities or payments of principal and interest

b. The use 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 value exceeds the principal value throughout its term (overcollateralization)

15.22 *Preferred stock and other securities of finance subsidiaries.* Finance subsidiaries, as defined in federal banking regulations, are a means by which institutions can issue preferred stock and other securities at rates lower than those the institutions would otherwise have to pay if they issued the securities directly. Thus, finance subsidiaries afford banking institutions the opportunity to obtain less costly funds.

15.23 *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 issued and any other securities guaranteed by its parent entity.

15.24 In a structured financing (the simplest form of a finance subsidiary), the parent entity 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 entity had been the issuer.

15.25 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 entity.

15.26 *CMOs.* 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 entity (issuer) established by one or more sponsors (frequently the original owners of the mortgages). The assets collateralizing the bonds are acquired by the special-purpose entity 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.

15.27 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," of this guide), or an unrelated third party may acquire the residual as an investment.

15.28 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.

15.29 *REMICs.* REMICs are vehicles for issuing multiclass mortgage-backed obligations that require compliance with a number of technical requirements of the 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.

15.30 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.

15.31 All of the interests in the REMIC normally consist of either regular interests or residual interests. A regular interest is an interest that unconditionally entitles the holder to receive specified principal and interest payments under terms that are fixed at the time of the REMIC's formation. A residual interest is any interest in a REMIC that is not a regular interest. Only one class of residual interest may exist with respect to a REMIC. In other words, the rights of all of the holders of an interest that does not qualify as a regular interest must be exactly the same.

Regulatory Matters

15.32 Federal savings institutions must notify the Office of the Comptroller of the Currency 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.

15.33 The Federal Reserve Act limits the availability of certain types of borrowings through the Federal Reserve discount window.

Accounting and Financial Reporting

15.34 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.

15.35 FASB ASC 860-30-45-2 states that liabilities incurred by either the secured party or obligor in securities borrowings or resale transactions should be separately classified. However, FASB ASC 860-30-45 does not specify the classification or the terminology to be used to describe such liabilities, nor does it specify the classification or the terminology to be used for pledged assets reclassified by the transferor of securities loaned or transferred under a repo accounted for as a collateralized borrowing if the transferee is permitted to sell or repledge those securities.

15.36 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 or earnings requirements), if any.

15.37 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 for disclosure requirements of future payments on long term borrowings.)

15.38 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.

15.39 According to "Pending Content" in FASB ASC 835-30-45-1A, debt issuance costs related to a note should be reported in the balance sheet as a direct deduction from that face amount of that note. The debt issuance costs should not be classified as a deferred charge or a deferred credit. "Pending Content" in FASB ASC 835-30-45-3 further states that the amortization of debt issuance costs should be reported as interest expense. FASB ASC 470-10-35-2 states that debt issue costs should be amortized over the same period used in the interest cost determination.

15.40 Debt instruments with redemption features should be carefully analyzed to determine the appropriate period over which these items should be amortized.

15.41 FASB ASC 480, *Distinguishing Liabilities from Equity*,[3] 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.

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[3] 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 SEC 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.

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:

  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), and

  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).

15.42 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.

15.43 *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, calculation of any beneficial conversion feature, and impact earnings per share calculations.

15.44 *Redeemable preferred stock*. As noted in paragraph 15.41, "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.[4]

15.45 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 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–.26 of this guide for a discussion of preferred stock and regulatory capital).

15.46 *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

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[4] See footnote 3.

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. FASB ASC 460-10-05-2 explains that certain disclosures are required to be made by a guarantor in its interim and annual financial statements about its obligations under guarantees. The "General" subsections of FASB ASC 460 also address 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.

15.47 *MBBs.* 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.

15.48 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 "Pending Content" in FASB ASC 835-30-45-1A and FASB Concept No. 6, *Elements of Financial Statements* (paragraphs 235–239). Similarly, related bond issuance costs should be reported in the balance sheet as a direct deduction from the face amount of that bond.

15.49 *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.

15.50 *Gain or loss on extinguishments*. Most gains or losses on extinguishments are recorded as ordinary items. However, in accordance with FASB ASC 225-20-45-16, gains or losses from extinguishment of debt that an entity considers to be a material event or transaction of an unusual nature and of a type that indicates infrequency of occurrence should be reported as a separate component of income from continuing operations. The nature and financial effects of each event or transaction should be presented as a separate component of income from continuing operations, or, alternatively disclosed in notes to financial statements. Gains or losses of a similar nature that are not individually material should be aggregated and such items should not be reported on the face of the income statement net of income taxes. Similarly, the earnings per share effects of those items should not be presented on the face of the income statement.

15.51 *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 accounting. FASB ASC

470-60 provides accounting and reporting guidance for determining when a modification is considered a troubled debt restructuring.

15.52 *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.

15.53 *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.

15.54 *REMICs.* As discussed, 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.

15.55 *Lease financing*. Accounting for leases by lessees and lessors is established in FASB ASC 840, *Leases*.

Update 15-1 *Accounting and Reporting*: Leases

FASB Accounting Standards Update (ASU) No. 2016-02, *Leases (Topic 842)*, issued in February 2016, is effective for fiscal years of a public business entity, a not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market, and an employee benefit plan that files financial statements with the SEC beginning after December 15, 2018, including interim periods within those fiscal years.

For all other entities, FASB ASU No. 2016-02 is effective for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2019.

Early application is permitted for all entities

FASB ASU No. 2016-02 supersedes the lease requirements in FASB ASC 840 and creates FASB ASC 842, *Leases*, to establish the principles that lessees and lessors should apply to report useful information to users of financial statements about the amount, timing, and uncertainty of cash flows arising from a lease. FASB ASC 842 affects any entity that enters into a lease (as that term is defined in FASB ASU No. 2016-02), with some specified scope exceptions.

This edition of the guide has not been updated to reflect changes as a result of this ASU, however, this discussion will be updated in a future edition. Readers are encouraged to consult the full text of this ASU on FASB's website at www.fasb.org.

For more information on FASB ASU No. 2016-02, see appendix F, "The New Leases Standard: FASB ASU No. 2016-02," of this guide.

15.56 *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*.

15.57 *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," of this guide 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*.

Auditing[5]

Objectives

15.58 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, including embedded derivatives that are required to be accounted for in accordance with FASB ASC 815 and debt issuance costs, include all such liabilities of the institution and that they have been properly valued, classified, described and disclosed, and reflect all transactions for the period;

b. financing subsidiaries are consolidated with the parent institution as required by FASB 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

[5] The auditing content in this guide focuses primarily on generally accepted auditing standards issued by the Auditing Standards Board and is applicable to audits of the financial statements of those entities not subject to the oversight authority of the PCAOB (that is, those audit reports not within the PCAOB's jurisdiction as defined by the Sarbanes-Oxley Act of 2002, as amended—hereinafter referred to as *nonissuers*). However, considerations for audits of entities subject to the oversight authority of the PCAOB (that is, those audit reports within the PCAOB's jurisdiction as defined by the Sarbanes-Oxley Act of 2002, as amended) may be discussed within this guide's chapter text. When such discussion is provided, the related paragraphs are designated with the following title: *Considerations for Audits Performed in Accordance With PCAOB Standards*.

f. the effects on reported amounts and disclosures of any noncompliance with debt covenants are properly identified, described, and disclosed.

g. the potential impact of failed covenants, debt maturing within 1 year or other related events that are considered in the auditor's going concern analysis.

Planning

15.59 In accordance with AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), the objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and relevant assertion levels through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement (as described in chapter 5, "Audit Considerations and Certain Financial Reporting Matters," of this guide). Factors related to debt that could influence the risks of material misstatement may include accounting for borrowings, regulatory considerations, the existence of restrictive covenants, the existence of conversion features, 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

15.60 AU-C section 315 addresses the auditor's responsibility to identify and assess the risks of material misstatement in the financial statements through understanding the entity and its environment, including the entity's internal control. Paragraphs .13–.14 of AU-C section 315 state that the auditor should obtain an understanding of internal control relevant to the audit, and, in doing so, should evaluate the design of those controls and determine whether they have been implemented by performing procedures in addition to inquiry of the entity's personnel. (See chapter 5 of this guide for further discussion of the components of internal control.) To provide a basis for designing and performing further audit procedures, paragraph .26 of AU-C section 315 states that the auditor should identify and assess the risks of material misstatement at the financial statement level and the relevant assertion level for classes of transactions, account balances, and disclosures.

15.61 AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*), addresses the auditor's responsibility to design and implement responses to the risks of material misstatement identified and assessed by the auditor in accordance with AU-C section 315 and to evaluate the audit evidence obtained in an audit of financial statements.

15.62 In accordance with paragraph .08 of AU-C section 330, the auditor should design and perform tests of controls to obtain sufficient appropriate audit evidence about the operating effectiveness of relevant controls if (*a*) the

auditor's assessment of risks of material misstatement at the relevant assertion level includes an expectation that the controls are operating effectively or (*b*) 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 U.S generally accepted accounting principles (GAAP) criteria for classification as a liability, debt agreements are evaluated for derivative accounting in accordance with FASB ASC 815 and debt issuance costs are appropriately identified and accounted for.
- Adjustments to liability accounts are reviewed and approved by responsible personnel.
- The subsidiary ledgers for long and short term borrowings and collateral are periodically reconciled with the general ledger. Reconciliations are regularly reviewed and approved by supervisory personnel.
- Reports or statements from outside trustees or transfer agents are periodically reconciled to the institution's records. Reconciliations are regularly reviewed and approved by supervisory personnel.
- 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.

15.63 AU-C section 402, *Audit Considerations Relating to an Entity Using a Service Organization* (AICPA, *Professional Standards*), 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 (for example, processing CMO or REMIC cash flows by a trustee). Specifically, it expands on how the user auditor applies AU-C sections 315 and 330 in obtaining an understanding of the user entity, including internal control relevant to the audit, sufficient to identify and assess the risks of material misstatement and in designing and performing further audit procedures responsive to those risks. If, in accordance with paragraph .16*a* of AU-C section 402, the user auditor plans to use a type 2 report as audit evidence that controls at the service organization are operating effectively, paragraph .17 of AU-C section 402 states that the user auditor should determine whether the service auditor's report provides sufficient appropriate audit evidence about the effectiveness of the controls to support the user auditor's risk assessment by

a. evaluating whether the type 2 report is for a period that is appropriate for the user auditor's purposes;

b. determining whether complementary user entity controls identified by the service organization are relevant in addressing the risks of material misstatement relating to the relevant assertions in the user entity's financial statements and, if so, obtaining an understanding of whether the user entity has designed and implemented such controls and, if so, testing their operating effectiveness;

c. evaluating the adequacy of the time period covered by the tests of controls and the time elapsed since the performance of the tests of controls; and

d. evaluating whether the tests of controls performed by the service auditor and the results thereof, as described in the service auditor's report, are relevant to the assertions in the user entity's financial statements and provide sufficient appropriate audit evidence to support the user auditor's risk assessment.

Substantive Tests

15.64 Irrespective of the assessed risks of material misstatement, paragraph .18 of AU-C section 330 states that 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 .A45 of AU-C section 330, this requirement reflects the facts that (*a*) the auditor's assessment of risk is judgmental and may not identify all risks of material misstatement and (*b*) inherent limitations to internal control exist, including management override.

15.65 *Review of documentation.* The auditor might review documentation such as legal agreements and signed 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

15.66 *Confirmation.* Paragraph .A8 of AU-C section 500, *Audit Evidence* (AICPA, *Professional Standards*), states that corroborating information obtained from a source independent of the entity may increase the assurance that the auditor obtains from audit evidence that is generated internally, such as evidence existing within the accounting records, minutes of meetings, or a management representation. AU-C section 505, *External Confirmations* (AICPA, *Professional Standards*), addresses the auditor's use of external confirmation procedures to obtain audit evidence, in accordance with the requirements of AU-C sections 330 and 500.

15.67 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 premiums, discounts, and issuance costs.* The auditor may consider testing borrowings that were issued at a premium or discount to determine whether amortization has been properly computed and recorded. The auditor may also evaluate the propriety of amortization of costs incurred in connection with a debt issuance. The auditor may also consider the appropriateness of debt issuance costs recorded and test the classification and account of the costs.

15.69 *Analytical procedures.* Paragraph .05 of AU-C section 520, *Analytical Procedures* (AICPA, *Professional Standards*), states that when designing and performing analytical procedures, either alone or in combination with tests of details, as substantive procedures in accordance with AU-C section 330,[6] the auditor should

a. determine the suitability of particular substantive analytical procedures for given assertions, taking into account the assessed risks of material misstatement and tests of details, if any, for these assertions. (For example, 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.)

b. evaluate the reliability of data from which the auditor's expectation of recorded amounts or ratios is developed, taking into account the source, comparability, and nature and relevance of information available and controls over preparation.

c. develop an expectation of recorded amounts or ratios and evaluate whether the expectation is sufficiently precise (taking into account whether substantive analytical procedures are to be performed alone or in combination with tests of details) to identify a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated.

d. determine the amount of any difference of recorded amounts from expected values that is acceptable without further investigation as required by paragraph .07 of AU-C section 520 and compare the recorded amounts, or ratios developed from recorded amounts, with the expectations.

15.70 As discussed in paragraph 15.69*a*, it is normally difficult to develop sufficiently precise expectations to be used in analyzing yields on debt. Accordingly, analytical procedures in this area might be considered only as a supplement to other substantive procedures, except where an expected yield can be

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[6] Paragraph .18 of AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*).

known with some precision (using computer-assisted audit techniques). Analytical review procedures that the auditor may apply in the debt area include analysis and evaluation of the following:

- Comparison of 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)
- 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

15.71 Paragraph .A7 of AU-C section 520 states that the auditor's substantive procedures to address the assessed risk of material misstatement for relevant assertions may be tests of details, substantive analytical procedures, or a combination of both. The decision about which audit procedures to perform, including whether to use substantive analytical procedures, is based on the auditor's judgment about the expected effectiveness and efficiency of the available audit procedures to reduce the assessed risk of material misstatement to an acceptably low level. Further guidance on the auditor's use of analytical procedures as substantive procedures is provided in AU-C section 520. AU-C section 315 addresses the use of analytical procedures as risk assessment procedures, and AU-C section 330 addresses the nature, timing, and extent of audit procedures in response to assessed risks; these audit procedures may include substantive analytical procedures.

15.72 *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 or consider confirmation procedures to validate that borrowings 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).
- Assess the sufficiency of the value of assets collateralizing any borrowings to determine whether the entity has posted and recorded sufficient collateral for its borrowings.

15.73 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.

15.74 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-C section 806, *Reporting on Compliance With Aspects of Contractual Agreements or Regulatory Requirements in Connection With Audited Financial Statements* (AICPA, *Professional Standards*).

15.75 *Finance company credit questionnaires.* Finance companies provide creditors with financial and operating information through standard credit questionnaires developed jointly by industry participants and the 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.

15.76 Paragraph .03 of AU-C section 725, *Supplementary Information in Relation to the Financial Statements as a Whole* (AICPA, *Professional Standards*), states that the objective of the auditor, when engaged to report on supplementary information in relation to the basic financial statements as a whole, is to evaluate the presentation of the supplementary information in relation to the basic financial statements as a whole and to report on whether the supplementary information (such as a credit questionnaire) is fairly stated, in all material respects, in relation to the financial statements as whole. *Supplementary information* (for purposes of generally accepted auditing standards) is defined as information presented outside the basic financial statements, excluding required supplementary information that is not considered necessary for the financial statements to be fairly presented in accordance with the applicable financial reporting framework. Paragraphs .A7–.A8 of AU-C section 725 explain that supplementary information includes additional details or explanations of items in or related to the basic financial statements, consolidating information, historical summaries of items extracted from the basic financial statements, statistical data, and other material, some of which may be from sources outside the accounting system or outside the entity. Supplementary information may be prepared in accordance with an applicable financial reporting framework, by regulatory or contractual requirements, in accordance with management's criteria or in accordance with other requirements. The auditor may report on such information using the guidance in paragraphs .09–.13 of AU-C section 725.

15.77 However, paragraphs .A1–.A2 of AU-C section 725 state that the auditor's responsibility for information that a designated accounting standard setter[7] requires to accompany an entity's basic financial statements is addressed in AU-C section 730, *Required Supplementary Information* (AICPA, *Professional Standards*). The auditor's responsibility for financial and nonfinancial information (other than the financial statements and the auditor's report thereon) that is included in a document containing audited financial statements and the auditor's report thereon, excluding required supplementary information, is addressed in AU-C section 720, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*).

[7] *Designated accounting standard setter* is defined in paragraph .04 of AU-C section 730, *Required Supplementary Information* (AICPA, *Professional Standards*).

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 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, investment companies or insurance agencies.

16.06 *Tax bad-debt deductions.* IRC Section 585 provides that a bank or savings institution with $500 million or less in assets is allowed a tax bad-debt deduction for reasonable additions to the bad-debt reserve. This asset test generally is based upon the average adjusted tax basis of all assets. If the institution is a member of a controlled group (as defined), all assets of the group are taken into account. The annual addition to the reserve generally cannot exceed

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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.

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, which generally permits taxpayers to deduct any debt that becomes worthless, in whole or in part, during the taxable year (that is, the specific charge-off method).[2] Treasury Regulation 1.166-2(d) provides circumstances under which a bank may presume a debt to have become worthless, in whole or in part including, if a bank makes a conformity election under Regulation 1.166-2(d)(3), that a debt or portion thereof charged off for regulatory purposes is presumed to be worthless for tax purposes as well. The conformity election must be formally adopted and requires a financial institution to obtain an express determination letter from its primary federal regulator during each examination. Presence of the conformity election can also support the non-recognition, for tax purposes, of contractually accrued interest that has not been recorded for financial reporting purposes, but only to the extent that no cash has been received that is required to be applied to the debtor's contractual balance of such outstanding interest.

16.08 According to IRC Section 593 and the accompanying regulations, a qualifying thrift institution that, prior to 1996, was permitted to establish a reserve for bad debts based on a percentage of taxable income may be required to recapture a portion of such bad-debt reserve if it makes distributions to shareholders that exceed earnings and profits accumulated after 1951. Additionally, if such an 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.

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. Legislation was passed in 2009 that allowed financial institutions that had not received assistance under the Troubled Asset Relief Program to make a one-time election to carry back NOLs generated in 2008 or 2009 up to 5 years instead of 2.

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 received

[2] Finance companies and mortgage companies also use the specific charge-off method.

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 in securities* is broadly defined as any taxpayer that regularly purchases securities from, or sells securities to, customers in the ordinary course of business or regularly offers to enter into, assume, offset, assign or otherwise terminate positions in securities with customers in the ordinary course of a trade or business. The definition of *securities* in the IRC differs from and is generally more expansive than the definition of *securities* in the FASB *Accounting Standards Codification* (ASC) glossary. For example, a bank regularly selling loans into the secondary market would be considered a dealer. Further, institutions that are dealers generally may not exempt any security held for investment from mark to market accounting for tax purposes, unless there is a proper identification statement in place and the security is identified as exempt at the date it is acquired. 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 income tax for federal and state purposes.

Regulatory Matters

16.14 The Federal Financial Institutions Examination Council (FFIEC) 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 Under final U.S. Basel III rules, certain deferred tax assets must be excluded from a bank's calculation of regulatory capital:

a. Deferred tax assets that arise from NOL and tax credit carry forwards

b. Deferred tax assets arising from temporary differences that could not be realized through carryback of losses if those differences reversed at the report date, but only to the extent the deferred tax assets that could not be realized exceed a 10 percent of common equity tier 1 capital threshold individually and a 15 percent threshold in aggregate with certain other assets (most commonly, mortgage servicing assets)

Deferred tax assets must be analyzed net of any related valuation allowances and on a jurisdiction by jurisdiction basis. A bank may also opt to net deferred tax liabilities, on a pro rata basis, against these two groups of deferred tax assets. Transition rules phase in these exclusions for certain banks through calendar year 2018.

16.16 Certain assets must be excluded from regulatory capital in their entirety (for example, goodwill and other intangible assets) or to the extent they exceed the 10 percent and 15 percent thresholds mentioned previously (for example, mortgage servicing assets). A bank may opt to net associated deferred tax liabilities against these assets in order to reduce the exclusion. The option to net deferred tax liabilities in this paragraph and in paragraph 16.15 is a policy decision that must be applied consistently from each reporting period to the next. In one circumstance, netting is not optional: a bank that opts out of including accumulated other comprehensive income in its regulatory capital must net that exclusion with both associated deferred tax assets and associated deferred tax liabilities.

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, which does not materially change any of the guidance previously issued by the agencies, generally, requires that intercorporate tax settlements between an institution and its parent company be no less favorable to the institution than if it 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.[3]

Accounting and Financial Reporting

16.18 FASB ASC 740, *Income Taxes*, addresses financial accounting and reporting for the effects of income taxes that result from an entity's activities

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[3] In June 2014, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the FDIC issued the *Addendum to the Interagency Policy Statement on Income Tax Allocation in a Holding Company*. The addendum instructs insured depository institutions (IDIs) and their holding companies to ensure their tax-allocation agreements expressly acknowledge that the holding companies are acting as agents for the IDI and are consistent with certain requirements of sections 23A and 23B of the Federal Reserve Act.

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.

16.19 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.

As stated in FASB ASC 740-10-15-2, the principles and requirements of FASB ASC 740 are applicable to domestic and foreign entities in preparing financial statements in accordance with GAAP.

16.20 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

16.21 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.)

16.22 An example of a deferred tax liability includes book and tax basis differences of assets and liabilities that will result in future taxable amounts. An example of a deferred tax asset includes book and tax basis differences of assets and liabilities that will result in future deductible amounts.

16.23 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.

Temporary Differences

© Update 16-1 *Accounting and Reporting*: Intra-Entity Transfers of Assets Other Than Inventory

FASB Accounting Standards Update (ASU) No. 2016-16, *Income Taxes (Topic 740): Intra-Entity Transfers of Assets Other Than Inventory*, issued in October 2016, is effective for annual reporting periods, including interim periods within those annual reporting periods, of a public business entity beginning after December 15, 2017.

For all other entities, FASB ASU No. 2016-16 is effective for annual reporting periods beginning after December 15, 2018, and interim periods within annual periods beginning after December 15, 2019. Early adoption is permitted for all entities as of the beginning of an annual reporting period for which financial statements (interim or annual) have not been issued or made available for issuance. That is, earlier adoption should be in the first interim period if an entity issues interim financial statements.

FASB ASU No. 2016-16 requires that entities recognize the income tax consequences of an intra-entity transfer of an asset other than inventory when the transfer occurs. The amendments in this ASU do not change GAAP for the pre-tax effects of an intra-entity asset transfer under FASB ASC 810, *Consolidation*, or for an intra-entity transfer of inventory.

This edition of the guide has not been updated to reflect changes as a result of this ASU, however, this section will be updated in a future edition. Readers are encouraged to consult the full text of this ASU on FASB's website at www.fasb.org.

16.24 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.

16.25 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 16.26) 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.)

- *Interest on nonperforming loans* is generally not recognized in income for financial and regulatory purposes, but may be required to be included in taxable income under IRC Section 451. This would result in additional tax basis in the interest receivable.

- *Unrealized gains or losses on securities* recorded under FASB ASC 320, *Investments—Debt and Equity Securities*, are generally not recognized for tax purposes.
- *Other real estate owned and other assets* may reflect postacquisition impairment write-downs in the financial statements; those write-downs are generally not recognized by a bank for tax purposes until the asset is sold or disposed of.[4]
- *Accrued deferred compensation* is not generally deductible for tax purposes until paid.
- *Accrued loss contingencies* are generally not deductible for tax purposes until the liability is fixed and determinable.
- *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 in which the expense is recognized for tax purposes.
- *Originated mortgage servicing assets* recorded in the financial statements are typically not capitalized for tax purposes to the extent not deemed to be excess serving compensation.
- *Other basis differences* in assets and liabilities may be 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.

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[4] In January 2014, Revenue Procedure 2014-16 was issued to allow financial institutions that had been capitalizing the costs to acquire and hold foreclosed property the opportunity to file for an automatic change of accounting method in order to deduct these costs currently under defined circumstances.

16.26 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.

Financial Statement Presentation and Disclosure[5]

16.27 FASB ASC 740-10-50 provides guidance on the financial statement disclosure requirements relating to income taxes applicable to all entities.

16.28 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 intraperiod tax allocation provisions of paragraphs 2–14 of FASB ASC 740-20-45) for each year that those items are presented. For example, the amount of income tax expense or benefit allocated to certain items whose tax effects are charged or credited directly to other comprehensive income (such as translation adjustments under FASB ASC 830, *Foreign Currency Matters*, and changes in the unrealized holding gains and losses of securities classified as available-for-sale under FASB ASC 320) should be separately allocated and disclosed.

16.29 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

16.30 If a thrift institution does not recognize a deferred tax liability for the base-year amount of a tax bad debt reserve in accordance with FASB ASC 740-10-25-3, it must disclose the amount of the deferred tax liability not recorded and the types of events that would cause the temporary difference (the base-year reserve) to become taxable, per FASB ASC 942-740-50-1.

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[5] In July 2016, FASB issued proposed Accounting Standards Update *Income Taxes (Topic 740): Disclosure Framework—Changes to the Disclosure Requirements for Income Taxes* to modify current disclosure requirements for income taxes. Readers are encouraged to visit the "Technical Agenda" page at www.fasb.org for the latest developments regarding the Disclosure Framework: Disclosure Review—Income Taxes project and how it may impact the guidance in this chapter.

Auditing[6]

Objectives

16.31 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

16.32 In accordance with AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), the objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and relevant assertion levels through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement (as described in chapter 5, "Audit Considerations and Certain Financial Reporting Matters," of this guide). 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

16.33 AU-C section 315 addresses the auditor's responsibility to identify and assess the risks of material misstatement in the financial statements through understanding the entity and its environment, including the entity's internal control. Paragraphs .13–.14 of AU-C section 315 state that the auditor should obtain an understanding of internal control relevant to the audit and, in doing so, should evaluate the design of those controls and determine whether they have been implemented by performing procedures in addition to inquiry of the entity's personnel. (See chapter 5 of this guide for further discussion of the components of internal control.) To provide a basis for designing and performing further audit procedures, paragraph .26 of AU-C section 315 states that the auditor should identify and assess the risks of material misstatement

[6] The auditing content in this guide focuses primarily on generally accepted auditing standards issued by the Auditing Standards Board and is applicable to audits of the financial statements of those entities not subject to the oversight authority of the PCAOB (that is, those audit reports not within the PCAOB's jurisdiction as defined by the Sarbanes-Oxley Act of 2002, as amended—hereinafter referred to as *nonissuers*). However, considerations for audits of entities subject to the oversight authority of the PCAOB (that is, those audit reports within the PCAOB's jurisdiction as defined by the Sarbanes-Oxley Act of 2002, as amended) may be discussed within this guide's chapter text. When such discussion is provided, the related paragraphs are designated with the following title: *Considerations for Audits Performed in Accordance With PCAOB Standards*.

at the financial statement level and the relevant assertion level for classes of transactions, account balances, and disclosures.

16.34 AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*), addresses the auditor's responsibility to design and implement responses to the risks of material misstatement identified and assessed by the auditor in accordance with AU-C section 315 and to evaluate the audit evidence obtained in an audit of financial statements.

Substantive Tests

16.35 Irrespective of the assessed risks of material misstatement, paragraph .18 of AU-C section 330 states that the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure, which for a financial institution subject to income tax would generally include income taxes. In accordance with paragraph .A45 of AU-C section 330, this requirement reflects the facts that (*a*) the auditor's assessment of risk is judgmental and may not identify all risks of material misstatement and (*b*) inherent limitations to internal control exist, including management override.

16.36 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 pre-acquisition tax liabilities and exposures, if acquired in a tax free acquisition.
- 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 and deferred 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 returns and determine the propriety of adjustments made in this regard and consider the impact on the current-year and prior-year tax accruals.
- 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 740 guidance on accounting for uncertain tax positions.
- Evaluate tax positions and consider the appropriate accounting treatment and disclosure requirements for any uncertain tax positions under FASB ASC 740.
- 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 entry *income taxes of a bank subsidiary of a holding company* in the "Glossary" section of the FFIEC's *Instructions for Preparation of Consolidated Reports of Condition and Income*, 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," of this guide discuss the regulatory capital requirements for banks and savings institutions and credit unions, respectively. Chapter 4, "Industry Overview—Mortgage Companies," of this guide 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 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 (Federal Reserve).

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, similar to credit unions. Savings institutions operating under the cooperative form are referred to as "mutual institutions." Although mutual institutions may be incorporated, they issue no capital stock and have no stockholders. The equity section of a mutual institution's statement of financial condition generally consists only of retained earnings and the accumulated other comprehensive income under FASB *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

Update 17-1 *Accounting and Reporting*: Recognition and Measurement of Financial Assets and Financial Liabilities

FASB Accounting Standards Update (ASU) No. 2016-01, *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*, issued in January 2016, is effective for fiscal years, and interim periods within those fiscal years, of a public business entity beginning after December 15, 2017.

For all other entities (including not-for-profit entities and employee benefit plans within the scope of FASB ASC 960, *Plan Accounting—Defined Benefit*

Pension Plans through FASB ASC 965, *Plan Accounting—Health and Welfare Benefit Plans*, on plan accounting), FASB ASU No. 2016-01 is effective for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. Early application is permitted for all other entities as of the fiscal years beginning after December 15, 2017, including interim periods within those fiscal years.

FASB ASU No. 2016-01 addresses certain aspects of recognition, measurement, presentation, and disclosure of financial instruments and affects all entities that hold financial assets or owe financial liabilities. Among other provisions of the guidance, the amendments in this ASU supersede the guidance to classify equity securities with readily determinable fair values into different categories (that is, trading or available-for-sale) and require equity securities (including other ownership interests, such as partnerships, unincorporated joint ventures, and limited liability companies) to be measured at fair value with changes in the fair value recognized through net income (other than equity securities accounted for under the equity method of accounting or those that result in consolidation of an investee).

The amendments in this ASU also require an entity to present separately in other comprehensive income the portion of the total change in fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments.

This edition of the guide has not been updated to reflect changes as a result of this ASU, however, this section will be updated in a future edition. Readers are encouraged to consult the full text of this ASU on FASB's website at www.fasb.org.

For more information on FASB ASU No. 2016-01, see appendix G, "Accounting for Financial Instruments," of this guide.

Update 17-2 *Accounting and Reporting*: Credit Losses

FASB ASU No. 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*, issued in June 2016, is effective for fiscal years of public business entities that are SEC filers beginning after December 15, 2019, including interim periods within those fiscal years.

For all other public business entities, the amendments in FASB ASU No. 2016-13 are effective for fiscal years beginning after December 15, 2020, including interim periods within those fiscal years.

For all other entities, including not-for-profit entities and employee benefit plans within the scope of FASB ASC 960 through FASB ASC 965 on plan accounting, FASB ASU No. 2016-13 is effective for fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021.

Early application is permitted for all entities as of the fiscal years beginning after December 15, 2018, *including* interim periods within those fiscal years.

FASB ASU No. 2016-13 creates FASB ASC 326, *Financial Instruments—Credit Losses*, to amend guidance on reporting credit losses for financial assets held at amortized cost basis and available-for-sale debt securities.

For financial assets held at amortized cost basis, FASB ASC 326 eliminates the probable initial recognition threshold in current U.S. generally accepted accounting principles (GAAP) and, instead, requires an entity to reflect its current estimate of all expected credit losses. The allowance for credit losses is a valuation account that is deducted from the amortized cost basis of the financial assets to present the net amount expected to be collected.

For available-for-sale debt securities, credit losses should be measured in a manner similar to current GAAP. However, FASB ASC 326 will require that credit losses be presented as an allowance rather than as a write-down.

FASB ASU No. 2016-13 affects entities holding financial assets and net investment in leases that are not accounted for at fair value through net income. The amendments affect loans, debt securities, trade receivables, net investments in leases, off-balance-sheet credit exposures, reinsurance receivables, and any other financial assets not excluded from the scope that have the contractual right to receive cash.

This edition of the guide has not been updated to reflect changes as a result of this ASU, however, this section will be updated in a future edition. Readers are encouraged to consult the full text of this ASU on FASB's website at www.fasb.org.

For more information on FASB ASU No. 2016-13, see appendix G of this guide.

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 presented separately from retained earnings and additional paid-in capital in a statement of financial position at the end of each accounting period.

17.09 In accordance with FASB ASC 220-10-45-10A, 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 item (c) in FASB ASC 815-20-35-1). 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 *Minority interest in consolidated subsidiaries*. A minority 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 minority interests in equity capital accounts (both common and noncumulative perpetual preferred stocks) of consolidated subsidiaries if the subsidiary is a depository institution or a foreign bank, unless such accounts would not otherwise qualify for inclusion in common equity tier 1 or tier 1 capital. For example, a bank may not include minority interests representing cumulative preferred stock in consolidated subsidiaries because such preferred stock, if issued directly by the bank, would not be eligible for inclusion in tier 1 capital. The amount of minority interest includable is limited if the subsidiary has equity in excess of the subsidiary's minimum capital requirements and the applicable capital conservation buffer. Minority 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 minority interest in a consolidated subsidiary is generally includable in common equity tier 1 or 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.* In accordance with FASB ASC 942-810-55-1, trust preferred securities (TPSs) have been issued by banks for a number of years due to favorable regulatory capital treatment. However, under current regulatory capital rules, TPSs no longer receive as favorable a capital treatment. See further discussion beginning in paragraph 17.20. FASB ASC 942-810-55-1 goes on to explain that 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 TPSs, 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 TPSs to the investors. The subordinated debentures have a stated maturity and may include an embedded call option. Most TPSs 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.

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[1] In 1988, the Basel Committee on Banking Supervision (Basel Committee) 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 (OCC), Board of Governors of the Federal Reserve System (Federal Reserve), and the FDIC published a final rule, *Risk-Based Capital Standards: Advanced Capital Adequacy Framework—Basel II; Establishment of a Risk-Based Capital Floor*. The final rule was effective July 28, 2011, and it amends (*a*) the advanced risk-based capital adequacy standards (advanced approaches rule) in a manner that is consistent with certain provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), and (*b*) 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.

In July 2013, the OCC, the Federal Reserve, and the FDIC issued the new regulatory capital rules that implement both the Basel III capital framework issued by the Basel Committee and certain requirements imposed by the Dodd-Frank Act. Readers can access the final U.S. Basel III rules from any of the agencies' websites.

In November 2015, the OCC, the Federal Reserve, and the FDIC issued guidance to clarify the interaction between the agencies' regulatory capital rule and Section 13 of the Bank Holding Company Act, also known as the Volcker rule, with respect to the appropriate capital treatment for investments in certain private equity funds and hedge funds (covered funds). Readers can access the guidance from any of the agencies' websites.

In March 2016, the OCC, the Federal Reserve, the FDIC, and the SEC issued a Frequently Asked Questions (FAQ) document to clarify the capital treatment of certain Collateralized Debt Obligations backed by Trust Preferred Securities (TruPS CDO) the Volcker rule. The Volcker rule permits a banking entity to retain its interest in a Qualifying TruPS CDO under Title 12 U.S. *Code of Federal Regulations* (CFR) Part 351.16 of the interagency interim final rule. Readers can access the FAQ from any of the agencies' websites.

17.13 The trust's dividend is financed by the trust through the purchase of the debentures.

17.14 In accordance with 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 TPSs*. On October 21, 1996, the Federal Reserve 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 FDIC, and the Office of Thrift Supervision (prior to its transfer of powers to the OCC, the FDIC, and the Federal Reserve).[2] 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 Federal Reserve issued *Risk-Based Capital Standards: Trust Preferred Securities and the Definition of Capital* (Title 12 U.S. *Code of Federal Regulations* [CFR] Parts 208 and 225 [Regulations H and Y]). This rule allows the continued limited inclusion of TPSs in the tier 1 capital of bank holding companies. Under this rule, TPSs and other restricted core capital elements are subject to stricter quantitative limits. Prior to the rule, the amount of TPSs, 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.

17.19 The requirement for TPSs to include a call option was eliminated and standards for the junior subordinated debt underlying TPSs eligible for tier 1 capital treatment were clarified. The rule also addressed supervisory concerns, competitive equity considerations, and the accounting for TPSs. The rule also strengthened the definition of regulatory capital by incorporating long

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[2] See chapter 1, "Industry Overview—Banks and Savings Institutions," of this guide for further discussion on the Office of Thrift Supervision transfer of powers.

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 were treated as tier 1 capital (subject to existing limitations, see paragraphs 17.17–.18) until January 2013. Then, the tier 1 capital treatment will be phased out over a 3-year period (see paragraph 17.21).
- 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 and savings and loan holding companies (holding companies with less than $1 billion in assets). See further discussion of small banking and savings and loan holding companies in paragraph 17.26.

17.21 In July 2013, the OCC, the Federal Reserve, and the FDIC issued the new regulatory capital rules. Among other provisions, the new rule improves the quality of capital by phasing out of tier 1 capital by 2016 instruments such as TPSs and cumulative preferred securities.[3] However, the new rule grandfathers the inclusion of these instruments in tier 1 capital, subject to limitations, for banking organizations that have consolidated assets of less than $15 billion as of December 31, 2009. Although new issuances from these institutions will have to meet new stricter criteria, these banking organizations may continue to include instruments issued prior to May 19, 2010, in tier 1 capital subject to current limitations.

17.22 *Mandatory redeemable preferred stock*. Banks may issue mandatorily redeemable preferred stock as part of their capital structure.

17.23 "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

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[3] Advanced approaches depository institution holding companies may include these instruments in tier 2 capital temporarily because the instruments are subject to the phase out schedule. All other depository institution holding companies may include these instruments in tier 2 capital permanently.

financial position.[4] See further discussion on distinguishing liabilities from equity in paragraph 15.41 of this guide.

17.24 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 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 SEC 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.

17.25 *Perpetual preferred stock issued to the U.S. Treasury.* On June 1, 2009, the Federal Reserve 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 Federal Reserve's risk-based and leverage capital guidelines for bank holding companies. The final rule became effective on July 1, 2009.

17.26 *Bank and savings and loan holding companies under $1 billion in assets*. The Federal Reserve adopted a Small Bank Holding Company Policy that provides flexibility for qualifying bank and savings and loan 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 and savings and loan holding companies regulated by the Federal Reserve. The bank and savings and loan holding company capital adequacy guidelines apply on a consolidated basis to bank and savings and loan holding companies with consolidated assets of $1 billion or more. For bank and savings and loan holding companies with less than $1 billion 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, conduct significant off-balance sheet activities, or the parent company has a significant amount of outstanding debt that is held by the general public.

17.27 *Foreign banking organizations with U.S. non-branch assets of $50 billion or more*. On February 17, 2014, the Federal Reserve adopted a final rule, which establishes a number of enhanced prudential standards for large U.S. bank holding companies and foreign banking organizations. These standards include liquidity, risk management, and capital. The final rule was required by section 165 of the Dodd-Frank Act. Foreign banking organizations with U.S. non-branch assets of $50 billion or more will be required to establish a U.S.

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[4] 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 SEC 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.

intermediate holding company over their U.S. subsidiaries. The foreign-owned U.S. intermediate holding company generally will be subject to the same risk-based and leverage capital standards applicable to U.S. bank holding companies. The intermediate holding companies also will be subject to the Federal Reserve's rules requiring regular capital plans and stress tests. Although the final rule became effective June 1, 2014, the initial compliance date for foreign banking organizations is July 1, 2016 and generally defers application of the leverage ratio to foreign-owned U.S. intermediate holding companies until 2018.

Disclosures for Banks and Savings Institutions

17.28 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 (PCA) 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 PCA 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.

17.29 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

17.30 In accordance with 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.

17.31 For "adequately capitalized" or "undercapitalized" institutions, the disclosure in item *c* in paragraph 17.28 should present the minimum amounts and ratios the institution must have to be categorized as *adequately capitalized* under the PCA 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. 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 FASB ASC 942-505-50-1(c) (see item *c* in paragraph 17.28) about whether the institution is in compliance.

17.32 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 PCA provisions, or (*c*) both, the possible material effects of such conditions and events on amounts and disclosures in the financial statements should be disclosed.

17.33 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 PCA 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.

17.34 If, after considering management's plans, substantial doubt about an entity's ability to continue as a going concern is alleviated as a result of consideration of management's plans, "Pending Content" in FASB ASC 205-40-50-12 states that an entity should disclose in the footnotes information that enables users of the financial statements to understand all of the following (or refer to similar information disclosed elsewhere in the footnotes):

- Principal conditions or events that raised substantial doubt about the entity's ability to continue as a going concern (before consideration of management's plans)
- Management's evaluation of the significance of those conditions or events in relation to the entity's ability to meet its obligations
- Management's plans that alleviated substantial doubt about the entity's ability to continue as a going concern

17.35 If, after considering management's plans, substantial doubt about an entity's ability to continue as a going concern is not alleviated, "Pending Content" in FASB ASC 205-40-50-13 states that an entity should include a statement in the footnotes indicating that there is substantial doubt about the entity's ability to continue as a going concern within one year after the date that the financial statements are issued. Additionally, the entity should disclose information that enables users of the financial statements to understand all of the following:

- Principal conditions or events that raised substantial doubt about the entity's ability to continue as a going concern
- Management's evaluation of the significance of those conditions or events in relation to the entity's ability to meet its obligations
- Management's plans that are intended to mitigate the conditions or events that raise substantial doubt about the entity's ability to continue as a going concern

17.36 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:

- Possible effects of such 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 discontinuance of operations; and
- Information about the recoverability or classification of recorded asset amounts or the amounts or classification of liabilities.

17.37 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 notes to the financial statements.

Disclosure for Holding Companies

17.38 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 PCA disclosure required by item (d) in FASB ASC 942-505-50-1. 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 PCA provisions of the FDI Act.

17.39 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 Federal Reserve 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 Federal Reserve 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 Federal Reserve's Bank Holding Company Supervision Manual provide additional guidance.

17.40 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)

17.41 *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 PCA 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, Tier 1 and common equity Tier 1 capital (as defined) to risk-weighted assets (as defined) and of Tier 1 capital (as defined) to average assets (as defined).[5] 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, common equity Tier 1 risk-based capital, and Tier 1 leverage ratios as set forth in the table.[6] There are no conditions or events since that notification that management believes have changed the institution's category.

17.42 *Adequately capitalized.* Following is an illustrative paragraph to be added to the disclosures illustrated in paragraph 17.41 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*].

17.43 *Undercapitalized.* Following are illustrative paragraphs to be added to the disclosures illustrated in paragraphs 17.41–.42 when an institution

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[5] See paragraph 17.31.

[6] Paragraphs 1.75–.85 of this guide describe the prompt corrective action (PCA) ratios. For some institutions, the calculation of required amounts and ratios under the PCA framework may differ from calculations under the capital adequacy requirements. The disclosure should provide the relevant amounts and ratios accordingly.

considers itself *undercapitalized*, *significantly undercapitalized*, or *critically undercapitalized*. For a discussion about the auditor's consideration of noncompliance, see discussion beginning in paragraph 5.212 of this guide.

> 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*.]

17.44 *Advanced approaches banks and savings institutions.* Following is an illustrative table for presentation in financial statements for an advanced approaches bank or 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, 2]		*To Be Well Capitalized Under Prompt Corrective Action Provisions*	
	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 (to Risk Weighted Assets)	$X,XXX,XXX	X.X%	$X,XXX,XXX	6.0%	$X,XXX,XXX	8.0%
Common Equity Tier 1 Capital (to Risk Weighted Assets)	$X,XXX,XXX	X.X%	$X,XXX,XXX	4.5%	$X,XXX,XXX	6.5%
Tier 1 Capital (to Average Assets)	$X,XXX,XXX	X.X%	$X,XXX,XXX	4.0%	$X,XXX,XXX	5.0%
Tier 1 Capital (to Total Leverage Exposure)	$X,XXX,XXX	X.X%	$X,XXX,XXX	[3]	[3]	[3]

[1] See paragraph 17.31.

[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] Advanced approaches banking organizations are required to calculate and report their minimum supplementary leverage ratio as of January 1, 2015, but they do no need to comply with the minimum capital adequacy requirements until January 1, 2018.

17.45 *Banks and savings institutions not subject to advanced approaches regulations.* Following is an illustrative table for presentation in financial statements for a bank or saving 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, 2]		*To Be Well Capitalized Under Prompt Corrective Action Provisions*	
	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 (to Risk Weighted Assets)	$X,XXX,XXX	X.X%	$X,XXX,XXX	6.0%	$X,XXX,XXX	8.0%
Common Equity Tier 1 Capital (to Risk Weighted Assets)	$X,XXX,XXX	X.X%	$X,XXX,XXX	4.5%	$X,XXX,XXX	6.5%
Tier 1 Capital (to Average Assets)	$X,XXX,XXX	X.X%	$X,XXX,XXX	4.0%	$X,XXX,XXX	5.0%

[1] See paragraph 17.31.

[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.

17.46 *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.[7] 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 item (d) disclosures in FASB ASC 942-505-50-1 related to PCA.

	Actual		*For Capital Adequacy Purposes* [1, 2]		*To Be Well Capitalized Under Prompt Corrective Action Provisions*	
	Amount	*Ratio*	*Amount*	*Ratio*	*Amount*	*Ratio*
Total Capital (to Risk Weighted Assets):						
Consolidated	**$X,XXX,XXX**	**X.X%**	**$X,XXX,XXX**	**X.X%**	**N/A**	
Subsidiary Bank A	$X,XXX,XXX	X.X%	$X,XXX,XXX	X.X%	$X,XXX,XXX	X.X%
Subsidiary Bank B	$X,XXX,XXX	X.X%	$X,XXX,XXX	X.X%	$X,XXX,XXX	X.X%
Subsidiary Bank C	$X,XXX,XXX	X.X%	$X,XXX,XXX	X.X%	$X,XXX,XXX	X.X%
Tier 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%

(continued)

[7] Bank holding companies subject to the advanced approaches rule are required to calculate and report their minimum supplementary leverage ratio, but they do not need to comply with the requirement until January 1, 2018 (see Update 17-3).

	Actual		For Capital Adequacy Purposes [1, 2]		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	*Ratio*	*Amount*	*Ratio*	*Amount*	*Ratio*
Common Equity 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%	$X,XXX,XXX	X.X%
Tier 1 Capital (to Average Assets):						
Consolidated	**$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 paragraph 17.31.

[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.

Update 17-3 *Regulatory*: Regulatory Capital Rules

The regulatory final rule *Regulatory Capital Rules: Regulatory Capital, Enhanced Supplementary Leverage Ratio Standards for Certain Bank Holding Companies and Their Subsidiary Insured Depository Institutions*, issued by the Federal Reserve, the OCC, and the FDIC in April 2014, will become effective on January 1, 2018. Banking organizations subject to the requirements were required to calculate and publicly disclose the ratio beginning January 1, 2015.

The final regulatory rule strengthens the agencies' supplementary leverage ratio standards for large, interconnected U.S. banking organizations and is applicable to any U.S. top-tier bank holding company with more than $700 billion in total consolidated assets or more than $10 trillion in assets under custody and any insured depository institution subsidiary of these bank holding companies. The final rule establishes enhanced supplementary leverage ratio standards for covered bank holding companies and their subsidiary insured depository institutions. Among other provisions of the final rule, an insured depository institution that is a subsidiary of a covered Bank Holding Company (BHC) must maintain a supplementary leverage ratio of at least 6 percent to be well capitalized under the agencies' PCA framework.

Readers are encouraged to consult the full text of this final rule at any of the respective agencies' websites.

Credit Unions

Update 17-4 *Regulatory*: Risk-Based Capital

The National Credit Union Administration (NCUA) regulatory final rule *Risk-Based Capital*, issued in October 2015, is effective on January 1, 2019 for federally insured, natural person credit unions with assets over $100 million.

The final regulation restructures the NCUA's PCA regulations and makes various revisions, including amending the agency's current risk-based net worth requirement (RBNWR) by replacing it with a new risk-based capital ratio for federally insured natural person credit unions. The risk-based capital requirement set forth in the final rule is more consistent with the NCUA's risk-based capital measure for corporate credit unions and, as the law requires, more comparable to the regulatory risk-based capital measures used by the FDIC, the Federal Reserve, and the OCC.

The final rule also eliminates several provisions in the NCUA's current PCA regulations, including provisions relating to regular reserve accounts, risk-mitigation credits, and alternative risk-weights.

This edition of the guide has not been updated to reflect changes as a result of this final ruling, however, this section will be updated in a future edition. Readers are encouraged to consult the full text of this regulation on NCUA's website at www.ncua.gov.

Introduction

17.47 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, GAAP requires other items to be classified as equity. As 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

17.48 *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 a restriction on undivided earnings. At one time, the regular (or statutory) reserve was used to record charged-off loans and its funding was based on a periodic (typically quarterly) charge to undivided earnings and a credit to the reserve account. For federal credit unions, the amount currently required to be transferred, if any, is defined in Sections 702.201 and 702.303 of the NCUA regulations. The PCA rules describe the mandatory and discretionary PCAs 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 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 RBNWR, 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*.

17.49 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.

17.50 *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 or appropriated undivided earnings.

17.51 *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.

17.52 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.

17.53 *Other components of equity.* 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).

17.54 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 presented 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 220-10-45-10A and paragraph 17.09 for examples of items required to be reported as other comprehensive income.

New Credit Unions and Low Income Designated Credit Unions

17.55 The PCA 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).[8]

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[8] PCA regulations can be found at 12 CFR 702.301–.307. Additional regulations for "low-income" credit unions can be found at 12 CFR 701.34.

Disclosures for Natural Person Credit Unions

17.56 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 notes to financial statements:

- *a*. A description of regulatory capital requirements (*a*) for capital adequacy purposes and (*b*) for PCA
- *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 PCA 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 PCA category

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.

17.57 The institution should consider also making such disclosures, as discussed in the preceding paragraph, when the institution's actual ratio is nearing noncompliance.

17.58 See paragraphs 17.34–.35 for required going concern disclosure guidance. 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:

- Possible effects of such 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 discontinuance of operations
- Information about the recoverability or classification of recorded asset amounts or the amounts or classification of liabilities.

17.59 Disclosures should also be presented for any state-imposed capital requirements that are more stringent than or significantly different from federal requirements, in accordance with FASB ASC 942-505-50-2.

17.60 The NCUA board adopted PCA 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 PCA rule, the NCUA board also issued a rule, which defines a *complex* credit union and establishes RBNWRs. Readers should refer to the NCUA regulations for the risk-based net worth and PCA requirements.

Illustrative Disclosures for Natural Person Credit Unions

17.61 *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 PCA 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 guidelines and the regulatory framework for prompt corrective action, the Credit Union must meet specific capital guidelines that involve quantitative measures of the Credit Union's assets, liabilities, and certain off-balance-sheet items as calculated under U.S. GAAP, regulatory reporting requirements, and regulatory capital standards. 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.
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> Quantitative measures established by regulatory capital standards 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.
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> 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.[9] There are no conditions or events since

[9] Paragraphs 2.28–.42 of this guide describe the PCA net worth ratios for natural person credit unions. For some institutions, the calculation of required amounts and net worth ratios under the PCA framework may differ from calculations under the capital adequacy requirements. The disclosure should provide the relevant amounts and ratios accordingly.

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.

17.62 *Adequately capitalized.* Following is an illustrative paragraph to be added in place of the third illustrative paragraph in paragraph 17.61 for an institution that is in compliance with capital adequacy requirements and considers itself *adequately capitalized* under the PCA framework:

As of December 31, 200X, and December 31, 200W, the most recent call reporting period, the NCUA categorized the Credit Union as *adequately capitalized* under the regulatory framework for prompt corrective action. To be categorized as *adequately capitalized* the Credit Union must maintain a minimum net worth ratio of 6 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.[10] 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.

17.63 *Undercapitalized.* Following are illustrative paragraphs to be added to the disclosures illustrated in paragraph 17.61 when a credit union considers itself *undercapitalized*, *significantly undercapitalized*, or *critically undercapitalized* [for existing credit unions].

[10] For some institutions, the calculation of required amounts and net worth ratios under the PCA framework may differ from calculations under the capital adequacy requirements. The disclosure should provide the relevant amounts and ratios accordingly.

> 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 has a net worth restoration plan that has been filed 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 provisions of the plan and all the regulatory net worth requirements by December 31, 200Y (or earlier if stated in the restoration plan). [*The disclosure should continue with discussion of any discretionary actions required by the NCUA*.]

17.64 *New credit unions.* Following are illustrative paragraphs to be added to the disclosures illustrated in paragraph 17.61 when a new credit union considers itself *moderately capitalized*, *marginally capitalized*, *minimally capitalized*, or *uncapitalized*.

> 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 provisions of the plan and all the regulatory net worth requirements by December 31, 200Y (or earlier if stated in the revised business plan). [*The disclosure should continue with discussion of any discretionary actions required by the NCUA*.]

Corporate Credit Unions

Introduction

17.65 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, GAAP requires other items to be classified as equity.[11] As 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

17.66 *Nonperpetual capital.*[12] Corporate credit unions are different from natural person credit unions in that they have specific nonperpetual capital accounts (NCAs). NCAs, as defined in 12 CFR 704.2, are funds contributed by

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[11] See paragraph 17.52.

[12] 12 CFR 704.3(f) addresses membership capital accounts that qualified as corporate capital prior to October 21, 2011, but which no longer satisfy the definitions of capital because the accounts were not converted by the member to nonperpetual capital accounts or perpetual contributed capital.

members or nonmembers that (*a*) are term certificates with an original minimum term of five years or that have an indefinite term (that is, no maturity) with a minimum withdrawal notice of five years, (*b*) are available to cover losses that exceed retained earnings and perpetual contributed capital (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. In the event the corporate credit union is liquidated, the holders of NCAs will claim equally. These claims will be subordinate to all other claims (including NCUSIF claims), except that any claims by the holders of PCC will be subordinate to the claims of holders of NCAs.

17.67 *PCC.* PCC, as defined in 12 CFR 704.2, means accounts or other interests of a corporate credit union that are perpetual, noncumulative dividend accounts; are available to cover losses that exceed retained earnings; are not insured by the NCUSIF or other share or deposit insurers; and cannot be pledged against borrowings. In the event the corporate is liquidated, any claims made by the holders of PCC will be subordinate to all other claims (including NCUSIF claims). These funds are callable only if the corporate credit union meets its minimum required capital and net economic value ratios after the funds are called and only with the prior approval of the NCUA and, for state chartered corporate credit unions, the applicable state regulator. They are callable on a pro-rata basis across an issuance class.[13] A corporate credit union may issue PCC to both members and nonmembers.[14,15]

17.68 *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 entities. Corporate credit unions must maintain at all times (*a*) a leverage ratio[16] of 4.0 percent or greater; (*b*) a tier 1 risk-based capital ratio[17] of 4.0 percent or greater; and (*c*) a total risk-based capital ratio[18] of 8.0 percent or greater. To ensure it meets its capital requirements, a corporate credit union must develop and ensure implementation of written short and long term capital goals, objectives, and strategies that provide for the building of capital consistent with regulatory requirements, the maintenance of sufficient capital to support the risk exposures that may arise from current and projected activities, and the periodic review and reassessment of the capital position of the corporate credit union.[19]

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[13] See 12 CFR 704.3(c)(3).

[14] See 12 CFR 704.3(c)(4).

[15] Auditors may need to be familiar with Part 704, "Corporate Credit Unions" of the National Credit Union Administration (NCUA) regulations to help assess the propriety and adequacy of financial statement disclosures.

[16] *Leverage ratio*, as defined in 12 CFR 704.2, means the ratio of tier 1 capital to moving daily average net assets. The *moving daily average net assets*, as defined in 12 CFR 704.2, means the average of daily average net assets for the month being measured and the previous 11 months.

[17] *Tier 1 risk-based capital ratio*, as defined in 12 CFR 704.2, means the ratio of tier 1 capital to the moving monthly average net risk-weighted assets. The *moving monthly average net risk-weighted assets*, as defined in 12 CFR 704.2, means the average of the net risk-weighted assets for the month being measured and the previous 11 months. Measurements must be taken on the last day of each month.

[18] *Total risk-based capital ratio*, as defined in 12 CFR 704.2, means the ratio of total capital to moving monthly average net risk-weighted assets.

[19] See 12 CFR 704.3(a).

17.69 When significant circumstances or events warrant, 12 CFR 704.3(d) notes that the NCUA may establish increased minimum capital requirements, including modification of the minimum capital requirements related to being either significantly and critically undercapitalized for purposes of 12 CFR 704.4, upon a determination that the corporate credit union's capital is or may become inadequate in view of the credit union's circumstances. Examples of when higher capital levels may be appropriate can be found in 12 CFR 704.3(d)(2).

17.70 *Other components of equity.* 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 presented 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 220-10-45-10A and paragraph 17.09 for examples of items required to be reported as other comprehensive income.

Disclosures for Corporate Credit Unions

17.72 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 PCA

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 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 PCA 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 PCA category

17.73 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. See paragraphs 17.34–.35 for required going concern disclosure guidance.

17.74 Disclosures should also be presented for any state-imposed capital requirements that are more stringent than or significantly differ from federal requirements, in accordance with FASB ASC 942-505-50-2.

17.75 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:

- Possible effects of such 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 discontinuance of operations
- Information about the recoverability or classification of recorded asset amounts or the amounts or classification of liabilities

17.76 Effective October 20, 2011, the NCUA adopted PCA requirements for corporate credit unions. The purpose of 12 CFR 704.4 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 the submission and review of capital restoration plans and the issuance and review of capital directives, orders, and other supervisory directives.

Illustrative Disclosures for Corporate Credit Unions

17.77 *Well capitalized.* The example disclosures that follow are for illustrative purposes only. Following is an illustrative disclosure for a corporate credit union that is in compliance with capital adequacy requirements and is considered *well capitalized* under the PCA framework. 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 mandatory—and possibly additional discretionary—actions by regulators that, if undertaken, could have a direct material effect on the Corporate Credit Union's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Corporate Credit Union must meet specific capital guidelines that involve quantitative measures of the Corporate Credit Union's assets, liabilities, and certain off-balance-sheet items as calculated under regulatory reporting requirements. The Credit Union's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.
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> Quantitative measures established by regulatory capital standards to ensure capital adequacy require the Corporate Credit Union to maintain minimum amounts and ratios (set forth in the following table) of total and Tier 1 capital (as defined) to moving monthly average net risk-weighted assets (as defined) and total capital to moving daily average net assets (as defined). Management believes, as of December 31, 200X, that the Corporate 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 Corporate Credit Union as [*well capitalized*] under the regulatory framework for prompt corrective action. To be categorized as [*well capitalized*] the Corporate Credit Union must maintain a minimum total risk-based, Tier 1 risk-based, and leverage ratios as set forth in the table.[20] There are no conditions or events since that notification that management believes have changed the Corporate Credit Union's category.

The Corporate 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*
Total Capital (to Moving Monthly Average Net Risk-Weighted Assets)	$X,XXX,XXX	X.X%	$X,XXX,XXX	8.0%	$X,XXX,XXX	10.0%
Tier 1 Risk-Based Capital (to Moving Monthly Average Net Risk-Weighted Assets)	$X,XXX,XXX	X.X%	$X,XXX,XXX	4.0%	$X,XXX,XXX	6.0%
Total Capital (to Moving Daily Average Net Assets)	$X,XXX,XXX	X.X%	$X,XXX,XXX	4.0%	$X,XXX,XXX	5.0%

[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.

17.78 *Adequately capitalized.* The following is an illustrative paragraph to be added in place of the third illustrative paragraph in paragraph 17.77 for a corporate credit union that is in compliance with capital adequacy requirements and is considered *adequately capitalized* under the PCA framework.

As of December 31, 200X, the most recent call reporting period, the NCUA categorized the Corporate Credit Union as [*adequately capitalized*] under the regulatory framework for prompt corrective action. To be categorized as [*adequately capitalized*] the Corporate Credit Union must maintain a minimum total risk-based, Tier 1 risk-based, and leverage ratios as set forth in the table.[21] There are no conditions or events since that notification that management believes have changed the Corporate Credit Union's category.

17.79 *Undercapitalized.* The following is an illustrative paragraph to be added to the disclosures illustrated in paragraph 17.77 when a corporate credit union is considered *undercapitalized*, *significantly undercapitalized*, or *critically undercapitalized*.

The Corporate Credit Union may not increase its daily average net assets during any calendar month to exceed its moving daily

[20] Paragraphs 2.49–.50 of this guide describe the PCA ratios for corporate credit unions.

[21] See footnote 20.

average net assets.[22] In addition, the Corporate Credit Union is prohibited from making any capital distribution, including payment of dividends on perpetual and nonperpetual capital accounts while the Corporate Credit Union is undercapitalized. [*Describe the possible effects of these restrictions.*] Also, as required by the framework, the Corporate Credit Union has a capital restoration plan that has been filed and accepted by the NCUA. The plan outlines the Corporate Credit Union's steps for attaining the required levels of regulatory capital. Management believes, at this time, that the Corporate Credit Union 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 any discretionary actions required by the NCUA.*]

Mortgage Companies and Mortgage Banking Activities

Introduction

17.80 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 of this guide. 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

17.81 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

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[22] The asset growth restriction may be waived if the NCUA has accepted the corporate credit union's capital restoration plan and an increase in total assets is consistent with that plan.

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

17.82 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. See paragraphs 17.34–.35 for required going concern disclosure guidance. 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

- possible effects of such 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 discontinuance of operations.
- information about the recoverability or classification of recorded asset amounts or the amounts or classification of liabilities.

17.83 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 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

17.84 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

17.85 The disclosure requirements related to capital adequacy and PCA do not apply to branches of foreign organizations because such branches do not have capital. See discussion of enhanced prudential standards for foreign banking organizations discussed in paragraph 17.27.

17.86 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

17.87 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.

17.88 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[23]

Banks, Savings Institutions, and Credit Unions

Objectives

17.89 In addition to testing of disclosures, as discussed subsequently, the auditor should consider the implications of capital noncompliance, as discussed in chapter 5, "Audit Considerations and Certain Financial Reporting Matters," and chapter 23, "Reporting Considerations," of this guide.

17.90 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.[24] Capital amounts are determined under GAAP, regulatory reporting requirements, and regulatory capital standards.

17.91 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 accordance 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

17.92 In accordance with AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), the objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and relevant assertion levels through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material

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[23] The auditing content in this guide focuses primarily on generally accepted auditing standards issued by the Auditing Standards Board and is applicable to audits of the financial statements of those entities not subject to the oversight authority of the PCAOB (that is, those audit reports not within the PCAOB's jurisdiction as defined by the Sarbanes-Oxley Act of 2002, as amended—hereinafter referred to as *nonissuers*). However, considerations for audits of entities subject to the oversight authority of the PCAOB (that is, those audit reports within the PCAOB's jurisdiction as defined by the Sarbanes-Oxley Act of 2002, as amended) may be discussed within this guide's chapter text. When such discussion is provided, the related paragraphs are designated with the following title: *Considerations for Audits Performed in Accordance With PCAOB Standards*.

[24] 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.

misstatement (see chapter 5 of this guide for additional information). In complying with the requirements of AU-C section 315, auditors should obtain an understanding of capital regulations sufficient to understand application and classification decisions made by management. In addition, the auditor should obtain audit evidence about the changes in regulatory reporting instructions and related capital requirements since the preceding audit. AU-C section 500, *Audit Evidence* (AICPA, *Professional Standards*), explains what constitutes audit evidence in an audit of financial statements and addresses the auditor's responsibility to design and perform audit procedures to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion (further discussion on AU-C section 500 can be found in chapter 5 of this guide).

17.93 Paragraphs 5.223–.228 of this guide discuss the auditor's responsibility relative to review of supervisory reports and coordination with examiners.

17.94 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 GAAP in greater detail, (*b*) GAAP equity amounts adjusted in calculating regulatory capital amounts (for example, tier 1 capital and tier 2 capital), and (*c*) 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 (including consideration of the relative risk weightings assigned to certain amounts or transactions).

17.95 As a part of understanding the entity and its environment, paragraph .12 of AU-C section 315 states that the auditor should obtain an understanding of relevant industry, regulatory, and other external factors, including the applicable financial reporting framework. 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 GAAP and regulatory capital amounts affecting the institution also will affect inherent risk in this area.

17.96 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.

17.97 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

17.98 AU-C section 315 addresses the auditor's responsibility to identify and assess the risks of material misstatement in the financial statements through understanding the entity and its environment, including the entity's internal control. Paragraphs .13–.14 of AU-C section 315 state that the auditor should obtain an understanding of internal control relevant to the audit and, in doing so, should evaluate the design of those controls and determine whether they have been implemented by performing procedures in addition to inquiry of the entity's personnel. (See chapter 5 of this guide for further discussion of the components of internal control.) To provide a basis for designing and performing further audit procedures, paragraph .26 of AU-C section 315 states that the auditor should identify and assess the risks of material misstatement at the financial statement level and the relevant assertion level for classes of transactions, account balances, and disclosures.

17.99 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 periodically by the internal audit function.

Substantive Procedures

17.100 Irrespective of the assessed risks of material misstatement, paragraph .18 of AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*), states that 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 .A45 of AU-C section 330, this requirement reflects the facts that (*a*) the auditor's assessment of risk is judgmental and may not identify all risks of material misstatement and (*b*) inherent limitations to internal control exist, including management override.

17.101 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 GAAP as applied in the financial statements versus GAAP as applied in regulatory reports (if management chose to use an option available under GAAP for financial statement purposes that is different than the regulatory interpretation of 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.

17.102 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 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.

17.103 Paragraphs 5.223–.228 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.

17.104 Paragraphs .A46–.A50 of AU-C section 330 provide additional guidance on the nature and extent of substantive procedures. Depending on the circumstances, the auditor may determine that performing only substantive analytical procedures will be sufficient to reduce audit risk to an acceptably low level (for example, when the auditor's assessment of risk is supported by audit evidence from tests of controls), only tests of details are appropriate, or a combination of substantive analytical procedures and tests of details are most responsible to the assessed risks. Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. The nature of the risk and assertion is relevant to the design of tests of details.

17.105 Substantive audit 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 GAAP as applied in the financial statements versus GAAP as applied in regulatory reports (if management chose to use an option available under GAAP for financial statement purposes that is different than the regulatory interpretation of 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 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 GAAP:
  - — Test management's supporting schedules and reconciliations for completeness and mathematical accuracy.
  - — Agree GAAP amounts to general or subsidiary ledgers, or both, and obtain supporting schedules for non-GAAP amounts.
- Review the nature and amount of material non-GAAP amounts for propriety and consistency with prior years.
- Consider current treatment of items that resulted in past corrections or changes to regulatory financial reports.
- Consider whether significant changes in instructions for preparation of Call Reports have been applied to material transactions.
- Inquire about, and discuss with officers having responsibility for call reporting, any significant reclassification of transactions since the last filed regulatory report.

Mortgage Companies and Activities

Objectives

17.106 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

17.107 In accordance with paragraph .A1 of AU-C section 300, *Planning an Audit* (AICPA, *Professional Standards*), the nature and extent of planning activities will vary according to the size and complexity of the entity, the key engagement team members' previous experience with the entity, and changes in circumstances that occur during the audit engagement. Paragraphs .09–.10 of AU-C section 210, *Terms of Engagement* (AICPA, *Professional Standards*), state that the auditor should agree upon the terms of the audit engagement with management or those charged with governance, as appropriate. The agreed-upon terms of the audit engagement should be documented in an audit engagement letter or other suitable form of written agreement (see paragraph .10 of AU-C section 210 for a listing of agreed-upon terms that should be included). Both management and the auditor have an interest in documenting the agreed-upon terms of the audit engagement before the commencement of the audit to help avoid misunderstandings with respect to the audit as stated in paragraph .A22 of AU-C section 210. 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 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.

17.108 In accordance with paragraph .12 of AU-C section 315, the auditor should obtain an understanding of the entity's objectives and strategies and those related business risks that may result in risks of material misstatement. For purposes of generally accepted auditing standards, business risks are defined as risks resulting 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 from the setting of inappropriate objectives and strategies.

17.109 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

17.110 In accordance with paragraph .08 of AU-C section 330, the auditor should design and perform tests of controls to obtain sufficient appropriate audit evidence about the operating effectiveness of relevant controls if (*a*) the auditor's assessment of risks of material misstatement at the relevant assertion level includes an expectation that the controls are operating effectively or (*b*) substantive procedures alone cannot provide sufficient appropriate audit evidence at the relevant assertion level.

17.111 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

17.112 Irrespective of the assessed risks of material misstatement, paragraph .18 of AU-C section 330 states that the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure.

17.113 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.

17.114 Paragraphs .A46–.A50 of AU-C section 330 provide additional guidance on the nature and extent of substantive procedures. Depending on the circumstances, the auditor may determine that performing only substantive analytical procedures will be sufficient to reduce audit risk to an acceptably low level (for example, when the auditor's assessment of risk is supported by audit evidence from tests of controls), only tests of details are appropriate, or a combination of substantive analytical procedures and tests of details are most responsible to the assessed risks. Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. The nature of the risk and assertion is relevant to the design of tests of details.

17.115 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 accordance with GAAP
- Test management's supporting schedules and reconciliations for completeness and mathematical accuracy
- Agree GAAP amounts to general or subsidiary ledgers, or both

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 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, forwards, swaps, 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 nature of the 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 The AICPA Audit Guide *Special Considerations in Auditing Financial Instruments* provides background information about financial instruments and discussion of audit considerations relating to financial instruments.

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 other types of financial instruments. However, derivatives have unique risks because derivative transactions are designed to create price exposure, and thereby transfer risk, by having their value determined—or derived—from the value of an underlying commodity, security, index, rate, or event. Unlike other financial instruments, derivatives generally do not involve the transfer of a title or principle, require little or no considerations to be exchanged at inception, and as such can be thought of as creating pure price exposure by linking their value to a notional amount (that is, principle of the underlying item). These characteristics give rise to potential risks and rewards substantially greater than the amounts recognized in the statement of financial position. Also, many derivatives are less liquid and have values that 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 *Counterparty credit risk* of derivative instruments is the risk that the counterparty to a transaction could default or deteriorate in creditworthiness before the final settlement of a transaction's cash flows. Counterparty credit risk creates a bilateral risk of loss because the market value of a transaction can be positive or negative to either counterparty. For example, if a derivative instrument is in an unrealized gain position to the holder, and the counterparty enters bankruptcy, it is unlikely that the holder would be able to collect the unrealized value of the derivative from the bankrupt counterparty. Conversely, if the derivative instrument is in an unrealized loss position to the holder and the holder experienced financial difficulties, it is possible that the counterparty 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 fair value of an identical contract. Master netting agreements and collateral maintenance provisions are some of the ways that financial institutions and other derivative counterparties seek to reduce counterparty credit risk. Requirements that participants settle or collateralize changes in the value of their positions can mitigate the credit risk associated with many derivatives. Such settlement or collateralization requirements, which are typically based on the change in the value of a position, or group of positions, may occur daily or when the change exceeds a threshold, as governed by the rules of the exchange (for exchange traded derivatives) or through credit support annex agreements of each party's 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) derivative contracts (that is, nonexchange-traded derivatives). 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 *Concentration risk* broadly defines the sensitivity of the entity to an excessive concentration of exposure to specific counterparties, industry sectors, geographical locations, or individual transactions; the concept also extends to the degree of anticipated positive correlation in the behavior of such variables under stressed economic conditions.

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 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 instance, from unauthorized trading in derivative instruments or in an institution's failing to understand a contract's economic characteristics, all of which could impact published financial information or compliance with applicable contracts, laws, or regulations. Failure to understand the 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 an underlying, such as 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
- *c.* The occurrence or nonoccurrence of a specified event

18.16 Derivatives can generally be described as either *forward-based* or *option-based* or combinations of the two. A traditional forward contract obligates one party to buy and another 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 traded 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.

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 specified 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 until a specified future date (the settlement date). The assumed deposit is also known as a notional amount. The term of the assumed deposit may begin at a future 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 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 many 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. Many swap contracts are not exchange-traded; however, certain types of interest rate, currency, and credit default swaps are required to be executed on an exchange or swap execution facility and settled through a clearinghouse. These execution and clearing requirements are the result of regulations and are applicable depending on the nature and size of the parties in the transaction. OTC swaps are generally tailored to the needs of the parties and thus often have unique terms; accordingly, they are not as liquid as futures contracts and may lack the credit 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.

18.26 *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. In such instances, an institution may cancel contracts, sell its position, or enter an offsetting swap contract.

18.29 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.

18.30 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.

18.31 *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.

18.32 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.

18.33 *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.

18.34 *Equity swaps*, also known as *total return 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.

18.35 The equity payer, on a floating-rate equity swap contract, typically receives LIBOR (plus or minus a 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.

18.36 *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.

18.37 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.

18.38 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 fair value as determined by the dealer.

18.39 *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.

18.40 *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.

18.41 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.

18.42 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.

18.43 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.

18.44 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 (an option to enter a swap).

18.45 *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 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.

18.46 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.

18.47 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.

18.48 *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 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.

18.49 *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.

18.50 *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.

18.51 Various contracts may need to be evaluated as possible derivatives including warrants, the embedded conversion feature in convertible debt or convertible preferred stock, 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. FASB ASC 815 requires bifurcation (separation) of embedded derivatives from host contracts if (*a*) the economic characteristics and risks of the embedded derivative are not clearly and closely related to those of the host, (*b*) a separate instrument with the same terms as the embedded derivative would be a derivative instrument subject to the requirements of FASB ASC 815-15, and (*c*) the hybrid instrument is not currently measured at fair value through profit or loss. For additional information on the scope of embedded derivatives guidance and evaluating embedded derivatives for bifurcation, see FASB ASC 815-15-15 and FASB ASC 815-15-25, respectively.[1]

18.52 *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)

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[1] FASB Accounting Standards Update (ASU) No. 2014-16, *Derivatives and Hedging (Topic 815): Determining Whether the Host Contract in a Hybrid Financial Instrument Issued in the Form of a Share Is More Akin to Debt or to Equity (a consensus of the FASB Emerging Issues Task Force)*, eliminates the use of different methods in practice and thereby reduces existing diversity under U.S. generally accepted accounting principles (GAAP) in the accounting for hybrid financial instruments issued in the form of a share. The amendments in this ASU do not change the current criteria in GAAP for determining when separation of certain embedded derivative features in a hybrid financial instrument is required. That is, an entity will continue to evaluate whether the economic characteristics and risks of the embedded derivative feature are clearly and closely related to those of the host contract, among other relevant criteria. The amendments clarify how current GAAP should be interpreted in evaluating the economic characteristics and risks of a host contract in a hybrid financial instrument that is issued in the form of a share. Specifically, the amendments clarify that an entity should consider all relevant terms and features—including the embedded derivative feature being evaluated for bifurcation—in evaluating the nature of the host contract. Furthermore, the amendments clarify that no single term or feature would necessarily determine the economic characteristics and risks of the host contract. Rather, the nature of the host contract depends upon the economic characteristics and risks of the entire hybrid financial instrument.

In addition, the amendments in this ASU clarify that, in evaluating the nature of a host contract, an entity should assess the substance of the relevant terms and features (that is, the relative strength of the debt-like or equity-like terms and features given the facts and circumstances) when considering how to weight those terms and features. Specifically, the assessment of the substance of the relevant terms and features should incorporate a consideration of (1) the characteristics of the terms and features themselves (for example, contingent versus noncontingent, in-the-money versus out-of-the-money), (2) the circumstances under which the hybrid financial instrument was issued or acquired (for example, issuer-specific characteristics, such as whether the issuer is thinly capitalized or profitable and well-capitalized), and (3) the potential outcomes of the hybrid financial instrument (for example, the instrument may be settled by the issuer issuing a fixed number of shares, the instrument may be settled by the issuer transferring a specified amount of cash, or the instrument may remain legal-form equity), as well as the likelihood of those potential outcomes.

Readers are encouraged to consult the full text of the ASU on FASB's website at www.fasb.org.

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, decline in credit rating, or repudiation. These instruments may be used by financial institutions to reduce or modify the credit exposure of their loan or investment portfolios. Credit derivatives should not be confused with *financial guarantee contracts* as described in FASB ASC 815-10-15-58, which are not derivatives. Credit derivatives differ from financial guarantees in that credit derivatives require settlement regardless of whether the holder has suffered a loss based on the underlying referenced obligation(s), whereas a settlement under a financial guarantee contract is based on loss suffered by the holder. A letter of credit is an example of a financial guarantee contract.

Uses of Derivatives to Alter Risk

18.53 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).

18.54 *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 for their own account in paragraphs 1.48 and 18.77–.78 of this guide.

18.55 *Risk management.* Most institutions that use derivatives do so to increase or decrease risks associated with existing or anticipated on- or off-balance-sheet transactions, not for speculation. 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 economically hedge those instruments where right of setoff exists. Any excess or shortfalls in the economic 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.

18.56 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 enter into derivatives to help manage and select their total exposure to IRR. Institutions also enter into 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).

18.57 *Hedging* connotes a risk alteration activity to protect against the risk of adverse price 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 existing or an anticipated issuance of debt. Derivatives may be designated as *accounting hedges*, as discussed further in the "Accounting and Financial Reporting" section of this chapter. Derivatives not designated as accounting hedges either because they do not qualify for specialized hedge accounting, or by management choice, but held to offset a risk are commonly referred to as *economic hedges*. If not held for an accounting or economic hedge, and if unrelated to transactions with customers and others (for instance, a bank may underwrite floating rate debt and also enter into a fixed to floating rate swap with the same customer or compensate employees with derivative instruments), the use of a derivative is generally considered speculative.

18.58 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.

18.59 *Basis risk* is an important risk encountered with most hedging contracts. As introduced previously, 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.

18.60 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).

18.61 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.

18.62 Basis changes occur 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.

18.63 *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.

18.64 *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

18.65 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 non-derivative 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.

18.66 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.

18.67 *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 (that is, leverage);
- additional payments as a result of specified conditions; and
- a settlement payment based upon the expiration of a contract.

18.68 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.

18.69 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[2]

18.70 Banking Circular 277, *Risk Management of Financial Derivatives*, issued by the Office of the Comptroller of the Currency (OCC), addresses banks'

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[2] Chapter 7, "Investments in Debt and Equity Securities," of this guide discusses the regulatory matters affecting the permissibility of certain investments.

risk management of derivatives and sets forth best practices and procedures for managing risk. Bulletin OCC 94-31, *Risk Management of Financial Derivatives Q & A's*, answers commonly asked questions about Banking Circular 277. Through Bulletin OCC 2014-8, *End-User Derivatives and Trading Activities: Comptroller's Handbook Supplemental Examination Procedures*, the OCC issued supplemental exam procedures applicable to banks that are active end users of derivatives or that have significant trading activity. The Board of Governors of the Federal Reserve System (Federal Reserve) issued supervisory concerns on trust preferred stock that has been hedged with an interest rate derivative contract that is asymmetrical with regard to deferral terms in Supervision and Regulation (SR) letter 02-10, *Derivative Contracts Hedging Trust Preferred Stock*. The FDIC issued guidance for its examiners in Financial Institution Letter (FIL)-62-96, *Credit Derivatives*, and FIL-45-98, *Investment 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. Readers can access the guidance from any of the respective agencies' websites.

18.71 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 Act. 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 Federal Reserve Board 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]).

18.72 The Federal Financial Institutions Examination Council's (FFIEC's) *Advisory on Interest Rate Risk Management*, issued in January 2010,[3] reminds institutions of supervisory expectations of sound practices for

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[3] In January 2012, the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System, the FDIC, the National Credit Union Administration, and State Liaison Committee issued the *Interagency Advisory on Interest Rate Risk Management Frequently Asked Questions*. This document was created to clarify points in the 2010 interagency *Advisory on Interest Rate Risk Management* by providing responses to the most common questions. The responses address interest rate risk (IRR) exposure measurement and reporting, model risk management, stress testing, assumption development, and model and systems validation. Financial institution management should consider the responses in the context of the institution's complexity, risk profile, business model, and scope of operations. Readers can access the guidance from any of the respective agencies' websites.

In conjunction with the release of this interagency advisory, Bulletin OCC 2012-5, *Interest Rate Risk Management: FAQs on 2010 Interagency Advisory on Interest Rate Risk Management*, also required that savings associations have an independent IRR measurement process that measures both earnings and capital at risk, as described in the 2010 interagency advisory and the 1996 IRR policy statement.

managing IRR. This advisory reiterates the importance of effective corporate governance, policies and procedures, risk measuring and monitoring systems, stress testing, and internal control 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. For the complete text of the advisory, see the FFIEC's website at www.ffiec.gov.

18.73 On March 22, 2010, the OCC, the Federal Reserve, and the FDIC (collectively, the federal banking agencies), along with the Office of Thrift Supervision (prior to its transfer of powers to the OCC, the Federal Reserve, and the FDIC),[4] 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.

18.74 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).

18.75 In response to the increased risk for model management, the OCC and the Federal Reserve jointly developed and issued *Supervisory Guidance on Model Risk Management*, which was released as Bulletin OCC 2011-12, *Sound Practices for Model Risk Management: Supervisory Guidance on Model Risk Management*, and SR letter 11-7, *Guidance on Model Risk Management*, in April 2011. The guidance replaces Bulletin OCC 2000-16, *Risk Modeling: Model Validation*. Although model validation remains at the core of the guidance, the broader scope of model risk management encompasses model development, implementation, and use, as well as governance and controls related to models. All banks and savings and loan holding companies should ensure that internal policies and procedures are consistent with the risk management principles and supervisory expectations contained in this guidance. For further information, readers can access the supervisory guidance from either the OCC website at www.occ.gov or the Federal Reserve website at www.federalreserve.gov.

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[4] See chapter 1, "Industry Overview—Banks and Savings Institutions," of this guide for further discussion on the Office of Thrift Supervision transfer of powers.

18.76 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 is intended for banks with significant derivatives portfolios. 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 simple interest rate swaps) should apply this guidance as appropriate. 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. Readers can access the guidance from any of the federal banking agencies' websites.

18.77 In January 2014, the OCC, the Federal Reserve, the FDIC, and the SEC published a final rule, *Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds*, implementing Section 13 of the Bank Holding Company Act, which was added 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," of this guide). National banks (other than certain limited-purpose trust banks), federal savings associations, and federal branches and agencies of foreign banks are required to fully conform their activities and investments to the requirements of the final regulations by the end of the conformance period, which the Federal Reserve extended to July 21, 2015.

18.78 The final regulations

- prohibit banks from engaging in short-term proprietary trading of certain securities, derivatives commodity futures, and options on these instruments for their own accounts.
- impose limits on banks' investments in, and other relationships with, hedge funds and private equity funds.
- provide exemptions for certain activities, including market-making-related activities, underwriting, risk-mitigating hedging, trading in government obligations, insurance company activities, and organizing and offering hedge funds and private equity funds.
- clarify that certain activities are not prohibited, including acting as agent, broker, or custodian.
- scale compliance requirements based on the size of the bank and the scope of the activities. Larger banks are required to establish detailed compliance programs and their CEOs must attest to the OCC that the bank's programs are reasonably designed to achieve compliance with the final regulations. Smaller banks engaged in modest activities are subject to a simplified compliance program.

Accounting and Financial Reporting[5]

18.79 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 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 is 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)

Update 18-1 *Accounting and Reporting*: Recognition and Measurement of Financial Assets and Financial Liabilities

FASB Accounting Standards Update (ASU) No. 2016-01, *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*, issued in January 2016, is effective for fiscal years, and interim periods within those fiscal years, of a public business entity beginning after December 15, 2017.

For all other entities (including not-for-profit entities and employee benefit plans within the scope of FASB ASC 960, *Plan Accounting—Defined Benefit Pension Plans*, through FASB ASC 965, *Plan Accounting—Health and Welfare Benefit Plans*, on plan accounting), FASB ASU No. 2016-01 is effective for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. Early application is permitted for all other entities as of the fiscal years beginning after December 15, 2017, including interim periods within those fiscal years.

All entities may adopt the presentation guidance in paragraphs 5–7 of FASB ASC 825-10-45 for financial statements of fiscal years or interim periods that have not yet been issued or that have not yet been made available for issuance. Furthermore, entities that are not public business entities may elect not to disclose the information about fair value of financial instruments required by the "General" subsection of FASB ASC 825-10-50 in financial statements of fiscal years or interim periods that have not yet been made available for issuance. Except as indicated previously in this paragraph, early application is not permitted.

[5] With the other major financial instruments related projects completed, FASB has re-engaged in the hedging project. The objective of this project is to make targeted improvements to the hedge accounting model based on feedback received from preparers, auditors, users and other stakeholders. For more information on FASB's recognition and measurement project titled Accounting for Financial Instruments—Hedging, see appendix G, "Accounting for Financial Instruments," of this guide.

FASB ASU No. 2016-01 addresses certain aspects of recognition, measurement, presentation, and disclosure of financial instruments and affects all entities that hold financial assets or owe financial liabilities. Among other provisions of the guidance, the amendments in this ASU supersede the guidance to classify equity securities with readily determinable fair values into different categories (that is, trading or available-for-sale) and require equity securities (including other ownership interests, such as partnerships, unincorporated joint ventures, and limited liability companies) to be measured at fair value with changes in the fair value recognized through net income (other than equity securities accounted for under the equity method of accounting or those that result in consolidation of an investee).

The amendments in this ASU also require an entity to present separately in other comprehensive income the portion of the total change in fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments.

Readers are encouraged to consult the full text of this ASU on FASB's website at www.fasb.org.

For more information on FASB ASU No. 2016-01, see appendix G, "Accounting for Financial Instruments," of this guide.

18.80 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. Paragraphs 5 and 5A of FASB ASC 820-10-35 state that a fair value measurement assumes that the transaction to sell the asset or transfer the liability takes place either in the principal market for the asset or liability or, in the absence of a principal market, in the most advantageous market for the asset or liability. The FASB ASC glossary defines the *principal market* as the market with the greatest volume and level of activity for the asset or liability. A reporting entity need not undertake an exhaustive search of all possible markets to identify the principal market or, in the absence of a principal market, the most advantageous market, but it should take into account all information that is reasonably available. In the absence of evidence to the contrary, the market in which the reporting entity normally would enter into a transaction to sell the asset or to transfer the liability is presumed to be the principal market or, in the absence of a principal market, the most advantageous market. If the market in which the transaction takes place is different from the principal market (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 820-10-30-3A(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. Unobservable inputs should reflect assumptions that market participants would use when pricing the asset or liability including assumptions about risk. See chapter 20, "Fair Value," of this guide and FASB ASC 820, *Fair Value Measurement*, for additional information.

18.81 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).

Considerations for Private Companies That Elect to Use Standards as Issued by the Private Company Council

FASB ASC 815 also allows the use of the simplified hedge accounting approach to account for swaps that are entered into for the purpose of economically converting a variable-rate borrowing into a fixed-rate borrowing. The approach may be applied to all entities, except for public business entities and not-for-profit entities as defined in the FASB ASC glossary, employee benefit plans within the scope of FASB ASC 960 through FASB ASC 965 on plan accounting, and financial institutions. As described in FASB ASC 942-320-50-1, the term *financial institutions* includes banks, savings and loan associations, savings banks, credit unions, finance companies, and insurance entities. Because mortgage companies do not fall under the financial institutions exclusion, mortgage companies that are not public business entities would be permitted to follow the simplified hedge accounting approach. Under this approach, the income statement charge for interest expense will be similar to the amount that would result if the entity had directly entered into a fixed-rate borrowing instead of a variable-rate borrowing and a receive-variable, pay-fixed interest rate swap. Alternatively, that entity may continue to follow the current guidance in FASB ASC 815.

The simplified hedge accounting approach provides entities within its scope with a practical expedient to qualify for cash flow hedge accounting under FASB ASC 815. Under this approach, an entity may assume no ineffectiveness for qualifying swaps designated in a hedging relationship under FASB ASC 815. This approach can be applied to a cash flow hedge of a variable-rate borrowing with a receive-variable, pay-fixed interest rate swap provided all of the following criteria are met:

- Both the variable rate on the swap and the borrowing are based on the same index and reset period (for example, both the swap and borrowing are based on one-month LIBOR or both the swap and borrowing are based on three-month LIBOR). In complying with this condition, an entity is not limited to benchmark interest rates described in FASB ASC 815-20-25-6A.
- The terms of the swap are typical (in other words, the swap is what is generally considered to be a "plain-vanilla" swap), and there is no floor or cap on the variable interest rate of the swap unless the borrowing has a comparable floor or cap.
- The repricing and settlement dates for the swap and the borrowing match or differ by no more than a few days.
- The swap's fair value at inception (that is, at the time the derivative was executed to hedge the IRR of the borrowing) is at or near zero.
- The notional amount of the swap matches the principal amount of the borrowing being hedged. In complying with this condition, the amount of the borrowing being hedged may be less than the total principal amount of the borrowing.
- All interest payments occurring on the borrowing during the term of the swap (or the effective term of the swap underlying the forward starting swap) are designated as hedged whether in total or in proportion to the principal amount of the borrowing being hedged.

Under the simplified hedge accounting approach, an entity that qualifies for the accounting alternative has the option to measure the designated swap at settlement value instead of fair value. The primary difference between settlement value and fair value is that nonperformance risk is not considered in determining settlement value. One approach for estimating the receive-variable, pay-fixed interest rate swap's settlement value is to perform a present value calculation of the swap's remaining estimated cash flows using a valuation technique that is not adjusted for nonperformance risk.

Under the simplified hedge accounting approach, documentation required by FASB ASC 815-20-25-3 to qualify for hedge accounting must be completed by the date on which the first annual financial statements are available to be issued after hedge inception rather than concurrently at hedge inception. Because FASB ASC 815 permits election of hedge accounting on a swap-by-swap basis, an entity that qualifies for the accounting alternative can elect to apply this approach to any qualifying swap, whether existing at the date of adoption of this approach or entered into after that date. In determining whether an existing swap otherwise meets all of the requirements for applying this approach at adoption, the criterion that the swap's fair value at the time of the application of this approach is at or near zero does not need to be considered as long as the swap's fair value was at or near zero at the time the swap was entered into.

All other requirements in FASB ASC 815 for cash flow hedge accounting apply for the simplified hedge accounting approach. In addition, the current disclosure requirements in FASB ASC 815 and 820 on fair value measurement continue to apply for a swap accounted for under the simplified hedge accounting approach. In providing those disclosures, amounts recorded at settlement value may be used in place of fair value wherever applicable with amounts disclosed at settlement value subject to all of the same disclosure requirements as amounts disclosed at fair value. Any amounts disclosed at settlement value should be clearly stated as such and disclosed separately from amounts disclosed at fair value.

For the purpose of evaluating whether FASB ASC 825, *Financial Instruments*, disclosures about the fair value of financial instruments are required, a swap recorded under the simplified hedge accounting approach is not considered a derivative instrument under FASB ASC 815.

18.82 Items (c) and (d) in FASB ASC 815-20-25-3 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.

18.83 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.

18.84 Companies typically receive periodic fair value reporting from the counterparty. These fair values may or may not conform to the requirements of FASB ASC 820. As such, additional consideration of these values may be warranted. See chapter 20 of this guide for additional information regarding fair value measurements and disclosures.

18.85 *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.

Update 18-2 *Accounting and Reporting*: Credit Losses

FASB ASU No. 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*, issued in June 2016, is effective for fiscal years of public business entities that are SEC filers beginning after December 15, 2019, including interim periods within those fiscal years.

For all other public business entities, the amendments in FASB ASU No. 2016-13 are effective for fiscal years beginning after December 15, 2020, including interim periods within those fiscal years.

For all other entities, including not-for-profit entities and employee benefit plans within the scope of FASB ASC 960 through FASB ASC 965 on plan accounting, FASB ASU No. 2016-13 is effective for fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021.

Early application is permitted for all entities as of the fiscal years beginning after December 15, 2018, *including* interim periods within those fiscal years.

FASB ASU No. 2016-13 creates FASB ASC 326, *Financial Instruments—Credit Losses*, to amend guidance on reporting credit losses for financial assets held at amortized cost basis and available-for-sale debt securities.

For financial assets held at amortized cost basis, FASB ASC 326 eliminates the probable initial recognition threshold in current U.S. generally accepted accounting principles (GAAP) and, instead, requires an entity to reflect its current estimate of all expected credit losses. The allowance for credit losses is a valuation account that is deducted from the amortized cost basis of the financial assets to present the net amount expected to be collected.

For available-for-sale debt securities, credit losses should be measured in a manner similar to current GAAP. However, FASB ASC 326 will require that credit losses be presented as an allowance rather than as a write-down.

FASB ASU No. 2016-13 affects entities holding financial assets and net investment in leases that are not accounted for at fair value through net income. The amendments affect loans, debt securities, trade receivables, net investments in leases, off-balance-sheet credit exposures, reinsurance receivables, and any other financial assets not excluded from the scope that have the contractual right to receive cash.

This edition of the guide has not been updated to reflect changes as a result of this ASU, however, this paragraph will be updated in a future edition. Readers are encouraged to consult the full text of this ASU on FASB's website at www.fasb.org.

For more information on FASB ASU No. 2016-13, see appendix G of this guide.

18.86 In accordance with FASB ASC 460-10-50-1, the loss contingency disclosures required by FASB ASC 460-10-50 apply to guarantees, including guarantees that are outside the scope of FASB ASC 460-10-15-4 (such as 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.

18.87 *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.

18.88 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. Regardless of whether or not instruments have been netted for presentation in the statement of financial position, FASB ASC 815-10-50-4B requires derivative instruments to be reported gross within the footnote disclosures.

18.89 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.

18.90 *SEC Market Risk Disclosure Rules*.[6] 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.

18.91 *SEC Management's Discussion and Analysis (MD&A) Requirements*.[7] 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.

18.92 *Written loan commitments.* In accordance with FASB ASC 815-10-15-71, 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, should 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.

18.93 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 FASB ASC 860-50-25-1, 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.

18.94 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

18.95 According to FASB ASC 815-10-50-1, an entity with derivative instruments (or non-derivative 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:

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[6] Refer to the "Division of Corporation Finance: Rules, Regulations and Schedule" page at www.sec.gov.

[7] See footnote 6.

- How and why an entity uses derivative instruments (or such non-derivative instruments)
- How derivative instruments (or such non-derivative instruments) and related hedged items are accounted for under FASB ASC 815
- How derivative instruments (or such non-derivative instruments) and related hedged items affect an entity's financial position, financial performance, and cash flows

18.96 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.

18.97 FASB ASC 815-10-50-4K requires certain disclosures about credit derivatives and hybrid instruments (for example, a credit-linked note) that have embedded credit derivatives to enable users of financial statements to assess 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.

18.98 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 non-derivative 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.

18.99 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.

18.100 FASB ASC 210-20-50 requires enhanced disclosures about financial instruments and derivative instruments that are either offset in accordance with FASB ASC 210-20-45 or FASB ASC 815-10-45 or subject to an enforceable master netting arrangement or similar agreement (irrespective of whether they are offset in accordance with the aforementioned FASB ASC sections). Further discussion on the scope of and specific disclosures required by FASB ASC 210-20-50 can be found beginning in paragraph 14.40 of this guide.

Auditing Considerations[8]

18.101 AU-C section 501, *Audit Evidence—Specific Considerations for Selected Items* (AICPA, *Professional Standards*), addresses specific considerations by the auditor in obtaining sufficient appropriate audit evidence, in accordance with AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*); AU-C section 500, *Audit Evidence* (AICPA, *Professional Standards*); and other relevant AU-C sections regarding, among other considerations, certain aspects of investments in securities and derivative instruments in an audit of financial statements. In addition, the companion AICPA Audit Guide *Special Considerations in Auditing Financial Instruments* provides background information about financial instruments and discussion of audit considerations relating to financial instruments. The suggested auditing procedures contained in the guide do not increase or otherwise modify the auditor's responsibilities described in AU-C section 501. Rather, the suggested procedures in the guide are intended to clarify and illustrate the application of the requirements of AU-C section 501. In addition, AU-C section 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* (AICPA, *Professional Standards*), addresses the auditor's responsibilities relating to accounting estimates, including fair value accounting estimates and related disclosures, in an audit of financial statements. Specifically, it expands on how AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*); AU-C section 330; and other relevant AU-C sections are to be applied with regard to accounting estimates. It also includes requirements and guidance related to misstatements of individual accounting estimates and indicators of possible management bias.

> *Considerations for Audits Performed in Accordance With PCAOB Standards*[9]
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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 Specialists* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400.02), 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.

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[8] The auditing content in this guide focuses primarily on generally accepted auditing standards issued by the Auditing Standards Board and is applicable to audits of the financial statements of those entities not subject to the oversight authority of the PCAOB (that is, those audit reports not within the PCAOB's jurisdiction as defined by the Sarbanes-Oxley Act of 2002, as amended—hereinafter referred to as *nonissuers*). However, considerations for audits of entities subject to the oversight authority of the PCAOB (that is, those audit reports within the PCAOB's jurisdiction as defined by the Sarbanes-Oxley Act of 2002, as amended) may be discussed within this guide's chapter text. When such discussion is provided, the related paragraphs are designated with the following title: *Considerations for Audits Performed in Accordance With PCAOB Standards*.

[9] 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.

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. 400.04), 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.

Chapter 19

Business Combinations

Introduction

19.01 *Business combinations*, as defined in the FASB *Accounting Standards Codification* (ASC) glossary, are transactions or other events in which an acquirer obtains control of one or more businesses. A *business*, as defined in the FASB ASC glossary, 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. In accordance with FASB ASC 805-10-55-3, a business combination may be structured in a variety of ways for legal, taxation, or other reasons, which include but are not limited to, the following:

- One or more businesses become subsidiaries of an acquirer or the net assets of one or more businesses are legally merged into the acquirer
- One combining entity transfers its nets assets or its owners transfer their equity interests to another combining entity or its owners
- All of the combining entities transfer their net assets or the owners of those entities transfer their equity interests to a newly formed entity (sometimes referred to as a roll-up or put-together transaction)
- A group of former owners of one of the combining entities obtains control of the combined entity

Business combinations may involve one entity acquiring the equity interests or net assets of another entity or both entities transferring their equity interests or net assets to a newly formed entity. 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 entities. This chapter addresses only significant issues that are unique to depository institutions.

Update 19-1 *Accounting and Reporting*: Clarifying the Definition of a Business

FASB Accounting Standards Update (ASU) No. 2017-01, *Business Combinations (Topic 805): Clarifying the Definition of a Business*, issued in January 2017, is effective for annual periods of public business entities beginning after December 15, 2017, including interim periods within those periods.

For all other entities, the amendments in FASB ASU No. 2017-01 are effective for annual periods beginning after December 15, 2018, and interim periods within annual periods beginning after December 15, 2019.

FASB ASU No. 2017-01 clarifies the definition of a business with the objective of adding guidance to assist entities with evaluating whether transactions should be accounted for as acquisitions (or disposals) of businesses.

The amendments in this ASU provide a screen to determine when a set is not a business. If the screen is not met, it (*a*) requires that to be considered a business, a set must include, at a minimum, an input and a substantive process that together significantly contribute to the ability to create output and (*b*) removes the evaluation of whether a market participant could replace the missing elements.

This edition of the guide has not been updated to reflect changes as a result of this ASU, however, this section will be updated in a future edition. Readers are encouraged to consult the full text of this ASU on FASB's website at www.fasb.org.

Regulatory Matters

19.02 Staff Accounting Bulletin (SAB) No. 112, which was issued by the 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 FASB 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. generally accepted accounting principles (GAAP). The full text of SAB No. 112 is located on the SEC website.

19.03 In certain circumstances, an acquired bank or savings institution uses the acquiring institution's basis of accounting in preparing the acquired institution's financial statements. GAAP provides that an acquired entity may elect to apply pushdown accounting in its separate financial statements upon a change-in-control event in which an acquirer obtains control of the acquired entity. FASB ASC 805-50 addresses the specific guidance on pushdown accounting for all entities.

19.04 As addressed in the entry *business combinations* in the "Glossary" section of the Federal Financial Institutions Examination Council's *Instructions for Preparation of Consolidated Reports of Condition and Income*, the federal bank supervisory agencies note that the pushdown accounting election available under GAAP can be used to produce a particular result in the Consolidated Reports of Condition and Income (Call Report) that may not be reflective of the economic substance of the underlying business combination. Therefore, an institution's primary federal regulator reserves the right to require or prohibit the institution's use of pushdown accounting for Call Report purposes based on the regulator's evaluation of whether the election best reflects the facts and circumstances of the business combination.

19.05 The Office of the Comptroller of the Currency's (OCC's) *Bank Accounting Advisory Series* (BAAS) is updated periodically to express the Office of the Chief Accountant's current views on accounting topics of interest to national banks and federal savings associations. See further discussion of the BAAS in paragraph 7.82 of this guide. Topic 10, "Acquisitions, Corporate Reorganizations, and Consolidations," of the BAAS includes interpretations and responses on (*a*) acquisitions, (*b*) intangible assets, (*c*) push-down accounting, (*d*) corporate reorganizations, and (*e*) related party transactions. Readers are encouraged to view this publication under the "Publications—Bank Management" page at www.occ.gov.

19.06 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.

19.07 On June 7, 2010, the OCC, the Board of Governors of the Federal Reserve System (Federal Reserve), the FDIC, the National Credit Union Administration (NCUA), and the Office of Thrift Supervision (prior to its transfer of powers to the OCC, the Federal Reserve, and the FDIC)[1] 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. Readers can access the full text of this guidance from the OCC, the Federal Reserve, the FDIC, or the NCUA websites.

Accounting and Financial Reporting

Update 19-2 *Accounting and Reporting*: Credit Losses

FASB ASU No. 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*, issued in June 2016, is effective for fiscal years of public business entities that are SEC filers

[1] See chapter 1, "Industry Overview—Banks and Savings Institutions," of this guide for further discussion on the Office of Thrift Supervision transfer of powers.

beginning after December 15, 2019, including interim periods within those fiscal years.

For all other public business entities, the amendments in FASB ASU No. 2016-13 are effective for fiscal years beginning after December 15, 2020, including interim periods within those fiscal years.

For all other entities, including not-for-profit entities and employee benefit plans within the scope of FASB ASC 960, *Plan Accounting–Defined Benefit Pension Plans*, through FASB ASC 965, *Plan Accounting—Health and Welfare Benefit Plans*, on plan accounting, FASB ASU No. 2016-13 is effective for fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021.

Early application is permitted for all entities as of the fiscal years beginning after December 15, 2018, *including* interim periods within those fiscal years.

FASB ASU No. 2016-13 creates FASB ASC 326, *Financial Instruments—Credit Losses*, to amend guidance on reporting credit losses for financial assets held at amortized cost basis and available-for-sale debt securities.

For financial assets held at amortized cost basis, FASB ASC 326 eliminates the probable initial recognition threshold in current GAAP and, instead, requires an entity to reflect its current estimate of all expected credit losses. The allowance for credit losses is a valuation account that is deducted from the amortized cost basis of the financial assets to present the net amount expected to be collected.

For available-for-sale debt securities, credit losses should be measured in a manner similar to current GAAP. However, FASB ASC 326 will require that credit losses be presented as an allowance rather than as a write-down.

FASB ASU No. 2016-13 affects entities holding financial assets and net investment in leases that are not accounted for at fair value through net income. The amendments affect loans, debt securities, trade receivables, net investments in leases, off-balance-sheet credit exposures, reinsurance receivables, and any other financial assets not excluded from the scope that have the contractual right to receive cash.

This edition of the guide has not been updated to reflect changes as a result of this ASU, however, this section will be updated in a future edition. Readers are encouraged to consult the full text of this ASU on FASB's website at www.fasb.org.

For more information on FASB ASU No. 2016-13, see appendix G, "Accounting for Financial Instruments," of this guide.

19.08 Accounting for business combinations involving financial institutions is similar to that for entities in other industries. 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.

19.09 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. An entity should account for each business combination by applying the acquisition method.

19.10 FASB ASC 805-10-05-4 explains that 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)

19.11 Regarding paragraph 19.10*a–b*, 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.

19.12 Regarding paragraph 19.10*c*, recognition of identifiable assets acquired and liabilities assumed is subject to the conditions specified in paragraphs 2–3 of FASB ASC 805-20-25. However, an entity (the acquirer) within the scope of FASB ASC 805-20-15-2 may elect to apply the accounting alternative for the recognition of identifiable assets acquired in a business combination as described in paragraphs 29–32 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 explained 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.

Considerations for Private Companies that Elect to use Standards as Issued by the Private Company Council

FASB ASU No. 2014-18, *Business Combinations (Topic 805): Accounting for Identifiable Intangible Assets in a Business Combination (a consensus of the Private Company Council)*, denotes that a private company that elects the accounting alternative to recognize or otherwise consider the fair value of intangible assets as a result of any in-scope transactions should no longer recognize separately from goodwill (1) customer-related intangible assets unless they are capable of being sold or licensed independently from the other assets of the business and (2) noncompetition agreements. An entity that elects the accounting alternative in FASB ASU No. 2014-18 must adopt the private company alternative to amortize goodwill as described in FASB ASU No. 2014-02, *Intangibles—Goodwill and Other (Topic 350): Accounting for Goodwill*. However, an entity that elects the accounting alternative in FASB ASU No. 2014-02 is not required to adopt the amendments in FASB ASU No. 2014-18. Readers of this guide are encouraged to consult the full text of FASB ASU No. 2014-18, available at www.fasb.org.

19.13 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, because FASB ASC 805-20 requires the acquirer to measure acquired receivables, including loans, at their acquisition date fair values, the acquirer does not recognize a separate valuation allowance for the contractual cash flows that are deemed to be uncollectible at that date.

19.14 Regarding paragraph 19.10*d* 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 items (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

19.15 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," of this guide for a discussion of the requirements of FASB ASC 350.

19.16 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.

19.17 For certain 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. However, other valuation techniques may be used to determine *fair value* as defined in FASB ASC 820, *Fair Value Measurement*. Core deposit intangibles represent a separate asset, and, therefore, demand deposits are generally valued at their face amount plus any accrued interest.

Purchase of a Loan or Group of Loans

19.18 FASB ASC 310-20-30-5 explains that the initial investment in a loan or group of loans acquired in other than a business combination 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 except for loans acquired with deteriorated credit quality, which are discussed in more detail beginning in paragraph 19.21.

19.19 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. In accordance with 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.

19.20 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 at aicpa.org.

Loans and Debt Securities Acquired With Deteriorated Credit Quality

19.21 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. The application of FASB ASC 310-30 requires that each loan should be evaluated individually to determine whether the loan meets the scope criteria of FASB ASC 310-30-15-2. 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 to the purchase price of the loan. There is further discussion on accounting for loans and debt securities acquired with deteriorated credit quality in chapter 8, "Loans," of this guide beginning with paragraph 8.110.

Special Considerations in Applying the Acquisition Method to Combinations of Mutual Entities

19.22 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.

19.23 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.

19.24 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.

19.25 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.

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.[2] See chapter 11, "Real Estate Investments, Real Estate Owned, and Other Foreclosed Assets," of this guide 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 and Variable Interest Entities," 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

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[2] The referenced discussion originated from paragraph A133 of FASB Statement No. 141(R), *Business Combinations*; however, upon restructuring of the accounting and reporting standards into the codified standards, the discussion was not carried forward. Although the discussion was not carried forward into the codified standards, the impairment and disposal provisions of FASB *Accounting Standards Codification* 360-10 are still considered applicable to long term customer relationship intangible assets.

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 Considerations[3]

19.31 Business combinations may take many forms and generally involve complex transactions that have a pervasive effect on the financial statements impacting numerous financial statement line items and assertions. The primary objective of audit procedures for business combinations is to obtain reasonable assurance that the transaction is properly recorded in accordance with GAAP. Supervisory management personnel need to review and adequately support accounting entries made to record the transaction initially including the recognition and measurement of the assets and liabilities of the acquired entity and those required in subsequent years. Supervisory management personnel also need to evaluate the disclosures made with respect to the business combinations. Moreover, subsequent to the acquisition date management should review assumptions used in assigning values to assets and liabilities for continuing validity.

19.32 AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), addresses the auditor's responsibility to identify and assess the risks of material misstatement in the financial statements through understanding the entity and its environment, including the entity's internal control. Paragraphs .13–.14 of AU-C section 315 state that the auditor should obtain an understanding of internal control relevant to the audit and, in doing so, should evaluate the design of those controls and determine whether they have been implemented by performing procedures in addition to inquiry of the entity's personnel. See chapter 5, "Audit Considerations and Certain Financial Reporting Matters," of this guide for further discussion of the components of internal control. To provide a basis for designing and performing further audit procedures, paragraph

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[3] The auditing content in this guide focuses primarily on generally accepted auditing standards issued by the Auditing Standards Board and is applicable to audits of the financial statements of those entities not subject to the oversight authority of the PCAOB (that is, those audit reports not within the PCAOB's jurisdiction as defined by the Sarbanes-Oxley Act of 2002, as amended—hereinafter referred to as *nonissuers*). However, considerations for audits of entities subject to the oversight authority of the PCAOB (that is, those audit reports within the PCAOB's jurisdiction as defined by the Sarbanes-Oxley Act of 2002, as amended) may be discussed within this guide's chapter text. When such discussion is provided, the related paragraphs are designated with the following title: *Considerations for Audits Performed in Accordance With PCAOB Standards*.

.26 of AU-C section 315 states that the auditor should identify and assess the risks of material misstatement at the financial statement level and the relevant assertion level for classes of transactions, account balances, and disclosures.

19.33 Paragraph .06 of AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*), states that the auditor should design and perform further audit procedures whose nature, timing, and extent are based on, and responsive to, the assessed risks of material misstatement at the relevant assertion level. Irrespective of the assessed risks of material misstatement, paragraph .18 of AU-C section 330 states that the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure. Paragraph .A45 of AU-C section 330 further states that this requirement reflects the facts that (*a*) the auditor's assessment of risk is judgmental and may not be sufficiently precise to identify all risks of material misstatement, and (*b*) inherent limitations to internal control exist, including management override.

19.34 AU-C section 501, *Audit Evidence—Specific Considerations for Selected Items* (AICPA, *Professional Standards*), addresses specific considerations by the auditor in obtaining sufficient appropriate audit evidence, in accordance with AU-C section 330; AU-C section 500, *Audit Evidence* (AICPA, *Professional Standards*); and other relevant AU-C sections, regarding certain aspects of (*a*) investments in securities and derivative instruments; (*b*) inventory; (*c*) litigation, claims, and assessments involving the entity; and (*d*) segment information in an audit of financial statements. In addition, AU-C section 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* (AICPA, *Professional Standards*), addresses the auditor's responsibilities relating to accounting estimates, including fair value accounting estimates and related disclosures, in an audit of financial statements.[4] Specifically, it expands on how AU-C section 315, AU-C section 330, and other relevant AU-C sections are to be applied with regard to accounting estimates. It also includes requirements and guidance related to misstatements of individual accounting estimates and indicators of possible management bias. The companion AICPA Audit Guide *Special Considerations in Auditing Financial Instruments* provides background information about financial instruments and discussion of audit considerations relating to financial instruments.

19.35 Many fair values assigned to an acquired depository institution's assets and liabilities will be based on valuations by independent third-party appraisals. In applying audit procedures over these fair values, the auditor often relies on representations of independent experts. AU-C section 500 addresses the auditor's use of the work of an individual or organization possessing expertise in a field other than accounting or auditing, whose work in that field is used by the entity to assist the entity in preparing the financial statements (defined in the auditing standards as a *management's specialist*). AU-C section 620, *Using the Work of an Auditor's Specialist* (AICPA, *Professional Standards*), addresses the auditor's responsibilities relating to the work of an individual or organization possessing expertise in a field other than accounting or auditing

[4] In response to issues identified during the inspection of accounting firms and comments received from members of the Standing Advisory Group, the PCAOB staff is drafting a proposed standard on auditing accounting estimates, including fair value measurements and related disclosures. Readers should be alert to developments and are encouraged to refer to the Standard-Setting Agenda at www.pcaobus.org.

when that work is used to assist the auditor in obtaining sufficient appropriate audit evidence (defined in the auditing standards as an *auditor's specialist*). See paragraph .A1 of AU-C section 620 for further examples of expertise in a field other than accounting or auditing.

19.36 *Using the work of a management's specialist.* If information to be used as audit evidence has been prepared using the work of a management's specialist, paragraph .08 of AU-C section 500 states that the auditor should, to the extent necessary, taking into account the significance of that specialist's work for the auditor's purposes,

- *a.* evaluate the competence, capabilities, and objectivity of that specialist;
- *b.* obtain an understanding of the work of that specialist; and
- *c.* evaluate the appropriateness of that specialist's work as audit evidence for the relevant assertion.

19.37 Information regarding the competence, capabilities, and objectivity of a management's specialist may come from a variety of sources, such as knowledge of that specialist's qualifications, membership in a professional body or industry association, license to practice, or other forms of external recognition (a listing of additional sources is addressed in paragraph .A39 of AU-C section 500). Further application and explanatory material regarding the reliability of information produced by a management's specialist is addressed in paragraphs .A35–.A49 of AU-C section 500.

19.38 *Using the work of an auditor's specialist.* In accordance with paragraph .09 of AU-C section 620, the auditor should evaluate whether the auditor's specialist has the necessary competence, capabilities, and objectivity for the auditor's purposes. In the case of an auditor's external specialist, the evaluation of objectivity should include inquiry regarding interests and relationships that may create a threat to the objectivity of the auditor's specialist.

19.39 Paragraphs .12–.13 of AU-C section 620 state that the auditor should evaluate the adequacy of the work of the auditor's specialist for the auditor's purposes, including

- *a.* the relevance and reasonableness of the findings and conclusions of the auditor's specialist and their consistency with other audit evidence.
- *b.* if the work of the auditor's specialist involves the use of significant assumptions and methods,[5]
  - i. obtaining an understanding of those assumptions and methods and
  - ii. evaluating the relevance and reasonableness of those assumptions and methods in the circumstances, giving consideration to the rationale and support provided by the specialist, and in relation to the auditor's other findings and conclusions.

[5] When the work of an auditor's specialist involves the use of significant assumptions and methods, the appropriateness and reasonableness of those assumptions and methods used and their application are the responsibility of the auditor's specialist. See paragraph .A40 of AU-C section 620, *Using the Work of an Auditor's Specialist* (AICPA, *Professional Standards*), for further discussion of factors relevant to the auditor's evaluation of those assumptions and methods.

c. if the work of the auditor's specialist involves the use of source data that is significant to the work of the auditor's specialist, the relevance, completeness, and accuracy of that source data.

19.40 If the auditor determines that the work of the auditor's specialist is not adequate for the auditor's purposes, the auditor should

a. agree with the auditor's specialist on the nature and extent of further work to be performed by the auditor's specialist or

b. perform additional audit procedures appropriate to the circumstances.

19.41 The audit objectives and procedures applied to an acquisition of assets and assumption of liabilities (for example a branch acquisition) will generally be substantially the same as the objectives and procedures applied to a business combination, as described more fully in the preceding paragraphs.

Chapter 20

Fair Value

Gray shaded text in this chapter reflects guidance issued but not yet effective as of the date of this guide, July 1, 2017, but becoming effective on or prior to December 31, 2017, exclusive of any option to early adopt ahead of the mandatory effective date. Unless otherwise indicated, all unshaded text reflects guidance that was already effective as of the date of this guide.

Introduction

20.01 The following section provides a discussion about fair value measurements and disclosures and the fair value option. 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*, allows entities to choose, at specified election dates, to measure eligible items at fair value (the fair value option). The following paragraphs summarize FASB ASC 820 and FASB ASC 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. The FASB ASC glossary defines an *orderly transaction* as a transaction that assumes exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets and liabilities; it is not a forced transaction (for example, a forced liquidation or distress sale).

Unit of Account

20.03 For recognition and disclosure purposes, the reporting entity must determine the appropriate unit of account to apply the provision of FASB ASC 820. FASB ASC 820-10-35-2E states that whether the asset or liability is a standalone asset or liability, a group of assets, a group of liabilities, or a group of assets and liabilities depends on its unit of account. The unit of account is generally based on the applicable guidance that requires or permits fair value measurement, except for instances explicitly discussed in FASB ASC 820.

[1] The Office of the Comptroller of the Currency's *Bank Accounting Advisory Series* (BAAS) is updated periodically to express the Office of the Chief Accountant's current views on accounting topics of interest to national banks and federal savings associations. See further discussion of the BAAS in paragraph 7.82 of this guide. Topic 11D, "Fair Value Accounting," includes interpretations related to fair value measurement. Readers are encouraged to view this publication under the "Publications—Bank Management" page at www.occ.gov.

The Principal (or Most Advantageous) Market

20.04 FASB ASC 820-10-35-5 states that a fair value measurement assumes that the transaction to sell the asset or transfer the liability takes place either in the principal market for the asset or liability or, in the absence of a principal market, in the most advantageous market for the asset or liability. The FASB ASC glossary defines the *principal market* as the market with the greatest volume and level of activity for the asset or liability. The *most advantageous market*, as defined in the FASB ASC glossary, is the market that maximizes the amount that would be received to sell the asset or minimizes the amount that would be paid to transfer the liability, after taking into account transaction costs and transportation costs. Paragraphs 5A–6 of FASB ASC 820-10-35 state that a reporting entity need not undertake an exhaustive search of all possible markets to identify the principal market or, in the absence of a principal market, the most advantageous market, but it should take into account all information that is reasonably available. If there is a principal market for the asset or liability, the fair value measurement should represent the price in that market (whether that price is directly observable or estimated using another valuation technique), even if the price in a different market is potentially more advantageous at the measurement date.

20.05 The reporting entity must have access to the principal (or most advantageous) market at the measurement date. Because different entities (and businesses within those entities) with different activities may have access to different markets, the principal (or most advantageous) market for the same asset or liability might be different for different entities (and businesses within those entities). Therefore, paragraphs 6A–6B of FASB ASC 820-10-35 state that the principal (or most advantageous) 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. Although a reporting entity must be able to access the market, the reporting entity does not need to be able to sell the particular asset or transfer the particular liability on the measurement date to be able to measure fair value on the basis of the price in that market.

20.06 Paragraphs 3–3A of FASB ASC 820-10-30 explain that, in many cases, the transaction price will equal the fair value (for example, that might be the case when, on the transaction date, the transaction to buy an asset takes place in the market in which the asset would be sold). When determining whether fair value at initial recognition equals the transaction price, a reporting entity should take into account factors specific to the transaction and to the asset or liability. Even when there is no observable market to provide pricing information about the sale of an asset or the transfer of a liability at the measurement date, FASB ASC 820-10-35-6C states that a fair value measurement should assume that a transaction takes place at that date, considered from the perspective of a market participant that holds the asset or owes the liability. That assumed transaction establishes a basis for estimating the price to sell the asset or to transfer the liability.

20.07 The transaction price might not represent the fair value of an asset or a liability at initial recognition under certain conditions. For example, if the transaction is conducted between related parties, the seller is under duress, the unit of account differs, the market in which the transaction was conducted differs from the principal (or most advantageous) market that would be used by the entity. Paragraphs 46–49 of FASB ASC 820-10-55 (example 5) illustrate when the price in a transaction involving a derivative instrument might (and might not) equal the fair value of the instrument at initial recognition.

Market Participants

20.08 Fair value measurement should be based on the assumptions of market participants, as stated in FASB ASC 820-10-35-9, where a reporting entity should measure the fair value of an asset or a liability using the assumptions that a market participant would use in pricing the asset or liability. The reporting entity is not required to identify specific market participants but rather identify characteristics that distinguish market participants generally considering factors specific to the asset or liability, the principal (or most advantageous) market for the asset or liability, and market participants with which the reporting entity would enter into a transaction in the market.

The Price

20.09 Paragraphs 9A–9C of FASB ASC 820-10-35 provide additional guidance on the price. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction in the principal (or most advantageous) market at the measurement date under current market conditions (that is, an exit price) regardless of whether that price is directly observable or estimated using another valuation technique. The price should not be adjusted for transaction costs because they are not a characteristic of an asset or a liability; rather, they are specific to the transaction and will differ depending on the transaction. Further, transaction costs do not include transportation costs. The price in the principal (or most advantageous) market should be adjusted for the costs, if any, that would be incurred to transport the asset from its current location to that market.

Application of Fair Value Measurement to Nonfinancial Assets

20.10 *Highest and best use for nonfinancial assets.* FASB ASC 820-10-35-10A states that a fair value measurement of a nonfinancial asset takes into account a market participant's ability to generate economic benefits by using the asset in its highest and best use or by selling it to another market participant that would use the asset in its highest and best use. (Application of the highest and best use concept is limited to the fair value measurement of nonfinancial assets and cannot be used to measure the fair value of financial assets.)

20.11 FASB ASC 820-10-35-10B states that the highest and best use of a nonfinancial asset takes into account the use of the asset that is physically possible, legally permissible, and financial feasible, as follows:

a. A use that is physically possible takes into account the physical characteristics of the asset that market participants would take into account when pricing the asset (for example, the location or size of a property).

b. A use that is legally feasible takes into account any legal restrictions on the use of the asset that market participants would take into account when pricing the asset (for example, the zoning regulation application to a property).

c. A use that is financially feasible takes into account whether a use of the asset that is physically possible and legally permissible generates adequate income or cash flows (taking into account the costs of converting the asset to that use) to produce an investment return that market participants would require from an investment in that asset put to that use.

20.12 Even if the reporting entity intends a different use, paragraphs 10C–10D of FASB ASC 820-10-35 state that the highest and best use is determined from the perspective of market participants. However, a reporting entity's current use of a nonfinancial asset is presumed to be its highest and best use unless market or other factors suggest that a different use by market participants would maximize the value of the asset. To protect its competitive position, or for other reasons, a reporting entity may intend not to use an acquired nonfinancial asset actively, or it may intend not to use the asset according to its highest and best use. For example, that might be the case for an acquired intangible asset that the reporting entity plans to use defensively by preventing others from using it. Nevertheless, the reporting entity should measure the fair value of a nonfinancial asset assuming its highest and best use by market participants.

20.13 *Valuation premise for nonfinancial assets.* FASB ASC 820-10-35-10E states that the highest and best use of a nonfinancial asset establishes the valuation premise used to measure the fair value of the asset, as follows:

a. The highest and best use of a nonfinancial asset might provide maximum value to market participants through its use in combination with other assets as a group (as installed or otherwise configured for use) or in combination with other assets and liabilities (for example, a business).

   i. If the highest and best use of the asset is to use the asset in combination with other assets or with other assets and liabilities, the fair value of the asset is the price that would be received in a current transaction to sell the asset assuming that the asset would be used with other assets or with other assets and liabilities and that those assets and liabilities (that is, its complementary assets and the associated liabilities) would be available to market participants.

   ii. Liabilities associated with the asset and with the complementary assets include liabilities that fund working capital, but do not include liabilities used to fund assets other than those within the group of assets.

   iii. Assumptions about the highest and best use of a nonfinancial asset should be consistent for all of the assets (for which highest and best use is relevant) of the group of assets or the group of assets and liabilities within which the asset would be used.

b. The highest and best use of a nonfinancial asset might provide maximum value to market participants on a standalone basis. If the highest and best use of the asset is to use it on a standalone basis, the fair value of the asset is the price that would be received in a current transaction to sell the asset to market participants that would use the asset on a standalone basis.

FASB ASC 820-10-55-25 (example 1) illustrates the application of the highest and best use and valuation premise concepts for nonfinancial assets.

Application of Fair Value Measurement to Liabilities and Instruments Classified in a Reporting Entity's Shareholders' Equity[2]

20.14 According to paragraphs 16–16AA of FASB ASC 820-10-35, a fair value measurement assumes that a financial or nonfinancial liability or an instrument classified in a reporting entity's shareholders' equity (for example, equity interests issued as consideration in a business combination) is transferred to a market participant at the measurement date. The transfer of such a liability or instrument assumes the following:

a. A liability would remain outstanding and the market participant transferee would be required to fulfill the obligation. The liability would not be settled with the counterparty or otherwise extinguished on the measurement date.

b. An instrument classified in a reporting entity's shareholders' equity would remain outstanding and the market participant transferee would take on the rights and responsibilities associated with the instrument. The instrument would not be canceled or otherwise extinguished on the measurement date.

Even when there is no observable market to provide pricing information about the transfer of such a liability or instrument (for example, because contractual or other legal restrictions prevent the transfer of such items), there might be an observable market for such items if they are held by other parties as assets (for example, a corporate bond or a call option on a reporting entity's shares). In all cases, a reporting entity should maximize the use of relevant observable inputs and minimize the use of unobservable inputs to meet the objective of a fair value measurement, which is to estimate the price at which an orderly transaction to transfer the liability or instrument classified in shareholders' equity would take place between market participants at the measurement date under current market conditions.

20.15 *Liabilities and instruments classified in a reporting entity's shareholders' equity held by other parties as assets.* Paragraphs 16B–16BB of FASB ASC 820-10-35 state that when a quoted price for the transfer of an identical liability or a similar liability or instrument classified in a reporting entity's shareholders' equity is not available and the identical item is held by another party as an asset, a reporting entity should measure the fair value of the liability or equity instrument from the perspective of a market participant that holds the identical items as an asset at the measurement date. In such cases, a reporting entity should measure the fair value of the liability or equity instrument as follows:

a. Using the quoted price in an *active market* (defined in the FASB ASC glossary as a market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis) for the identical item held by another party as an asset, if that price is available.

b. If that price is not available, using other observable inputs, such as the quoted price in a market that is not active for the identical item held by another party as an asset.

c. If the observable prices discussed in item (*a*) or item (*b*) are not available, using another valuation technique, such as

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[2] The guidance discussed in this section does not apply to share-based payment transactions.

i. an income approach (for example, a present value technique that takes into account the future cash flows that a market participant would expect to receive from holding the liability or equity instrument as an asset; see FASB ASC 820-10-55-3F).

ii. a market approach (for example, using quoted prices for similar liabilities or instruments classified as shareholders' equity held by other parties as assets; see FASB ASC 820-10-55-3A).

Liabilities and instruments classified in a reporting entity's shareholders' equity held by other parties as assets.[3] Paragraphs 16B and "Pending Content" in paragraph 16BB of FASB ASC 820-10-35 state that when a quoted price for the transfer of an identical liability or a similar liability or instrument classified in a reporting entity's shareholders' equity is not available and the identical item is held by another party as an asset, a reporting entity should measure the fair value of the liability or equity instrument from the perspective of a market participant that holds the identical items as an asset at the measurement date. In such cases, a reporting entity should measure the fair value of the liability or equity instrument as follows:

a . Using the quoted price in an active market (defined in the FASB ASC glossary as a market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis) for the identical item held by another party as an asset, if that price is available.

b . If that price is not available, using other observable inputs, such as the quoted price in a market that is not active for the identical item held by another party as an asset.

c . If the observable prices discussed in item (*a*) or item (*b*) are not available, using another valuation approach, such as

i . an income approach (for example, a present value technique that takes into account the future cash flows that a market participant would expect to receive from holding the liability or equity instrument as an asset; see FASB ASC 820-10-55-3F).

ii . a market approach (for example, using quoted prices for similar liabilities or instruments classified as shareholders' equity held by other parties as assets; see FASB ASC 820-10-55-3A).

20.16 According to FASB ASC 820-10-35-16D, a reporting entity should adjust the quoted price only if there are factors specific to the asset that are not

[3] FASB Accounting Standards Update (ASU) No. 2016-19, *Technical Corrections and Improvements*, issued in December 2016, applies to all reporting entities within the scope of the affected accounting guidance. The amendments to FASB ASC 820, *Fair Value Measurement*, clarifies the difference between a valuation approach and a valuation technique when applying the guidance in FASB ASC 820. The "Pending Content" associated for this respective amendment is effective for fiscal years, and interim periods within those fiscal years, for all entities beginning after December 15, 2016. An entity should apply these amendments prospectively. Early application is permitted for any fiscal year or interim period for which the entity's financial statements have not yet been issued or for which financial statements are available to be issued.

Readers are encouraged to read the full text of the ASU, available at www.fasb.org. Readers should apply the appropriate guidance based on their facts and circumstances.

applicable to the fair value measurement of the liability or equity instrument. A reporting entity should ensure that the price of the asset does not reflect the effect of a restriction preventing the sale of that asset. Some factors that may indicate that the quoted price of the asset should be adjusted include the following:

- The quoted price for the asset relates to a similar (but not identical) liability or equity instrument held by another party as an asset. For example, the liability or equity instrument may have a particular characteristic (for example, the credit quality of the issuer) that is different from that reflected in the fair value of the similar liability or equity instrument held as an asset.
- The unit of account for the asset is not the same as for the liability or equity instrument. For example, for liabilities, in some cases the price for an asset reflects a combined price for a package comprising both the amounts due from the issuer and a third-party credit enhancement. If the unit of account for the liability is not for the combined package, the objective is to measure the fair value of the issuer's liability, not the fair value of the combined package. Thus, in such cases, the reporting entity would adjust the observed price for the asset to exclude the effect of the third-party credit enhancement. See FASB ASC 820-10-35-18A for further guidance.

20.17 *Liabilities and instruments classified in a reporting entity's shareholders' equity not held by other parties as assets.* Paragraphs 16H–16I of FASB ASC 820-10-35 explain that when a quoted price for the transfer of an identical or a similar liability or instrument classified in a reporting entity's shareholders' equity is not available and the identical item is not held by another party as an asset, a reporting entity should measure the fair value of the liability or equity instrument using a valuation technique from the perspective of a market participant that owes the liability or has issued the claim on equity. For example, when applying a present value technique, a reporting entity might take into account either of the following:

- The future cash outflows that a market participant would expect to incur in fulfilling the obligation, including the compensation that a market participant would require for taking on the obligation (see paragraphs 16J–16K of FASB ASC 820-10-35).
- The amount that a market participant would receive to enter into or issue an identical liability or equity instrument, using the assumptions that market participants would use when pricing, the identical item (for example, having the same credit characteristics) in the principal (or most advantageous) market for issuing a liability or an equity instrument with the same contractual terms.

20.18 *Nonperformance risk.* Paragraphs 17–18 of FASB ASC 820-10-35 state that the fair value of a liability reflects the effect of nonperformance risk. Nonperformance risk includes, but may not be limited to, a reporting entity's own credit risk and is assumed to be the same before and after the transfer of the liability. When measuring the fair value of a liability, a reporting entity should take into account the effect of its credit risk (credit standing) and any other factors that might influence the likelihood that the obligation will or will not be fulfilled. That effect may differ depending on the liability. For example, whether the liability is an obligation to deliver cash (a financial liability) or an obligation to deliver goods or services (a nonfinancial liability), or the terms of credit enhancements related to the liability, if any.

FASB ASC 820-10-55-56 illustrates the effect of credit risk on the fair value measurement of a liability.

20.19 *Third-party credit enhancements.* As stated in paragraph 18A of FASB ASC 820-10-35, the issuer of a liability issued with an inseparable third-party credit enhancement that is accounted for separately from the liability should not include the effect of the credit enhancement in the fair value measurement of the liability. Instead, the issuer would take into account its own credit standing and not that of the third-party guarantor when measuring the fair value of the liability.

20.20 *Restriction preventing the transfer of a liability or an instrument classified in a reporting entity's shareholders' equity*. When measuring the fair value, FASB ASC 820-10-35-18B states that a reporting entity should not include a separate input or an adjustment to other inputs relating to the existence of a restriction that prevents the transfer of the item. The effect of that restriction is either implicitly or explicitly included in the other inputs to the fair value measurement.

Application of Fair Value Measurement to Financial Assets and Financial Liabilities with Offsetting Positions in Market Risks or Counterparty Credit Risk

20.21 Paragraphs 18D–18L of FASB ASC 820-10-35 provide fair value guidance to reporting entities that hold a group of financial assets and financial liabilities with offsetting positions in market risks or counterparty credit risks. The guidance permits a reporting entity that manages a group of financial assets and financial liabilities on the basis of its net exposure to either market risks or credit risk to apply an exception to FASB ASC 820 for measuring fair value. That exception permits a reporting entity to measure the fair value of a group of financial assets and financial liabilities on the basis of the price that would be received to sell a net long position (that is, an asset) for a particular risk exposure or paid to transfer a net short position (that is, a liability) for a particular risk exposure in an orderly transaction between market participants at the measurement date under current market conditions. Accordingly, a reporting entity should measure the fair value of the group of financial assets and financial liabilities consistently with how market participants would price the net risk exposure at the measurement date.

20.22 A reporting entity is permitted to use the exception in the preceding paragraph only if the reporting entity does all of the following:

- *a.* Manages the group of financial assets and financial liabilities on the basis of the reporting entity's net exposure to a particular market risk (or risks) or to the credit risk of a particular counterparty in accordance with the reporting entity's documented risk management or investment strategy
- *b.* Provides information on that basis about the group of financial assets and financial liabilities to the reporting entity's management
- *c.* Is required or has elected to measure those financial assets and financial liabilities at fair value in the statement of financial position at the end of each reporting period

The exception does not pertain to financial statement presentation. In some cases, the basis for the presentation of financial instruments in the statement of financial position differs from the basis for the measurement of financial instruments (for example, if a FASB ASC topic does not require or permit financial instruments to be presented on a net basis). In such cases, a reporting entity may need to allocate the portfolio-level adjustments (see subsequent discussion of exposure to market risks and credit risk of a particular counterparty) to the individual assets or liabilities that make up the group of financial assets and financial liabilities managed on the basis of the reporting entity's net risk exposure. A reporting entity should perform such allocations on a reasonable and consistent basis using a methodology appropriate in the circumstances.

20.23 A reporting entity should make an accounting policy decision to use the portfolio measurement exception described in paragraph 20.21. A reporting entity that uses the exception should apply that accounting policy, including its policy for allocating bid-ask adjustments (see subsequent discussion of exposure to market risks in paragraph 20.24) and credit adjustments (see subsequent discussion of exposure to the credit risk of a particular counterparty in paragraph 20.27), if applicable, consistently from period to period for a particular portfolio. The exception applies only to financial assets and financial liabilities within the scope of FASB ASC 815, *Derivatives and Hedging*, or FASB ASC 825.

20.24 *Exposure to market risks*. When using the exception to measure the fair value of a group of financial assets and financial liabilities managed on the basis of the reporting entity's net exposure to a particular market risk (or risks), the reporting entity should apply the price within the bid-ask spread that is most representative of fair value in the circumstances to the reporting entity's net exposure to those market risks (see paragraphs 36C–36D of FASB ASC 820-10-35).

20.25 In regard to applying the portfolio measurement exception, a reporting entity should also ensure that the market risk (or risks) to which the reporting entity is exposed within that group of financial assets and financial liabilities is substantially the same. For example, a reporting entity would not combine the interest rate risk associated with a financial asset with the commodity price risk associated with a financial liability, because doing so would not mitigate the reporting entity's exposure to interest rate risk or commodity price risk. When using the exception, any basis risk resulting from the market risk parameters not being identical should be taken into account in the fair value measurement of the financial assets and financial liabilities within the group.

20.26 Similarly, the duration of the reporting entity's exposure to a particular market risk (or risks) arising from the financial assets and financial liabilities should be substantially the same. For example, a reporting entity that uses a 12-month futures contract against the cash flows associated with 12 months' worth of interest rate risk exposure on a 5-year financial instrument within a group made up of only those financial assets and financial liabilities measures the fair value of the exposure to 12-month interest rate risk on a net basis and the remaining interest rate risk exposure (that is, years 2–5) on a gross basis.

20.27 *Exposure to the credit risk of a particular counterparty*. When using the exception to measure the fair value of a group of financial assets and financial liabilities entered into with a particular counterparty, the reporting entity should include the effect of the reporting entity's net exposure to the credit risk of that counterparty or the counterparty's net exposure to the credit risk of the reporting entity in the fair value measurement when market participants would take into account any existing arrangements that mitigate credit risk exposure in the event of default (for example, a master netting agreement with the counterparty or an agreement that requires the exchange of collateral on the basis of each party's net exposure to the credit risk of the other party). The fair value measurement should reflect market participants' expectations about the likelihood that such an arrangement would be legally enforceable in the event of default.

Valuation Techniques

20.28 Paragraphs 24–24A of FASB ASC 820-10-35 explain that a reporting entity should use valuation techniques that are appropriate in the circumstances and for which sufficient data are available to measure fair value. Three widely used valuation techniques are the market approach, cost approach, and income approach. The main aspects of those approaches are summarized in paragraphs 3A–3G of FASB ASC 820-10-55. An entity should use valuation techniques consistent with one or more of these approaches to measure fair value:

a. *Market approach.* The market approach uses prices and other relevant information generated by market transactions involving identical or comparable (that is, similar) assets, liabilities, or a group of assets and liabilities (for example, a business). Valuation techniques consistent with the market approach include matrix pricing and those that use market multiples derived from a set of comparables.

b. *Cost approach*. The cost approach reflects the amount that would be required currently 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. That is because a market participant buyer would not pay more for an asset than the amount for which it could replace the service capacity of that asset.

c. *Income approach.* 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 multiperiod excess earnings method. See discussion beginning in paragraph 20.31 regarding guidance for using the present value technique.

Paragraph 24 and "Pending Content" in paragraph 24A of FASB ASC 820-10-35 explain that a reporting entity should use valuation techniques that are appropriate in the circumstances and for which sufficient data are available to measure fair value. Three widely used valuation approaches are the market approach, cost approach, and income approach. The main aspects of valuation techniques consistent with those approaches are summarized in paragraphs

3A–3G of FASB ASC 820-10-55. An entity should use valuation techniques consistent with one or more of these approaches to measure fair value:[4]

a. *Market approach*. The market approach uses prices and other relevant information generated by market transactions involving identical or comparable (that is, similar) assets, liabilities, or a group of assets and liabilities (for example, a business). Valuation techniques consistent with the market approach include matrix pricing and those that use market multiples derived from a set of comparables.

b. *Cost approach*. The cost approach reflects the amount that would be required currently 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. That is because a market participant buyer would not pay more for an asset than the amount for which it could replace the service capacity of that asset.

c. *Income approach*. 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 multiperiod excess earnings method. See discussion beginning in paragraph 20.31 regarding guidance for using the present value technique.

20.29 FASB ASC 820-10-35-24B states that, 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, that might be the case when valuing a reporting unit). If multiple valuation techniques are used to measure fair value, the results (that is, respective indications of fair value) should be evaluated considering the reasonableness of the range of values indicated by those results. A fair value measurement is the point within that range that is most representative of fair value in the circumstances. Example 3 beginning in FASB ASC 820-10-55-35 illustrates the use of multiple valuation techniques.

20.30 As explained in paragraphs 25–26 of FASB ASC 820-10-35, valuation techniques used to measure fair value should be applied consistently. 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*. However, FASB ASC 250-10-50-5 explains that the disclosures in FASB ASC 250 for a change in accounting estimate are not required for revisions resulting from a change in a valuation technique or its application. See discussion of FASB ASC 820-10-50-2bbb for disclosure requirements when there has been a change in valuation techniques.

[4] See footnote 3.

Present Value Techniques

20.31 *The components of a present value measurement.* Paragraphs 4–19 of FASB ASC 820-10-55 and 820-10-55-20 describe the use of present value techniques to measure fair value. Those paragraphs neither prescribe the use of a single specific present value technique nor limit the use of present value techniques to measure fair value to the techniques discussed. Present value (that is, the application of the income approach) is a tool used to link future amounts (for example, cash flows or values) to a present amount using a discount rate. A fair value measurement of an asset or a liability using a present value technique captures all of the following elements from the perspective of market participants at the measurement date: (*a*) an estimate of future cash flows for the asset or liability being measured; (*b*) expectations about possible variations in the amount and timing of the cash flows representing the uncertainty inherent in the cash flows; (*c*) the time value of money, represented by the rate on risk-free monetary assets that have maturity dates or durations that coincide with the period covered by the cash flows and pose neither uncertainty in timing nor risk of default to the holder (that is, a risk-free interest rate); (*d*) the price for bearing the uncertainty inherent in the cash flows (that is, a risk premium); (*e*) other factors that market participants would take into account in the circumstances; and (*f*) for a liability, the nonperformance risk relating to that liability, including the reporting entity's (that is, the obligor's) own credit risk.

20.32 *General principles.* Present value techniques differ in how they capture the elements discussed in the preceding paragraph. FASB ASC 820-10-55-6 provides the general principles that govern the application of any present value technique used to measure fair value, as follows:

- Cash flows and discount rates should reflect assumptions that market participants would use when pricing the asset or liability.
- Cash flows and discount rates should take into account only factors attributable 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 the uncertainty in expectations about future defaults is appropriate if using the contractual cash flows of a loan (that is, a discount rate adjustment technique), but is not appropriate if using expected (that is, probability-weighted) cash flows (that is, an expected present value technique) because the expected cash flows already reflect assumptions about the uncertainty in future defaults; instead, a discount rate that is commensurate with the risk inherent in the expected cash flows should be used.
- Assumptions about cash flows and discount rates should be internally consistent. For example, nominal cash flows, which 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 in which the cash flows are denominated.

20.33 *Risks and uncertainty.* 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 uses a risk-adjusted discount rate and contractual, promised, or most likely cash flows. In contrast, method 1 of the expected present value technique uses risk-adjusted expected cash flows and a risk-free rate. *Expected cash flow*, as defined in the FASB ASC glossary, is the probability-weighted average (that is, the mean of the distribution) of possible future cash flows. Method 2 of the expected present value technique uses expected cash flows that are not risk adjusted and a discount rate (this rate is different from the rate used in the discount rate adjustment technique) adjusted to include the risk premium that market participants require. The discount rate adjustment technique and two methods of expected present value techniques are discussed more fully in paragraphs 10–16 of FASB ASC 820-10-55.

The Fair Value Hierarchy

20.34 Because fair value is a market-based measurement, FASB ASC 820-10-35-9 states that fair value should be measured using the assumptions that market participants would use in pricing the asset or liability (referred to as *inputs*), assuming that market participants act in their economic best interest. The FASB ASC glossary defines *inputs* as assumptions that market participants would use when pricing the asset or liability, including assumptions about risk, such as the risk inherent in a particular valuation technique used to measure fair value (such as a pricing model) or the risk inherent in the inputs to the valuation technique. Inputs may be observable or unobservable (both as defined in the FASB ASC glossary):

- *Observable inputs* are developed using market data, such as publicly available information about actual events or transactions, and that reflect the assumptions that market participants would use when pricing the asset or liability.
- *Unobservable inputs* are inputs for which market data are not available and that are developed using the best information available about the assumptions that market participants would use when pricing the asset or liability.

Paragraphs 37–54B of FASB ASC 820-10-35 establish a fair value hierarchy that distinguishes between observable and unobservable inputs. FASB ASC 820-10-35-36 states that valuation techniques used to measure fair value should maximize the use of relevant observable inputs and minimize the use of unobservable inputs.

20.35 The fair value hierarchy in FASB ASC 820 categorizes the inputs to valuation techniques used to measure fair value into three broad levels. The three levels are discussed as follows:

- *Level 1.* FASB ASC 820-10-35-40 defines *Level 1 inputs* as quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity can access at the measurement date. The FASB ASC glossary defines *active market* as a market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis. Paragraphs 41–41C and 44 of FASB ASC 820-10-35 go on to explain that a quoted price in an active market provides the most reliable evidence of fair value and should be used without adjustment to measure fair value whenever available, except as specified in FASB ASC 820-10-35-41C. A Level 1 input will be available for many financial assets and financial liabilities, some of which might be exchanged in multiple active markets (for example, on different exchanges). Therefore, the emphasis within Level 1 is on determining both 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 and whether the reporting entity can enter into a transaction for the asset or liability at the price in the market for the asset or liability at the measurement date. If a reporting entity holds a position in a single asset or liability (including a position comprising a large number of identical assets or liabilities, such as a holding of financial instruments) and the asset or liability is traded in an active market, the fair value of the asset or liability should be measured within Level 1 as the product of the quoted price for the individual asset or liability and the quantity held by the reporting entity. That is the case, 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. FASB ASC 820-10-55-42 (example 4) illustrates the use of Level 1 inputs to measure the fair value of a financial asset that trades in multiple active markets with different prices.

- *Level 2.* FASB ASC 820-10-35-47 defines *Level 2 inputs* as inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. Paragraphs 48–51 of FASB ASC 820-10-35 go on to explain that 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, the extent to which inputs relate to items that are comparable to the asset or liability (including those factors described in FASB ASC 820-10-35-16D [see paragraph 20.16]), and the volume or level of activity in the markets within which the inputs are observed. An adjustment to a Level 2 input that is significant to the entire measurement might result in a fair value measurement categorized within Level 3 of the fair value hierarchy if the adjustment uses significant unobservable inputs. 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, implied volatilities, or credit spreads)

— *Market-corroborated inputs* (defined in the FASB ASC glossary as inputs that are derived principally from or corroborated by observable market data by correlation or other means).

- *Level 3. Level 3* inputs, as defined in the FASB ASC glossary, are unobservable inputs for the asset or liability. Paragraphs 53–54A of FASB ASC 820-10-35 state that unobservable inputs should be used to measure fair value to the extent that relevant observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at the measurement date. Unobservable inputs should reflect the assumptions that market participants would use when pricing the asset or liability (including assumptions about risk). Assumptions about risk include the risk inherent in a particular valuation technique used to measure fair value (such as a pricing model) and the risk inherent in the inputs to the valuation technique. A measurement that does not include an adjustment for risk would not represent a fair value measurement if market participants would include one when pricing the asset or liability. A reporting entity should develop unobservable inputs using the best information available in the circumstances, which might include the reporting entity's own data. In developing unobservable inputs, a reporting entity may begin with its own data, but it should adjust those data if reasonably available information indicates that other market participants would use different data or there is something particular to the reporting entity that is not available to other market participants (for example, an energy-specific synergy). A reporting entity need not undertake exhaustive efforts to obtain information about market participant assumptions. However, a reporting entity should take into account all information about market participant assumptions that is reasonably available. Unobservable inputs developed in the manner described previously are considered market participant assumptions and meet the objectives of a fair value measurement.

As explained in FASB ASC 820-10-35-37A, in some cases, the inputs used to measure fair value of an asset or liability might be categorized within different levels of the fair value hierarchy. In those cases, the fair value measurement is categorized in its entirety in the same level of the fair value hierarchy as the lowest level input that is significant to the entire measurement. Assessing the significance of a particular input to the entire measurement requires judgment, taking into account factors specific to the asset or liability. Adjustments to arrive at measurements based on fair value, such as costs to sell when measuring fair value less costs to sell, should not be taken into account when determining the level of the fair value hierarchy within which a fair value measurement is categorized.

20.36 As discussed in paragraphs 38 and 38A of FASB ASC 820-10-35, the availability of relevant inputs and their relative subjectivity might affect the selection of appropriate valuation techniques (see FASB ASC 820-10-35-24 discussed in paragraph 20.28). However, the fair value hierarchy prioritizes the inputs to valuation techniques, not the valuation techniques used to measure fair value. For example, a fair value measurement developed using a present value technique might be categorized within Level 2 or Level 3, depending on the inputs that are significant to the entire measurement and the level of the fair value hierarchy within which those inputs are categorized. If an observable input requires an adjustment using an unobservable input and that adjustment results in a significantly higher or lower fair value measurement, the resulting measurement would be categorized within Level 3 of the fair value hierarchy. For example, if a market participant would take into account the effect of a restriction on the sale of an asset when estimating the price for the asset, a reporting entity would adjust the quoted price to reflect the effect of that restriction. If that quoted price is a Level 2 input and the adjustment is an unobservable input that is significant to the entire measurement, the measurement would be categorized within Level 3 of the fair value hierarchy.

Categorizing Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent) Within the Fair Value Hierarchy

20.37 According to FASB ASC 820-10-35-54B, categorization within the fair value hierarchy of a fair value measurement of an investment within the scope of paragraphs 4–5 of FASB ASC 820-10-15 that is measured at net asset value per share (or its equivalent, for example member units or an ownership interest in partners' capital to which a proportionate share of net assets is attributed) requires judgment, considering the following:

- If a reporting entity has the ability to redeem its investment with the investee at net asset value per share (or its equivalent) at the measurement date, the fair value measurement of the investment should be categorized within Level 2 of the fair value hierarchy.
- If a reporting entity would never have the ability to redeem its investment with the investee at net asset value per share (or its equivalent), the fair value measurement of the investment should be categorized within Level 3 of the fair value hierarchy.
- If a reporting entity cannot redeem its investment with the investee at net asset value per share (or its equivalent) at the measurement date but the investment may be redeemable with the investee at a future date (for example, investments subject to a lockup or gate or investments whose redemption period does not coincide with the measurement date), the reporting entity should take into account the length of time until the investment will become redeemable in determining whether the fair value measurement of the investment should be categorized within Level 2 or Level 3 of the fair value hierarchy. For example, if the reporting entity does not know when it will have the ability to redeem the investment or it does not have the ability to redeem the investment in the near term at net asset value per share (or its equivalent), the fair value measurement of the investment should be categorized within Level 3 of the fair value hierarchy.

Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)[5]

FASB ASC 820-10-35-54B states that an investment within the scope of paragraphs 4–5 of FASB ASC 820-10-15 for which fair value is measured using net asset value per share (or its equivalent, for example member units or an ownership interest in partners' capital to which a proportionate share of net assets is attributed) as a practical expedient, as described in FASB ASC 820-10-35-59, should not be categorized within the fair value hierarchy. In addition, the disclosure requirements in FASB ASC 820-10-50-2 do not apply to that investment. Disclosures required for an investment for which fair value is measured using net asset value per share (or its equivalent) as a practical expedient are described in FASB ASC 820-10-50-6A. Although the investment is not categorized within the fair value hierarchy, a reporting entity should provide the amount measured using the net asset value per share (or its equivalent) practical expedient to permit reconciliation of the fair value of investments included in the fair value hierarchy to the line items presented in the statement of financial position in accordance with FASB ASC 820-10-50-2B.

Measuring the Fair Value of Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)[6]

20.38 Paragraphs 59–62 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. This practical expedient permits a reporting entity to estimate the fair value of an investment within the scope of paragraphs 4–5 of FASB ASC 820-10-15 using the net asset value per share (or its equivalent) of the investment, if the net asset value per share of the investment is calculated in a manner consistent with the measurement principles of FASB ASC 946, *Financial Services—Investment Companies*, as of the reporting entity's measurement date.

20.39 According to FASB ASC 820-10-15-4, the guidance contained in paragraphs 59–62 of FASB ASC 820-10-35 and FASB ASC 820-10-50-6A should

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[5] FASB ASU No. 2015-07, *Fair Value Measurement (Topic 820): Disclosures for Investments in Certain Entities That Calculate Net asset Value per Share (or Its Equivalent) (a consensus of the FASB Emerging Issues Task Force)*, issued in May 2015, applies to reporting entities that elect to measure the fair value of an investment within the scope of paragraphs 4–5 of FASB *Accounting Standards Codification* (ASC) 820-10-15 using the net asset value per share (or its equivalent) practical expedient in FASB ASC 820-10-35-59. FASB ASU No. 2015-07 is effective for public business entities for fiscal years beginning after December 15, 2015, and interim periods within those fiscal years. For all other entities, the amendments in this ASU are effective for fiscal years beginning after December 15, 2016, and interim periods within those fiscal years. A reporting entity should apply the amendments retrospectively to all periods presented. The retrospective approach requires that an investment for which fair value is measured using the net asset value per share practical expedient be removed from the fair value hierarchy in all periods presented in an entity's financial statements. Earlier application is permitted.

Readers are encouraged to read the full text of the ASU, available at www.fasb.org. Readers should apply the appropriate guidance based on their facts and circumstances.

[6] Technical Questions and Answers (Q&A) sections 2220.18–.27 (AICPA, *Technical Questions and Answers*) are intended to assist reporting entities when implementing the provisions of FASB ASC 820 to estimate the fair value of their investments in certain entities that calculate net asset value. Q&A sections 2220.18–.27 apply to investments that are required to be measured and reported at fair value and are within the scope of paragraphs 4–5 of FASB ASC 820-10-15.

apply only to an investment that meets both of the following criteria as of the entity's measurement date:

a. The investment does not have a readily determinable fair value.[7]

b. The investment is an investment company within the scope of FASB ASC 946 or is an investment in a real estate fund for which it is industry practice to measure investment assets at fair value on a recurring basis and to issue financial statements that are consistent with the measurement principles in FASB ASC 946.

20.40 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.

20.41 FASB ASC 820-10-35-61 states that a reporting entity should decide on an investment-by-investment basis whether to apply the practical expedient in FASB ASC 820-10-35-59 and should apply the practical expedient consistently to the fair value measurement of the reporting entity's entire position in a particular investment, unless it is probable at the measurement date that the 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 FASB ASC 820 (that is, the reporting entity should not apply the guidance discussed in FASB ASC 820-10-35-59).

Measuring Fair Value When the Volume or Level of Activity for an Asset or a Liability Has Significantly Decreased

20.42 Paragraphs 54C–54J of FASB ASC 820-10-35 clarify the application of FASB ASC 820 in measuring fair value when the volume and level of activity for an asset or liability has significantly decreased. Guidance is also included in identifying transactions that are not orderly. In addition, paragraphs 90–98 of FASB ASC 820-10-55 include illustrations on the application of this guidance.

20.43 The fair value of an asset or liability might be affected when there has been a significant decrease in the volume or level of activity for the asset or liability in relation to normal market activity for the asset or liability (or similar assets or liabilities). To determine whether there has been a significant decrease, FASB ASC 820-10-35-54C provides a number of factors a reporting entity should evaluate for significance and relevance. According to FASB ASC 820-10-35-54D, if, after evaluating the factors, the reporting entity concludes that there has been a significant decrease, further analysis of the transactions

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[7] FASB ASC 820-10-15-5 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 SEC or in the over-the-counter market, provided that those 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 OTC Markets Group, Inc. The definition notes that restricted stock meets that definition if the restriction expires within one year. If an investment otherwise would have a readily determinable fair value, except that the investment has a restriction expiring in more than one year, the reporting entity should not apply paragraphs 59–62 of FASB ASC 820-10-35 and in FASB ASC 820-10-50-6A to the investment.

or quoted prices is needed. A decrease in the volume or level of activity on its own may not indicate that a transaction price or quoted price does not represent fair value or that a transaction in that market is not orderly. However, if a reporting entity determines that a transaction or quoted price does not represent fair value (for example, there may be transactions that are not orderly), an adjustment to the transaction or quoted price will be necessary if the reporting entity uses that price as a basis for measuring fair value and that adjustment may be significant to the fair value measurement in its entirety.

20.44 If determined there has been a significant decrease, FASB ASC 820-10-35-54F states that a change in valuation technique or the use of multiple valuation techniques may be appropriate (for example, the use of a market approach and a present value technique). When weighing indications of fair value resulting from the use of multiple valuation techniques, a reporting entity should consider the reasonableness of the range of fair value measurements. The objective is to determine the point within the range that is most representative of fair value under current market conditions. A wide range of fair value estimates may be an indication that further analysis is needed.

20.45 Even when there has been such a significant decrease, paragraphs 54G–54H of FASB ASC 820-10-35 state that the objective of a fair value measurement remains the same. Estimating the price at which market participants would be willing to enter into a transaction 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 at the measurement date and requires judgment. A reporting entity's intention to hold the asset or to settle or otherwise fulfill the liability is not relevant when measuring fair value because fair value is a market-based measurement, not an entity-specific measurement.

20.46 *Identifying transactions that are not orderly*. According to FASB ASC 820-10-35-54I, the determination of whether a transaction is orderly (or is not orderly) is more difficult if there has been a significant decrease in the volume or level of activity for the asset or liability in relation to normal market activity for the asset or liability (or similar assets or liabilities). In such circumstances, it is not appropriate to conclude that all transactions in that market are not orderly (that is, forced liquidations or distressed sales). Circumstances that may indicate that a transaction is not orderly include the following:

- There was not adequate exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities under current market conditions.
- There was a usual and customary marketing period, but the seller marketed the asset or liability to a single market participant.
- The seller is in or near bankruptcy or receivership (that is, the seller is distressed).
- The seller was required to sell to meet regulatory or legal requirements (that is, the seller was forced).
- The transaction price is an outlier when compared with other recent transactions for the same or a similar asset or liability.

A reporting entity should evaluate the circumstances to determine whether the transaction is orderly based on the weight of the evidence available.

20.47 FASB ASC 820-10-35-54J states that a reporting entity should consider all the following when measuring fair value or estimating market risk premiums:

- If the evidence indicates the transaction is not orderly, a reporting entity should place little, if any, weight (compared with other indications of fair value) on that transaction price.
- If the evidence indicates that a transaction is orderly, a reporting entity should take into account that transaction price. The amount of weight placed on the transaction price when compared with other indications of fair value will depend on the facts and circumstances, such as the following:
  - — The volume of the transaction.
  - — The comparability of the transaction to the asset or liability being measured.
  - — The proximity of the transaction to the measurement date.
- If a reporting entity does not have sufficient information to conclude whether a transaction is orderly, it should take into account the transaction price. However, the transaction price may not represent fair value (that is, the transaction price is not necessarily the sole or primary basis for measuring fair value or estimating market risk premiums). When a reporting entity does not have sufficient information to conclude whether particular transactions are orderly, the reporting entity should place less weight on those transactions when compared with other transactions that are known to be orderly.

A reporting entity need not undertake exhaustive efforts to determine whether a transaction is orderly, but it should not ignore information that is reasonably available. When a reporting entity is a party to a transaction, it is presumed to have sufficient information to conclude whether a transaction is orderly.

Using Quoted Prices Provided by Third Parties

20.48 Paragraphs 54K–54M of FASB ASC 820-10-35 address using quoted prices provided by third parties. Specifically, FASB ASC 820 does not preclude the use of quoted priced provided by third parties, such as pricing services or brokers, if a reporting entity has determined that the quoted prices provided by those parties are developed in accordance with FASB ASC 820. If there has been a significant decrease in the volume or level of activity for the asset or liability, a reporting entity should evaluate whether the quoted prices provided by third parties are developed using current information that reflects orderly transactions or a valuation technique that reflects market participation assumptions (including assumptions about risk). In weighing a quoted price as an input to a fair value measurement, a reporting entity places less weight (when compared with other indications of fair value that reflect the results of transactions) on quotes that do not reflect the result of transactions. Furthermore, the nature of a quote (for example, whether the quote is an indicative price or a binding offer) should be taken into account when weighing the available evidence, with more weight given to quotes provided by third parties that represent binding offers. Management is ultimately responsible for the estimates recorded on its financial statements and accordingly should establish processes and procedures for persons with an appropriate level of expertise to review prices provided by third parties for reasonableness.

Disclosures[8]

20.49 FASB ASC 820-10-50 discusses the disclosures required for assets and liabilities measured at fair value. FASB ASC 820-10-50-1 explains that the reporting entity should disclose information that helps users of its financial statements assess both (*a*) for assets and liabilities that are measured at fair value on a recurring or nonrecurring basis in the statement of financial position after 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 (or changes in net assets) or other comprehensive income for the period.

20.50 To meet the objectives described in FASB ASC 820-10-50-1 (see paragraph 20.49), FASB ASC 820-10-50-2 requires a reporting entity to disclose, at a minimum, the following information for each of assets and liabilities measured at fair value in the statement of financial position after initial recognition:

a. For recurring fair value measurements, the fair value measurement at the end of the reporting period, and for nonrecurring fair value measurements, the fair value measurement at the relevant measurement date and the reasons for the measurement.

b. For recurring and nonrecurring fair value measurements, the level of the fair value hierarchy within which the fair value measurements are categorized in their entirety (Level 1, 2, or 3).

c. For assets and liabilities held at the end of the reporting period that are measured at fair value on a recurring basis, the amounts of any transfers between Level 1 and Level 2 of the fair value hierarchy, the reasons for the transfers, and the reporting entity's policy for determining when transfers between levels are deemed to have occurred (see FASB ASC 820-10-50-2C discussed in paragraph 20.52). Transfers into each level should be disclosed and discussed separately from transfers out of each level.

d. For recurring and nonrecurring fair value measurements categorized within Level 2 and Level 3 of the fair value hierarchy, a description of the valuation technique(s) and the inputs used in the fair value measurement. If there has been a change in valuation technique, the reporting entity should disclose that change and the reason(s) for making it. For fair value measurements categorized within Level 3 of the fair value hierarchy, a reporting entity should

[8] FASB has an open project titled Disclosure Framework—Disclosure Review: Fair Value Measurement. This project is a subset of the Disclosure Framework project intended to improve the effectiveness of disclosures in notes to financial statements by clearing communicating the information that is most important to users of each entity's financial statements. In December 2015, FASB issued proposed ASU *Fair Value Measurement (Topic 820): Disclosure Framework—Changes to the Disclosure Requirements for Fair Value Measurement* to propose modification to the disclosure requirements on fair value measurements.

Readers are encouraged to visit the "Technical Agenda" page at www.fasb.org for the latest developments regarding the project and how it may impact the guidance in this chapter.

provide quantitative information about the significant unobservable inputs used in the fair value measurement. A reporting entity is not required to create quantitative information to comply with this disclosure requirement if quantitative unobservable inputs are not developed by the reporting entity when measuring fair value (for example, when a reporting entity uses prices from prior transactions or third-party pricing information without adjustment). However, when providing this disclosure, a reporting entity cannot ignore quantitative unobservable inputs that are significant to the fair value measurement and are reasonably available to the reporting entity.

e. For recurring fair value measurements categorized within Level 3 of the fair value hierarchy, a reconciliation from the opening balances to the closing balances, disclosing separately changes during the period attributable to the following:

   i. Total gains or losses for the period recognized in earnings (or changes in net assets), and the line item(s) in the statement of income (or activities) in which those gains or losses are recognized.

   ii. Total gains or losses for the period recognized in other comprehensive income, and the line item(s) in other comprehensive income in which those gains or losses are recognized.

   iii. Purchases, sales, issuances, and settlements (each of those types of changes disclosed separately).

   iv. The amounts of any transfers into or out of Level 3 of the fair value hierarchy, the reasons for those transfers, and the reporting entity's policy for determining when transfers between levels are deemed to have occurred (see FASB ASC 820-10-50-2C discussed in paragraph 20.52). Transfers into Level 3 should be disclosed and discussed separately from transfers out of Level 3.

f. For recurring fair value measurements categorized within Level 3 of the fair value hierarchy, the amount of the total gains or losses for the period in item (*e*)(i) included in earnings (or changes in net assets) that is attributable to the change in unrealized gains or losses relating to those assets and liabilities held at the end of the reporting period, and the line item(s) in the statement of income (or activities) in which those unrealized gains or losses are recognized.

g. For recurring and nonrecurring fair value measurements categorized within Level 3 of the fair value hierarchy, a description of the valuation processes used by the reporting entity (including, for example, how an entity decides its valuation policies and procedures and analyzes changes in fair value measurements from period to period).

h. For recurring fair value measurements categorized within Level 3 of the fair value hierarchy, a narrative description of the sensitivity of the fair value measurement to changes in unobservable inputs if a change in those inputs to a different amount might result in a significantly higher or lower fair value measurement. If there are interrelationships between those inputs and other unobservable inputs used in the fair value measurement, a reporting entity should also provide a description of those interrelationships and how they magnify or mitigate the effect of changes in the unobservable inputs on the fair value measurement. To comply with that disclosure requirement, the narrative description of the sensitivity to changes in unobservable inputs should include, at a minimum, the unobservable inputs disclosed when complying with item (*d*).

i. For recurring and nonrecurring fair value measurements, if the highest and best use of a nonfinancial asset differs from its current use, a reporting entity should disclose that fact and why the nonfinancial asset is being used in a manner that differs from its highest and best use.

FASB ASC 820-10-50-2F states that a nonpublic entity is not required to disclose the information discussed in items (*c*) and (*h*) unless required by another FASB ASC topic.

To meet the objectives described in FASB ASC 820-10-50-1 (see paragraph 20.49), FASB ASC 820-10-50-2 requires a reporting entity to disclose, at a minimum, the following information for each of assets and liabilities measured at fair value in the statement of financial position after initial recognition:

a . For recurring fair value measurements, the fair value measurement at the end of the reporting period, and for nonrecurring fair value measurements, the fair value measurement at the relevant measurement date and the reasons for the measurement.

b . For recurring and nonrecurring fair value measurements, the level of the fair value hierarchy within which the fair value measurements are categorized in their entirety (Level 1, 2, or 3).

c . For assets and liabilities held at the end of the reporting period that are measured at fair value on a recurring basis, the amounts of any transfers between Level 1 and Level 2 of the fair value hierarchy, the reasons for the transfers, and the reporting entity's policy for determining when transfers between levels are deemed to have occurred (see FASB ASC 820-10-50-2C discussed in paragraph 20.52). Transfers into each level should be disclosed and discussed separately from transfers out of each level.

d . For recurring and nonrecurring fair value measurements categorized within Level 2 and Level 3 of the fair value hierarchy, a description of the valuation technique(s) and the inputs used in the fair value measurement. If there has been a change in either or both a valuation approach and a valuation technique, the reporting entity should disclose that change and the reason(s) for making it. For fair value measurements categorized within Level 3 of the fair value hierarchy, a reporting entity should provide quantitative information about the significant unobservable inputs used in the fair value measurement. A reporting entity is not required to create quantitative information to comply with this disclosure requirement if quantitative unobservable inputs are not developed by the reporting entity when measuring fair value (for example, when a reporting entity uses prices from prior transactions or third-party pricing information without adjustment). However, when providing this disclosure, a reporting entity cannot ignore quantitative unobservable inputs that are significant to the fair value measurement and are reasonably available to the reporting entity.[9]

e . For recurring fair value measurements categorized within Level 3 of the fair value hierarchy, a reconciliation from the opening balances to the closing balances, disclosing separately changes during the period attributable to the following:

   i. Total gains or losses for the period recognized in earnings (or changes in net assets), and the line item(s) in the statement of income (or activities) in which those gains or losses are recognized.

   ii. Total gains or losses for the period recognized in other comprehensive income, and the line item(s) in other comprehensive income in which those gains or losses are recognized.

   iii. Purchases, sales, issuances, and settlements (each of those types of changes disclosed separately).

   iv. The amounts of any transfers into or out of Level 3 of the fair value hierarchy, the reasons for those transfers, and the reporting entity's policy for determining when transfers between levels are deemed to have occurred (see FASB ASC 820-10-50-2C discussed in paragraph 20.52). Transfers into Level 3 should be disclosed and discussed separately from transfers out of Level 3.

f . For recurring fair value measurements categorized within Level 3 of the fair value hierarchy, the amount of the total gains or losses for the period in item (*e*)(i) included in earnings (or changes in net assets) that is attributable to the change in unrealized gains or losses relating to those assets and liabilities held at the end of the reporting period, and the line item(s) in the statement of income (or activities) in which those unrealized gains or losses are recognized.

g . For recurring and nonrecurring fair value measurements categorized within Level 3 of the fair value hierarchy, a description of the valuation processes used by the reporting entity (including, for example, how an entity decides its valuation policies and procedures and analyzes changes in fair value measurements from period to period).

h . For recurring fair value measurements categorized within Level 3 of the fair value hierarchy, a narrative description of the sensitivity of the fair value measurement to changes in unobservable inputs if a change in those inputs to a different amount might result in a significantly higher or lower fair value measurement. If there are interrelationships between those inputs and other unobservable inputs used in the fair value measurement, a report-

[9] See footnote 3.

ing entity should also provide a description of those interrelationships and how they magnify or mitigate the effect of changes in the unobservable inputs on the fair value measurement. To comply with that disclosure requirement, the narrative description of the sensitivity to changes in unobservable inputs should include, at a minimum, the unobservable inputs disclosed when complying with item (*d*).

i . For recurring and nonrecurring fair value measurements, if the highest and best use of a nonfinancial asset differs from its current use, a reporting entity should disclose that fact and why the nonfinancial asset is being used in a manner that differs from its highest and best use.

FASB ASC 820-10-50-2F states that a nonpublic entity is not required to disclose the information discussed in items (*c*) and (*h*) unless required by another FASB ASC topic.

20.51 FASB ASC 820-10-50-2B explains that a reporting entity should determine appropriate classes of assets and liabilities on the basis of (*a*) the nature, characteristics, and risks of the asset or liability; and (*b*) the level of the fair value hierarchy within which the fair value measurement is categorized. Further, the number of classes may need to be greater for fair value measurements within Level 3 of the fair value hierarchy because those measurements have a greater degree of uncertainty and subjectivity. A class of assets and liabilities will often require greater disaggregation than the line items presented in the statement of financial position.

20.52 FASB ASC 820-10-50-2C explains that a reporting entity should disclose and consistently follow its policy for determining when transfers between levels of the fair value hierarchy are deemed to have occurred in accordance with items (bb) and (c)(3) in FASB ASC 820-10-50-2 (see items (*c*) and (*e*)(iv) in paragraph 20.50). The policy about the timing of recognizing transfers should be the same for transfers into the levels as for transfers out of the levels. Examples of policies for determining the timing of transfers include the following:

- The date of the event or change in circumstances that caused the transfer
- The beginning of the reporting period
- The end of the reporting period

20.53 If a reporting entity makes an accounting policy decision to use the exception in FASB ASC 820-10-35-18D (see paragraph 20.21), FASB ASC 820-10-50-2D requires disclosure of that fact.

20.54 For each class of assets and liabilities not measured at fair value in the statement of financial position but for which the fair value is disclosed, FASB ASC 820-10-50-2E requires a reporting entity to disclose the information required by items (*b*), (*bbb*)(1), and (*h*) in FASB ASC 820-10-50-2 (see items (*b*), (*d*), and (*i*) in paragraph 20.50). However, a reporting entity is not required to provide the quantitative disclosures about significant unobservable inputs used in fair value measurements categorized within Level 3 of the fair value hierarchy required by item (*bbb*)(2) in FASB ASC 820-10-50-2 (see item (*d*) in paragraph 20.50). For such assets and liabilities, a reporting entity does not need to provide the other disclosures required by FASB ASC 820.

20.55 FASB ASC 820-10-50-3 states that, for derivative assets and liabilities, the reporting entity should present both the fair value disclosures required by items (a)–(bb) in FASB ASC 820-10-50-2 (see items (*a*)–(*c*) in paragraph 20.50) on a gross basis and the reconciliation disclosures required by items (c)–(d) in FASB ASC 820-10-50-2 (see items (*e*)–(*f*) in paragraph 20.50) on either a gross or net basis.

20.56 For a liability measured at fair value and issued with an inseparable third-party credit enhancement, FASB ASC 820-10-50-4A requires an issuer to disclose the existence of that credit enhancement.

Additional Disclosures for Financial Instruments

20.57 Paragraphs 2A–7 of FASB ASC 825-10-50 provide guidance about which entities are required to apply the disclosure requirements for financial instruments. For annual reporting periods, the disclosure guidance related to fair value of financial instruments in paragraphs 10–19 of FASB ASC 825-10-50 applies to all entities but is optional for an entity that is a nonpublic entity, the entity's total assets are less than $100 million on the date of the financial statements, and the entity has no instrument that, in whole or in part, is accounted for as a derivative instrument under FASB ASC 815 other than commitments related to origination of mortgage loans to be held for sale during the reporting period. For all interim periods, the disclosure guidance applies to all entities but is optional for those entities that do not meet the definition of a *publicly traded company*, as defined in U.S. generally accepted accounting principles (GAAP).

Update 20-1 *Accounting and Reporting*: Recognition and Measurement of Financial Assets and Financial Liabilities

FASB Accounting Standards Update (ASU) No. 2016-01, *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*, issued in January 2016, is effective for fiscal years, and interim periods within those fiscal years, of a public business entity beginning after December 15, 2017.

For all other entities (including not-for-profit entities and employee benefit plans within the scope of FASB ASC 960, *Plan Accounting—Defined Benefit Plans*, through FASB ASC 965, *Plan Accounting—Health and Welfare Benefit Plans*, on plan accounting), FASB ASU No. 2016-01 is effective for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. Early application is permitted for all other entities as of the fiscal years beginning after December 15, 2017, including interim periods within those fiscal years.

All entities may adopt the presentation guidance in paragraphs 5–7 of FASB ASC 825-10-45 for financial statements of fiscal years or interim periods that have not yet been issued or that have not yet been made available for issuance. Furthermore, entities that are not public business entities may elect not to disclose the information about fair value of financial instruments required by the "General" subsection of FASB ASC 825-10-50 in financial statements of fiscal years or interim periods that have not yet been made available for issuance. Except as indicated previously in this paragraph, early application is not permitted.

FASB ASU No. 2016-01 addresses certain aspects of recognition, measurement, presentation, and disclosure of financial instruments and affects all entities that hold financial assets or owe financial liabilities. Among other provisions of the guidance, the amendments in this ASU exempt all entities that are not public business entities from disclosing fair value information for financial instruments measured at amortized cost. In addition, for public business entities, the amendments supersede the requirement to disclose the methods and significant assumptions used in calculating the fair value of financial instruments required to be disclosed for financial instruments measured at amortized cost on the balance sheet.

Furthermore, the amendments in this ASU require public business entities that are required to disclose the fair value of financial instruments measured at amortized cost on the balance sheet to measure that fair value using the exit price notion consistent with FASB ASC 820. This change to GAAP eliminates the entry price method previously used by some entities for disclosure purposes for some financial assets.

In addition, the amendments in this ASU require separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (that is, securities or loans and receivables) on the balance sheet or in the accompanying notes to the financial statements.

This edition of the guide has not been updated to reflect changes as a result of this ASU, however, this paragraph will be updated in a future edition. Readers are encouraged to consult the full text of this ASU on FASB's website at www.fasb.org.

For more information on FASB ASU No. 2016-01, see appendix G, "Accounting for Financial Instruments," of this guide.

20.58 *Concentrations of credit risk of all financial instruments.* 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. When applying this disclosure requirement, the term *financial instrument* includes derivative instruments accounted for under FASB ASC 815. Refer to FASB ASC 825-10-50-21 for specific information to be disclosed about each significant concentration. Entities are not required to disclose information about concentrations of credit risk for the financial instruments included in FASB ASC 825-10-50-22.

20.59 *Market risk of all financial instruments.* FASB ASC 825-10-50-23 states that 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. Appropriate ways of reporting that quantitative information will differ for different entities and will likely evolve over time as management approaches and measurement techniques evolve.

Fair Value Measurements of Investments in Certain Entities That Calculate Net Asset Value per Share (or its Equivalent)

20.60 For investments that are within the scope of paragraphs 4–5 of FASB ASC 820-10-15 and measured at fair value on a recurring or nonrecurring basis during the period, FASB ASC 820-10-50-6A requires disclosure of information that will help users of the financial statements to understand the nature and risks of the investments and whether the investments are probable of being sold at amounts different from net asset value per share (or its equivalent). These disclosures, to the extent applicable, are required for each class of investment. The required disclosures, at a minimum, are as follows:

a. The fair value measurement (as determined by applying paragraphs 59–62 of FASB ASC 820-10-35) of the investments in the class at the reporting date and a description of the significant investment strategies of the investee(s) in the class.

b. For each class of investment that includes investments that can never be redeemed with the investees, but the reporting entity receives distributions through the liquidation of the underlying assets of the investees, the reporting entity's estimate of the period of time over which the underlying assets are expected to be liquidated by the investees.

c. The amount of the reporting entity's unfunded commitments related to investments in the class.

d. A general description of the terms and conditions upon which the investor may redeem investments in the class (for example, quarterly redemption with 60 days' notice).

e. The circumstances in which an otherwise redeemable investment in the class (or a portion thereof) might not be redeemable (for example, investments subject to a lockup or gate). Also, for those otherwise redeemable investments that are restricted from redemption as of the reporting entity's measurement date, the reporting entity should disclose its estimate of when the restriction from redemption might lapse. If an estimate cannot be made, the reporting entity should disclose that fact and how long the restriction has been in effect.

f. Any other significant restriction on the ability to sell investments in the class at the measurement date.

g. If a reporting entity determines that it is probable that it will sell an investment(s) for an amount different from net asset value per share (or its equivalent), as described in FASB ASC 820-10-35-62, the reporting entity should disclose the total fair value of all investments that meet the criteria in FASB ASC 820-10-35-62 and any remaining actions required to complete the sale.

h. If a group of investments would otherwise meet the criteria in FASB ASC 820-10-35-62 but the individual investments to be sold have not been identified (for example, if a reporting entity decides to sell 20 percent of its investments in private equity funds, but the individual investments to be sold have not been identified), so the investments continue to qualify for the practical expedient in FASB ASC 820-10-35-59, the reporting entity should disclose its plans to sell and any remaining actions required to complete the sale(s).

For investments that are within the scope of paragraphs 4–5 of FASB ASC 820-10-15 and that are measured using the practical expedient in FASB ASC 820-10-35-59 on a recurring or nonrecurring basis during the period, "Pending Content" in FASB ASC 820-10-50-6A requires disclosure of information that helps users of the financial statements to understand the nature and risks of the investments and whether the investments, if sold, are probable of being sold at amounts different from net asset value per share (or its equivalent).

To meet that objective, to the extent applicable, a reporting entity should disclose, at a minimum, the following information for each class of investment:[10]

a. The fair value measurement (as determined by applying paragraphs 59–62 of FASB ASC 820-10-35) of the investments in the class at the reporting date and a description of the significant investment strategies of the investee(s) in the class.

b. For each class of investment that includes investments that can never be redeemed with the investees, but the reporting entity receives distributions through the liquidation of the underlying assets of the investees, the reporting entity's estimate of the period of time over which the underlying assets are expected to be liquidated by the investees.

c. The amount of the reporting entity's unfunded commitments related to investments in the class.

d. A general description of the terms and conditions upon which the investor may redeem investments in the class (for example, quarterly redemption with 60 days' notice).

e. The circumstances in which an otherwise redeemable investment in the class (or a portion thereof) might not be redeemable (for example, investments subject to a lockup or gate). Also, for those otherwise redeemable investments that are restricted from redemption as of the reporting entity's measurement date, the reporting entity should disclose its estimate of when the restriction from redemption might lapse. If an estimate cannot be made, the reporting entity should disclose that fact and how long the restriction has been in effect.

f. Any other significant restriction on the ability to sell investments in the class at the measurement date.

g. If a group of investments would otherwise meet the criteria in FASB ASC 820-10-35-62 but the individual investments to be sold have not been identified (for example, if a reporting entity decides to sell 20 percent of its investments in private equity funds, but the individual investments to be sold have not been identified), so the investments continue to qualify for the practical expedient in FASB ASC 820-10-35-59, the reporting entity should disclose its plans to sell and any remaining actions required to complete the sale(s).

Fair Value Option

20.61 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 earnings 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 as discussed in FASB ASC 825-10-25-7), generally when an instrument is initially recognized in the financial statements and certain other

[10] See footnote 5.

election dates as outlined in FASB ASC 825-10-25-4. 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 (described in FASB ASC 825-10-15-4).

20.62 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 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).

20.63 FASB ASC 825-10-45 and 825-10-50[11] 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.

Auditing Considerations[12]

20.64 AU-C section 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* (AICPA, *Professional*

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[11] Q&A 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 Questions and Answers*), addresses the applicability of FASB ASC 820 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.

As a result of FASB ASU No. 2013-03, *Financial Instruments (Topic 825): Clarifying the Scope and Applicability of a Particular Disclosure to Nonpublic Entities*, FASB ASC 825-10-50-3A was added to exempt all nonpublic entities from providing the disclosure in item (d) in FASB ASC 825-10-50-10 for items disclosed at fair value but not measured at fair value in the statement of financial position.

[12] The auditing content in this guide focuses primarily on generally accepted auditing standards issued by the Auditing Standards Board and is applicable to audits of the financial statements of those entities not subject to the oversight authority of the PCAOB (that is, those audit reports not within the PCAOB's jurisdiction as defined by the Sarbanes-Oxley Act of 2002, as amended—hereinafter referred to as *nonissuers*). However, considerations for audits of entities subject to the oversight authority of the PCAOB (that is, those audit reports within the PCAOB's jurisdiction as defined by the Sarbanes-Oxley Act of 2002, as amended) may be discussed within this guide's chapter text. When such discussion is provided, the related paragraphs are designated with the following title: *Considerations for Audits Performed in Accordance With PCAOB Standards*.

Standards), addresses the auditor's responsibilities relating to accounting estimates, including fair value accounting estimates and related disclosures, in an audit of financial statements. Specifically, it expands on how AU-C sections 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*; 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*); and other relevant AU-C sections are to be applied with regard to accounting estimates. It also includes requirements and guidance related to misstatements of individual accounting estimates and indicators of possible management bias.

20.65 If the preparation of the financial statements involves the use of expertise in a field other than accounting, paragraph .A7 of AU-C section 620, *Using the Work of an Auditor's Specialist* (AICPA, *Professional Standards*), states that the auditor, who is skilled in accounting and auditing, may not possess the necessary expertise to audit those financial statements. The engagement partner is required by AU-C section 220, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards* (AICPA, *Professional Standards*), to be satisfied that the engagement team and any external *auditor's specialists* (defined in the auditing standards as an individual or organization possessing expertise in a field other than accounting or auditing, whose work in that field is used by the auditor to assist the auditor in obtaining sufficient appropriate audit evidence) who are not part of the engagement team, collectively, have the appropriate competence and capabilities to perform the audit engagement.[13] Further, the auditor is required by AU-C section 300, *Planning an Audit* (AICPA, *Professional Standards*), to ascertain the nature, timing, and extent of resources necessary to perform the engagement.[14] The auditor's determination of whether to use the work of an auditor's specialist, and, if so, when and to what extent, assists the auditor in meeting these requirements. As the audit progresses or as circumstances change, the auditor may need to revise earlier decisions about using the work of an auditor's specialist.

20.66 *Auditing interests in trusts held by a third-party trustee and reported at fair value.* In circumstances in which the auditor determines that the nature and extent of auditing procedures should include verifying the existence and testing the measurement of investments held by a trust simply receiving a confirmation from the trustee, either in aggregate or on an investment by investment basis, does not in and of itself constitute adequate audit evidence with respect to the requirements for auditing the fair value of the interest in trust under AU-C section 540. In addition, receiving conformation from the trustee for investments in aggregate does not constitute adequate audit evidence with respect to the existence assertion. Receiving confirmation from the trustee on an investment-by-investment basis, however, typically would constitute adequate audit evidence with respect to the existence assertion. Also, in discussing obtaining an understanding of how management identifies the need for accounting estimates, paragraph .A15 of AU-C section 540 states that the preparation and fair presentation of the financial statements requires management to determine whether a transaction, an event, or a condition gives rise to the

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[13] Paragraph .16 of AU-C section 220, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards* (AICPA, *Professional Standards*).

[14] Paragraph .08*e* of AU-C section 300, *Planning an Audit* (AICPA, *Professional Standards*).

need to make an accounting estimate and that all necessary accounting estimates have been recognized, measured, and disclosed in the financial statements in accordance with the applicable financial reporting framework.

20.67 In circumstances in which the auditor is unable to audit the existence or measurement of interests in trusts at the financial statement date, the auditor should consider whether that scope limitation requires the auditor to either qualify his or her opinion or to disclaim an opinion, as discussed in AU-C section 705, *Modifications to the Opinion in the Independent Auditor's Report* (AICPA, *Professional Standards*).

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Considerations for Audits Performed in Accordance With PCAOB Standards[15]

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. 400.02), 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. 4, *Auditor Considerations Regarding Fair Value Measurements, Disclosures, and Other-Than-Temporary Impairments* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400.04), 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.

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[15] 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.

Chapter 21

Trust and Asset Management Activities

FASB *Accounting Standards Codification* (ASC) 606, *Revenue from Contracts with Customers*

FASB ASC 606 is effective for annual reporting periods of a public business entity, a not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market, and an employee benefit plan that files or furnishes financial statements with or to the SEC beginning after December 15, 2017, including interim periods within that reporting period. Early application is permitted only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period.

For all other entities, FASB ASC 606 is effective for annual reporting periods beginning after December 15, 2018, and interim periods within annual periods beginning after December 15, 2019. Other entities may elect to adopt the standard earlier, however, only as of either

- an annual reporting period beginning after December 15, 2016, including interim periods within that reporting period, or
- an annual reporting period beginning after December 15, 2016, and interim periods within annual periods beginning one year after the annual reporting period in which an entity first applies the "Pending Content" that links to FASB ASC 606-10-65-1.

FASB ASC 606 provides a framework for revenue recognition and supersedes or amends several of the revenue recognition requirements in FASB ASC 605, *Revenue Recognition*, as well as guidance within the 900 series of industry-specific topics, including FASB ASC 942, *Financial Services—Depository and Lending*. The standard applies to any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets unless those contracts are within the scope of other standards (for example, insurance or lease contracts).

Readers are encouraged to consult the full text of FASB ASC 606 on FASB's website at www.fasb.org.

The AICPA has formed 16 industry task forces to assist in developing a new Audit and Accounting Guide on revenue recognition that provides helpful hints and illustrative examples for how to apply the new standard (guide available at www.aicpastore.com). Revenue recognition implementation issues identified by the Depository and Lending Institutions Revenue Recognition Task Force are available for informal comment, after review by the AICPA Financial Reporting Executive Committee, at the "Depository and Lending Institutions Revenue Recognition Task Force" page at aicpa.org.

Readers are encouraged to submit comments to revreccomments@aicpa.org.

For more information, see appendix E, "The New Revenue Recognition Standard: FASB ASC 606," of this guide.

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.

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.

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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 AT-C section 320, *Reporting on an Examination of Controls at a Service Organization Relevant to User Entities' Internal Control Over Financial Reporting* (AICPA, *Professional Standards*). The related AICPA Guide *Reporting on an Examination of Controls at a Service Organization Relevant to User Entities' Internal Control Over Financial Reporting (SOC 1®)* provides further guidance. Paragraph .89 of AU-C section 940, *An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements* (AICPA, *Professional Standards*), states that the auditor in required to perform the procedures in AU-C section 402, *Audit Considerations Relating to an Entity Using a Service Organization* (AICPA, *Professional Standards*), with respect to the activities performed by the service organization. In an audit of internal control over financial reporting, the auditor should also obtain evidence that controls at the service organization that are relevant to the auditor's opinion on internal control over financial reporting are operating effectively.

[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 SEC and PCAOB 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 (the 1934 Act). In place of the blanket exemption, GLBA provided 11 specific exceptions to 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, "Definition of Terms and Exemptions Relating to the 'Broker' Exceptions for Banks," defines important terms relating to the broker exceptions in the 1934 Act and provides a number of exemptions.

[4] Most notably, Title 12 U.S. *Code of Federal Regulations* (CFR) Parts 9 and 150; state fiduciary laws often provide additional requirements.

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 for both federal savings associations (Title 12 U.S. *Code of Federal Regulations* [CFR] Part 150.440) and national banks (12 CFR 9.9), the Office of the Comptroller of the Currency (OCC) requires 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. Trusts maintaining state charters would be required to follow rules issued by the individual states.

21.07 The audit requirements of the 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 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.

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.

[5] Common trust funds are exempt from federal income taxes under Section 584 of the IRC. Collective investment funds are exempt from federal income taxes under IRS Revenue Ruling 81-100.

Readers may refer to the FDIC's nondeposit investment products exam procedures as a resource for evaluating these transactions.

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

Update 21-1 *Accounting and Reporting*: Revenue From Contracts With Customers

FASB ASC 606 is effective for annual reporting periods of a public business entity, a not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market, and an employee benefit plan that files or furnishes financial statements with or to the SEC beginning after December 15, 2017, including interim periods within that reporting period. Early application is permitted only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period.

For all other entities, FASB ASC 606 is effective for annual reporting periods beginning after December 15, 2018, and interim periods within annual periods beginning after December 15, 2019. Other entities may elect to adopt the standard earlier, however, only as either

- an annual reporting period beginning after December 15, 2016, including interim periods within that reporting period, or
- an annual reporting period beginning after December 15, 2016, and interim periods within annual periods beginning one year after the annual reporting period in which an entity first applies the "Pending Content" that links to FASB ASC 606-10-65-1.

FASB ASC 606 provides a framework for revenue recognition and supersedes or amends several of the revenue recognition requirements in FASB ASC 605 as well as guidance within the 900 series of industry-specific topics. The standard applies to any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets unless those contracts are within the scope of other standards (for example, insurance or lease contracts).

Readers are encouraged to consult the full text of FASB ASC 606 on FASB's website at www.fasb.org.

For more information, see appendix E of this guide.

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 FASB 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.[6]

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[7,8]

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

b. fee income resulting from trust activities is recognized properly in the institution's financial statements.

Planning

21.18 In accordance with AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), the objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and relevant assertion levels through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material

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[6] In accordance with 12 CFR 9.10(b), a national bank may deposit funds of a fiduciary account that are awaiting investment or distribution in the commercial, savings, or another department of the bank, unless prohibited by applicable law. To the extent that the funds are not insured by the FDIC, the bank should set aside collateral as security, under the control of the appropriate fiduciary officers and employees, in accordance with 12 CFR 9.10(b)(2). The market value of the collateral set aside must at all times equal or exceed the amount of the uninsured fiduciary funds.

[7] 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, readers can access the SEC's *Staff Responses to Questions about the Custody Rule* from the SEC website. See the section "Compliance With Laws and Regulations" in chapter 5, "Audit Considerations and Certain Financial Reporting Matters," of this guide for further discussion on controls associated with laws and regulations.

[8] The auditing content in this guide focuses primarily on generally accepted auditing standards issued by the Auditing Standards Board and is applicable to audits of the financial statements of those entities not subject to the oversight authority of the PCAOB (that is, those audit reports not within the PCAOB's jurisdiction as defined by the Sarbanes-Oxley Act of 2002, as amended—hereinafter referred to as *nonissuers*). However, considerations for audits of entities subject to the oversight authority of the PCAOB (that is, those audit reports within the PCAOB's jurisdiction as defined by the Sarbanes-Oxley Act of 2002, as amended) may be discussed within this guide's chapter text. When such discussion is provided, the related paragraphs are designated with the following title: *Considerations for Audits Performed in Accordance With PCAOB Standards*.

misstatement (see chapter 5, "Audit Considerations and Certain Financial Reporting Matters," of this guide 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. Auditors might also consider the complexity of the assets owned and the investment mandate.

Internal Control Over Financial Reporting and Possible Tests of Controls

21.19 AU-C section 315 addresses the auditor's responsibility to identify and assess the risks of material misstatement in the financial statements through understanding the entity and its environment, including the entity's internal control. Paragraphs .13–.14 of AU-C section 315 state that the auditor should obtain an understanding of internal control relevant to the audit and, in doing so, should evaluate the design of those controls and determine whether they have been implemented by performing procedures in addition to inquiry of the entity's personnel. (See chapter 5 of this guide for further discussion of the components of internal control.) To provide a basis for designing and performing further audit procedures, paragraph .26 of AU-C section 315 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.

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. Appropriate supervisory personnel routinely review and approve reconciliations.
- 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.
- Written policies and procedures exist for collateral maintenance and reinvestment.
- 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. Appropriate supervisory personnel routinely review and approve reconciliations.
- Measures have been taken to safeguard trust assets by dual control.
- Accurate files of documents creating trusts and authorizing transactions are maintained. A review of document files for completeness is performed by an independent individual.
- Vault deposits and withdrawals are reconciled with accounting records to promptly reflect the purchase and sale of trust assets. Appropriate supervisory personnel routinely review and approve reconciliations.
- Reconciliation of agency accounts (for example, dividends, coupons, bond redemptions, and holdings or principal balance) 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.
- Trust fees are posted to the general ledger by persons who do not have conflicting duties from detailed records produced by the trust system.

- Trust fee income is periodically reviewed for accuracy by appropriate personnel with no conflicting duties.
- Management or independent employees perform an analytical review of trust fee income. Differences are investigated timely.

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 AT-C section 320, *Reporting on an Examination of Controls at a Service Organization Relevant to User Entities' Internal Control Over Financial Reporting* [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. Paragraph .19 of AU-C section 315 states that the auditor should obtain an understanding of the information system, including the related business processes relevant to financial reporting.
- 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.
- 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 AT-C section 320 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
- 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.* Depending on the circumstances, paragraph .A46 of AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*), states that the auditor may determine the following:

- Performing only substantive analytical procedures will be sufficient to reduce audit risk to an acceptably low level, such as, for example, when the auditor's assessment of risk is supported by audit evidence from tests of controls.
- Only tests of details are appropriate.
- A combination of substantive analytical procedures and tests of details are most responsive to the assessed risks.

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 IRC 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

Gray shaded text in this chapter reflects guidance issued but not yet effective as of the date of this guide, July 1, 2017, but becoming effective on or prior to December 31, 2017, exclusive of any option to early adopt ahead of the mandatory effective date. Unless otherwise indicated, all unshaded text reflects guidance that was already effective as of the date of this guide.

FASB *Accounting Standards Codification* (ASC) 606, *Revenue from Contracts with Customers*

FASB ASC 606 is effective for annual reporting periods of a public business entity, a not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market, and an employee benefit plan that files or furnishes financial statements with or to the SEC beginning after December 15, 2017, including interim periods within that reporting period. Early application is permitted only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period.

For all other entities, FASB ASC 606 is effective for annual reporting periods beginning after December 15, 2018, and interim periods within annual periods beginning after December 15, 2019. Other entities may elect to adopt the standard earlier, however, only as of either

- an annual reporting period beginning after December 15, 2016, including interim periods within that reporting period, or
- an annual reporting period beginning after December 15, 2016, and interim periods within annual periods beginning one year after the annual reporting period in which an entity first applies the "Pending Content" that links to FASB ASC 606-10-65-1.

FASB ASC 606 provides a framework for revenue recognition and supersedes or amends several of the revenue recognition requirements in FASB ASC 605, *Revenue Recognition*, as well as guidance within the 900 series of industry-specific topics, including FASB ASC 944, *Financial Services—Insurance*. The standard applies to any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets unless those contracts are within the scope of other standards (for example, insurance or lease contracts).

Readers are encouraged to consult the full text of FASB ASC 606 on FASB's website at www.fasb.org.

The AICPA has formed 16 industry task forces to assist in developing a new Audit and Accounting Guide on revenue recognition that provides helpful hints and illustrative examples for how to apply the new standard (guide available at www.aicpastore.com). Revenue recognition implementation issues identified by the Depository and Lending Institutions Revenue Recognition Task Force are available for informal comment, after review by the AICPA Financial Reporting Executive Committee, at the "Depository and Lending Institutions Revenue Recognition Task Force" page at aicpa.org.

Readers are encouraged to submit comments to revreccomments@aicpa.org.

For more information, see appendix E, "The New Revenue Recognition Standard: FASB ASC 606," of this guide.

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 712.5 of the National Credit Union Administration regulations.

Accounting

22.12 The primary source of accounting guidance for entities that issue insurance contracts is FASB ASC 944.[1] 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.

b. Long-duration contracts generally are not subject to unilateral changes in their provisions, such as noncancelable or guaranteed

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[1] In August 2007, 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 International Accounting Standards Board (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's objective in undertaking the proposed project was to develop a common, high-quality standard that addresses recognition, measurement, presentation, and disclosure requirements for insurance contracts. Although IASB and FASB reached common decisions in many areas, they reached different conclusions in others. In June 2013, FASB issued a proposed Accounting Standards Update (ASU), *Insurance Contracts (Topic 834)*. In light of feedback received on the proposed ASU, FASB elected to limit the scope to insurance entities as described in existing U.S. generally accepted accounting principles (GAAP) (instead of continuing to include all entities that issue insurance contracts or purchase reinsurance contracts as proposed in the June 2013 exposure draft). FASB also decided the following:

- For short-duration contracts, the targeted improvements were limited to enhancing disclosures (not including measurement and recognition). FASB ASU No. 2015-09, *Financial Services—Insurance (Topic 944): Disclosures about Short-Duration Contracts*, requires additional disclosures about the liability for unpaid claims and claim adjustment expenses for all insurance entities that issue short-duration contracts as defined in FASB *Accounting Standards Codification* (ASC) 944, *Financial Services—Insurance*. FASB ASU No. 2015-09 is effective for public business entities for annual periods beginning after December 15, 2015, and interim periods within annual periods beginning after December 15, 2016. For all other entities, FASB ASU No. 2015-09 is effective for annual periods beginning after December 15, 2016, and interim periods within annual periods beginning after December 15, 2017. Readers are encouraged to consult the full text of this ASU on FASB's website at www.fasb.org.
- For long-duration contracts, the project should focus on making targeted improvements to existing GAAP addressing recognition, measurement, presentation and disclosure. In September 2016, FASB issued a proposed ASU, *Financial Services—Insurance (Topic 944): Targeted Improvements to the Accounting for Long-Duration Contracts*. Readers are encouraged to visit the "Technical Agenda" page at www.fasb.org for the latest developments regarding the Insurance—Targeted Improvements to the Accounting for Loan-Duration Contracts project and how it may impact the guidance in this chapter.

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 Under U.S. generally accepted accounting principles (GAAP), FASB Accounting Standards Update (ASU) No. 2010-26, *Financial Services—Insurance (Topic 944): Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts (a consensus of the FASB Emerging Issues Task Force)*, that was codified into FASB ASC 944-30 states that only acquisition costs that are directly related to the successful acquisition of a contract can be capitalized as deferred acquisition costs (DAC). As noted in FASB ASU No. 2010-26, if the initial application of the amendments in FASB ASU No. 2010-26 results in the capitalization of acquisition costs that had not been capitalized previously by an entity, the entity may elect not to capitalize those types of costs. These deferred amounts are recorded as an asset on the balance sheet and amortized to income in a systematic manner based on related contract revenues or gross profits (or gross margins), as appropriate. Previously, the guidance of FASB ASC 944-30 did not address successful versus unsuccessful efforts.[2]

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[2] The AICPA issued two technical practice aids to assist with the retrospective adoption of FASB ASU No. 2010-26, *Financial Services—Insurance (Topic 944): Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts (a consensus of the FASB Emerging Issues Task Force)*:

- Technical Questions and Answers (Q&A) section 6300.38, "Retrospective Application of ASU No. 2010-26" (AICPA, *Technical Questions and Answers*), addresses these questions:
  - — If different levels of historical information are available for various products, how should this information be included when retrospectively applying FASB ASU No. 2010-26 if it is impracticable to determine the cumulative effect of applying a change in accounting principle to all prior periods?

(continued)

22.19 *Determination of deferrable costs*. The FASB ASC glossary defines *acquisition costs* as costs that are related directly to the successful acquisition of new or renewal insurance contracts.

22.20 As stated in FASB ASC 944-30-25-1A, an insurance entity should capitalize only the following as acquisition costs related directly to the successful acquisition of new or renewal insurance contracts:

a. Incremental direct costs of contract acquisition

b. The portion of the 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 any of the following acquisition activities for a contract that actually has been acquired:

   i. Underwriting

   ii. Policy issuance and processing

   iii. Medical and inspection

   iv. Sales force contract selling

c. Other costs related directly to the insurer's acquisition activities in item (*b*) that would not have been incurred by the insurance entity had the acquisition contract transaction(s) not occurred

d. Advertising costs that meet the capitalization criteria in FASB ASC 340-20-25-4

22.21 *Incremental direct costs of contract acquisition*. The FASB ASC glossary defines *incremental direct costs of contract acquisition* as a cost to acquire an insurance contract that has both of the following characteristics:

a. It results directly from, and is essential to, the contract transaction(s).

b. It would not have been incurred by the insurance entity had the contract transaction(s) not occurred.

22.22 FASB ASC 944-30-55-1 discusses the types of incremental direct cost of contract acquisition to be capitalized under item (a) in FASB ASC 944-30-25-1A. Such costs include the following:

a. An agent or broker commission or bonus for successful contract acquisition(s)

b. Medical and inspection fees for successful contract acquisition(s)

22.23 *Total compensation, benefits, and other costs directly related to acquisition activities*. Items (a)–(c) in FASB ASC 944-30-25-1A require that only the portion of costs related directly to time spent performing specified acquisition activities for a contract that actually has been acquired (that is, successful efforts) may be deferred.

(footnote continued)

— Can FASB ASU No. 2010-26 be applied retrospectively to different points in time for various products?

- Q&A section 6300.39, "Cumulative Effect of Change in Accounting Principle—ASU No. 2010-26" (AICPA, *Technical Questions and Answers*), provides some items to consider when evaluating the direct effects of retrospective application of FASB ASU No. 2010-26.

22.24 FASB ASC 944-30-55-1C discusses that payroll-related fringe benefits include any costs incurred for employees as part of the total compensation and benefits program. Examples of such benefits include all of the following:

a. Payroll taxes

b. Dental and medical insurance

c. Group life insurance

d. Retirement plans

e. 401(k) plans

f. Stock compensation plans, such as stock options and stock appreciation rights

g. Overtime meal allowances

22.25 FASB ASC 944-30-55-1G discusses that the portion of total compensation of executive employees that relates directly to the time spent approving successful contracts may be deferred as acquisition costs. For example, the amount of compensation allocable to time spent by members of a contract approval committee is a component of acquisition costs.

22.26 FASB ASC 944-30-55-1A discusses that examples of other costs related directly to the insurer's acquisition activities in item (b) in FASB ASC 944-30-25-1A that would not have been incurred by the insurance entity had the acquisition contract transaction(s) not occurred include all of the following:

a. Reimbursement of costs for air travel, hotel accommodations, automobile mileage, and similar costs incurred by personnel relating to the specified activities

b. Costs of itemized long-distance telephone calls related to contract underwriting

c. Reimbursement for mileage and tolls to personnel involved in onsite reviews of individuals before the contract is executed

22.27 *Direct-response advertising*. FASB ASC 340-20-25-4 notes that the costs of direct-response advertising should be capitalized if both of the following conditions are met:

a. The primary purpose of the advertising is to elicit sales to customers who could be shown to have responded specifically to the advertising.

b. The direct-response advertising results in probable future benefits.

22.28 FASB ASC 340-20-25-6 specifies that in order to conclude that advertising elicits sales to customers who could be shown to have responded specifically to the advertising, there must be a means of documenting that response, including a record that can identify the name of the customer and the advertising that elicited the direct response. Examples of such documentation include the following:

a. Files indicating the customer names and related direct-response advertisement

b. A coded order form, coupon, or response card included with an advertisement indicating the customer name

c. A log of customers who have made phone calls to a number appearing in an advertisement that links those calls to the advertisement

22.29 Additional guidance for issuers to consider can be found in section 1(B), "Accounting for Advertising Costs," of the SEC's *Division of Corporation Finance: Frequently Requested Accounting and Financial Reporting Interpretations and Guidance*:

> Certain direct response advertising costs may be deferred under [FASB ASC 340-20-25]. Qualifying costs relating to a specific advertising activity must meet all of the following criteria:
>
> *a*. A direct relationship between a sale and the specific advertising activity for which cost is deferred must be demonstrated clearly. More than trivial marketing effort after customer response to the advertising and before the sale is consummated (such as customer contact with a sales person or furnishing of additional product or financing information) will disqualify the sale as being deemed a direct result of the advertising. A significant lapse of time between the advertising activity and the ultimate sale in an environment of broad general advertising may disqualify the sale as being deemed a direct result of the advertising.
>
> *b*. The advertisement's purpose must be one of eliciting a direct response in the form of a sale. For example, if the primary purpose (based on either intent or most frequent actual outcome) is identification of customers to which additional marketing efforts will be targeted, the advertising costs do not qualify.
>
> *c*. Deferrable costs do not include administrative costs, occupancy costs, or depreciation of assets other than those used directly in advertising activities. Payroll related costs that are deferrable include only that portion of employees' total compensation and payroll-related fringe benefits that can be shown to relate directly relate to time spent performing the qualifying activities. Costs of prizes, gifts, membership kits and similar items are not deferrable under [FASB ASC 340-20-25], but are accounted for as inventory in most circumstances.
>
> *d*. The costs must be probable of recovery from future benefits. Objective historical evidence directly relevant to the particular advertising activity is necessary to demonstrate probability of recoverability. Ancillary income from sources other than the responding customer may not be included in the calculation of future benefits for the test. Future benefits to be included in the calculation are limited to revenues derived from the customer which are the direct result of the advertising activity alone, without significant additional marketing effort. Revenues from subsequent sales and renewals may be included only if insignificant market effort is required to obtain those revenues.

22.30 If the capitalization criteria in FASB ASC 340-20-25-4 are met, the direct-response advertising costs should be included as DAC for classification, subsequent measurement, and premium deficiency test purposes, in accordance with FASB ASC 944 applicable to insurance industry DAC.

22.31 As noted in FASB ASC 340-20-25-12, the cost of the direct-response advertising directed to all prospective customers, not only the cost related to the portion of the potential customers that is expected to respond to the advertising, should be used to measure the amounts of such reported assets.

22.32 As noted in FASB ASC 340-20-25-8, the probable future benefits of direct-response advertising activities are probable future revenues arising from that advertising in excess of future costs to be incurred in realizing those revenues. FASB ASC 340-20-25-9 discusses that demonstrating that direct-response advertising will result in future benefits requires persuasive evidence that its effects will be similar to the effects of responses to past direct-response advertising activities of the entity that resulted in future benefits. Such evidence should include verifiable historical patterns of results for the entity. Attributes to consider in determining whether the responses will be similar include the following:

a. The demographics of the audience

b. The method of advertising

c. The product

d. The economic conditions

Update 22-1 ***Accounting and Reporting*****: Revenue From Contracts With Customers**

FASB ASC 606 is effective for annual reporting periods of a public business entity, a not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market, and an employee benefit plan that files or furnishes financial statements with or to the SEC beginning after December 15, 2017, including interim periods within that reporting period. Early application is permitted only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period.

For all other entities, FASB ASC 606 is effective for annual reporting periods beginning after December 15, 2018, and interim periods within annual periods beginning after December 15, 2019. Other entities may elect to adopt the standard earlier, however, only as either

- an annual reporting period beginning after December 15, 2016, including interim periods within that reporting period, or
- an annual reporting period beginning after December 15, 2016, and interim periods within annual periods beginning one year after the annual reporting period in which an entity first applies the "Pending Content" that links to FASB ASC 606-10-65-1.

FASB ASC 606 provides a framework for revenue recognition and supersedes or amends several of the revenue recognition requirements in FASB ASC 605 as well as guidance within the 900 series of industry-specific topics. The standard applies to any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets unless those contracts are within the scope of other standards (for example, insurance or lease contracts).[3]

Readers are encouraged to consult the full text of FASB ASC 606 on FASB's website at www.fasb.org.

For more information, see appendix E of this guide.

22.33 *Nondeferrable expenses*. As stated in FASB ASC 944-720-25-2, an insurance entity should charge to expense as incurred any of the following costs:

a. An acquisition-related cost that cannot be capitalized in accordance with FASB ASC 944-30-25-1A (for implementation guidance, see FASB ASC 944-720-55-1)

b. An indirect cost (for implementation guidance, see FASB ASC 944-720-55-2)

22.34 FASB ASC 944-720-55-1 includes examples of acquisition-related costs that cannot be capitalized in accordance with FASB ASC 944-30-25-1A:

a. Soliciting potential customers (except direct-response advertising capitalized in accordance with item [d] in FASB ASC 944-30-25-1A)

b. Market research

c. Training

d. Administration

e. Unsuccessful acquisition or renewal efforts (except direct-response advertising capitalized in accordance with item [d] in FASB ASC 944-30-25-1A)

f. Product development

22.35 As discussed in FASB ASC 944-30-55-1F, employees' compensation and fringe benefits related to the activities described in chapter 9, "Commissions, General Expenses, and Deferred Acquisition Costs," of the AICPA Audit and Accounting Guide *Life and Health Insurance Entities*, unsuccessful contract acquisition efforts, and idle time should be charged to expense as incurred.

22.36 FASB ASC 944-720-55-2 includes examples of indirect costs, per item (b) in FASB ASC 944-720-25-2, that should be expensed as incurred:

a. Administrative costs

b. Rent

c. Depreciation

d. Occupancy costs

e. Equipment costs, including data processing equipment dedicated to acquiring insurance contracts

f. Other general overhead

[3] FASB ASU No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, has codified the guidance on direct response advertising from FASB ASC 340-20 into FASB ASC 944-30 and clarified that the entire cost of a qualifying advertising campaign can be capitalized as direct-response advertising costs consistent with the methodology in FASB ASC 340-20. FASB ASC 944-30 will require the entire cost of direct-response advertising campaign to be capitalized; FASB ASC 944-30-25-1A limits the capitalization to successful efforts only.

22.37 FASB ASC 944-30-55-1B discusses that costs for software dedicated to contract acquisition are not eligible for deferral as DAC under the definition of that term. Such costs are not other costs directly related to the insurer's acquisition activities that would not have been incurred but for that contract under the definition of that term. Notwithstanding that the guidance, as described in chapter 9 of the AICPA Audit and Accounting Guide *Life and Health Insurance Entities*, indicates that equipment costs are expensed as incurred, insurance entities should consider the criteria in FASB ASC 350-40 to determine whether the costs qualify for capitalization as internal-use software.

22.38 As is the case with other business entities, expenses that do not qualify to be capitalized are charged to expense or operating expenses in the period incurred.

22.39 *Cost determination*. The identification of acquisition costs requires considerable judgment, such as how to determine successful versus unsuccessful efforts and how to determine what types of activities performed by employees are considered to be directly related to sales. The determination of the costs to be deferred can often be determined separately or via a standard costing technique or through a combination of both. Paragraphs 1D–1E of FASB ASC 944-30-55 provide additional discussion.

22.40 *Allocation of DAC*. FASB ASC 944-30-25-1B requires the following:

> To associate acquisition costs with related premium revenue, capitalized 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.

22.41 *Determining deferrable acquisition costs*. FASB ASC 944-30-25-1A discusses what types of costs an insurance entity should capitalize as acquisition costs. An insurance entity should evaluate whether employee compensation and payroll-related fringe benefits are related directly to time spent performing acquisition activities for contracts that actually have been acquired. This determination may be accomplished by a two-step process:

a. Determine the portion of the employee's time spent performing acquisition activities.

b. Determine the portion of the employee's time spent in acquisition activities directly related to contracts that have been acquired (that is, successful efforts).

22.42 Both of the following examples are meant to be illustrative, and the actual determination of deferrable acquisition costs under FASB ASC 944 should be based on the facts and circumstances of an entity's specific situation.

> Example 1: In 201X, an employee of an insurance entity whose responsibility is sales force contract selling is compensated solely on a commission basis, based on the volume of business sold directly by the employee. The employee's current year commission of $125,000 is calculated as a percentage of premiums relating to business sold directly by the employee in the current year. In this fact pattern, the $125,000 commission is an incremental direct cost of contract acquisition, and the entire $125,000 would be deferrable by the insurance entity.

> Example 2: In 201X, an employee of an insurance entity earned a salary and payroll-related fringe benefits of $120,000 and spent

approximately 80 percent of his or her time on qualifying acquisition activities, as described in chapter 9 of the AICPA Audit and Accounting Guide *Life and Health Insurance Entities*. Approximately 50 percent of this time resulted in successful contract acquisitions. The amount of costs that would be deferrable as acquisition costs would be $48,000 ($120,000 x 80% qualifying acquisition activities x 50% successful efforts).

22.43 In situations when an employee is compensated by both commission and salary, judgment will be needed to determine what costs can be capitalized as acquisition costs, based on the facts and circumstances of each specific situation.

22.44 *Estimated gross profit*. FASB ASC 944-30-35-5 notes that estimated gross profits should include estimates of amounts expected to be assessed for contract administration less costs incurred for contract administration, including acquisition costs not included in capitalized acquisition costs. The guidance in FASB ASC 944-30-35-5 also specifies that those acquisition costs to be included in estimated gross profits that are not included in capitalized acquisition costs consist of policy-related acquisition costs that are not capitalized under paragraphs 3–4 of FASB ASC 944-30-25, such as ultimate renewal commission and recurring premium taxes. Also, as stated in FASB ASC 944-30-35-5, nonpolicy-related expenses, such as certain overhead costs, and costs that are related to the acquisition of business that are not capitalized under FASB ASC 944-30-25, such as certain advertising costs, should not be included in estimated gross profit.

22.45 It should be noted that FASB ASU No. 2010-26 does not change the guidance related to the components or calculation of estimated gross profits. Costs that no longer qualify for deferral under FASB ASU No. 2010-26 do not meet the criteria for inclusion in estimated gross profits.

22.46 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.

22.47 Technical Questions and Answers (Q&A) section 6300.40, "Deferrable Commissions and Bonuses Under ASU No. 2010-26" (AICPA, *Technical Questions and Answers*), states that commissions and bonuses are not deferrable solely due to an insurance entity having a sales transaction. To be deferrable as an incremental direct acquisition cost, the costs must result directly from, and be essential to, the sales transaction(s) and would not have been incurred by the insurance entity had the sales transaction(s) not occurred. Entities will need to use judgment to determine whether acquisition costs related to commissions and bonuses for employees or nonemployees meet the criterion to be deferrable under FASB ASU No. 2010-26 of resulting directly from and being essential to, the sale transaction. Paragraphs 1F–1G of FASB ASC 944-30-55 provide examples of some of the types of activities for which related costs are deferrable and those that are not. Chapter 9 of the AICPA Audit and Accounting Guide *Life and Health Insurance Entities* contains discussion of the guidance in FASB ASU No. 2010-26.

22.48 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.

22.49 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.

22.50 The AICPA also issued a series of Q&A sections on accounting and financial reporting issues related to the "Internal Replacement Transactions" subsections in FASB ASC 944-30 (see Q&A sections 6300.25–.34 [AICPA, *Technical Questions and Answers*]).

Investment Portfolios

22.51 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.

22.52 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.

Update 22-2 *Accounting and Reporting*: Recognition and Measurement of Financial Assets and Financial Liabilities

FASB ASU No. 2016-01, *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*, issued in January 2016, is effective for fiscal years, and interim periods within those fiscal years, of a public business entity beginning after December 15, 2017.

For all other entities (including not-for-profit entities and employee benefit plans within the scope of FASB ASC 960 through FASB ASC 965 on plan accounting), FASB ASU No. 2016-01 is effective for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. Early application is permitted for all other entities as of the fiscal years beginning after December 15, 2017, including interim periods within those fiscal years.

All entities may adopt the presentation guidance in paragraphs 5–7 of FASB ASC 825-10-45 for financial statements of fiscal years or interim periods that have not yet been issued or that have not yet been made available for issuance.

Furthermore, entities that are not public business entities may elect not to disclose the information about fair value of financial instruments required by the "General" subsection of FASB ASC 825-10-50 in financial statements of fiscal years or interim periods that have not yet been made available for issuance. Except as indicated previously in this paragraph, early application is not permitted.

FASB ASU No. 2016-01 addresses certain aspects of recognition, measurement, presentation, and disclosure of financial instruments and affects all entities that hold financial assets or owe financial liabilities. Among other provisions of the guidance, the amendments in this ASU supersede the guidance to classify equity securities with readily determinable fair values into different categories (that is, trading or available-for-sale) and require equity securities (including other ownership interests, such as partnerships, unincorporated joint ventures, and limited liability companies) to be measured at fair value with changes in the fair value recognized through net income (other than equity securities accounted for under the equity method of accounting or those that result in consolidation of an investee).

The amendments in this ASU also require an entity to present separately in other comprehensive income the portion of the total change in fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments.

This edition of the guide has not been updated to reflect changes as a result of this ASU, however, this paragraph will be updated in a future edition. Readers are encouraged to consult the full text of this ASU on FASB's website at www.fasb.org.

For more information on FASB ASU No. 2016-01, see appendix G, "Accounting for Financial Instruments," of this guide.

22.53 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 gains and losses recorded in earnings at each subsequent reporting date.

22.54 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

22.55 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 GAAP. Accordingly, the financial statements of insurance subsidiaries prepared for submission to regulatory authorities must be adjusted to conform to GAAP before they can be consolidated with the financial statements of the parent companies.

Commissions

Update 22-3 *Accounting and Reporting*: Revenue From Contracts With Customers

FASB ASC 606 is effective for annual reporting periods of a public business entity, a not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market, and an employee benefit plan that files or furnishes financial statements with or to the SEC beginning after December 15, 2017, including interim periods within that reporting period. Early application is permitted only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period.

For all other entities, FASB ASC 606 is effective for annual reporting periods beginning after December 15, 2018, and interim periods within annual periods beginning after December 15, 2019. Other entities may elect to adopt the standard earlier, however, only as either"

- An annual reporting period beginning after December 15, 2016, including interim periods within that reporting period, or
- An annual reporting period beginning after December 15, 2016, and interim periods within annual periods beginning one year after the annual reporting period in which an entity first applies the "Pending Content" that links to FASB ASC 606-10-65-1.

FASB ASC 606 provides a framework for revenue recognition and supersedes or amends several of the revenue recognition requirements in FASB ASC 605 as well as guidance within the 900 series of industry-specific topics. The standard applies to any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets unless those contracts are within the scope of other standards (for example, insurance or lease contracts).[4]

Readers are encouraged to consult the full text of FASB ASC 606 on FASB's website at www.fasb.org.

For more information, see appendix E of this guide.

22.56 A finance company may receive commissions from an independent insurer for policies issued to finance customers, according to FASB ASC 942-605-05-2.

22.57 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.

[4] See footnote 3.

22.58 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.

22.59 Commissions paid to the parent company by an insurance subsidiary are eliminated in consolidation.

Consolidation Policy

22.60 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.

For legal entities other than limited partnerships, 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 "Pending Content" in FASB ASC 810-10-25-1.[5] 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.

22.61 The "Variable Interest Entities" subsections of FASB ASC 810-10 clarify the application of the "General" subsections 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 of the legal entity, according to "Pending Content" in item (d) in FASB ASC 810-10-15-17, are primarily related to securitizations or other forms of asset-backed financings or single-lessee leasing arrangements, then

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[5] FASB ASU No. 2015-02, *Consolidation (Topic 810): Amendments to the Consolidation Analysis*, was issued in February 2015. The amendments are effective for public business entities for fiscal years, and for interim periods within those fiscal years, beginning after December 15, 2015. For all other entities, the amendments in this ASU are effective for fiscal years beginning after December 15, 2016, and for interim periods within fiscal years beginning after December 15, 2017. Early adoption is permitted, including adoption in an interim period. If an entity early adopts the amendments in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period. A reporting entity may apply the amendments in this ASU using a modified retrospective approach by recording a cumulative-effect adjustment to equity as of the beginning of the fiscal year of adoption. A reporting entity also may apply the amendments retrospectively.

FASB ASU No. 2015-02 affects reporting entities that are required to evaluate whether they should consolidate certain legal entities. All legal entities are subject to reevaluation under the revised consolidation model.

Readers are encouraged to read the full text of the ASU, available at www.fasb.org. Readers should apply the appropriate guidance based on their facts and circumstances.

the legal entity should be evaluated by a reporting entity to determine if the legal entity is a variable interest entity (VIE) under the requirements of the "Variable Interest Entities" subsections of FASB ASC 810-10.[6]

Considerations for Private Companies that Elect to use Standards as Issued by the Private Company Council

FASB ASU No. 2014-07, *Consolidation (Topic 810): Applying Variable Interest Entities Guidance to Common Control Leasing Arrangements (a consensus of the Private Company Council)*, permits a private company lessee (the reporting entity) to elect an alternative not to apply VIE guidance to a lessor entity if the following criteria are met:

- The private company lessee and the lessor legal entity are under common control.
- The private company lessee has a lease arrangement with the lessor legal entity.
- Substantially all activities between the private company lessee and the lessor legal entity are related to leasing activities (including supporting leasing activities) between those two entities.
- If the private company lessee explicitly guarantees or provides collateral for any obligation of the lessor legal entity related to the asset leased by the private company, then the principal amount of the obligation at inception of such guarantee or collateral arrangement does not exceed the value of the asset leased by the private company from the lessor legal entity.

The accounting alternative is an accounting policy election that, when elected, should be applied by a private company lessee to all current and future lessor entities under common control that meet the criteria for applying this approach. If any of the criteria for applying the alternative cease to be met, a private company should apply the VIE guidance at the date of change on a prospective basis.

22.62 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.

22.63 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

[6] Many paragraphs in FASB ASC 810-10 are labeled as "Pending Content" and relate to FASB ASU No. 2009-17, *Consolidations (Topic 810): Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities*. Although labeled as "Pending Content," this guidance is applicable for many entities except those that qualify for the deferral in FASB ASU No. 2010-10, *Consolidation (Topic 810): Amendments for Certain Investment Funds*. In February 2015, FASB issued ASU No. 2015-02. Among other provisions, the amendments in this ASU rescind the indefinite deferral in FASB ASU No. 2010-10 and provide a scope exception from FASB ASC 810, *Consolidation*, for reporting entities with interests in legal entities that are required to comply with or operate in accordance with requirements similar to those in Rule 2a-7 of the Investment Company Act of 1940 for registered money market funds. See footnote 5 for further details on the effective date of FASB ASU No. 2015-02. Readers should carefully review the transition guidance in FASB ASC 810-10-65-2 associated with "Pending Content" to determine the applicability.

to consolidation according to the requirements of the "Variable Interest Entities" subsections.[7] 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.

22.64 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

22.65 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.

22.66 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

22.67 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.

22.68 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.

[7] See footnote 6.

Auditing

22.69 The AICPA Audit and Accounting Guides *Life and Health Insurance Entities* and *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.

22.70 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

Gray shaded text in this chapter reflects guidance issued but not yet effective as of the date of this guide, July 1, 2017, but becoming effective on or prior to December 31, 2017, exclusive of any option to early adopt ahead of the mandatory effective date. Unless otherwise indicated, all unshaded text reflects guidance that was already effective as of the date of this guide.

The auditing content in this guide focuses primarily on generally accepted auditing standards (GAAS) issued by the Auditing Standards Board and is applicable to audits of the financial statements of those entities not subject to the oversight authority of the PCAOB (that is, those audit reports not within the PCAOB's jurisdiction as defined by the Sarbanes-Oxley Act of 2002, as amended—hereinafter referred to as *nonissuers*). These standards are codified in AICPA *Professional Standards* and referenced by AU-C section numbers within the codification. Issuers are defined by Section 3 of the Securities Exchange Act of 1934. Audits of issuers are required to be performed under PCAOB standards. Readers of this guide should evaluate their audit engagements to determine which auditing standards are applicable.

In April 2003, the PCAOB adopted as interim standards certain preexisting auditing and related standards via PCAOB Rules 3200T, *Interim Auditing Standards*; 3300T, *Interim Attestation Standards*; 3400T, *Interim Quality Control Standards*; 3500T, *Interim Ethics Standards*; and 3600T, *Interim Independence Standards* (AICPA, *PCAOB Standards and Related Rules*). Although the PCAOB has subsequently issued standards that supersede or amend those interim standards, the reporting guidance that was adopted by the PCAOB remains largely consistent with the reporting guidance applicable to audits conducted in accordance with GAAS as they existed prior to adoption of the clarified Statements on Auditing Standards.[1] As a consequence, significant differences will exist between audit reports for audits conducted in accordance with GAAS as compared to those conducted in accordance with PCAOB standards. In 2010, the PCAOB initiated its own project to consider changes to the auditor's reporting model and, in June 2017, the PCAOB adopted, subject to SEC approval, a new standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*. This chapter addresses only reporting guidance applicable to audits conducted in accordance with GAAS and does not include reporting guidance applicable to audits conducted in accordance with PCAOB standards. Appendix A, "Illustrative Unqualified PCAOB Reports," of this chapter provides illustrations of unqualified audit reports prepared in accordance with PCAOB standards.

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[1] Differences in reporting guidance prior to the Clarity Project were the result of the PCAOB's issuance of Auditing Standard No. 1, *References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board*, and 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*).

With the reorganization of the PCAOB auditing standards, Auditing Standard No. 1 has been superseded as a result of amendments made to the other standards and Auditing Standard No. 5 became AS 2201.

Considerations for audits of issuers in accordance with PCAOB standards may be discussed within this guide's chapter text. When such discussion is provided, the related paragraphs are designated with the following title: *Considerations for Audits Performed in Accordance With PCAOB Standards*.

Introduction

23.01 This chapter applies the reporting guidance found in AU-C sections 700, *Forming an Opinion and Reporting on Financial Statements*; 705, *Modifications to the Opinion in the Independent Auditor's Report*; and 706, *Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor's Report* (AICPA, *Professional Standards*), to audit reports on the financial statements of depository and lending institutions. Such reports may contain an unmodified opinion, an unmodified opinion with emphasis-of-matter (EOM) or other-matter paragraphs, 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 23.22–.24 and 23.28–.34 apply only to credit unions.

Forming an Opinion on the Financial Statements

23.02 Paragraphs .13–.18 of AU-C section 700 address the auditor's responsibility to form an opinion on the financial statements. The auditor should form an opinion on whether the financial statements are presented fairly, in all material respects, in accordance with the applicable financial reporting framework. In order to form that opinion, the auditor should conclude whether the auditor has obtained reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. That conclusion should take into account the following:

a. The auditor's conclusion, in accordance with AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*), about whether sufficient appropriate audit evidence has been obtained

b. The auditor's conclusion, in accordance with AU-C section 450, *Evaluation of Misstatements Identified During the Audit* (AICPA, *Professional Standards*), about whether uncorrected misstatements are material, individually or in aggregate

c. The evaluations required by paragraphs .15–.18 of AU-C section 700 (as discussed in paragraphs 23.03–.04)

23.03 The auditor should evaluate whether the financial statements are prepared, in all material respects, in accordance with the requirements of the applicable financial reporting framework. This evaluation should include consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments. In particular, the auditor should evaluate whether, in view of the requirements of the applicable financial reporting framework *a*. the financial statements adequately disclose the significant accounting policies selected and applied;

b. the accounting policies selected and applied are consistent with the applicable financial reporting framework and are appropriate;

c. the accounting estimates made by management are reasonable;

d. the information presented in the financial statements is relevant, reliable, comparable, and understandable;

e. the financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements; and

f. the terminology used in the financial statements, including the title of each financial statement, is appropriate.

23.04 The auditor's evaluation about whether the financial statements achieve fair presentation should also include consideration of the overall presentation, structure, and content of the financial statements and whether the financial statements, including the related notes, represent the underlying transactions and events in a manner that achieves fair presentation. Finally, the auditor should evaluate whether the financial statements adequately refer to or describe the applicable financial reporting framework.

Reports

Unmodified Opinion

23.05 The auditor should express an unmodified opinion when the auditor concludes that the financial statements are presented fairly, in all material respects, in accordance with the applicable financial reporting framework. The following is an illustration of an auditor's report (unmodified opinion) on the comparative financial statements of a bank or savings institution prepared in accordance with U.S. generally accepted accounting principles (GAAP).

Independent Auditor's Report

To the [*Institution, Board of Directors, or Stockholders*]:

Report on the Financial Statements[2]

We have audited the accompanying financial statements of ABC Institution, which comprise the balance sheets as of December 31, 20X1 and 20X0, and the related statements of income and comprehensive income, changes in stockholders' equity, and cash flows for the years then ended, and the related notes to the financial statements.[3]

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[2] The subtitle "Report on the Financial Statements" is unnecessary in circumstances when the second subtitle, "Report on Other Legal and Regulatory Requirements," is not applicable.

[3] These references to the financial statements should conform to the titles and periods of the statements being reported upon. For example, pursuant to FASB Accounting Standards Update (ASU) No. 2011-05, *Comprehensive Income (Topic 220): Presentation of Comprehensive Income*, institutions may present the components of net income and other comprehensive income either in a single continuous statement or in two separate but consecutive statements. The statements identified in the first paragraph of the audit would depend on an institution's selected presentation. In addition, there may be circumstances (such as for Emerging Growth or Smaller Reporting Companies, a change in auditor, or a newly organized registrant, for example) where less than two years of a balance sheet and three years of the other financial statements are being reported upon.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

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 involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.[4] Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

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 accordance with accounting principles generally accepted in the United States of America.

Report on Other Legal and Regulatory Requirements

[*Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities*.]

[*Auditor's signature*]
[*Auditor's city and state*]
[*Date of the auditor's report*]

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[4] In circumstances when the auditor also has responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements, this sentence would be worded as follows: "In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances." In addition, the next sentence, "Accordingly, we express no such opinion," would not be included.

23.06 In accordance with paragraphs .37–.38 of AU-C section 700, if the auditor addresses other reporting responsibilities in the auditor's report on the financial statements that are in addition to the auditor's responsibility under GAAS to report on the financial statements, these other reporting responsibilities should be addressed in a separate section in the auditor's report that follows the section titled "Report on the Financial Statements" and that should be subtitled "Report on Other Legal and Regulatory Requirements" or otherwise, as appropriate to the content of the section. Paragraphs .A32–.A34 of AU-C section 700 indicate that, for example, for audits conducted under *Government Auditing Standards*, the auditor may be required to report on internal control over financial reporting and compliance with laws, regulations, and provisions of contracts or grant agreements. However, reporting requirements in AU-C section 935, *Compliance Audits* (AICPA, *Professional Standards*), apply when the auditor is engaged or required by law or regulation to perform a compliance audit in accordance with GAAS, *Government Auditing Standards*, and a governmental audit requirement. In some cases, the relevant law or regulation may require or permit the auditor to report on these other responsibilities within the auditor's report on the financial statements. In other cases, the auditor may be required or permitted to report on them in a separate report. As previously discussed in paragraph 4.37 of this guide, financial institutions may participate in the U.S. Department of Housing and Urban Development (HUD) programs and must comply with the requirements of the *Consolidated Audit Guide for Audits of HUD Programs* (HUD Audit Guide), which includes reporting on internal control over financial reporting and compliance with laws, regulations, and provisions of contracts or grant agreements. Chapter 2 of the HUD Audit Guide provides illustrative reporting examples for audits conducted under *Government Auditing Standards* for HUD programs.

EOM and Other-Matter Paragraphs Added to the Independent Auditor's Report

EOM Paragraphs

23.07 If the auditor considers it necessary to draw users' attention to a matter appropriately presented or disclosed in the financial statements that, in the auditor's professional judgment, is of such importance that it is fundamental to users' understanding of the financial statements, paragraphs .06–.07 of AU-C section 706 state that the auditor should include an EOM paragraph in the auditor's report, provided that the auditor has obtained sufficient appropriate audit evidence that the matter is not materially misstated in the financial statements. Such a paragraph should refer only to information presented or disclosed in the financial statements. When the auditor includes an EOM paragraph in the auditor's report, the auditor should

a. include it immediately after the opinion paragraph in the auditor's report,

b. use the heading "Emphasis of Matter" or other appropriate heading,

c. include in the paragraph a clear reference to the matter being emphasized and to where relevant disclosures that fully describe the matter can be found in the financial statements, and

d. indicate that the auditor's opinion is not modified with respect to the matter emphasized.

23.08 Exhibit B, "List of AU-C Sections Containing Requirements for Emphasis-of-Matter Paragraphs," of AU-C section 706 identifies other AU-C sections that require the auditor to include an EOM paragraph in the auditor's report in certain circumstances. One such circumstance is when 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.[5] AU-C section 570A, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*), addresses the auditor's responsibilities in an audit of financial statements with respect to evaluating whether there is substantial doubt about the ability of the entity to continue as a going concern for a *reasonable period of time*, which is defined as a period of time not to exceed one year beyond the date of the financial statements being audited.[6] 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, after considering management's plans that are intended to mitigate the adverse effects of conditions or events that indicate substantial doubt could exist, the auditor concludes that substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time remains, paragraph .15 of AU-C section 570A states that the auditor should include an EOM paragraph in the auditor's report to reflect that conclusion. Paragraph .16 of AU-C section 570A further 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*. In a going concern EOM 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. 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, paragraph .17 of AU-C section 570A states that the auditor should modify the opinion in accordance with AU-C section 705. The following is an illustration of an auditor's report on the financial statements of a bank or savings institution that includes an EOM 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.

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[5] FASB *Accounting Standards Codification* 205-40 provides guidance for evaluating whether there is substantial doubt about an entity's ability to continue as a going concern and about related footnote disclosures.

[6] When the applicable financial reporting framework includes a definition of *substantial doubt about an entity's ability to continue as a going concern*, Interpretation No. 1, "Definition of *Substantial Doubt About an Entity's Ability to Continue as a Going Concern*" (AICPA, *Professional Standards*, AU-C sec. 9570A par. .01–.02), of AU-C section 570A, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, requires that definition to be used by the auditor when applying the requirements of AU-C section 570A. Interpretation No. 2, "Definition of *Reasonable Period of Time*" (AICPA, *Professional Standards*, AU-C sec. 9570A par. .03–.05), of AU-C section 570A provides guidance on how an auditor should apply the term *reasonable period of time* when the applicable financial reporting framework requires management to evaluate whether there are conditions and events that raise substantial doubt for a period of time greater than one year from the date of the financial statements. Specifically, Interpretation No. 2 states that the auditor's assessment of management's going concern evaluation would be for the same period of time as required by the applicable financial reporting framework.

Independent Auditor's Report

To the [*Institution, Board of Directors, or Stockholders*]:

Report on the Financial Statements[7]

[*Same first, second, third, fourth, fifth, and sixth paragraphs as the unmodified report. See illustrative example at paragraph 23.05*.]

Emphasis of Matter Going Concern

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 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 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 capital restoration 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 the 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 restoration 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. Our opinion is not modified with respect to this matter.

Report on Other Legal and Regulatory Requirements

[*Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities*.]

[*Auditor's signature*]
[*Auditor's city and state*]
[*Date of the auditor's report*]

Exhibit B, "List of AU-C Sections Containing Requirements for Emphasis-of-Matter Paragraphs," of AU-C section 706 identifies other AU-C sections that require the auditor to include an EOM paragraph in the auditor's report in certain circumstances. One such circumstance is when 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.[8] Statement on Auditing Standards (SAS) No. 132, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, AU-C sec. 570), addresses the auditor's responsibilities in the audit

[7] See footnote 2.

[8] FASB *Accounting Standards Codification* 205-40 provides guidance for evaluating whether there is substantial doubt about an entity's ability to continue as a going concern and about related footnote disclosures.

of financial statements relating to the entity's ability to continue as a going concern for a reasonable period of time and the implications for the auditor's report.[9] For purposes of SAS No. 132, a *reasonable period of time* is defined as the period of time reqired by the applicable financial reporting framework, or, if no such requirement exists, within one year after the date that the financial statements are issued (or within one year after the date that the financial statements are available to be issued, when applicable). 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.[10]

If the financial statements have been prepared using the going concern basis of accounting but, in the auditor's judgment, management's use of the going concern basis of accounting in the preparation of the financial statements is inappropriate, paragraph 23 of SAS No. 132 states that the auditor should express an adverse opinion. Paragraphs A48–A50 of SAS No. 132 go on to explain that this requirement applies regardless of whether the financial statements include disclosure of the inappropriateness of management's use of the going concern basis of accounting. When the use of the going concern basis of accounting is not appropriate in the circumstances, management may be required, or may elect, to prepare the financial statements on another basis (for example, under FASB ASC, the entity is required to comply with FASB ASC 205-30 and prepare the financial statements using the liquidation basis of accounting when an entity's liquidation becomes imminent). Interpretation No. 1, "Reporting on Financial Statements Prepared on a Liquidation Basis of Accounting" (AICPA, *Professional Standards*, AU-C sec. 9700 par. .01–.05), of AU-C section 700 addresses the situation in which an auditor issues an unmodified opinion on the entity's financial statements prepared under the liquidation basis of accounting and the auditor determines an EOM paragraph is appropriate.

If, after considering identified conditions or 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, paragraph 24 of SAS No. 132 states that the auditor should include an EOM paragraph

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[9] When the applicable financial reporting framework includes a definition of *substantial doubt about an entity's ability to continue as a going concern*, Interpretation No. 1, "Definition of *Substantial Doubt About an Entity's Ability to Continue as a Going Concern*" (AICPA, *Professional Standards*, AU-C sec. 9570A par. .01–.02), of AU-C section 570A, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, requires that definition to be used by the auditor when applying the requirements of AU-C section 570A. Interpretation No. 2, "Definition of *Reasonable Period of Time*" (AICPA, *Professional Standards*, AU-C sec. 9570A par. .03–.05), of AU-C section 570A provides guidance on how an auditor should apply the term *reasonable period of time* when the applicable financial reporting framework requires management to evaluate whether there are conditions and events that raise substantial doubt for a period of time greater than one year from the date of the financial statements. Specifically, Interpretation No. 2 states that the auditor's assessment of management's going concern evaluation would be for the same period of time as required by the applicable financial reporting framework.

[10] Statement on Auditing Standard No. 132, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, AU-C sec. 570), was issued in February 2017. This SAS is effective for audits of financial statements for periods ending on or after December 15, 2017.

in the auditor's report. Paragraph 25 of SAS No. 132 further states that the EOM paragraph about the entity's ability to continue as a going concern for a reasonable period of time should be expressed through the use of terms consistent with those included in the applicable financial reporting framework. In a going concern EOM paragraph, the auditor should not use conditional language concerning the existence of substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. When FASB ASC is the applicable financial reporting framework used in the preparation of the financial statements, paragraph A51 of SAS No. 132 explains that the auditor's conclusion about the entity's ability to continue as a going concern is expressed through the use of the phrase "substantial doubt about its (the entity's) ability to continue as a going concern." If adequate disclosure about an entity's ability to continue as a going concern for a reasonable period of time is not made in the financial statements, paragraph 26 of SAS No. 132 states that the auditor should express a qualified opinion or adverse opinion, as appropriate, in accordance with AU-C section 705. The following is an illustration of an auditor's report on the financial statements of a bank or savings institution that includes an EOM paragraph when (*a*) the auditor concludes substantial doubt exists about the institution's ability to continue as a going concern for a reasonable period of time, (*b*) management's plans do not alleviate the substantial doubt, and (*c*) the entity is required under the applicable financial reporting framework to include a statement in the notes to the financial statements that substantial doubt exists.

Independent Report

To the [*Institution, Board of Directors, or Stockholders*]:

Report on the Financial Statements[11]

[*Same first, second, third, fourth, fifth, and sixth paragraphs as the unmodified report. See illustrative example at paragraph 23.05.*]

Emphasis of Matter Going Concern

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 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 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 capital restoration 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 the 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 restoration plan. Management's evaluation of the

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11 See footnote 2.

events and conditions and management's plans regarding these matters are also described in Note XX. The financial statements do not include any adjustments that might result from the outcome of this uncertainty. Our opinion is not modified with respect to this matter.

Report on Other Legal and Regulatory Requirements

[*Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.*]

[*Auditor's signature*]
[*Auditor's city and state*]
[*Date of the auditor's report*]

23.09 Paragraph .A6 of AU-C section 570A states that the inclusion of a going-concern EOM paragraph in the auditor's report (as described previously) is sufficient to inform users of the financial statements that substantial doubt exists about the entity's ability to continue as a going concern for a reasonable period of time. Nevertheless, AU-C section 570A does not preclude an auditor from disclaiming an opinion in cases involving uncertainties. When an auditor disclaims an opinion, paragraph .18 of AU-C section 570A states that the report should not include the going-concern EOM paragraph but, rather describe the substantive reasons for the auditor's disclaimer of opinion as required by paragraph .17 of AU-C section 705. The auditor should consider the adequacy of disclosure of the uncertainties and their possible effects on the financial statements as described in paragraph .12 of AU-C section 570A, even when disclaiming an 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*]:

Report on Financial Statements[12]

We have audited the accompanying financial statements of ABC Institution, which comprise the balance sheet as of December 31, 20X0, and the related statements of income and comprehensive income, changes in stockholders' equity, and cash flows for the years then ended, and the related notes to the financial statements.[13] Further, we were engaged to audit the accompanying financial statements of ABC Institution, which comprise the balance sheet as of December 31, 20X1, and the related statements of income, comprehensive income, changes in stockholders' equity, and cash flows for the year then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant

[12] See footnote 2.

[13] See footnote 3.

to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. Except as explained in the Basis for Disclaimer of Opinion paragraph, 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 audits to obtain reasonable assurance about whether the financial statements are free of material misstatement.[14]

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.[15] Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.[16]

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinions on the balance sheet as of December 31, 20X0, and the statements of income, comprehensive income, changes in stockholders equity, and cash flows for the year then ended.[17]

Basis for Disclaimer of Opinion on 20X1 Financial Statements

The accompanying financial statements have been prepared assuming that the 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 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

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[14] If the auditor was disclaiming an opinion due to a scope limitation, this paragraph would state the following: "Our responsibility is to express an opinion on these financial statements based on conducting the audit in accordance with auditing standards generally accepted in the United States of America. Because of the matters described in the Basis for Disclaimer of Opinion paragraph, however, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion." (See paragraph 23.21 on "Disclaimer of Opinion.")

[15] See footnote 4.

[16] If the auditor was disclaiming an opinion due to a scope limitation, this paragraph would be omitted. (See paragraph 23.21 on "Disclaimer of Opinion.")

[17] See footnote 16.

in the capital restoration 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 the 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 restoration 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.

Disclaimer of Opinion on 20X1 Financial Statements

Because of the significance of the matter described in the Basis for Disclaimer of Opinion paragraph, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the financial statements for the year ended December 31, 20X1.

Opinion on 20X0 Financial Statements

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 accordance with accounting principles generally accepted in the United States of America.

Report on Other Legal and Regulatory Requirements

[*Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities*.]

[*Auditor's signature*]
[*Auditor's city and state*]
[*Date of the auditor's report*]

23.10 AICPA Technical Questions and Answers (Q&A) section 9160.28, "Combining a Going Concern Emphasis-of-Matter Paragraph With Another Emphasis-of-Matter Paragraph" (AICPA, *Technical Questions and Answers*), addresses whether an auditor may combine a going concern EOM paragraph with another EOM paragraph. Q&A section 9160.28 states that AU-C section 706 does not preclude the auditor from combining matters in an EOM paragraph that are either required to be included in the auditor's report or included at the auditor's discretion, recognizing that the requirements in paragraph .07 of AU-C section 706 should be followed for each matter identified. Whether the auditor decides to combine more than one matter in the same paragraph is a matter of professional judgment. However, it may be prudent to emphasize each matter separately in separate paragraphs to make it clear that you have more than one matter of emphasis in your report.

23.11 In addition to the required EOM paragraphs listed in exhibit B of AU-C section 706 (referenced in paragraph 23.08), paragraph .A2 of AU-C section 706 provides the following examples of circumstances when the auditor may consider it necessary to include an EOM paragraph:

- An uncertainty relating to the future outcome of unusually important litigation or regulatory action
- A major catastrophe that has had, or continues to have, a significant effect on the entity's financial position

- Significant transactions with related parties
- Unusually important subsequent event

The following is an illustration of an unmodified opinion with an EOM paragraph regarding an institution's failure to meet minimum regulatory capital standards on the institution's financial statements (note that in this illustration, this EOM is not a going concern matter).

Independent Auditor's Report

To the [*Institution, Board of Directors, or Stockholders*]:

Report on the Financial Statements[18]

[*Same first, second, third, fourth, fifth, and sixth paragraphs as the unmodified report. See illustrative example at paragraph 23.05.*]

Emphasis of Matter

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 FDIC. The Institution has filed, and the FDIC has accepted, a capital restoration plan for attaining the required level of regulatory risk-based capital by December 31, 20X2. Our opinion is not modified with respect to this matter.

Report on Other Legal and Regulatory Requirements

[*Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.*]

[*Auditor's signature*]

[*Auditor's city and state*]

[*Date of the auditor's report*]

23.12 Q&A section 9160.29, "Modification to the Auditor's Report When a Client Adopts a PCC Accounting Alternative" (AICPA, *Technical Questions and Answers*), addresses the need for an EOM paragraph in the auditor's report for a change in accounting principle as a result of an entity adopting a Private Company Council (PCC) accounting alternative. Q&A section 9160.29 states that according to paragraphs .07–.12 of AU-C section 708, *Consistency of Financial Statements* (AICPA, *Professional Standards*), if an entity has adopted a change in accounting principle and that change has a material effect on the financial statements, the auditor should include in the auditor's report an EOM paragraph in the period of the change and in subsequent periods until the new accounting principle is applied in all periods presented. If the change in accounting principle is accounted for by retrospective application to the financial statements of all prior periods presented, the EOM paragraph is needed only in the period of such change. The auditor's EOM paragraph should describe the change in accounting principle and provide a reference to the entity's note disclosure.

23.13 Q&A section 9160.30, "Modification to the Auditor's Report When a Client Adopts a PCC Accounting Alternative that Results in a Change to a Previously Issued Report" (AICPA, *Technical Questions and Answers*), addresses the need to include an EOM paragraph in the auditor's report when an entity adopts a PCC alternative that results in a change to a previously issued report, specifically if the prior year report included a departure from GAAP and now

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[18] See footnote 2.

that the PCC alternative had been adopted, the prior year no longer contains the departure from GAAP. According to paragraph .54 of AU-C section 700, when reporting on prior period financial statements in connection with an audit of the current period, the auditor should disclose the following matters in an EOM paragraph in accordance with AU-C section 706 if the auditor's opinion on such prior period financial statements differs from the opinion the auditor previously expressed:

a. The date of the auditor's previous report.

b. The type of opinion previously expressed.

c. The substantive reason for the different opinion.

d. The auditor's opinion on the amended financial statements is different from the auditor's previous opinion.

Other-Matter Paragraphs

23.14 If the auditor considers it necessary to communicate a matter other than those that are presented or disclosed in the financial statements that, in the auditor's professional judgment, is relevant to users' understanding of the audit, the auditor's responsibilities, or the auditor's report, paragraph .08 of AU-C section 706 states that the auditor should do so in a paragraph in the auditor's report with the heading "Other Matter" or other appropriate heading. The auditor should include this paragraph immediately after the opinion paragraph and any EOM paragraph or elsewhere in the auditor's report if the content of the other-matter paragraph is relevant to the "Other Reporting Responsibilities" section. Exhibit C, "Lists of AU-C Sections Containing Requirements for Other-Matter Paragraphs," of AU-C section 706 identifies other AU-C sections that require the auditor to include an other-matter paragraph in the auditor's report in certain circumstances. The following is an illustration of an unmodified opinion that contains an other-matter paragraph to draw user attention to an updated auditor's report on the financial statements of a prior period that contains an opinion different from the opinion previously expressed.

Independent Auditor's Report

To the [*Institution, Board of Directors, or Stockholders*]:

Report on the Financial Statements[19]

[*Same first, second, third, fourth, fifth, and sixth paragraphs as the unmodified report. See illustrative example at paragraph 23.05*.]

Other Matter

In our report dated March 1, 20X1, we expressed an opinion that the 20X0 financial statements did not fairly present the financial position, results of operations, and cash flows of ABC Institution in accordance with accounting principles generally accepted in the United States of America because of two departures from such principles: (1) ABC Institution carried its property, plant, and equipment at appraisal values, and provided for depreciation on the basis of such values, and (2) ABC Institution did not provide for deferred income taxes with respect to differences between income for financial reporting purposes and taxable income. As described in Note X, the Company has changed its method of accounting for these items and restated its 20X0 financial

[19] See footnote 2.

statements to conform with accounting principles generally accepted in the United States of America. Accordingly, our present opinion on the restated 20X0 financial statements, as presented herein, is different from that expressed in our previous report.

Report on Other Legal and Regulatory Requirements

[*Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.*]

[*Auditor's signature*]

[*Auditor's city and state*]

[*Date of the auditor's report*]

Modified Opinions

23.15 AU-C section 705 addresses the auditor's responsibility to issue an appropriate report in circumstances when, in forming an opinion in accordance with AU-C section 700, the auditor concludes that a modification to the auditor's opinion on the financial statements is necessary. Paragraph .07 of AU-C section 705 states that the auditor should modify the opinion in the auditor's report when

- *a.* the auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are materially misstated or
- *b.* the auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

23.16 AU-C section 705 establishes three types of modified opinions: a qualified opinion, an adverse opinion, and a disclaimer of opinion. The decision regarding which type of modified opinion is appropriate depends upon the following:

- *a.* The nature of the matter giving rise to the modification (that is, whether the financial statements are materially misstated or, in the case of an inability to obtain sufficient appropriate audit evidence, may be materially misstated)
- *b.* The auditor's professional judgment about the pervasiveness of the effects or possible effects of the matter on the financial statements

AU-C section 705 also provides guidance on the circumstances when a modification to the auditor's opinion is required as well as guidance on determining the type of modification to the auditor's opinion (for example, guidance illustrating how the auditor's professional judgment about the nature of the matter giving rise to the modification and the pervasiveness of its effects or possible effects on the financial statement opinion).

23.17 When the auditor modifies the opinion on the financial statements, paragraph .17 of AU-C section 705 states that the auditor should, in addition to the specific elements required by AU-C section 700, include a paragraph in the auditor's report that provides a description of the matter giving rise to the modification. The auditor should place this paragraph immediately before the opinion paragraph in the auditor's report and use a heading that includes "Basis for Qualified Opinion," "Basis for Adverse Opinion," or "Basis for Disclaimer of Opinion," as appropriate. Paragraphs .18–.22 of AU-C section 705 provide further discussion on information that should be included within the basis for modification paragraph. In addition, paragraph .23 of AU-C section 705 states that the auditor should use a heading that includes "Qualified Opinion," "Adverse Opinion," or "Disclaimer of Opinion," as appropriate, for the opinion paragraph.

Qualified Opinion

23.18 In accordance with paragraph .08 of AU-C section 705, the auditor should express a qualified opinion when

a. the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material but not pervasive to the financial statements, or

b. the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.

23.19 For purposes of GAAS, AU-C section 705 defines *pervasive* as a term used in the context of misstatements to describe the effects on the financial statements of misstatements or the possible effects on the financial statements of misstatements, if any, that are undetected due to an inability to obtain sufficient appropriate audit evidence. Pervasive effects on the financial statements are those that, in the auditor's professional judgment

- are not confined to specific elements, accounts, or items of the financial statements;
- if so confined, represent or could represent a substantial proportion of the financial statements; or
- with regard to disclosures, are fundamental to users' understanding of the financial statements.

Paragraph 23.24 describes a circumstance in which a qualified opinion is appropriate and provides an illustrative qualified opinion.

Adverse Opinion

23.20 In accordance with paragraph .09 of AU-C section 705, the auditor should express an adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements. When the auditor expresses an adverse opinion, paragraph .25 of AU-C section 705 states that the auditor should state in the opinion paragraph that, in the auditor's opinion, because of the significance of the matter(s) described in the basis for adverse opinion paragraph, the financial statements are not presented fairly in accordance with the applicable financial reporting framework. In accordance with paragraph .27 of AU-C section 705, the auditor should also amend the description of the auditor's responsibility to state that the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor's modified audit opinion.

Disclaimer of Opinion

23.21 In accordance with paragraph .10 of AU-C section 705, the auditor should disclaim an opinion when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive. When the auditor disclaims an opinion due to an inability to obtain sufficient appropriate audit evidence (also referred to as a limitation on the scope of the audit), paragraph .26 of AU-C section 705 states that the auditor should state in the opinion paragraph that

a. because of the significance of the matter(s) described in the basis for disclaimer of opinion paragraph, the auditor has not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion and

b. accordingly, the auditor does not express an opinion on the financial statements.

When the auditor disclaims an opinion due to an inability to obtain sufficient appropriate audit evidence, paragraph .28 of AU-C section 705 states that the auditor should amend the introductory paragraph of the auditor's report to state that the auditor was engaged to audit the financial statements. The auditor should also amend the description of the auditor's responsibility and the description of the scope of the audit to state only the following:

> Our responsibility is to express an opinion on the financial statements based on conducting the audit in accordance with auditing standards generally accepted in the United States of America. Because of the matter(s) described in the Basis for Disclaimer of Opinion paragraph, however, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion.

Financial Statements Prepared in Accordance With a Special Purpose Framework

23.22 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 GAAP. Credit unions with assets under $10 million may use a basis of accounting other than GAAP; the National Credit Union Administration (NCUA) provides the *Accounting Manual for Federal Credit Unions* as a guide in accounting for financial transactions and reporting in accordance with the regulatory-basis of accounting described therein that may be adopted by federally insured, state-chartered credit unions with under $10 million in assets. AU-C section 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks* (AICPA, *Professional Standards*), addresses special considerations in an audit of financial statements prepared in accordance with a special purpose framework, which includes a regulatory basis of accounting. For purposes of GAAS, a *regulatory basis* is defined in AU-C section 800 as a basis of accounting that the entity uses to comply with the requirements or financial reporting provisions of a regulatory agency to whose jurisdiction the entity is subject. The objective of the auditor, when applying GAAS in an audit of financial statements prepared in accordance with a special purpose framework, is to address appropriately the special considerations that are relevant to (*a*) the acceptance of the engagement, (*b*) the planning and performance of that engagement, and (*c*) forming an opinion and reporting on the financial statements. The illustration included in paragraph 23.23 specifically focuses on reporting considerations in an audit of financial statements prepared in accordance with a special purpose framework.

23.23 The following is an illustration of an auditor's report on financial statements prepared in accordance with the financial reporting provisions prescribed by the NCUA (a special purpose framework). In this illustration, the financial statements together with the auditor's report are not intended for general use.

Independent Auditor's Report

To the [*Institution, Board of Directors, or Stockholders*]:

Report on the Financial Statements[20]

We have audited the accompanying financial statements of XYZ Credit Union, which comprise the statements of financial condition—regulatory basis as of December 31, 20X1 and 20X0, and the related statements of income and comprehensive income—regulatory basis, members' equity—regulatory basis, and cash flows—regulatory basis for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with the financial reporting provisions prescribed or permitted by the National Credit Union Administration (NCUA) as more fully described in Note X; this includes determining that the regulatory basis of accounting described in Note X is an acceptable basis for the preparation of the financial statements in the circumstances.[21] Management is also responsible for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

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 involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.[22] Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

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[20] See footnote 2.

[21] If management does not have a choice of financial reporting frameworks, the auditor is not required to make reference to management's responsibility for determining that the applicable financial reporting framework is acceptable in the circumstances.

[22] See footnote 4.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

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 in accordance with the financial reporting provisions prescribed or permitted by the NCUA as described in Note X.

Basis of Accounting

We draw attention to Note X to the financial statements, which describes the basis of accounting. As described in Note X to the financial statements, the financial statements are prepared by XYZ Credit Union on the basis of the financial reporting provisions prescribed or permitted by the NCUA, which is a basis of accounting other than accounting principles generally accepted in the United States of America, to meet the requirements of the NCUA. Our opinion is not modified with respect to this matter.

Restriction on Use

Our 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.

Report on Other Legal and Regulatory Requirements

[*Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities*.]

[*Auditor's signature*]

[*Auditor's city and state*]

[*Date of the auditor's report*]

Members' Shares Reported as Equity

23.24 As discussed in paragraph 13.43 of this guide, GAAP require that members' shares of a credit union 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 special purpose framework (see paragraphs 23.22–.23). An illustration of a report modified for a qualified opinion in those circumstances follows.

Independent Auditor's Report

To the [*Institution, Board of Directors, or Stockholders*]:

Report on the Financial Statements[23]

[*Same first and second paragraphs as the standard report*]

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[23] See footnote 2.

Auditor's Responsibility

[*Same third and fourth paragraphs as the standard report*]

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified audit opinion.

Basis for Qualified Opinion

XYZ Credit Union has reported members' shares as equity in the accompanying balance sheets. Accounting principles generally accepted in the United States of America require members' shares to be reported as liabilities in the balance sheet. If the Credit Union had properly reported these shares as liabilities, liabilities would increase and equity would decrease by $________ and $________ as of December 31, 20X1 and 20X0, respectively.

Qualified Opinion

In our opinion, except for the effects of the matter described in the Basis for Qualified Opinion 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 accordance with accounting principles generally accepted in the United States of America.

Report on Other Legal and Regulatory Requirements

[*Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.*]

[*Auditor's signature*]

[*Auditor's city and state*]

[*Date of the auditor's report*]

Communication of Internal Control Related Matters

23.25 AU-C section 265, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*), addresses the auditor's responsibility to appropriately communicate to those charged with governance and management deficiencies in internal control that the auditor has identified in an audit of financial statements. Paragraphs .11–.12 of AU-C section 265 state that the auditor should communicate, in writing to those charged with governance, on a timely basis, significant deficiencies and material weaknesses identified during the audit, including those that were remediated during the audit. The auditor also should communicate to management at an appropriate level of responsibility, on a timely basis

a. in writing, significant deficiencies and material weaknesses that the auditor has communicated or intends to communicate to those charged with governance, unless it would be inappropriate to communicate directly to management in the circumstances.

b. in writing or orally, other deficiencies in internal control identified during the audit that have not been communicated to management by other parties and that, in the auditor's professional judgment, are of sufficient importance to merit management's attention. If other deficiencies in internal control are communicated orally, the auditor should document the communication.

These communications, as stated in paragraph .13 of AU-C section 265, should be made no later than 60 days following the report release date. However, as further explained in paragraph .A16 of AU-C section 265, the communication is best made by the report release date because receipt of such communication may be an important factor in enabling those charged with governance to discharge their oversight responsibilities. Nothing in AU-C section 265 precludes the auditor from communicating to those charged with governance or management other internal control matters that the auditor has identified during the audit. Paragraph .16 of AU-C section 265 states that the auditor should not issue a written communication stating that no significant deficiencies were identified during the audit.

23.26 AU-C section 265 is not applicable if the auditor is engaged to perform an audit of internal control over financial reporting that is integrated with an audit of financial statements. In such circumstances, AU-C section 940, *An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Financial Statements* (AICPA, Professional Standards), applies. AU-C section 940 establishes requirements and provides guidance that applies only when an auditor is engaged to perform an audit of internal control over financial reporting that is integrated with an audit of financial statements. Among other reporting considerations, because the auditor issues a report that expresses an opinion on the effectiveness of the entity's internal control over financial reporting, paragraph .65 of AU-C section 940 states that the auditor should not issue a report indicating that no material weaknesses were identified during the integrated audit.

23.27 Part 363 of the 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 D, "Reporting Under Section 112 of the Federal Deposit Insurance Corporation Improvement Act," of AU-C section 940 provides guidance and an illustrative definition paragraph to assist auditors in complying with the Federal Deposit Insurance Corporation Improvement Act and Part 363.

Reports on Supervisory Committee Audits

23.28 Part 715 of the NCUA's regulations requires a credit union's Supervisory Committee to obtain an annual audit of the credit union according to its charter type and asset size. Any federally insured credit union can meet this requirement by obtaining an independent audit of its financial statements performed in accordance with GAAS. Depending on the credit union's charter type and asset size, this requirement may also be met through other audit options, one of which may be an audit conducted in accordance with the procedures prescribed in NCUA's *Supervisory Committee Guide for Federal Credit Unions*.[24] 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

[24] An audit in accordance with the *Supervisory Committee Guide for Federal Credit Unions* may be performed by the supervisory committee, the credit union's internal auditor, or any other qualified person (including an independent public accountant); qualified persons that are not state-licensed cannot provide assurance services.

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.

23.29 Independent auditors' reports on audits of financial statements should comply with the reporting provisions contained in applicable AICPA professional standards. AU-C sections 700, 705, 706, and 805, *Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts, or Items of a Financial Statement* (AICPA, *Professional Standards*), provide guidance on reports on audited financial statements.

23.30 Independent accountants' 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 .35 of AT-C section 215, *Agreed-Upon Procedures Engagements* (AICPA, *Professional Standards*), states that the practitioner's agreed-upon procedures report should include the following:

- A title that includes the word *independent*.
- An appropriate addressee as required by the circumstances of the engagement.
- An identification of the subject matter or assertion and the nature of an agreed-upon procedures engagement.
- An identification of the specified parties.
- A statement that the procedures performed were those agreed to by the specified parties identified in the report.
- A statement that identifies the responsible party and its responsibility for the subject matter or its assertion.
- A statement that
  - — the sufficiency of the procedures is solely the responsibility of the parties specified in the report.
  - — the practitioner makes no representation regarding the sufficiency of the procedures either for the purpose for which the report has been requested or for any other purpose.
- A list of the procedures performed (or reference thereto) and related findings. (The practitioner should not provide a conclusion. See paragraph .25 of AT-C section 215).
- When applicable, a description of any agreed-upon materiality limits.
- A statement that
  - — the agreed-upon procedures engagement was conducted in accordance with attestation standards established by the AICPA.

- the practitioner was not engaged to and did not conduct an examination or review, the objective of which would be the expression of an opinion or conclusion, respectively, on the subject matter.
- the practitioner does not express such an opinion or conclusion.
- had the practitioner performed additional procedures, other matters might have come to the practitioner's attention that would have been reported.

- When applicable, a description of the nature of the assistance provided by a practitioner's external specialist, as discussed in paragraphs .21–.22 of AT-C section 215.
- When applicable, reservations or restrictions concerning procedures or findings.
- An alert, in a separate paragraph, that restricts the use of the report. The alert should
    - state that the practitioner's report is intended solely for the information and use of the specified parties,
    - identify the specified parties for whom use is intended, and
    - state that the report is not intended to be, and should not be, used by anyone other than the specified parties.
- When the engagements is also performed in accordance with *Government Auditing Standards*, the alert that restricts the use of the report should include the following information, rather than the information required by the previous bullet:
    - A description of the purpose of the report.
    - A statement that the report is not suitable for any other purpose.
- The manual or printed signature of the practitioner's firm.
- The city and state where the practitioner practices.
- The date of the report. (The report should be dated no earlier than the date on which the practitioner completed the procedures and determined the findings, including that
    - the attestation documention has been reviewed,
    - if applicable, the written presentation of the subject matter has been prepared, and
    - the responsible party has provided a written assertion, unless the responsible party refuses to provide an assertion.)

23.31 As mentioned previously, 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.

23.32 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, should comply with, among other professional standards, the provisions of AR-C section 60, *General Principles for Engagements Performed in Accordance With Statements on Standards for Accounting and Review Services*; AR-C section 80, *Compilation Engagements*; and AR-C 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.

23.33 Q&A section 9150.34, "Modifications to the Accountant's Compilation or Review Report When a Client Adopts a Private Company Council Accounting Alternative That Results in a Changes to a Previously Issued Report" (AICPA, *Technical Questions and Answers*), addresses the need to include an explanatory paragraph in the auditor's report when an entity adopts a PCC alternative that results in a change to a previously issued report, specifically if the prior year report included a departure from GAAP and now that the PCC alternative had been adopted, the prior year no longer contains the departure from GAAP. Paragraph .49 of AR-C section 90, states that when the accountant's report on the financial statements of the prior period contains a changed reference to a departure from the applicable financial reporting framework, the accountant's review report should include an other-matter paragraph indicating

a. the date of the accountant's previous review report.

b. the circumstances or events that caused the reference to be changed.

c. when applicable, that the financial statements of the prior period have been changed.

According to paragraph .86 of AR-C section 90, a changed reference to a departure from the applicable financial reporting framework includes the removal of a prior reference or the inclusion of a new reference.

Example Report on the Application of Agreed-Upon Procedures Performed in Connection With a Supervisory Committee Audit

23.34 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

To the Supervisory Committee XYZ Credit Union

We have performed the procedures enumerated in the attached supplement, which were agreed to by [*list specified parties*,[25] *ordinarily the Supervisory Committee of XYZ Credit Union*], on XYZ Credit Union's financial statements or specified elements, accounts, or items thereof

[25] The National Credit Union Administration (NCUA) should not be named as a specified party.

for the period ended June 30, 20X0 to assist you with your supervisory audit of XYZ Credit Union conducted pursuant to section 715 of the National Credit Union Administration regulations. XYZ Credit Union's management is responsible for the selected accounting records and transactions of XYZ Credit Union for the period ended June 30, 20X0. 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. The sufficiency of the procedures is solely the responsibility of the parties specified in this report. Consequently, we make no representation regarding the sufficiency of the procedures enumerated in the supplement either for the purpose for which this report has been requested or for any other purpose.

This agreed-upon procedures engagement was conducted in accordance with the attestation standards established by the American Institute of Certified Public Accountants. We were not engaged to and did not conduct an examination or review, the objective of which would be the expression of an opinion or conclusion, respectively, on XYZ Credit Union's financial statements or specified elements, accounts, or items thereof for the period ended June 30, 20X0. Accordingly, we do not express such an opinion or conclusion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you.

[*Additional paragraph(s) may be added to describe other matters*]

This report is intended solely for the information and use of [*identify the specified parties*] and is not intended to be, and should not be, used by anyone other than the specified parties.

[*Practitioner's signature*]
[*Practitioner's city and state*]
[*Date of practitioner's report*]

Supplement to Illustrative Report[26]

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:

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[26] This supplement is for illustrative purposes only and, therefore, is not considered to be an all-inclusive list of either the accounts on which procedures may be performed or the procedures that may be performed. The illustrative procedures listed may or may not be relevant to a particular engagement. The independent accountant should describe those accounts on which procedures were performed and the 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.

Appendix A to the NCUA's *Supervisory Committee Guide for Federal Credit Unions* presents the minimum procedures that a supervisory committee or its auditor or other accountant must complete when a Supervisory Committee chooses the *Supervisory Committee Guide for Federal Credit* option for completing its annual audit requirement under Part 715 of the NCUA regulations.

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 procedures 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 and inspected readily marketable securities and other collateral recorded as held in respect of certain selected secured loans.

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:

Name	*Due Date*	*Amount Outstanding at June 30, 20X0*	*Amount Outstanding at July 31, 20X0*

Similarly, we obtained the Credit Union's listing of consumer loans ten days or more past due as of June 30, 20X0, and compared it to a like listing as of July 31, 20X0. The following loans were listed in both reports:

Name	*Due Date*	*Amount at June 30, 20X0*	*Amount 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. We found no instances where favorable interest rates or repayment terms were granted to directors, officers, and other related parties.

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 June 30, 20X0*
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 FDIC Loss Sharing Purchase and Assumption Transactions

23.35 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 losses 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[27] relative to the accuracy of any computations made regarding shared loss assets. It must also perform a semi-annual internal audit of the shared loss compliance and provide the FDIC with copies of the internal audit reports and access to the internal audit work papers.

23.36 Q&A section 9110.16, "Example Reports on Federal Deposit Insurance Corporation Loss Sharing Purchase and Assumption Transactions" (AICPA, *Technical Questions and Answers*), provides examples of how the auditor might respond to FDIC reporting requirements for an engagement covering an FDIC loss sharing P&A transaction. Q&A section 9110.16 suggests that the auditor may respond by issuing a report in accordance with the requirements of AU-C section 806, *Reporting on Compliance With Aspects of Contractual Agreements or Regulatory Requirements in Connection With Audited Financial Statements* (AICPA, *Professional Standards*), and also provides illustrative auditor reports for three possible outcomes for which the independent auditor might report.

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[27] 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.

Small Business Lending Fund Auditor Certification Guidance

23.37 Under the terms of the Small Business Lending Fund (SBLF), a community bank is required to calculate and report to the Treasury Department the amount of its qualified small business lending in a supplemental report. The bank's management is required to certify that the information provided in the report is accurate and also to submit a certification from its external auditors that the processes and controls used to generate the supplemental reports are satisfactory. Q&A section 9110.18, "Small Business Lending Fund Auditor Certification Guidance" (AICPA, *Technical Questions and Answers*), indicates that an independent auditor may satisfy this requirement by issuing a report in accordance with the requirements of AU-C section 806 and provides an illustration of a report that an auditor may use when, as a result of the auditor's audit procedures, nothing has come to the auditor's attention to indicate that the bank failed to comply with the terms of the SBLF.

23.38

Appendix A—Illustrative Unqualified PCAOB Reports

This appendix is nonauthoritative and is included for informational purposes only.

Introduction

This appendix provides illustrative unqualified reports applying the requirements of the PCAOB.[1] The reports are illustrative; the facts and circumstances of each particular audit will govern the appropriate form of report. A discussion of the types of modifications of the reports that may be appropriate (for example, adverse opinion, disclaimer of opinion, and explanatory paragraphs) is not presented herein.

Reports

General Form of Unqualified Opinion on Financial Statements

The following is an illustration of an auditor's report (unqualified opinion) on the financial statements of a bank or savings institution when a report on internal controls over financial reporting is not being issued.

Report of Independent Registered Public Accounting Firm

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 and comprehensive income, stockholders' equity, and cash flows for each of the years in the three-year period ended December 31, 20X1.[2] These financial statements are the responsibility of ABC Institution's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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[1] In June 2017, the PCAOB adopted, subject to SEC approval, a new standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*. The final standard retains the pass/fail opinion of the existing auditor's report, requires the auditor to provide new information about the audit, and makes the auditor's report more informative and relevant to investors and other financial statement users. Although the final standard requires the auditor to communicate in the auditor's report "critical audit matters" specific to each audit, the requirements will not apply to audits of brokers and dealers reporting under the Securities Exchange Act of 1934 Rule 17a-5, investment companies registered under the Investment Company Act of 1940 other than business development companies, emerging growth companies, and employee stock purchase, savings and similar plans. The auditor's required communication should focus on those matters communicated or required to be communicated to the audit committee and that relate to accounts or disclosures that are material to the financial statements and involved especially challenging, subjective, or complex auditor judgments.

Readers are encouraged to visit the PCAOB website at www.pcaobus.org for the full text of the final standard and should remain alert for further developments.

[2] These references to the financial statements should conform to the titles and periods of the statements being reported upon. For example, pursuant to FASB Accounting Standards Update No. 2011-05, *Comprehensive Income (Topic 220): Presentation of Comprehensive Income*, institutions may present the components of net income and other comprehensive income either in a single continuous statement or in two separate but consecutive statements. The financial statements identified in the first paragraph would depend on an institution's selected presentation. In addition, there may be circumstances (such as for Emerging Growth or Smaller Reporting Companies, a change in auditor, or a newly organized registrant, for example) where less than two years of a balance sheet and three years of the other financial statements are being reported upon.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of ABC Institution as of December 31, 20X1 and 20X0, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 20X1 in conformity with U.S. generally accepted accounting principles.

[*Signature*]

[*City and State or Country*]

[*Date*]

General Form of Unqualified Opinion on the Effectiveness of Internal Control over Financial Reporting

When performing an integrated audit of financial statements and internal control over financial reporting in accordance with PCAOB standards, 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 AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*), for direction on reporting on internal control over financial reporting.

The following is an illustration of an auditor's *combined* report expressing unqualified opinions on each of the financial statements and the effectiveness of internal control over financial reporting of a bank or savings institution.

Report of Independent Registered Public Accounting Firm

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 and comprehensive income, stockholders' equity, and cash flows for each of the years in the three-year period ended December 31, 20X1.[3] We also have audited ABC Institution's internal control over financial reporting as of December 31, 20X1, based on [*identify criteria*].[4] ABC Institution's management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying [*title*

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[3] See footnote 2.

[4] For example, the following may be used to identify the criteria: "Criteria established in the 2013 (or 1992) *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)." On May 14, 2013, COSO published an updated *Internal Control—Integrated Framework*.

of management's report]. Our responsibility is to express an opinion on these financial statements and an opinion on ABC Institution's internal control over financial reporting based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included 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. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection and correction of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

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 each of the years in the three-year period ended December 31, 20X1, in conformity with U.S. generally accepted accounting principles. Also in our opinion, ABC Institution maintained, in all material respects, effective internal control over financial reporting as of December 31, 20X1, based on [*identify criteria*].[5]

[*Signature*]

[*City and State or Country*]

[*Date*]

The following is an illustration of an auditor's report expressing an unqualified opinion on the effectiveness of internal control over financial reporting of a bank or savings institution when a separate report expressing an unqualified opinion on the financial statements is issued.

Report of Independent Registered Public Accounting Firm

To the [*Institution, Board of Directors, or Stockholders*]:

We have audited ABC Institution's internal control over financial reporting as of December 31, 20X1, based on [*identify criteria*].[6] ABC Institution's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying [*title of management's report*]. Our responsibility is to express an opinion on ABC Institution's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

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[5] See footnote 4.

[6] See footnote 4.

> Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.
>
> In our opinion, ABC Institution maintained, in all material respects, effective internal control over financial reporting as of December 31, 20X1, based on [*identify criteria*].[7]
>
> We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the balance sheets of ABC Institution as of December 31, 20X1 and 20X0, and the related statements of income and comprehensive income, stockholders' equity, and cash flows for each of the years in the three-year period ended December 31, 20X1, 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*].[8]

If the auditor issues separate reports on the company's financial statements and on the effectiveness of internal control over financial reporting, the following paragraph, as presented in paragraph 88 of AS 2201, 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), ABC Institution's internal control over financial reporting as of December 31, 20X1, based on [*identify control criteria*][9] 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*].

When performing an integrated audit of financial statements and internal control over financial reporting in accordance with PCAOB 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 AS 2201.

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[7] See footnote 4.

[8] See footnote 4.

[9] See footnote 4.

Appendix A

FDI Act Reporting Requirements

This appendix is nonauthoritative and is included for informational purposes only.

A.01 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 each institution's management and its auditors over 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 FDIC-insured depository institution having total assets of $500 million or greater at the beginning of its fiscal year. The requirements specified in Section 36 and Part 363 are in addition to any other statutory and regulatory requirements otherwise applicable to an insured depository institution.

A.02 Part 363 was initially adopted by the FDIC's Board of Directors in 1993 and was most recently amended in 2013. 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, as well as 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 to Part 363, "Guidelines and Interpretations," and the illustrative management reports in appendix B to Part 363, "Illustrative Management Reports," 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.03 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. 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;[1] and

[1] For purposes of U.S. *Code of Federal Regulations*, Title 12, Part 363, financial reporting encompasses both financial statements prepared in accordance with generally accepted accounting principles and those prepared for regulatory reporting purposes.

(3) complying with the designated safety and soundness laws and regulations pertaining to insider loans and dividend restrictions.

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.04 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 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.05 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;[2] and

(3) complying with the designated safety and soundness laws and regulations pertaining to insider loans and dividend restrictions.

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

[2] See footnote 1.

(1) identify the internal control framework[3] 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;[4] 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. The 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;

[3] For example, in the United States, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) published on May 14, 2013, its updated *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. In addition to the updated Framework, COSO also issued the following companion documents: *Illustrative Tools for Assessing Effectiveness of a System of Internal Control* and *Internal Control over External Financial Reporting (ICEFR): A Compendium of Approaches and Examples*.

[4] 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.

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 whether internal control over financial reporting is effective as of the institution's fiscal year-end;[5] 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.06 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) compose less than 75 percent of the consolidated total assets of the public holding company as of the beginning of its fiscal year.

A.07 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) compose 75 percent or more of the consolidated total assets of the public holding company as of the beginning of its fiscal year.

A.08 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.09 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

[5] 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.

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 PCAOB, as appropriate.
- for an institution with consolidated 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) compose 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.
- 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) compose 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 accountant must also agree to provide regulators with copies of any working papers, policies, and procedures related to services performed under Part 363. Independent accountants should be familiar with Interpretation No. 1, "Providing Access to or Copies of Audit Documentation to a Regulator," (AICPA, *Professional Standards*, AU-C sec. 9230 par. .01–.15) of AU-C section 230, *Audit Documentation*.

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, prior to its transfer of powers to the federal banking agencies, (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 review 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 in its audit committee 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 the FDIC's rules and regulations, *Part 363—Annual Independent Audits and Reporting Requirements*, (left column) and appendix A to Part 363 (right column). Part 363 and appendix A were initially published in 1993. The most recent amendments to this regulation were published in 2013. 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.[6]

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.

Guidelines and Interpretations

Scope of Rule and Definitions (§363.1)

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).

[6] Readers should be aware that the FDIC has not updated Part 363 of its rules and regulations to reflect that the Office of the Comptroller of the Currency eliminated the use of the Thrift Financial Report and now requires all federal savings associations to file using the Call Report.

Regulation

(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 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.

Guidelines and Interpretations

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., 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.

(continued)

Regulation

(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.

(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.

(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

Guidelines and Interpretations

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.

[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).

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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.

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Annual Reporting Requirements (§363.2)

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 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

(continued)

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	(*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 control 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.
(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

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(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 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

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(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

(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 framework[1] 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

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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.

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. 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.

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(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):

(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.

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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.

10. *Standards for Internal Control*. 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

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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 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.

Role of Independent Public Accountant (§363.3)

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]

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(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:

(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 remediated prior to the insured

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 under Section 38 of the FDI Act, and any correspondence from the appropriate Federal banking agency concerning compliance with this part.

18. *Attestation Report and Management Letters*. The independent public accountant should provide the institution with any management letter and, if applicable, an internal control 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.

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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 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.

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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 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.

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(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 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.

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(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.*

(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

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Filing and Notice Requirements (§363.4)

22. [Reserved]

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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 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.

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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 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.

25. [Reserved]

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(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) 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.

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(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.

§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.

(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.

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Audit Committees (§363.5)

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.

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(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 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.

Guidelines and Interpretations

28. "*Independent of Management*" *Considerations*. 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.

(continued)

Regulation	*Guidelines and Interpretations*

(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 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

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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, controls, or is controlled by, or is under common control with, the person specified.

(continued)

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(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]

Regulation	*Guidelines and Interpretations*

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.

(continued)

Regulation	Guidelines and Interpretations

31. *Duties*. The audit committee should perform all duties determined by the 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

(*e*) Overseeing the internal audit function.

Regulation	*Guidelines and Interpretations*
(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 and Interpretations*

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.

(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

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(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.

Other

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 to review and approval of the FDIC Board of Directors.

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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 Non-member 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	√	√	....	....
60	Dividends and Surplus Fund	√	√	....	....
1467a(f)	Declaration of Dividends	....	....	....	√
1831o(d)(1)	Prompt Corrective Action—Capital Distributions Restricted	√	√	√	√

TABLE 1 TO APPENDIX A—continued

Designated Federal Laws and Regulations Applicable to:

		National Banks	***State Member Banks***	***State Non-member Banks***	***Savings Associations***
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 or 324.403, as applicable	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]

This appendix is nonauthoritative and is included for informational purposes only.

[See table on following page.]

[1] Every national bank and saving and loan association, state member bank, state chartered saving and loan association, 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 federally insured credit union is required to file the National Credit Union Administration (NCUA) 5300 Call Report. Call Reports (for example, FFIEC and NCUA) 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 GAAP. The Call Report explains 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 GAAP standards. Financial institutions are encouraged to discuss specific events and transactions not covered by GAAP or the guidance in the regulatory report instructions with their primary supervisory agency for more technical detail on the application of the 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.

U.S. 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.	FASB *Accounting Standards Codification* (ASC) 310-10-35	Regulatory guidance provides a general rule to ensure an institution's net income is not overstated 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 institutions should use alternative methods of evaluation to ensure that this objective is met.	Refer to the entry *nonaccrual status* in the "Glossary" section of the Federal Financial Institutions Examination Council's (FFIEC's) *Instructions for Preparation of Consolidated Reports of Condition and Income*, and Schedule RC-N of the FFIEC Consolidated Reports of Condition and Income (Call Report).

U.S. Generally Accepted Accounting Principles (GAAP)		Regulatory Reporting Matters	
Description	*References*	*Description*	*References*
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.	FASB ASC 310-10-35	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).	Refer to the entry *nonaccrual status* in the "Glossary" section of the FFIEC's *Instructions for Preparation of Consolidated Reports of Condition and Income*.
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 may 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.	

(continued)

[2] There are additional requirements for applying the first part of this test, please see the "Nonaccrual Status" section of the Call Report instructions.

U.S. 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.	Refer to the entry *loan impairment* in the "Glossary" section of the FFIEC's *Instructions for Preparation of Consolidated Reports of Condition and Income.*
Charge-Offs			
No specific guidance exists on the timing of charge-offs.	No specific guidance exists.	In general, any portion of the recorded investment in an impaired collateral-dependent loan (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).	*Interagency Policy Statement on the Allowance for Loan and Lease Losses* issued December 16, 2006.

U.S. Generally Accepted Accounting Principles (GAAP)		Regulatory Reporting Matters	
Description	*References*	*Description*	*References*
Restructured Lease Matters			
No specific guidance exists on disclosure of impaired modified finance lease receivables in FASB ASC 840-10-50.	No specific guidance exists.	Restructured loans and leases are reported in bank Call Report schedules RC-C/RC-N, 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. If the restructured finance lease is reclassified as a new operating lease, the operating lease property is reported as an "Other asset" and depreciated.	
Foreclosed Assets			
U.S. GAAP allows for the grouping of assets when subsequently measuring a long-lived asset (disposal group) classified as held for sale. Such a measurement should be measured at the lower of its carrying amount or fair value less cost to sell.	FASB ASC 360-10-35-43	After foreclosure, each foreclosed real estate asset must be carried at the lower of (*a*) the fair value of the asset minus the estimated costs to sell the asset or (*b*) the cost of the asset (as defined in the glossary definition of foreclosed assets). This determination must be made on an asset-by-asset basis.	Refer to the entry *foreclosed assets* in the "Glossary" section of the FFIEC's *Instructions for Preparation of Consolidated Reports of Condition and Income*.
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, of the Call Report

(continued)

U.S. Generally Accepted Accounting Principles (GAAP)		Regulatory Reporting Matters	
Description	*References*	*Description*	*References*
Acquirer's Accounting Pushed Down to Acquiree's Financial Statements			
FASB Accounting Standards Update (ASU) No. 2014-17, *Pushdown Accounting,* provides an acquired entity, either public or nonpublic, the option to apply pushdown accounting in its separate financial statements upon occurrence of an event in which an acquirer obtains control of the acquired entity. Previously, for SEC registrants, under Staff Accounting Bulletins (SAB), Topic 5.J., "*New Basis of Accounting Required in Certain Circumstances*", pushdown accounting generally was permitted when 80 percent or more of an entity's ownership was acquired, required when 95 percent or more was acquired, and prohibited when less than 80 percent was acquired. Prior to the issuance of FASB ASU No. 2014-17, GAAP offered limited guidance on pushdown accounting for non-SEC registrants.	FASB ASC 805-50-25 SEC SAB No. 115	Pushdown accounting is an acquiree's establishment of a new accounting basis in its separate financial statements when an acquirer obtains control of the acquired entity. Under Call Report instructions, an acquiree that retains its separate corporate existence may apply pushdown accounting upon a change-in-control event. A change-in-control event occurs when an acquirer obtains a controlling financial interest, as defined under U.S. GAAP, in the acquiree. A controlling financial interest typically requires ownership of more than 50 percent of the voting rights in an acquired entity. In all cases, the institution's primary federal regulators reserve the right to require or prohibit the institution's use of pushdown accounting for Call Report purposes based on the regulator's evaluation of whether the election best reflects the facts and circumstances of the business combination.	Refer to entry *business combinations* in the "Glossary" section of the FFIEC's *Instructions for Preparation of Consolidated Reports of Condition and Income*.

U.S. 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.	No specific guidance exists.	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 loss should also be considered a cash dividend paid by the bank to the parent holding company.	Refer to entry *income taxes of a bank subsidiary of a holding company* in the "Glossary" section of the FFIEC's *Instructions for Preparation of Consolidated Reports of Condition and Income*; and *Interagency Policy Statement on Income Tax Allocation in a Holding Company Structure*, issued December 23, 1998[3]

(continued)

[3] In June 2014, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System (Federal Reserve), and the FDIC issued the *Addendum to the Interagency Policy Statement on Income Tax Allocation in a Holding Company*. The addendum instructs insured depository institutions (IDIs) and their holding companies to ensure their tax-allocation agreements expressly acknowledge that the holding companies are acting as agents for the IDI and are consistent with certain requirements of sections 23A and 23B of the Federal Reserve Act.

U.S. Generally Accepted Accounting Principles (GAAP)		Regulatory Reporting Matters	
Description	*References*	*Description*	*References*
Related Party Transactions [4]			
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 entities or persons under common control. Rather, such transfers are accounted for at historical cost. 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.	FASB ASC 845-10 and FASB ASC 805-50-30 General guidance on related party disclosures is established in FASB ASC 850-10-50	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. Institutions must disclose extensions of credit to executive officers, directors, principal shareholders, and their related interests.	Refer to entry *property dividends* within the entry *dividends* in the "Glossary" section of the FFIEC's *Instructions for Preparation of Consolidated Reports of Condition and Income* and Schedule RC-M of the Call Report.

[4] Intercompany 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").

U.S. 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.	Refer to the entry *accounting changes* in the "Glossary" section of the FFIEC's *Instructions for Preparation of Consolidated Reports of Condition and Income*. 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 of the Call Report.
Gain/Loss on Certain Sales			
SEC registrants are required to include in *noninterest expense* the net cost of foreclosed real estate, including gains, losses, and rental income. In practice, classification by nonregistrants of gains and losses on sales of loans, real estate owned, fixed assets (including branch office assets), and other assets varies.	Article 9.04.14(d) of SEC Regulation S-X	The agencies require that institutions always include rental income in noninterest income. In 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.	Line 5(i)–5(l) and 7(d) of Schedule RI of the Call Report and the related FFIEC's *Instructions for Preparation of Consolidated Reports of Condition and Income*.

Appendix C

Information Sources

This appendix is nonauthoritative and is included for informational purposes only.

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 Custserv@aba.com		www.aba.com	
American Institute of Certified Public Accountants	*Member Service Center*: 888.777.7077 *Durham Office*: 220 Leigh Farm Road Durham, NC 27707 919.402.4500	*Member Service Center*: 800.362.5066 *Durham Office*: 919.402.4505	www.aicpa.org www.aicpastore.com	
Board of Governors of the Federal Reserve System	*General Comments for the Chair and Board of Governors*: 20th Street and Constitution Avenue, N.W. Washington, DC 20551 202.974.7008 *Publications Services*: Publications Fulfillment Mail Stop N-127 Washington, DC 20551 202.452.3245 *Consumer Assistance*: 888.851.1920 *Main Telephone*: 202.452.3000	*Publication Services*: 202.728.5886	www.federalreserve.gov	*Federal Reserve Board Highlights*: 202.452.3206

Organization	*General Information*	*Fax Services*	*Website*	*Recorded Announcements*
Conference of State Bank Supervisors	1129 20th St., NW 9th Floor Washington, DC 20036 202.296.2840	202.296.1928	www.csbs.org	
Consumer Financial Protection Bureau	P.O. Box 4503 Iowa City, IA 52244 851.411.2372	855.237.2392	www.consumerfinance.gov	
Credit Union National Association	*Wisconsin Mailing Address*: P.O. Box 431 Madison, WI 53701 *Wisconsin Shipping Address*: 5710 Mineral Point Road Madison, WI 53705 *Washington, DC Office*: 601 Pennsylvania Avenue NW Suite 600, South Building Washington, DC 20004-2601 *CUNA, Inc.*: 800.356.9655 *CUNA Member Services*: 800.356.8010 *General Inquiry*: ccsorders@cuna.coop	*CUNA, Inc.*: 608.231.4333 *CUNA Member Services*: 608.231.1869	www.cuna.org	
Federal Deposit Insurance Corporation	*Public Information Center*: 3501 North Fairfax Drive Room E-1021 Arlington, VA 22226 877.275.3342 703.562.2200 publicinfo@fdic.gov	703.562.2296	www.fdic.gov	

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Organization	*General Information*	*Fax Services*	*Website*	*Recorded Announcements*
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	
Federal Housing Finance Agency	*Constitution Center*: 400 7th Street, SW Washington, DC 20219 202.649.3800	202.649.1071	www.fhfa.gov	
Federal National Mortgage Association (Fannie Mae)	*Headquarters*: 3900 Wisconsin Ave., NW Washington, DC 20016-2892 *Resource Center*: 800.232.6643		www.fanniemae.com	
Financial Accounting Standards Board	401 Merritt 7 PO Box 5116 Norwalk, CT 06856-5116 203.847.0700 fasbpubs@fasb.org	203.849.9714	www.fasb.org	
Financial Managers Society	1 North LaSalle Street Suite 3100 Chicago, IL 60602-4003 800.275.4367 info@fmsinc.org		www.fmsinc.org	
Government National Mortgage Association (Ginnie Mae)	451 7th Street, SW Room B-133 Washington, DC 20410 *Ginnie Mae Relationship Services*: 800.234.4662		www.ginniemae.gov	

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 info@icba.org	202.659.3604	www.icba.org	
Mortgage Bankers Association	1919 M Street, NW, 5th Floor Washington, DC 20036 800.793.6222 202.557.2700		www.mbaa.org	
NACHA—The Electronic Payments Association	2550 Wasser Terrace Suite 400 Herndon, VA 20171 703.561.1100 info@nacha.org	703.787.0996	www.nacha.org	
National Association of Federal Credit Union	3138 10th Street North Arlington, VA 22201-2149 800.344.5580 msc@nafcu.org		www.nafcu.org	
National Association of Insurance Commissioners	*Central Office*: 1100 Walnut Street Suite 1500 Kansas City, MO 64106-2197 816.842.3600 *Publications*: 816.783.8300 prodserv@naic.org *Help Desk*: 816.783.8500	*Central Office*: 816.783.8175 *Publications*: 816.460.7593 *Help Desk*: 816.460.7456	www.naic.org	

(continued)

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 22314-3428 703.518.6300 *Consumer Assistance*: 800.755.1030		www.ncua.gov	
Public Company Accounting Oversight Board	*Headquarters*: 1666 K Street, NW Washington, DC 20006 202.207.9100 *New York Office*: 1251 Avenue of the Americas New York, NY 10020 646.437.5100 *General Information*: 202.591.4135 info@pcaobus.org	*Headquarters*: 202.862.8430 *New York Office*: 646.792.0001	www.pcaobus.org	

Organization	*General Information*	*Fax Services*	*Website*	*Recorded Announcements*
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 *Membership & Membership Inquiries*: 212.313.1150 inquiry@sifma.org *Website Inquiries*: 212.313.1000 webmaster@sifma.org	*New York*: 212.313.1301 *Washington, DC*: 202.962.7305	www.sifma.org	
U.S. Department of the Treasury—Office of the Comptroller of the Currency	*OCC Headquarters*: 400 7th Street, SW Washington, DC 20219 202.649.6800 *Customer Assistance*: 800.613.6743 713.658.0340		www.occ.gov	

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Organization	*General Information*	*Fax Services*	*Website*	*Recorded Announcements*
U.S. Department of Education	400 Maryland Avenue, SW Washington, DC 20202 *General Inquiries*: 800.872.5327 *Organizational Directory*: 202.401.2000 800.872.5327		www.ed.gov	
U.S. Department of Housing and Urban Development	451 7th Street, SW Washington, DC 20410 202.708.1112		www.hud.gov	
U.S. General Accountability Office	441 G Street, NW Washington, DC 20548 202.512.3000 contact@gao.gov		www.gao.gov	
U.S. Government Printing Office	732 North Capitol Street, NW Washington, DC 20401-0001 866.512.1800 202.512.1800 contactcenter@gpo.gov	202.512.2104	www.gpo.gov	
U.S. Securities and Exchange Commission	*SEC Headquarters*: 100 F Street, NE Washington, DC 20549 202.942.8088 *SEC Investor Information Service*: 800.SEC.0330	202.772.9295	www.sec.gov	

Appendix D

Overview of Statements on Quality Control Standards

This appendix is nonauthoritative and is included for informational purposes only.

This appendix is a partial reproduction of chapter 1 of the AICPA practice aid *Establishing and Maintaining a System of Quality Control for a CPA Firm's Accounting and Auditing Practice*, available at www.aicpa.org/interestareas/frc/pages/enhancingauditqualitypracticeaid.aspx.

This appendix highlights certain aspects of the quality control standards issued by the AICPA. If appropriate, readers should also refer to the quality control standards issued by the PCAOB, available at www.pcaobus.org/standards/qc/pages/default.aspx.

1.01 The objectives of a system of quality control are to provide a CPA firm with reasonable assurance[1] that the firm and its personnel comply with professional standards and applicable regulatory and legal requirements, and that the firm or engagement partners issue reports that are appropriate in the circumstances. QC section 10, *A Firm's System of Quality Control* (AICPA, *Professional Standards*), addresses a CPA firm's responsibilities for its system of quality control for its accounting and auditing practice. That section is to be read in conjunction with the AICPA Code of Professional Conduct and other relevant ethical requirements.

1.02 A system of quality control consists of policies designed to achieve the objectives of the system and the procedures necessary to implement and monitor compliance with those policies. The nature, extent, and formality of a firm's quality control policies and procedures will depend on various factors such as the firm's size; the number and operating characteristics of its offices; the degree of authority allowed to, and the knowledge and experience possessed by, firm personnel; and the nature and complexity of the firm's practice.

Communication of Quality Control Policies and Procedures

1.03 The firm should communicate its quality control policies and procedures to its personnel. Most firms will find it appropriate to communicate their policies and procedures in writing and distribute them, or make them available electronically, to all professional personnel. Effective communication includes the following:

- A description of quality control policies and procedures and the objectives they are designed to achieve
- The message that each individual has a personal responsibility for quality
- A requirement for each individual to be familiar with and to comply with these policies and procedures

[1] The term *reasonable assurance*, which is defined as a high, but not absolute, level of assurance, is used because absolute assurance cannot be attained. Paragraph .53 of QC section 10, *A Firm's System of Quality Control* (AICPA, *Professional Standards*), states, "Any system of quality control has inherent limitations that can reduce its effectiveness."

Effective communication also includes procedures for personnel to communicate their views or concerns on quality control matters to the firm's management.

Elements of a System of Quality Control

1.04 A firm must establish and maintain a system of quality control. The firm's system of quality control should include policies and procedures that address each of the following elements of quality control identified in paragraph .17 of QC section 10:

- Leadership responsibilities for quality within the firm (the "tone at the top")
- Relevant ethical requirements
- Acceptance and continuance of client relationships and specific engagements
- Human resources
- Engagement performance
- Monitoring

1.05 The elements of quality control are interrelated. For example, a firm continually assesses client relationships to comply with relevant ethical requirements, including independence, integrity, and objectivity, and policies and procedures related to the acceptance and continuance of client relationships and specific engagements. Similarly, the human resources element of quality control encompasses criteria related to professional development, hiring, advancement, and assignment of firm personnel to engagements, all of which affect policies and procedures related to engagement performance. In addition, policies and procedures related to the monitoring element of quality control enable a firm to evaluate whether its policies and procedures for each of the other five elements of quality control are suitably designed and effectively applied.

1.06 Policies and procedures established by the firm related to each element are designed to achieve reasonable assurance with respect to the purpose of that element. Deficiencies in policies and procedures for an element may result in not achieving reasonable assurance with respect to the purpose of that element; however, the system of quality control, as a whole, may still be effective in providing the firm with reasonable assurance that the firm and its personnel comply with professional standards and applicable regulatory and legal requirements and that the firm or engagement partners issue reports that are appropriate in the circumstances.

1.07 If a firm merges, acquires, sells, or otherwise changes a portion of its practice, the surviving firm evaluates and, as necessary, revises, implements, and maintains firm-wide quality control policies and procedures that are appropriate for the changed circumstances.

Leadership Responsibilities for Quality Within the Firm (the "Tone at the Top")

1.08 The purpose of the leadership responsibilities element of a system of quality control is to promote an internal culture based on the recognition that quality is essential in performing engagements. The firm should establish and maintain the following policies and procedures to achieve this purpose:

- Require the firm's leadership (managing partner, board of managing partners, CEO, or equivalent) to assume ultimate responsibility for the firm's system of quality control.
- Provide the firm with reasonable assurance that personnel assigned operational responsibility for the firm's quality control system have sufficient and appropriate experience and ability to identify and understand quality control issues and develop appropriate policies and procedures, as well as the necessary authority to implement those policies and procedures.

1.09 Establishing and maintaining the following policies and procedures assists firms in recognizing that the firm's business strategy is subject to the overarching requirement for the firm to achieve the objectives of the system of quality control in all the engagements that the firm performs:

- Assign management responsibilities so that commercial considerations do not override the quality of the work performed.
- Design policies and procedures addressing performance evaluation, compensation, and advancement (including incentive systems) with regard to personnel to demonstrate the firm's overarching commitment to the objectives of the system of quality control.
- Devote sufficient and appropriate resources for the development, communication, and support of its quality control policies and procedures.

Relevant Ethical Requirements

1.10 The purpose of the relevant ethical requirements element of a system of quality control is to provide the firm with reasonable assurance that the firm and its personnel comply with relevant ethical requirements when discharging professional responsibilities. Relevant ethical requirements include independence, integrity, and objectivity. Establishing and maintaining policies such as the following assist the firm in obtaining this assurance:

- Require that personnel adhere to relevant ethical requirements such as those in regulations, interpretations, and rules of the AICPA, state CPA societies, state boards of accountancy, state statutes, the U.S. Government Accountability Office, and any other applicable regulators.
- Establish procedures to communicate independence requirements to firm personnel and, where applicable, others subject to them.
- Establish procedures to identify and evaluate possible threats to independence and objectivity, including the familiarity threat that may be created by using the same senior personnel on an audit or attest engagement over a long period of time, and to take appropriate action to eliminate those threats or reduce them to an acceptable level by applying safeguards.

- Require that the firm withdraw from the engagement if effective safeguards to reduce threats to independence to an acceptable level cannot be applied.
- Require written confirmation, at least annually, of compliance with the firm's policies and procedures on independence from all firm personnel required to be independent by relevant requirements.
- Establish procedures for confirming the independence of another firm or firm personnel in associated member firms who perform part of the engagement. This would apply to national firm personnel, foreign firm personnel, and foreign-associated firms.[2]
- Require the rotation of personnel for audit or attest engagements where regulatory or other authorities require such rotation after a specified period.

Acceptance and Continuance of Client Relationships and Specific Engagements

1.11 The purpose of the quality control element that addresses acceptance and continuance of client relationships and specific engagements is to establish criteria for deciding whether to accept or continue a client relationship and whether to perform a specific engagement for a client. A firm's client acceptance and continuance policies represent a key element in mitigating litigation and business risk. Accordingly, it is important that a firm be aware that the integrity and reputation of a client's management could reflect the reliability of the client's accounting records and financial representations and, therefore, affect the firm's reputation or involvement in litigation. A firm's policies and procedures related to the acceptance and continuance of client relationships and specific engagements should provide the firm with reasonable assurance that it will undertake or continue relationships and engagements only where it

- is competent to perform the engagement and has the capabilities, including the time and resources, to do so;
- can comply with legal and relevant ethical requirements;
- has considered the client's integrity and does not have information that would lead it to conclude that the client lacks integrity; and
- has reached an understanding with the client regarding the services to be performed.

1.12 This assurance should be obtained before accepting an engagement with a new client, when deciding whether to continue an existing engagement, and when considering acceptance of a new engagement with an existing client. Establishing and maintaining policies such as the following assist the firm in obtaining this assurance:

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[2] A *foreign-associated firm* is a firm domiciled outside of the United States and its territories that is a member of, correspondent with, or similarly associated with an international firm or international association of firms.

- Evaluate factors that have a bearing on management's integrity and consider the risk associated with providing professional services in particular circumstances.[3]
- Evaluate whether the engagement can be completed with professional competence; undertake only those engagements for which the firm has the capabilities, resources, and professional competence to complete; and evaluate, at the end of specific periods or upon occurrence of certain events, whether the relationship should be continued.
- Obtain an understanding, preferably in writing, with the client regarding the services to be performed.
- Establish procedures on continuing an engagement and the client relationship, including procedures for dealing with information that would have caused the firm to decline an engagement if the information had been available earlier.
- Require documentation of how issues relating to acceptance or continuance of client relationships and specific engagements were resolved.

Human Resources

1.13 The purpose of the human resources element of a system of quality control is to provide the firm with reasonable assurance that it has sufficient personnel with the capabilities, competence, and commitment to ethical principles necessary (*a*) to perform its engagements in accordance with professional standards and regulatory and legal requirements, and (*b*) to enable the firm to issue reports that are appropriate in the circumstances. Establishing and maintaining policies such as the following assist the firm in obtaining this assurance:

- Recruit and hire personnel of integrity who possess the characteristics that enable them to perform competently.
- Determine capabilities and competencies required for an engagement, especially for the engagement partner, based on the characteristics of the particular client, industry, and kind of service being performed. Specific competencies necessary for an engagement partner are discussed in paragraph .A27 of QC section 10.
- Determine the capabilities and competencies possessed by personnel.
- Assign the responsibility for each engagement to an engagement partner.

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[3] Such considerations would include the risk of providing professional services to significant clients or to other clients for which the practitioner's objectivity or the appearance of independence may be impaired. In broad terms, the significance of a client to a member or a firm refers to relationships that could diminish a practitioner's objectivity and independence in performing attest services. Examples of factors to consider in determining the significance of a client to an engagement partner, office, or practice unit include (*a*) the amount of time the partner, office, or practice unit devotes to the engagement, (*b*) the effect on the partner's stature within the firm as a result of his or her service to the client, (*c*) the manner in which the partner, office, or practice unit is compensated, or (*d*) the effect that losing the client would have on the partner, office, or practice unit.

- Assign personnel based on the knowledge, skills, and abilities required in the circumstances and the nature and extent of supervision needed.
- Have personnel participate in general and industry-specific continuing professional education and professional development activities that enable them to accomplish assigned responsibilities and satisfy applicable continuing professional education requirements of the AICPA, state boards of accountancy, and other regulators.
- Select for advancement only those individuals who have the qualifications necessary to fulfill the responsibilities they will be called on to assume.

Engagement Performance

1.14 The purpose of the engagement performance element of quality control is to provide the firm with reasonable assurance (*a*) that engagements are consistently performed in accordance with applicable professional standards and regulatory and legal requirements, and (*b*) that the firm or the engagement partner issues reports that are appropriate in the circumstances. Policies and procedures for engagement performance should address all phases of the design and execution of the engagement, including engagement performance, supervision responsibilities, and review responsibilities. Policies and procedures also should require that consultation takes place when appropriate. In addition, a policy should establish criteria against which all engagements are to be evaluated to determine whether an engagement quality control review should be performed.

1.15 Establishing and maintaining policies such as the following assist the firm in obtaining the assurance required relating to the engagement performance element of quality control:

- Plan all engagements to meet professional, regulatory, and the firm's requirements.
- Perform work and issue reports and other communications that meet professional, regulatory, and the firm's requirements.
- Require that work performed by other team members be reviewed by qualified engagement team members, which may include the engagement partner, on a timely basis.
- Require the engagement team to complete the assembly of final engagement files on a timely basis.
- Establish procedures to maintain the confidentiality, safe custody, integrity, accessibility, and retrievability of engagement documentation.
- Require the retention of engagement documentation for a period of time sufficient to meet the needs of the firm, professional standards, laws, and regulations.
- Require that
  - — consultation take place when appropriate (for example, when dealing with complex, unusual, unfamiliar, difficult, or contentious issues);

  - sufficient and appropriate resources be available to enable appropriate consultation to take place;
  - all the relevant facts known to the engagement team be provided to those consulted;
  - the nature, scope, and conclusions of such consultations be documented; and
  - the conclusions resulting from such consultations be implemented.

- Require that
  - differences of opinion be dealt with and resolved;
  - conclusions reached are documented and implemented; and
  - the report not be released until the matter is resolved.
- Require that
  - all engagements be evaluated against the criteria for determining whether an engagement quality control review should be performed;
  - an engagement quality control review be performed for all engagements that meet the criteria; and
  - the review be completed before the report is released.
- Establish procedures addressing the nature, timing, extent, and documentation of the engagement quality control review.
- Establish criteria for the eligibility of engagement quality control reviewers.

Monitoring

1.16 The purpose of the monitoring element of a system of quality control is to provide the firm and its engagement partners with reasonable assurance that the policies and procedures related to the system of quality control are relevant, adequate, operating effectively, and complied with in practice. Monitoring involves an ongoing consideration and evaluation of the appropriateness of the design, the effectiveness of the operation of a firm's quality control system, and a firm's compliance with its quality control policies and procedures. The purpose of monitoring compliance with quality control policies and procedures is to provide an evaluation of the following:

- Adherence to professional standards and regulatory and legal requirements
- Whether the quality control system has been appropriately designed and effectively implemented
- Whether the firm's quality control policies and procedures have been operating effectively so that reports issued by the firm are appropriate in the circumstances

1.17 Establishing and maintaining policies such as the following assist the firm in obtaining the assurance required relating to the monitoring element of quality control:

- Assign responsibility for the monitoring process to a partner or partners or other persons with sufficient and appropriate experience and authority in the firm to assume that responsibility.
- Assign performance of the monitoring process to competent individuals.
- Require the performance of monitoring procedures that are sufficiently comprehensive to enable the firm to assess compliance with all applicable professional standards and the firm's quality control policies and procedures. Monitoring procedures consist of the following:
  - — Review of selected administrative and personnel records pertaining to the quality control elements.
  - — Review of engagement documentation, reports, and clients' financial statements.
  - — Summarization of the findings from the monitoring procedures, at least annually, and consideration of the systemic causes of findings that indicate that improvements are needed.
  - — Determination of any corrective actions to be taken or improvements to be made with respect to the specific engagements reviewed or the firm's quality control policies and procedures.
  - — Communication of the identified findings to appropriate firm management personnel.
  - — Consideration of findings by appropriate firm management personnel who should also determine that any actions necessary, including necessary modifications to the quality control system, are taken on a timely basis.
  - — Assessment of
    - the appropriateness of the firm's guidance materials and any practice aids;
    - new developments in professional standards and regulatory and legal requirements and how they are reflected in the firm's policies and procedures where appropriate;
    - compliance with policies and procedures on independence;
    - the effectiveness of continuing professional development, including training;
    - decisions related to acceptance and continuance of client relationships and specific engagements; and
    - firm personnel's understanding of the firm's quality control policies and procedures and implementation thereof.
- Communicate at least annually, to relevant engagement partners and other appropriate personnel, deficiencies noted as a result of

the monitoring process and recommendations for appropriate remedial action.

- Communicate the results of the monitoring of its quality control system process to relevant firm personnel at least annually.
- Establish procedures designed to provide the firm with reasonable assurance that it deals appropriately with the following:
  - Complaints and allegations that the work performed by the firm fails to comply with professional standards and regulatory and legal requirements.
  - Allegations of noncompliance with the firm's system of quality control.
  - Deficiencies in the design or operation of the firm's quality control policies and procedures, or noncompliance with the firm's system of quality control by an individual or individuals, as identified during the investigations into complaints and allegations.

  This includes establishing clearly defined channels for firm personnel to raise any concerns in a manner that enables them to come forward without fear of reprisal and documenting complaints and allegations and the responses to them.
- Require appropriate documentation to provide evidence of the operation of each element of its system of quality control. The form and content of documentation evidencing the operation of each of the elements of the system of quality control is a matter of judgment and depends on a number of factors, including the following, for example:
  - The size of the firm and the number of offices.
  - The nature and complexity of the firm's practice and organization.
- Require retention of documentation providing evidence of the operation of the system of quality control for a period of time sufficient to permit those performing monitoring procedures and peer review to evaluate the firm's compliance with its system of quality control, or for a longer period if required by law or regulation.

1.18 Some of the monitoring procedures discussed in the previous list may be accomplished through the performance of the following:

- Engagement quality control review
- Review of engagement documentation, reports, and clients' financial statements for selected engagements after the report release date
- Inspection[4] procedures

[4] *Inspection* is a retrospective evaluation of the adequacy of the firm's quality control policies and procedures, its personnel's understanding of those policies and procedures, and the extent of the firm's compliance with them. Although monitoring procedures are meant to be ongoing, they may include inspection procedures performed at a fixed point in time. Monitoring is a broad concept; inspection is one specific type of monitoring procedure.

Documentation of Quality Control Policies and Procedures

1.19 The firm should document each element of its system of quality control. The extent of the documentation will depend on the size, structure, and nature of the firm's practice. Documentation may be as simple as a checklist of the firm's policies and procedures or as extensive as practice manuals.

Appendix E

The New Revenue Recognition Standard: FASB ASC 606

This appendix is nonauthoritative and is included for informational purposes only.

Overview

On May 28, 2014, the International Accounting Standards Board (IASB) and FASB issued a joint accounting standard on revenue recognition to address a number of concerns regarding the complexity and lack of consistency surrounding the accounting for revenue transactions. Consistent with each board's policy, FASB issued Accounting Standards Update (ASU) No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, and the IASB issued International Financial Reporting Standard (IFRS) 15, *Revenue from Contracts with Customers*. FASB ASU No. 2014-09 will amend the FASB *Accounting Standards Codification®* (ASC) by creating a new Topic 606, *Revenue from Contracts with Customers*, and a new Subtopic 340-40, *Other Assets and Deferred Costs—Contracts with Customers*. The guidance in ASU No. 2014-09 provides what FASB describes as a framework for revenue recognition and supersedes or amends several of the revenue recognition requirements in FASB ASC 605, *Revenue Recognition*, as well as guidance within the 900 series of industry-specific topics.

As part of the boards' efforts to converge U.S. generally accepted accounting principles (GAAP) and IFRSs, the standard eliminates the transaction- and industry-specific revenue recognition guidance under current GAAP and replaces it with a principles-based approach for revenue recognition. The intent is to avoid inconsistencies of accounting treatment across different geographies and industries. In addition to improving comparability of revenue recognition practices, the new guidance provides more useful information to financial statement users through enhanced disclosure requirements. FASB and the IASB have essentially achieved convergence with these standards, with some minor differences related to the collectibility threshold, interim disclosure requirements, early application and effective date, impairment loss reversal, and nonpublic entity requirements.

The standard applies to any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets, unless those contracts are within the scope of other standards (for example, insurance or lease contracts).

Effective or Applicability Date

The guidance in ASU No. 2014-09 was originally effective for annual reporting periods of public entities beginning after December 15, 2016, including interim periods within that reporting period. Early application was not permitted for public entities, including not-for-profit entities (NFPs) that have issued, or are conduit bond obligors for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market and for employee benefit plans that file or furnish financial statements to the SEC.

For nonpublic entities, the amendments in the new guidance were originally effective for annual reporting periods beginning after December 15, 2017, and interim periods within annual periods beginning after December 15, 2018.

On August 12, 2015, FASB issued ASU No. 2015-14, *Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date*, to allow entities additional time to implement systems, gather data, and resolve implementation questions. This update allows for public business entities, certain NFPs, and certain employee benefit plans to apply the new requirements to annual reporting periods beginning after December 15, 2017, including interim reporting periods within that reporting period. Earlier application is permitted only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period.

All other entities will now apply the guidance in ASU No. 2014-09 to annual reporting periods beginning after December 15, 2018, and interim reporting periods within annual reporting periods beginning after December 15, 2019. Application is permitted earlier only as of an annual reporting period beginning after December 15, 2016, including interim reporting periods within that reporting period, or an annual reporting period beginning after December 15, 2016, and interim reporting periods within annual reporting periods beginning one year after the annual reporting period in which an entity first applies the guidance in ASU No. 2014-09.

Overview of the New Guidance

The core principle of the revised revenue recognition standard is that an entity should recognize revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those good or services.

To apply the proposed revenue recognition standard, ASU No. 2014-09 states that an entity should follow these five steps:

1. Identify the contract(s) with a customer.
2. Identify the performance obligations in the contract.
3. Determine the transaction price.
4. Allocate the transaction price to the performance obligations in the contract.
5. Recognize revenue when (or as) the entity satisfies a performance obligation.

Under the new standard, revenue is recognized when a company satisfies a performance obligation by transferring a promised good or service to a customer (which is when the customer obtains control of that good or service). See the following discussion of the five steps involved when recognizing revenue under the new guidance.

Understanding the Five-Step Process

Step 1: Identify the Contract(s) With a Customer

ASU No. 2014-09 defines a contract as "an agreement between two or more parties that creates enforceable rights and obligations." The new standard affects contracts with a customer that meet the following criteria:

- Approval (in writing, orally, or in accordance with other customary business practices) and commitment of the parties
- Identification of the rights of the parties
- Identification of the payment terms
- Contract has commercial substance
- Probable that the entity will collect substantially all the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer

A contract does not exist if each party to the contract has the unilateral enforceable right to terminate a wholly unperformed contract without compensating the other party (parties).

Step 2: Identify the Performance Obligations in the Contract

A *performance obligation* is a promise in a contract with a customer to transfer a good or service to the customer.

At contract inception, an entity should assess the goods or services promised in a contract with a customer and identify as a performance obligation (possibly multiple performance obligations) each promise to transfer to the customer either

- a good or service (or bundle of goods or services) that is distinct, or
- a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.

A good or service that is not distinct should be combined with other promised goods or services until the entity identifies a bundle of goods or services that is distinct. In some cases, that would result in the entity accounting for all the goods or services promised in a contract as a single performance obligation.

Step 3: Determine the Transaction Price

The transaction price is the amount of consideration (fixed or variable) the entity expects to receive in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties. To determine the transaction price, an entity should consider the effects of

- variable consideration,
- constraining estimates of variable consideration,
- the existence of a significant financing component,
- noncash considerations, and
- consideration payable to the customer.

If the consideration promised in a contract includes a variable amount, then an entity should estimate the amount of consideration to which the entity will be entitled in exchange for transferring the promised goods or services to a customer. An entity would then include in the transaction price some or all of an amount of variable consideration only to the extent that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved.

An entity should consider the terms of the contract and its customary business practices to determine the transaction price.

Step 4: Allocate the Transaction Price to the Performance Obligations in the Contract

The transaction price is allocated to separate performance obligations in proportion to the standalone selling price of the promised goods or services. If a standalone selling price is not directly observable, then an entity should estimate it. Reallocation of the transaction price for changes in the standalone selling price is not permitted. When estimating the standalone selling price, entities can use various methods, including the adjusted market assessment approach, expected cost plus a margin approach, and residual approach (only if the selling price is highly variable and uncertain).

Sometimes, the transaction price includes a discount or a variable amount of consideration that relates entirely to one of the performance obligations in a contract. Guidance under the new standard specifies when an entity should allocate the discount or variable consideration to one (or some) performance obligation(s), rather than to all the performance obligations in the contract.

Step 5: Recognize Revenue When (or as) the Entity Satisfies a Performance Obligation

The amount of revenue recognized when transferring the promised good or service to a customer is equal to the amount allocated to the satisfied performance obligation, which may be satisfied at a point in time or over time. Control of an asset refers to the ability to direct the use of, and obtain substantially all the remaining benefits from, the asset. Control also includes the ability to prevent *other entities* from directing the use of, and obtaining the benefits from, an asset.

When performance obligations are satisfied over time, the entity should select an appropriate method for measuring its progress toward complete satisfaction of that performance obligation. The standard discusses methods of measuring progress, including input and output methods, and how to determine which method is appropriate.

Additional Guidance Under the New Standard

In addition to the five-step process for recognizing revenue, ASU No. 2014-09 also addresses the following areas:

- Accounting for incremental costs of obtaining a contract, as well as costs incurred to fulfill a contract
- Licenses
- Warranties

Lastly, the new guidance enhances disclosure requirements to include more information about specific revenue contracts entered into by the entity, including performance obligations and the transaction price.

Transition Resource Group

Due to the potential for significant changes that may result from the issuance of the new standard, FASB and the IASB have received an abundance of implementation questions from interested parties. To address these questions, the boards have formed a joint Transition Resource Group (TRG) for revenue recognition to promote effective implementation and transition to the converged standard.

Since the issuance of the standard, the TRG has met several times to discuss implementation issues raised by concerned parties and actions to take to address these issues. Refer to FASB's TRG website for more information on this group and the status of their efforts, including meeting materials and meeting summaries.

Latest Developments

Based on discussions held thus far on individual areas affected by the new standard, the TRG informed the boards that technical corrections are needed to further articulate the guidance in the standard. As a result, FASB has issued updates to clarify guidance on performance obligations, licensing, principal versus agent considerations, and other narrow-scope improvements and practical expedients.

ASU No. 2016-08, *Revenue from Contracts with Customers (Topic 606): Principle versus Agent Considerations (Reporting Revenue Gross versus Net)*, was issued in March 2016 to clarify the guidance in FASB ASC 606 with respect to principal versus agent. There is little disagreement that an entity who is a principal recognizes revenue in the gross amount of consideration when a performance obligation is satisfied. An entity who is an agent (collecting revenue on behalf of the principal) recognizes revenue only to the extent of the commission or fee that the agent collects. This ASU hopes to eliminate the potential diversity in practice when determining whether an entity is a principal or an agent by clarifying the following:

- An entity determines whether it is a principal or an agent for each distinct good or service.
- An entity determines the nature of each specified good or service (including whether it is a right to a good or service)
- When an entity is a principal, it obtains control of
  - — a good or another asset from the other party that it then transfers to the customer;
  - — a right to a service that will be performed by another party, which gives the entity the ability to direct that party to provide the service to the customer on the entity's behalf; or

— a good or service from the other party that it combines with other goods or services to provide the specified good or service to the customer.

- Indicators in the assessment of control may be more or less relevant or persuasive, or both, to the control assessment, depending on the facts and circumstances.

Additional illustrative examples are also provided in ASU No. 2016-08 to further assist practitioners in applying this guidance. The effective date of this update is in line with the guidance in ASU No. 2014-09, as amended by ASU No. 2015-14.

ASU No. 2016-10, *Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing*, was issued in April 2016 to reduce potential for diversity in practice at initial application of FASB ASC 606, as well as the cost and complexity of applying FASB ASC 606 at transition and on an ongoing basis. When identifying promised goods and services in a contract, this ASU states that entities

- are not required to assess whether promised goods or services are performance obligations if they are immaterial to the contract.
- can elect to account for shipping and handling activities as an activity to fulfill promises within the contract, rather than as an additional promised service.

When assessing whether promised goods or services are distinct, this ASU emphasizes the need to determine whether the nature of the promise is to transfer

- each of the goods or services, or
- a combined item (or items) to which the promised goods or services are inputs.

With regards to licensing, ASU No. 2016-10 clarifies whether revenue should be recognized at a point in time or over time, based on whether the license provides a right to use an entity's intellectual property or a right to access the entity's intellectual property. Specifically,

- if the intellectual property has significant standalone functionality, the license does not include supporting or maintaining that intellectual property during the license period. Therefore, the performance obligation would be considered satisfied at a point in time. Examples of this type of intellectual property include software, biological compounds or drug formulas, and media.
- licenses for symbolic intellectual property include supporting or maintaining that intellectual property during the license period and, therefore, are considered to be satisfied over time. Examples of symbolic intellectual property include brands, team or trade names, logos, and franchise rights.

Lastly, ASU No. 2016-10 provides clarification on implementation guidance on recognizing revenue for sales-based or usage-based royalty promised in exchange for a license of intellectual property. The effective date of this ASU is in line with the guidance in ASU No. 2014-09, as amended by ASU No. 2015-14.

In addition to ASU Nos. 2016-08 and 2016-10, ASU No. 2016-12, *Revenue from Contracts with Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients*, was issued in May 2016. Topics covered in this ASU include

- clarification on contract modifications. This amendment permits an entity to determine and allocate the transaction price on the basis of all satisfied and unsatisfied performance obligations in a modified contract as of the beginning of the earliest period presented in accordance with the guidance in FASB ASC 606. An entity would not be required to separately evaluate the effects of each contract modification. An entity that chooses to apply this practical expedient would apply the expedient consistently to similar types of contracts.
- how to assess the collectibility criterion. The amendment introduces new criteria to meet the collectibility requirement. An entity should assess the collectibility of the consideration promised in a contract for the goods or services that will be transferred to the customer, rather than assessing the collectibility of the consideration promised in the contract for all the promised goods or services.
- how to report sales taxes and similar taxes. This amendment states that an entity may make an accounting policy election to exclude from the measurement of the transaction price all taxes assessed by a governmental authority that are both imposed on and concurrent with a specific revenue-producing transaction and collected by the entity from a customer (for example, sales, use, value added, and some excise taxes). Taxes assessed on an entity's total gross receipts or imposed during the inventory procurement process should be excluded from the scope of the election. An entity that makes this election should exclude from the transaction price all taxes in the scope of the election and should comply with the applicable accounting policy guidance, including disclosure requirements.
- when to measure noncash consideration. This amendment clarifies that the measurement date for noncash consideration is contract inception. If the fair value of the noncash consideration varies because of the form of the consideration and for reasons other than the form of the consideration, an entity should apply the guidance on variable consideration only to the variability resulting from reasons other than the form of the consideration.
- how to apply transition guidance. This amendment clarifies that a completed contract for purposes of transition is a contract for which all (or substantially all) the revenue was recognized under legacy GAAP before the date of initial application. Accounting for elements of a contract that do not affect revenue under legacy GAAP are irrelevant to the assessment of whether a contract is complete. In addition, the amendment permits an entity to apply the modified retrospective transition method either to all contracts or only to contracts that are not completed contracts.

The effective date of this ASU is in line with the guidance in ASU No. 2014-09, as amended by ASU No. 2015-14.

FASB also issued ASU No. 2016-20, *Technical Corrections and Improvements to Topic 606, Revenue from Contracts with Customers*, in December 2016. These amendments affect narrow aspects of guidance issued in ASU No. 2014-09, including but not limited to, guidance on

- impairment testing. When performing impairment testing, an entity should consider expected contract renewals and extensions. In addition, the assessment should include both the amount of consideration it already has received but has not yet recognized as revenue, and the amount it expects to receive in the future.
- additional scope exceptions. The term "insurance" is removed from the scope exceptions of FASB ASC 606 to clarify that all contracts within the scope of FASB ASC 944, *Financial Services—Insurance*, are excluded.
- provisions for losses on construction-type and production-type contracts. Such provisions should be determined at least at the contract level; however, an entity can make an accounting policy election to determine the provision for losses at the performance obligation level.
- disclosure of remaining performance obligations. Optional exemptions from the disclosure requirement are provided for remaining performance obligations when an entity is not required to estimate variable consideration to recognize revenue.

Consistent with the other ASUs, the effective date of ASU No. 2016-20 is in line with the guidance in ASU No. 2014-09, as amended by ASU No. 2015-14.

Conclusion

Upon implementation of the new standard, consistency of revenue recognition principles across geography and industry will be enhanced and financial statement users will be provided better insight through improved disclosure requirements. To provide CPAs with guidance during this time of transition, the AICPA's Financial Reporting Center (FRC) offers invaluable resources on the topic, including a roadmap to ensure that companies take the necessary steps to prepare themselves for the new standard. In addition, the FRC includes a list of conferences, webcasts, and other products to keep you informed on upcoming changes in revenue recognition. Refer to www.aicpa.org/interestareas/frc/accountingfinancialreporting/revenuerecognition/pages/revenuerecognition.aspx to stay updated on the latest information available on revenue recognition.

Appendix F

The New Leases Standard: FASB ASU No. 2016-02

This appendix is nonauthoritative and is included for informational purposes only.

Overview

Issuance and Objective

On February 25, 2016, FASB issued Accounting Standards Update (ASU) No. 2016-02, *Leases (Topic 842)*. The objective of the ASU is to increase transparency and comparability in financial reporting by requiring balance sheet recognition of leases and note disclosure of certain information about lease arrangements. This ASU codifies the new FASB ASC topic 842, *Leases*, and makes conforming amendments to other FASB ASC topics.

The new FASB ASC topic on leases consists of these subtopics:

a. Overall
b. Lessee
c. Lessor
d. Sale and leaseback transactions
e. Leveraged lease arrangements

Applicability and Effective Date

ASU No. 2016-02 is applicable to any entity that enters into a lease and is effective as follows:

	Fiscal Years Beginning After	***Interim Periods Within Fiscal Years Beginning After***
Public business entities, certain not-for-profit entities with conduit financing arrangements, and employee benefit plans	December 15, 2018	December 15, 2018
All other entities	December 15, 2019	December 15, 2020

FASB ASC 842 applies to all leases and subleases of property, plant, and equipment; it specifically does not apply to the following nondepreciable assets accounted for under other FASB ASC topics:

a. Leases of intangible assets
b. Leases to explore for or use nonregenerative resources such as minerals, oil, and natural gas
c. Leases of biological assets, such as timber

d. Leases of inventory

e. Leases of assets under construction

Main Provisions

Overall

Identifying a Lease

Key changes in the guidance are illustrated by comparing the definition of a lease in FASB ASC 840 (extant GAAP) and FASB ASC 842.

FASB ASC 840	***FASB ASC 842***
An agreement conveying the right to use property, plant, or equipment (land and/or depreciable assets) usually for a stated period of time.	A contract, or part of a contract, that conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration.

The identification of a lease under FASB ASC 842 should be based on the presence of key elements in the definition.

Separating Components of a Lease Contract

Under FASB ASC 842, a contract that contains a lease should be separated into lease and nonlease components. Separation should be based on the right to use; each underlying asset should be considered to be separate from other lease components when both of the following criteria are met:

a. The lessee can benefit from the right-of-use of the asset (either alone or with other readily available resources)

b. The right-of-use is neither highly dependent on or highly interrelated with other underlying assets in the contract

The consideration in the contract should be allocated to the separate lease and nonlease components in accordance with provisions of FASB ASC 842.

Lessees can make an accounting policy election to treat both lease and nonlease elements as a single lease component.

Lease Classification

When a lease meets any of the following specified criteria at commencement, the lease should be classified by the lessee and lessor as a finance lease and a sales-type lease, respectively. These criteria can be summarized as follows:

a. Transfers ownership to lessee

b. Purchase option reasonably certain to be exercised

c. Lease term for major portion of asset's remaining economic life

d. Present value of lease payments and residual value exceeds substantially all of the fair value of the underlying asset

e. Specialized nature of underlying asset results in no expectation of alternative use after the lease term

If none of the above criteria are met, the lease should be classified as follows:

Lessee—classify as an operating lease

Lessor—classify as an operating lease unless (1) the present value of the lease payments and any residual value guarantee that equals or exceeds substantially all of the fair value of the underlying asset and (2) it is probable that the lessor will collect the lease payments plus any residual value guarantee. If both of these summarized criteria from FASB ASC 842-10-25-3 are met, the lessor should classify the lease as a direct financing lease.

Lease Term and Measurement

The lease term is the noncancellable period of the lease together with all of the following:

a. Period covered by the option for the lessee to extend the lease if the option is reasonably certain to be exercised

b. Period covered by option for lessee to terminate the lease if reasonably certain not to be exercised

c. Period covered by option for lessor to extend or not terminate the lease if option is controlled by lessor.

Lease Payments

Lease payments relating to use of the underlying asset during the lease term include the following at the commencement date:

a. Fixed payments less incentives payable to lessee

b. Variable lease payments based on an index or other rate

c. Exercise price of an option to purchase the underlying asset if it is reasonably certain to be exercised

d. Payments for penalties for terminating a lease if the lease term reflects exercise of lessee option

e. Fees paid by the lessee to the owners of a special purpose entity for structuring the lease

f. For lessee only, amounts probable of being owed under residual value guarantees

Lease payments specifically exclude the following:

a. Certain other variable lease payments

b. Any guarantee by the lessee of the lessor's debt

c. Certain amounts allocated to nonlease components

Reassessment of the lease term and purchase options, and subsequent remeasurement by either the lessee or lessor are limited to certain specified circumstances.

Lessee

Recognition and Measurement

Commencement Date

At the commencement date of the lease, a lessee should recognize a right-of-use asset and a lease liability; for short term leases, an alternative accounting policy election is available.

The lease liability should be measured at the present value of the unpaid lease payments. The right-of-use asset should consist of the following: the amount of the initial lease liability; any lease payments made to lessor at or before the commencement date minus any incentives received; and initial direct costs.

A short term lease is defined by the FASB ASC master glossary as a lease that, at the commencement date has a lease term of 12 months or less and does not include an option to purchase the underlying asset that the lessee is reasonably certain to exercise. The accounting policy election for short term leases should be made by class of underlying asset. The election provides for recognition of the lease payments in profit or loss on a straight-line basis over the lease term and variable lease payments in the period in which the obligation for those payments is incurred.

After the Commencement Date

After the commencement date, the lessee should recognize in profit or loss (unless costs are included in the carrying amount of another asset) the following:

- Finance leases:
  - *a*. Amortization of the right-of-use asset and interest on the lease liability
  - *b*. Variable lease payments not included in the lease liability in the period obligation incurred
  - *c*. Any impairment
- Operating leases:
  - *a*. A single lease cost calculated such that the remaining cost is allocated on a straight line basis over the remaining lease term (unless another allocation is more representative of the benefit from use of the asset)
  - *b*. Variable lease payments not included in the lease liability in the period in which the obligation is incurred
  - *c*. Any impairment

Subsequent Measurement

FASB ASC 842-20-35 provides guidance for subsequent measurement.

Presentation and Disclosure

Key presentation matters include the following:

- Statement of financial position.
  - — Separate presentation of right-of-use assets and lease liabilities from finance leases and operating leases.
- Statement of comprehensive income.
  - — Finance leases—interest expense on the lease liability and amortization of right-of-use asset in a manner consistent with how the entity presents other interest expense and depreciation or amortization of similar assets.
  - — Operating leases—expense to be included in the lessee's income from continuing operations.

- Statement of cash flows.
  - Presentation within financing activities—the repayment of the principal portion of the lease liability arising from finance leases.
  - Presentation within operating activities—payments arising from operating leases; interest payments on the lease liability; variable lease payments and short term lease payments not included in lease liability.

Disclosure requirements include qualitative and quantitative information for leases, significant judgements, and amounts recognized in the financial statements, including certain specified information and amounts.

Lessor

Recognition and Measurement

FASB ASC 842 provides recognition guidance for sales-type leases, direct financing leases, and operating leases. The following table summarizes the guidance:

Sales-Type Leases	
At the Commencement Date	**After the Commencement Date**
Lessor should derecognize the underlying asset and recognize the following: *a*. Net investment in the lease (lease receivable and unguaranteed residual asset) *b*. Selling profit or loss arising from the lease *c*. Initial direct costs as an expense	Lessor should recognize all of the following: *a*. Interest income on the net investment in the lease *b*. Certain variable lease payments *c*. Impairment
Direct Financing Leases	
At the Commencement Date	**After the Commencement Date**
Lessor should derecognize the underlying asset and recognize the following: *a*. Net investment in the lease (lease receivable and unguaranteed residual asset reduced by selling profit) *b*. Selling loss arising from the lease, if applicable	Lessor should recognize all of the following: *a*. Interest income on the net investment in the lease *b*. Certain variable lease payments *c*. Impairment

(continued)

Operating Leases	
At the Commencement Date	**After the Commencement Date**
Lessor should defer initial direct costs.	Lessor should recognize all of the following: *a.* The lease payments as income in profit or loss over the lease term on a straight line basis (unless another method in more representative of the benefit received) *b.* Certain variable lease payments as income in profit or loss *c.* Initial direct costs as an expense over the lease term on the same basis as lease income

FASB ASC 842-30-35 provides guidance for subsequent measurement.

Presentation and Disclosure

Key presentation matters include the following:

For sales-type and direct financing leases:

- Statement of financial position
  - — Separate presentation of lease assets (that is, aggregate of lessor's net investment in sales-type leases and direct financing leases) from other assets.
  - — Classified as current or noncurrent based on same considerations as other assets.
- Statement of comprehensive income
  - — Presentation of income from leases in the statement of comprehensive income or disclosure of income from leases in the notes with a reference to the corresponding line in the statement of comprehensive income.
  - — Presentation of profit or loss recognized at commencement date in a manner appropriate to lessor's business model.
- Statement of cash flows
  - — Presentation within operating activities—cash receipts from leases.

For operating leases:

- Statement of financial position
  - Presentation of an underlying asset subject to an operating leases in accordance with other FASB ASC topics.
- Statement of cash flows
  - Presentation within operating activities—cash receipts from leases.

Disclosure requirements include qualitative and quantitative information for leases, significant judgements, and amounts recognized in the financial statements, including certain specified information and amounts.

Sale and Leaseback Transactions

FASB ASC 842 provides guidance for both the transfer contract and the lease in a sale and leaseback transaction (a transaction in which a seller-lessee transfers an asset to a buyer-lessor and leases that asset back). Determination of whether the transfer is a sale should be based on provisions of FASB ASC 606, *Revenue from Contracts with Customers*. FASB ASC 842-40-25 provides measurement guidance for a transfer that is either determined to be a sale or determined not to be a sale.

FASB ASC 842-40 provides guidance for subsequent measurement, financial statement presentation, and disclosures.

Leveraged Lease Arrangements

The legacy accounting model for leveraged leases continues to apply to those leveraged leases that commenced before the effective date of FASB ASC 842. There is no separate accounting model for leveraged leases that commence after the effective date of FASB ASC 842.

Appendix G

Accounting for Financial Instruments

This appendix is nonauthoritative and is included for informational purposes only.

Overall Project Objective

The objective of FASB's Accounting for Financial Instruments project is to significantly improve the decision usefulness of financial instrument reporting for users of financial statements. The project was initiated to reconsider recognition and measurement of financial instruments, address issues related to impairment of financial instruments and hedge accounting, and increase convergence in accounting for financial instruments. In replacing the existing financial instruments standards, an expected outcome is the simplification of the accounting requirements for financial instruments. The project was split into three phases including classification and measurement, impairment, and hedge accounting. This appendix focusses on the latest developments in each of these phases.

Classification and Measurement

Overview

On January 5, 2016, FASB issued Accounting Standards Update (ASU) No. 2016-01, *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*, to enhance the reporting model for financial instruments and to provide users of financial statements with more decision-useful information. The amendments in the ASU are intended to improve certain aspects of recognition, measurement, presentation, and disclosure of financial instruments.

The new guidance will accomplish the following:

- Require equity investments (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income
- Replace the impairment model for equity investments without readily determinable fair values with a qualitative impairment assessment
- Eliminate the requirement to disclose the fair values of financial assets and financial liabilities measured at amortized cost for entities that are not public business entities
- Eliminate the requirement for public business entities to disclose the methods and significant assumptions used to estimate fair value that is required to be disclosed for financial assets and financial liabilities measured at amortized cost on the balance sheet
- Require public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes

- Require an entity to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments
- Require separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (that is, securities or loans and receivables) on the balance sheet or the accompanying notes to the financial statements
- Clarify that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale debt securities in combination with an entity's other deferred tax assets
- Eliminate an entity's ability to estimate the disclosed fair values of financial assets and financial liabilities on the basis of entry prices

Applicability and Effective Date

ASU No. 2016-01 affects all entities that hold financial assets or have financial liabilities and is effective as follows:

	Fiscal Years Beginning After	***Interim Periods Within Fiscal Years Beginning After***
Public business entities	December 15, 2017	December 15, 2017
All other entities, including not-for-profit entities and employee benefit plans within the scope of FASB *Accounting Standards Codification* (ASC) 960–965 on plan accounting	December 15, 2018	December 15, 2019

All entities that are not public business entities may adopt the amendments in this ASU earlier as of the fiscal years beginning after December 15, 2017, including interim periods within those fiscal years.

Early application by public business entities to financial statements of fiscal years or interim periods that have not yet been issued or, by all other entities, that have not yet been made available for issuance of the following amendments in this ASU are permitted as of the beginning of the fiscal year of adoption:

- An entity should present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk if the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments.
- Entities that are not public business entities are not required to apply the fair value of financial instruments disclosure guidance in the "General" subsection of FASB ASC 825-10-50.

With the exception of this early application guidance, early adoption of the amendments in this ASU is not permitted.

Impairment

Overview

On June 16, 2016, FASB issued ASU No. 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*, to provide financial statement users with more decision-useful information about the expected credit losses on financial instruments and other commitments to extend credit held by a reporting entity at each reporting date. Upon the effective date of this ASU, the incurred loss impairment methodology in current general accepted accounting principles (GAAP) is replaced with a methodology that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information to inform credit loss estimates.

Assets Measured at Amortized Cost

ASU No. 2016-13 eliminates the probable initial recognition threshold under current GAAP and requires entities that measure financial assets (or a group of financial assets) at amortized cost basis to present such assets at the net amount expected to be collected. The amendments in this ASU broaden the information that an entity must consider in developing its expected credit loss estimate for assets measured either collectively or individually. In addition to past events and current conditions, entities should also consider reasonable and supportable forecasts that affect the collectibility of the reported amount. However, an entity may revert to historical loss information that is reflective of the contractual term (considering the effect of prepayments) for periods that are beyond the time frame for which the entity is able to develop reasonable and supportable forecasts.

An entity may apply any method for measuring expected credit losses as long as their method reasonably reflects its expectations of the credit loss estimate.

Purchased Financial Assets With Credit Deterioration

ASU No. 2016-13 defines *purchased financial assets with credit deterioration* (PCD assets) as acquired individual financial assets (or acquired groups of financial assets with similar risk characteristics) that as of the date of acquisition have experienced a more-than-insignificant deterioration in credit quality since origination, as determined by the acquirer's assessment. The allowance for credit losses for PCD assets that are measured at amortized cost basis is determined in a similar manner to other financial assets measured at amortized cost basis. The initial allowance for credit losses is added to the purchase price, rather than being reported as a credit loss expense. Entities record only subsequent changes in the allowance for credit losses as a credit loss expense for PCD assets. Furthermore, an entity should recognize interest income for PCD assets based on the effective interest rate, excluding the discount embedded in the purchase price that is attributable to the acquirer's assessment of credit losses at acquisition.

Disclosures

In an effort to increase users' understanding of underwriting standards and credit quality trends, ASU No. 2016-13 requires the current disclosure on credit quality indicators in relation to the amortized cost of financing receivables to be further disaggregated by year of origination (or vintage). Entities that are not public business entities are not required to disclose the disaggregation by year of origination.

Available for Sale Debt Securities

Entities will now be required to present credit losses on available-for-sale debt securities as an allowance, rather than as a permanent write-down.

An entity will now be able to record reversals of credit losses on debt securities (in situations in which the estimate of credit declines) in current period net income. Thus, aligning the income statement recognition of credit losses with the reporting period in which changes occur. However, an entity may not record an allowance for credit losses exceeding the amount by which fair value is below amortized cost.

Purchased Debt Securities With Credit Deterioration

The allowance for credit losses for purchased available-for-sale debt securities with a more-than-insignificant amount of credit deterioration since origination is also determined in a similar manner to other available-for-sale debt securities. However, ASU No. 2016-13 requires an entity to add the initial allowance for credit losses to the purchase price, rather than reporting it as a credit loss expense. Entities record only subsequent changes in the allowance for credit losses as a credit loss expense. Furthermore, an entity should recognize interest income based on the effective interest rate, excluding the discount embedded in the purchase price that is attributable to the acquirer's assessment of credit losses at acquisition.

Troubled Debt Restructurings

The ASU does not change the definition or derecognition guidelines for troubled debt restructurings (TDRs), but, rather, changes the impairment recognized on restructuring. Credit losses for TDRs now will be measured using the current expected credit loss model. The ASU eliminates the current GAAP requirement to use a discounted cash flow technique. Credit losses, including concessions given to a borrower under a TDR, will be recognized through an allowance account.

Applicability and Effective Date

ASU No. 2016-13 affects entities holding financial assets and net investment in leases that are not accounted for at fair value through net income. It also affects loans, debt securities, trade receivables, net investments in leases, off-balance sheet credit exposures, reinsurance receivables, and any other financial assets not excluded from the scope that have the contractual right to receive cash.

Because there is diversity in practice in applying the incurred loss methodology, ASU No. 2016-13 will affect entities to varying degrees depending on the credit quality of the assets held by the entities, their duration, and how the entity applies current GAAP.

ASU No. 2016-13 is effective as follows:

	Fiscal Years Beginning After	***Interim Periods Within Fiscal Years Beginning After***
Public business entities that are SEC filers	December 15, 2019	December 15, 2019
All other public entities	December 15, 2020	December 15, 2020
All other entities, including not-for-profit entities and employee benefit plans within the scope of FASB ASC 960–965 on plan accounting	December 15, 2020	December 15, 2021

All entities may adopt the amendments in this ASU earlier as of the fiscal years beginning after December 15, 2018, including interim periods within those fiscal years.

Transition Resource Group

Due to the potential for significant changes that may result from the issuance of the new standard, FASB has formed the Transition Resource Group (TRG) for Credit Losses to

- solicit, analyze, and discuss stakeholder issues arising from implementation of the new guidance.
- inform FASB about those implementation issues, which will help FASB determine what, if any, action will be needed to address those issues.
- provide a forum for stakeholders to learn about the new guidance from others involved with implementation.

The TRG will meet to discuss and share their views on potential implementation issues raised by concerned parties and, subsequent to each meeting, FASB will determine what actions, if any, will be taken on each issue. Refer to the page "Transition Resource Group for Credit Losses" on FASB's website for more information on this group and the status of their efforts, including meeting materials and meeting summaries.

Hedge Accounting

Overview

Hedge accounting is the third phase in FASB's overall project on accounting for financial instruments. The objective of this project is to make targeted improvements to the hedge accounting model based on the feedback received from preparers, auditors, users, and other stakeholders. FASB has also noted it will consider opportunities to align with IFRS 9, *Financial Instruments*.

Latest Developments

FASB staff are drafting a proposed ASU based on the tentative decisions reached by the board. Readers are encouraged to visit the "Technical Agenda" page under "Projects" at www.fasb.org for the latest developments regarding the hedge accounting phase.

Conclusion

The extent of the effect of the new financial instruments standards will depend upon the relative significance of financial instruments to an entity's operations and financial positon as well as the entity's business strategy. To provide CPAs with guidance during this time of transition, the AICPA's Financial Reporting Center (FRC) offers invaluable resources on the topic. In addition, the FRC includes a list of conferences, webcasts, and products to keep you informed on the latest developments in accounting for financial instruments. Refer to www.aicpa.org/InterestAreas/FRC/AccountingFinancialReporting/Financial-Instruments/Pages/financial-instruments.aspx to stay updated on the latest information available on accounting for financial instruments.

Appendix H

Schedule of Changes Made to the Text From the Previous Edition

This appendix is nonauthoritative and is included for informational purposes only.

As of July 1, 2017

This schedule of changes identifies areas in the text and footnotes of this guide that have 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***
General	Guide content included in shaded areas and "Guidance Update" boxes within the chapters have been updated to appropriately reflect guidance not yet effective as of the date of the guide. See the preface of this guide for more explanation to this "dual guidance" treatment.
General	Editorial changes, including rephrasing, have been made in this guide to improve readability where necessary.
Preface	Updated.
Former paragraphs 1.48–.53; former footnote 9 in former paragraph 1.49	Moved to chapter 3.
Paragraphs 1.92 and 1.108	Revised to reflect the issuance of the PCAOB's *Reorganization of PCAOB Auditing Standards and Related Amendments to PCAOB Auditing Standards and Rules*.
Former footnote 21 in paragraph 1.92	Deleted to reflect the issuance of Statement on Auditing Standards (SAS) No. 130, *An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Financial Statements* (AICPA, *Professional Standards*, AU-C sec. 940).

(continued)

Reference	*Change*
Paragraphs 1.92 and 1.109	Revised to reflect the issuance of SAS No. 130.
Former footnote 23 in paragraph 1.109	Deleted to reflect the issuance of SAS No. 130.
Paragraphs 1.112	Revised to reflect the issuance of Statement on Standards for Attestation Engagements (SSAE) No. 18, *Attestation Standards: Clarification and Recodification* (AICPA, *Professional Standards*).
Paragraphs 3.15–.20; footnote 2 in paragraph 3.16	Moved from chapter 1.
Paragraphs 4.33–.36	Moved from chapter 10.
Former footnote 3 in paragraph 4.37	Deleted for the passage of time.
Paragraph 4.38	Revised to reflect the issuance of HUD Handbook 4000.1.
Paragraph 4.40	Revised to reflect the issuance of SSAE No. 18.
Paragraph 5.75	Revised to reflect the issuance of SAS No. 130.
Former footnote 19 in paragraph 5.75	Deleted to reflect the issuance of SAS No. 130.
Former footnote 2 in paragraph 6.12	Deleted to reflect the issuance of FASB Accounting Standards Update (ASU) No. 2016-18, *Statement of Cash Flows (Topic 230): Restricted Cash (a consensus of the FASB Emerging Issues Task Force)*.
Former footnotes 3–4 in paragraphs 6.17 and 6.21	Deleted to reflect the issuance of FASB ASU No. 2016-15, *Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments (a consensus of the Emerging Issues Task Force)*.
Footnote 9 in paragraph 8.90	Revised for the passage of time.
Footnote 19 to heading before paragraph 8.185	Revised to reflect the issuance of SAS No. 130.
Paragraph 9.30	Moved from former paragraph 9.33.
Former paragraph 9.33	Moved to paragraph 9.30.
Former paragraph 9.36	Deleted for the passage of time.
Paragraph 9.64	Revised for the passage of time.

Reference	***Change***
Former footnote 8 in paragraph 9.105	Deleted for the passage of time.
Former paragraphs 10.16–.19	Moved to chapter 4.
Footnote 6 in paragraph 10.93	Revised to reflect the issuance of FASB ASU No. 2017-05, *Other Income—Gains and Losses from the Derecognition of Nonfinancial Assets (Subtopic 610-20): Clarifying the Scope of Asset Derecognition Guidance and Accounting for Partial Sales of Nonfinancial Assets*.
Former paragraph 11.04	Deleted for the passage of time.
Footnote 2 to heading before paragraph 11.43	Revised to reflect the issuance of FASB ASU No. 2017-05.
Paragraph 12.11	Revised to reflect the issuance of NCUA final regulation *Federal Credit Union Occupancy, Planning, and Disposal of Acquired and Abandoned Premises; Incidental Powers*.
Footnote 3 in paragraph 12.23	Revised for the passage of time.
Former footnotes 4–5 and 8–9 in paragraphs 12.23, 12.35–.36, and 12.47	Deleted to reflect the issuance of FASB ASU No. 2017-04, *Intangibles—Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment*.
Paragraph 12.50	Revised to reflect the issuance of FASB ASU No. 2016-19, *Technical Corrections and Improvements*.
Paragraph 14.53	Revised to reflect the issuance of SSAE No.18.
Paragraph 15.39	Revised to reflect the issuance of FASB ASU No. 2015-03, *Interest—Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs*.
Former footnote 3 in paragraph 15.39	Deleted to reflect the issuance of FASB ASU No. 2015-03.
Paragraph 15.48	Revised to reflect the issuance of FASB ASU No. 2015-03.
Former footnote 6 in paragraph 15.48	Deleted to reflect the issuance of FASB ASU No. 2015-03.

(continued)

Reference	*Change*
Paragraph 15.50	Revised to reflect the issuance of FASB ASU No. 2015-01, *Income Statement—Extraordinary and Unusual Items (Subtopic 225-20): Simplifying Income Statement Presentation by Eliminating the Concept of Extraordinary Items*.
Former footnote 7 in paragraph 15.50	Deleted to reflect the issuance of FASB ASU No. 2015-01.
Former footnote 3 in to header before paragraph 16.14	Deleted for the passage of time.
Former footnotes 5–6 in paragraphs 16.21 and 16.24	Deleted to reflect the issuance of FASB ASU No. 2016-16, *Income Taxes (Topic 740): Intra-Entity Transfers of Assets Other Than Inventory*.
Footnote 5 to header before paragraph 16.27	Added to reflect the issuance of proposed ASU *Income Taxes (Topic 740): Disclosure Framework—Changes to the Disclosure Requirements for Income Taxes*.
Former footnotes 5–6 in paragraphs 17.34–.35	Deleted to reflect the issuance of FASB ASU No. 2014-15, *Presentation of Financial Statements—Going Concern (Subtopic 205-40): Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern*.
Paragraph. 17.36	Revised to reflect the issuance of FASB ASU No. 2014-15.
Former footnote 7 in paragraph 17.36	Deleted to reflect the issuance of FASB ASU No. 2014-15.
Paragraph 17.58	Revised to reflect the issuance of FASB ASU No. 2014-15.
Former footnote 12 in paragraph 17.58	Deleted to reflect the issuance of FASB ASU No. 2014-15.
Paragraph 17.73	Revised to reflect the issuance of FASB ASU No. 2014-15.
Former footnote 24 in paragraph 17.73	Deleted to reflect the issuance of FASB ASU No. 2014-15.
Paragraph 17.75	Revised to reflect the issuance of FASB ASU No. 2014-15.

Reference	***Change***
Former footnote 25 in paragraph 17.75	Deleted to reflect the issuance of FASB ASU No. 2014-15.
Paragraph 17.82	Revised to reflect the issuance of FASB ASU No. 2014-15.
Former footnote 29 in paragraph 17.82	Deleted to reflect the issuance of FASB ASU No. 2014-15.
Footnote 1 in paragraph 18.51	Revised for the passage of time.
Paragraph 18.70	Revised to reflect the issuance of SR Letter 16-19.
Former footnote 1 in paragraph 19.01	Deleted to reflect the issuance of FASB ASU No. 2017-01, *Income Statement—Extraordinary and Unusual Items (Subtopic 225-20): Simplifying Income Statement Presentation by Eliminating the Concept of Extraordinary Items*.
Footnote 1 in paragraph 21.01	Revised to reflect the issuance of SAS No. 130.
Paragraphs 21.22 and 21.25	Revised to reflect the issuance of SSAE No. 18.
Footnote 1 in paragraph 22.12	Revised to reflect the issuance of proposed ASU *Financial Services–Insurance (Topic 944): Targeted Improvements to the Accounting for Long-Duration Contracts*
Footnote 1 to general note box; footnote 5 in paragraph 23.08	Revised for the passage of time.
Paragraph 23.26	Revised to reflect the issuance of SAS No. 130.
Former footnote 20 in paragraph 23.26	Deleted to reflect the issuance of SAS No. 130.
Paragraph 23.27	Revised to reflect the issuance of SAS No. 130.
Former footnote 21 in paragraph 23.27	Deleted to reflect the issuance of SAS No. 130.
Paragraphs 23.30 and 23.34	Revised to reflect the issuance of SSAE No. 18.

(continued)

Reference	*Change*
Footnote 1 to appendix A to chapter 23	Revised to reflect the adoption of PCAOB's final auditing standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses and Unqualified Opinion*.
Appendixes A, C, E, G	Updated.
Index of Pronouncements and Other Technical Guidance	Updated.
Subject Index	Updated.

Index of Pronouncements and Other Technical Guidance

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