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Lending and Depository Institutions Industry Developments—2000/2001

AICPA

American Institute of Certified Public Accountants

AUDIT RISK ALERTS

Lending and Depository Institutions Industry Developments—2000/2001

Complement to AICPA Audit and Accounting Guides *Banks and Savings Institutions, Audits of Credit Unions,* and *Audits of Finance Companies*

AICPA

Notice to Readers

This Audit Risk Alert is intended to provide CPAs serving banks, credit unions, savings institutions, finance companies, and other depository institutions and lenders with an overview of recent economic, industry, regulatory, and other professional developments that may affect the engagements and audits they perform. The AICPA staff prepared this document. It has not been approved, disapproved, or otherwise acted on by any senior technical committee of the AICPA. The discussions presented in this publication do not represent the views, positions, or opinions of the AICPA.

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Technical Manager
Accounting and Auditing Publications

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AUDIT RISK ALERTS

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Complement to AICPA Audit and Accounting Guides *Banks and Savings Institutions, Audits of Credit Unions,* and *Audits of Finance Companies*

American Institute of Certified Public Accountants

AICPA

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Lending and Depository Institutions Industry Developments—2000/2001

How This Alert Helps You

This Alert helps you expand your knowledge and understanding of the business environment your clients operate in. This Alert helps you provide top-quality audit services to your clients in the lending and depository institutions industry and helps you provide relevant information to those clients, thus adding value to the business decision-making process. The information in this Alert bolsters your audit planning efforts in considering industry matters. Moreover, this Alert helps you analyze and interpret relevant information and converging information.

If you understand what is happening in the financial institutions industry and you can interpret and add value to that information, you will be able to offer valuable service and advice to your clients. This Alert assists you in making solid and rapid strides in gaining that industry information and understanding it.

It is best to read this Alert in conjunction with the AICPA general *Audit Risk Alert—2000/2001*. To order, call the AICPA Order Department at 1-888-777-7077.

Industry and Economic Developments

What are the current and emerging economic and industry forces and trends?

The U.S. Economy

The impressive performance of the U.S. economy persists, with economic activity expanding at a rapid pace. Inflation and unemployment remain low, while productivity and personal income have

surged. Businesses continue to invest heavily in equipment and technology, and consumer spending remains high. All major macroeconomic indicators are strong. Indeed, this great period of economic expansion has been marked by a transformation to an economy that is more productive, as competitive forces become increasingly intense and new technologies raise the efficiency of businesses.

Signs of moderation exist, however, as consumers have slowed their spending pace and inflation is slightly higher than 1999. Also, debt levels in the nation have risen to record levels and the U.S. trade deficit has widened enormously.

What Lies Behind the Economic Expansion?

The groundwork for this historic period of economic growth was laid in the 1980s through cuts in tax rates, a strengthening of the dollar, trade globalization, the deregulation of key industries, the rebuilding of the military, and the peace dividend that resulted from the Cold War victory. These factors generated powerful entrepreneurial and technological forces that transformed the economy and unleashed a wave of prosperity.

Hidden Risks

The vast amounts of consumer and business debt piling up in the country are worrisome. Rising interest rates or a mild economic downturn can lead to a surge in defaults and a liquidity crunch. Moreover, the huge trade deficit is a major problem that, when combined with a falling stock market or a falling dollar, could cause an economic crisis.

Overview of Foreign Economies

Western Europe

Economies in Western Europe generally are growing and show strong signs of expansion. Unemployment is at its lowest level since the early 1990s and inflation is very low, despite the huge increase in oil prices. Domestic consumption and investment are high; in fact, domestic consumption is beginning to outpace exports as the main driver of economic expansion. Western European governments have

been reducing taxes and running budget surpluses. Moreover, deregulation efforts have helped foster competition and keep inflation in check.

The Euro. The euro has been falling substantially. Since its inception at the beginning of 1999, its value is down 23 percent. This euro slide has many people worried. If the euro continues to fall, inflation may shoot up and confidence in the currency and in Europe's economies will falter. A plunging euro is hurting the earnings of U.S. companies that do business in the eleven-nation euro zone. More importantly, the steady downward plight of the euro threatens global economic stability. Pressure has been mounting on the European Central Bank to raise interest rates to support the euro; however, interest rate increases could ruin the current economic growth in many European countries. Group of Seven finance ministers are expected to address the risky euro situation in the future.

Many factors lie behind the decline of the euro. Primary among them are the superior growth of the U.S. economy, higher U.S. interest rates that make it worthwhile to hold dollar-denominated securities, and a massive capital flow into the United States and away from Europe.

Asia

Economic activity in many Asian countries, like the Philippines, Indonesia, and Singapore, continues to firm, but at varying rates. Some Asian currencies, like the Indonesian rupiah and the Thai baht, have been undergoing significant devaluations lately. The main reason for these current currency problems seems to be specific political and economic difficulties in each nation suffering from the devaluations. Little evidence exists, however, that the problems will spread to other Asian nations or become a serious global crisis like the currency crisis of 1997-98.

South Korea. South Korea's economy has been experiencing extremely fast growth and its currency has appreciated due to the excellent economic picture. Economists predict that the current growth will decrease in the future to more normal growth rates.

Japan. The Japanese economy is showing signs of stronger performance, with particular strength in private consumption and investment. Industrial production is expanding at a healthy pace and business confidence has picked up. Unemployment is high, however, and outstanding public debt remains large and growing. Deflation also remains a concern.

The Americas

A general economic recovery in Latin America continues. Heightened political uncertainty in Venezuela, Peru, Colombia, and Ecuador has sparked financial market pressures. In Argentina, the pace of recovery appears to have slackened, as the government's fiscal position and, in particular, its ability to meet the targets of its International Monetary Fund program remain a focus of market concern.

Mexico. In Mexico, economic activity has been strong, boosted by strong exports to the United States, soaring private investment, and increased consumer spending. Nevertheless, the Mexican economy is still vulnerable. Eighty-five percent of Mexico's exports go to the United States, and oil production is a big factor influencing the country's economic health. An economic downturn in the United States or a significant drop in oil prices could quickly and seriously hurt Mexico's economy. The country's banking sector is still shaky and lending activity is light.

Canada. Economic activity in Canada is quite robust, generating strong gains in employment and reducing the remaining slack in the economy. The expansion is supported by both domestic demand and spillovers from the U.S. economy. Inflation remains low and interest rates have risen, matching increases in U.S. rates.

Brazil. In Brazil, inflation is remarkably well contained and interest rates have been lowered, but unemployment remains high. An improved financial situation allowed the Brazilian government to repay most of the funds obtained under its December 1998 international support package. However, Brazilian financial markets exhibit continued volatility.

Russia

Foreign investment in the Russian economy has all but dried up. Systemic corruption, unstable economics, and the Russian government's 1998 default have all contributed to driving away foreign investment. Russian accounting rules, which do not adhere to U.S. or international standards, make judging the financial health of businesses in the country next to impossible. Most non-Russian financial institutions doing business in the country concern themselves primarily with providing services to multinational corporations and help with trade agreements and letters of credit. The Russian economy has been on an upswing, due primarily to the great increase in oil prices, which is a main Russian export.

Forces Influencing the Industry

Consolidation and Convergence. Many forces are at work shaping the lending and depository institutions industry. The industry has been consolidating and converging for years, although merger and acquisition activity during 2000 was generally light, due partly to low stock prices and an uninviting market for new deals. Nevertheless, some very substantial deals were announced, fueling the consolidation trend. Chase Manhattan's agreement to acquire J.P. Morgan, the announced merger of Credit Suisse First Boston and Donaldson, Lufkin & Jenrette Co., and the announced merger of UBS AG with PaineWebber Group Inc. are recent examples of industry consolidation and the rapid rise of financial service conglomerates. Further global mergers and acquisitions are expected. As these and future mergers occur, pressure builds on the remaining institutions within the industry and on companies in the rest of the financial services industry to consolidate, converge or consider strategic alliances in order to remain competitive and even viable.

In the wake of these numerous mergers and acquisitions, new community-sized institutions continue springing up. However, even the small, neighborhood institutions find a need to offer a variety of financial services, including Internet access, to gain and retain customers.

Globalization and Competition. Hand-in-hand with the forces of consolidation and convergence, a process of globalization and intense competition between institutions and with firms in other financial services industries continues to grow.

Modernization Legislation. In the midst of all of these powerful forces, financial modernization legislation, enacted in 1999, is in the process of taking effect. As the details of that legislation are hammered out, a system for regulating the vast financial services landscape will take shape. The banking regulators are creating systems to supervise and regulate the new, interdiscipline financial conglomerates.

Electronic Commerce, Privacy, and Predatory Lending. Electronic commerce (e-commerce) promises to reinvent the way financial institutions do business and the way audits are planned and performed. In connection with e-commerce, the issue of privacy has become a hot topic of concern. Another hot topic currently affecting the industry is predatory lending. Most predatory lending occurs in the subprime market and takes advantage of vulnerable people with limited access to financial counseling or to fairly priced financial alternatives.

Expansion Into New Businesses. As in previous years, financial institutions continue to enter and deepen their involvement in such businesses as insurance, securities underwriting, asset management, mutual funds, and trust management. In addition, institutions continue to expand their product lines in the search for higher earnings and fee-generated income.

Rising Interest Rates. Finally, interest rates have risen considerably in the United States, affecting the business growth and financial condition of lending and depository institutions.

General Industry Performance

The performance of financial institutions is mixed, but generally very good. Performance results highlight the reliance more and more institutions are placing on nontraditional, more volatile lines of business. Generally, institutions are posting

strong earnings, positive loan growth, and are well capitalized. Community-sized institutions appear to have a solid capital base. The performance of commercial mortgage-backed securities (CMBS) servicers has not been as strong, however, due to a slowdown in the issuance of CMBS as a result of higher interest rates.

Credit unions have generally been experiencing solid growth in their customer bases but slowing growth in their savings bases. New legislation has allowed credit unions to broaden their fields of membership. In addition, many credit unions, as well as other community-sized institutions, are using more aggressive marketing tactics to draw in customers who are disaffected with recent bank mergers or who feel ill served by larger, less personal institutions. As loan growth has recently been outpacing savings growth, some credit unions may face a liquidity crunch.

Credit Quality Generally Good

Delinquency rates on most loans remain low. Rising incomes, low unemployment, and strong business earnings are contributing to healthy loan portfolios at most institutions. Moreover, many institutions have tightened their underwriting standards and lending terms on most kinds of loans, particularly commercial loans.

Some Concern About Credit Quality

Although credit quality at most institutions appears healthy, some concern exists about credit quality and underwriting standards for agricultural, construction, realty, and commercial and industrial loan portfolios. Several indicators of weakening business credit quality, including increasing corporate indebtedness, stress in some prominent industry sectors, and adverse trends in corporate bond defaults point to potential credit quality problems in the future. Also, some institutions have incurred losses related to syndicated loans made to companies experiencing financial difficulties. A number of lenders have begun preparing for an expected economic downturn by tightening underwriting standards and closely monitoring credit quality.

Commercial, Construction, and Realty Lending

Commercial business lending has expanded briskly. The commercial mortgage lending industry has experienced solid growth as businesses continue to invest in office space and other facilities. In addition, commercial realty lending exhibits healthy growth. Commercial lending has increased, in part, because some businesses are seeking loans from financial institutions as an alternative to a less receptive corporate bond market.

Real estate markets appear relatively healthy. Construction and land development lending has grown well over the past year. Overall credit quality on construction and realty loans appears very good.

Some signs of overbuilding are present however. (See the discussion in "Credit Quality Concerns" section.)

Rising interest rates have tempered the growth in commercial, construction, and realty lending, and the outlook for further strong growth does not look promising, given the upward trend in interest rates.

Credit Quality Concerns

As mentioned above, some concern exists about overbuilding in the industry. The potential for overbuilding is present in the Atlanta, Charlotte, Dallas, Denver, Fort Worth, Jacksonville, Las Vegas, Orlando, Phoenix, Portland (Oregon), Sacramento, Salt Lake City, and Seattle markets. Furthermore, underwriting standards and interest rate margins have slipped recently in the overall construction and real estate lending sector, raising legitimate concern about the future quality of loan portfolios in the sector if economic conditions should falter.

Consumer and Home Mortgage Lending

While consumer lending has been growing briskly, consumer debt increases have slowed from the strong levels of previous years. Auto loans, credit card lending, mobile home loans, and boat loans have been surging at many institutions. A favorable

economic outlook and increasing personal wealth have contributed to increased consumer spending and consumer debt. Household debt service levels have risen to significant heights due to the combination of rapid debt growth and rising interest rates.

Financial institutions' increased holdings of consumer and mortgage loans were also caused in part by a slower pace of securitizations. In the housing sector, for instance, the rising interest rate environment has kept the demand for adjustable-rate mortgages (ARMs) relatively elevated, and institutions tend to hold these securities on their books rather than securitize them.

As with commercial loans, rising interest rates have tempered consumer and mortgage loan growth recently and will apparently continue to do so in the future. Rising interest rates cause housing affordability to deteriorate and, as a result, new home purchases, existing home purchases, housing construction, mortgage lending, and mortgage refinancings all have declined of late. However, new home sales in July 2000 skyrocketed, countering the declining trend. Keep in mind that new homes sales reports tend to be volatile and somewhat questionable. It seems that although short-term interest rates have been rising, long-term rates, which are based on bond market yields, have been falling, thus benefiting housing demand.

Agricultural Lending

Weak exports and surplus commodity supplies continue to affect farmers and ranchers adversely. Despite these factors, loan quality remains strong at agricultural lending institutions. Federal assistance to farmers has helped them maintain adequate cash flow and remain current on their debts. Charge-offs, foreclosures, and delinquencies remain low in the sector. Moreover, other traditional benchmarks of an institution's health, such as increased earnings, strong loan growth, good asset quality, and capital, are at high levels.

Some Risk Exists

Nevertheless, weak exports, surplus supplies, a strong dollar, and foreign competition are all factors putting pressure on the agricultural industry. Management at many agricultural lending institutions expects the quality of their loan portfolios to deteriorate in the future.

Industry Risks and Pressures

Management at numerous institutions may come to view the current exceptional period of vibrant economic growth and strong industry performance as the norm rather than the exception. When lending decisions are made and underwriting standards are developed under that mindset, an institution's ability to weather weaker economic conditions becomes troubling and uncertain. Remember that most bad loans are made during good times. Despite the growing economy and the excellent existing lending conditions, factors such as lax underwriting standards, fraud, credit concentrations, and rapid entry into new and unfamiliar businesses can lead to serious losses at financial institutions. Also, an economic slowdown could spell trouble for any financial institution that has aggressively grown its loan portfolio over the last few years, including the host of newly chartered community institutions.

Furthermore, pressure exists in the industry on liquidity and interest margins. Deposit bases have been under pressure for over two decades, especially owing to the rise in equity values and mutual funds.

Competitive Pressures

The industry continues to experience intense competition, affecting institutions of all sizes. The boundaries between traditional lines of business are eroding and competition from other industries and from virtual players is increasing. Financial institutions are competing with each other over many areas, including the kinds of products and services they offer and the pricing of those products and services.

Pricing competition hurts margins and often leads institutions to engage in riskier lending to reach higher nominal yields and compensate for lower profits. Management of some of these institutions may fail to recognize the difference between nominal and risk-adjusted yields. Consequently, serious losses can befall those institutions.

In the face of intense competition, a number of community-sized institutions have successfully partnered with brokerages, insurance companies, high-technology companies, and other firms to provide the kinds of products and services that the market demands. One advantage to that approach is the avoidance of steep costs that would be necessary to develop those products and services in-house.

Rising Interest Rates

The Federal Reserve Board (FRB) has raised interest rates over the past year in an effort to cool off the super-heated U.S. economy and prevent inflation. Interest rate increases tend to dampen loan demand and refinancing activity and increase an institution's funding costs. If the Fed succeeds in slowing down the economy, commercial lending, mortgage lending, and demand for other services offered by financial institutions will suffer. Furthermore, both long-term assets and volatile liabilities have been growing as a percentage of total assets at some institutions, suggesting that earnings and equity values are increasingly at risk to rising interest rates.

More ARMs. Higher interest rates also make ARMs more attractive than fixed-rate mortgages (FRMs) for borrowers. The recent shift in demand from FRMs to ARMs has benefited the thrifts who have traditionally been the major ARM lender. Many of these loans are held in portfolio by the thrifts as opposed to being sold or securitized. While the holders of the ARMs may benefit from rising rates, the increase in monthly payments caused by the increases in the ARMs' index rates, have the negative effect of increasing the credit risk of borrowers with already high levels of consumer debt.

FRMs' Sensitivity to Rising Rates. The intense mortgage refinancing activity of previous years brought about a dramatic change in the asset portfolio composition of many financial institutions. Homeowners switched from ARMs into longer-term FRMs, especially 30-year mortgages, to take advantage of historically low 30-year mortgage rates. As a result, many institutions that have historically been portfolio lenders, were forced to increase their absolute and relative holdings of FRMs. This makes those institutions more sensitive to interest-rate increases.

Managing Interest Rate Risk. To counter the effects of rising interest rates, numerous financial institutions take positive steps by changing their mix of interest-rate-sensitive assets and funding sources. Also, the recent shift in product demand towards ARMs will naturally tend to reduce interest-rate risk as ARMs are added to portfolios. Changes in the interest rate risk profile of an institution can be a very slow, extended process. Unfortunately, institutions often take other, short-term steps, such as enacting layoffs and lowering their underwriting standards, to counter rising interest rates.

Auditor Considerations. As noted above, rising interest rates can have a considerable impact on a financial institution's profitability, liquidity, and the value of its loan and investment portfolios. You may need to consider whether the institution has adequate asset liability management procedures in place to understand and manage its interest-rate risk and liquidity risk in a rising interest rate environment. Additionally, you may need to assess what effect layoffs and lower underwriting standards may have on your client and your audit procedures. Finally, the impact of interest rates on the client's asset values and capital should be considered.

Statement on Auditing Standards (SAS) No. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), requires auditors to consider fraud risk factors that relate to both misstatements arising from fraudulent financial reporting and misstatements arising from misappropriation of assets. The economic and industry conditions discussed above may present fraud risk factors depending upon the individual circumstances of the engagement. You should consult the requirements of SAS No. 82 as part of your planning procedures.

Financial Modernization Legislation

On November 12, 1999, the Gramm-Leach-Bliley Act (GLB, or the Act) became law, thus modernizing the U.S. financial framework. Many aspects of GLB became effective on March 11, 2000.

Summary of the Legislation

GLB repealed the last vestiges of the Glass Steagall Act of 1933. It modified portions of the 1956 Bank Holding Company Act to allow affiliations between banks and insurance underwriters. While preserving the authority of states to regulate insurance, the Act prohibits state actions that have the effect of preventing bank-affiliated firms from selling insurance on an equal basis with other insurance agents. GLB allows for the creation of a new financial holding company, authorized to engage in underwriting and selling insurance and securities, to conduct both commercial and merchant banking, to invest in and develop real estate and other "complementary activities." There remain limits on the kinds of nonfinancial activities these new entities engage in. In addition, GLB allows national banks to underwrite municipal bonds.

The Act restricts the disclosure of nonpublic customer information by financial institutions. All financial institutions must provide customers the opportunity to "opt-out" of the sharing of the customers' nonpublic information with unaffiliated third parties. The Act imposes criminal penalties on anyone who obtains customer information from a financial institution under false pretenses.

GLB amended the Community Reinvestment Act (CRA) to require that financial holding companies not be formed unless their insured depository institutions have received no less than a satisfactory CRA rating. GLB also requires public disclosure of bank community CRA-related agreements. The Act grants some regulatory relief to small institutions in the shape of reducing the frequency of their CRA examinations if they have received outstanding or satisfactory ratings. The Act prohibits affiliations and acquisitions between commercial firms and unitary thrift institutions.

GLB makes significant changes in the operation of the Federal Home Loan Bank (FHLB) System, easing membership requirements and loosening restrictions on the use of FHLB funds.

Help Desk—For much more detailed information on GLB, visit the following Web sites—

- U.S. House Committee on Banking: www.house.gov/banking/s900lang.htm
- Federal Reserve Bank of Philadelphia: www.phil.frb.org/src/glba.html
- U.S. Senate Banking Committee: www.senate.gov/~banking/conf

The FRB and other regulatory agencies have issued regulations in connection with GLB, financial holding companies, financial subsidiaries, and other GLB-related matters. CPAs should be alert to the issuance of new regulations and laws that will follow in the wake of GLB.

Institutions Expanding Product and Service Lines

Financial institutions that add or expand products, services, and businesses may generate audit risks and risks to themselves. Combining institutions may join together different financial sector products and services (for example, insurance, checking accounts, loans, asset management, and brokerage services) under one roof. You should consider the following factors when your client is adding or expanding products, services, or businesses.

- Management may lack expertise in the new areas. For example, management may not possess the knowledge and skills needed to manage the business and risk of selling insurance. This lack of expertise may contribute to financial statement misstatements and internal control weaknesses. You may want to assess management's level of expertise in the new areas of business and consider that assessment in the determination of your audit procedures.

- Management may not properly implement industry-specific accounting principles related to the new areas. You should determine that proper accounting principles are being applied concerning the new areas of business.
- The accounting, operations, and other systems related to the new areas may lack adequate testing and proper integration with core systems. Thus, these new systems may have inadequate internal control, which may result in unreliable accounting data. You should consider this when planning and performing the audit. SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), provides guidance on internal control. In addition, you should be familiar with the requirements of SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325).
- According to SAS No. 60, auditors may become aware of matters relating to internal control that, in their judgment, should be communicated to the audit committee. Such matters represent significant deficiencies in the design or operation of internal control, which could adversely affect the institution's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.
- The institution may fail to comply with regulations attendant to the new area of business. The institution's failure to comply may result from an unfamiliarity with the regulations and a lack of expertise in the new area. You may want to inquire about the regulations that exist in new business areas (to the extent necessary to perform a proper audit). SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317), describes an auditor's responsibilities regarding violations of laws or governmental regulations.

You may want to assess management's depth and an institution's strategic plans when a client enters complicated, new areas of

business. If you require the help of a specialist, you should consider the guidance in SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 336).

Tight Labor Market Generating Risks

Like many organizations today, financial institutions have been affected by the tight labor market and shortage of qualified applicants to fill needed positions, from tellers to senior management. Positions have remained vacant for longer periods and institutions are often forced to fill positions with individuals who may not meet prior qualification standards. The unusually high employee turnover and the industry's inability to fill open positions in a timely manner can have a serious effect on the financial institution's internal control structure and financial reporting and accounting systems.

Auditing Considerations

You should be aware of the possible effect that key unfilled positions can have on internal control. Institutions that in prior years had strong financial reporting and accounting controls could see those controls deteriorate due to a lack of qualified employees. Controls over other areas such as lending and collections could also suffer. Moreover, the tight labor market could pressure institutions to compromise their standard hiring practices. This could create additional exposure to possible internal fraudulent activity. You may want to consider these issues in planning and performing the audit and in assessing control risk. Remember that gaps in key positions may cause control weaknesses representing reportable conditions that should be communicated to management and the audit or supervisory committee in accordance with SAS No. 60.

Internal Control Deficiencies and Audit Processes

Increasing concern exists about a number of audit and internal control deficiencies at many institutions. Underscoring these concerns are the results of a recent industry survey reporting that

financial institutions lost $7 billion dollars in 1998 due to internal control problems. Some of these deficiencies have contributed to significant operating losses and failures. Many institutions have cut back the size, status, independence, and proficiency of internal audit departments. Also, under pressure to maximize earnings, management at some institutions has accepted a higher risk of operational losses stemming from weak internal control in return for whatever quick savings might be realized by failing to make those controls more robust.

Regulatory Agencies Focus on Internal Control and Audit Processes

Going forward, the regulatory agencies will be emphasizing internal control and audit processes. The Office of the Comptroller of the Currency (OCC) has also distributed a handbook to institutions and examiners to help them assess the adequacy of internal control and audit programs and identify areas where they may need to be strengthened. (See OCC Advisory Letter 2000-6 for further information. The OCC Web site is www.ustreas.gov.) The Office of Thrift Supervision (OTS) is currently revising its internal control, internal audit, and external audit handbook sections as well.

As part of the OCC's emphasis, its examiners will be evaluating the quality and effectiveness of the work performed by the internal and external auditors. This may involve increased requests to review certain aspects of the auditors' workpapers. Auditors are required by law to make workpapers available to examiners of institutions over $500 million in assets.

Guidance on Internal Control

On every audit, the auditor is required to obtain an understanding of internal control sufficient to plan the audit. A sufficient understanding means the auditor should determine how internal controls, relevant to an audit of financial statements, are designed and whether they have been placed in operation. SAS No. 55, as amended, provides a framework to help the auditor obtain

an understanding of internal control. That framework is built on two concepts: objectives and components.

Objectives and Components of Internal Control. An objective is what the institution is trying to achieve. Generally, an institution tries to achieve objectives in the following three categories:

1. Reliability of financial reporting
2. Effectiveness and efficiency of operations
3. Compliance with applicable laws and regulations

For each of these objectives, internal control consists of the following five interrelated components:

1. Control environment
2. Risk assessment
3. Control activities
4. Information and communication
5. Monitoring

See SAS No. 55, as amended, for an extensive discussion about these internal control components.

Understanding an Institution's Internal Control. Your understanding of internal control is used to identify types of potential misstatements, consider factors that affect the risk of material misstatement, and design substantive tests. Your understanding of a client's internal control should be based on your previous experience with the client, inquiries of appropriate personnel, inspection of documents, and observation of the institution's activities and operations.

Communication of Internal Control-Related Matters

SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*, as amended, provides guidance in identifying and reporting conditions that relate to an entity's internal control observed during an audit of financial statements. During the course of an audit, the auditor may become aware of matters

relating to internal control that may be of interest to the institution's board of directors or the board's audit committee. Matters that, in the auditor's judgement, represent significant deficiencies in the design or operation of internal control, which could adversely affect the institution's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements, should be communicated to the audit committee. Such matters are referred to as "reportable conditions."

Material Weaknesses in Internal Control. A reportable condition may be of such magnitude as to be considered a material weakness. A "material weakness" in internal control is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. An auditor is not required to identify and communicate separately material weaknesses.

Increased Outsourcing to Third-Party Service Organizations

Financial institutions are significantly increasing their use of outside service organizations to help manage a growing number of services and products. Factors such as cost reduction, competitive pressures, and a lack of qualified employees are hastening this trend. Critical services are now outsourced, many of which could have a material effect on the internal control and the financial information systems of an institution. Some typical examples of outsourcing are—

- Mortgage loan processing, servicing, originations, and documentation.
- Consumer loan approval and application processing.
- Investment accounting, record keeping, and valuations.
- Credit card processing and account services.

- Web site hosting, online banking, and internet bill payment.
- Payroll and employee benefit programs.
- Asset liability management services.
- Accounting and servicing of automobile leases.

Internal Control Considerations

Financial institutions need to implement effective internal control over transactions performed by third parties. When an institution uses a third party or service organization, transactions that affect the institution's financial statements are subjected to controls that are, at least in part, physically and operationally separate from the financial institution. The significance of the controls of the service organization to those of the institution depends on the nature of the services provided by the service organization, primarily the nature and materiality of the transactions it processes for the institution and the degree of interaction between its activities and those of the financial institution.

Auditing Considerations

An auditor should obtain an understanding of each of the five components of an institution's internal control sufficient to plan the audit. This understanding may encompass controls placed in operation by the financial institution and by service organizations whose services are part of the institution's information system. In planning the audit, such knowledge should be used to—

- Identify types of potential misstatements.
- Identify factors that affect the risk of material misstatement.
- Design substantive tests.

SAS No. 70, *Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324), provides guidance on the factors an auditor should consider when auditing the financial statements of an entity that uses a service organization to process certain transactions. SAS No. 70 guides an auditor through planning, understanding

controls, assessing control risk, contacting the service organization, using a service auditor, and other essential matters.

Credit Union Charter Conversions

For a variety of reasons, many credit unions have recently converted from federal to state charters. When a credit union converts its charter, it often gains a new field of membership that may include a community covering a wider geographic area and new core membership groups.

Credit unions that convert from a federal to a state charter may risk failing to comply with new and unfamiliar regulations. In these cases, you may need to be aware of any new regulations affecting your client and inquire about the client's process to ensure compliance with the new regulations. SAS No. 54 describes an auditor's responsibilities regarding violations of laws or government regulations.

Possible Risks Created by Charter Conversions

A credit union that previously serviced a single core group of members may gain a wider and much larger group of members to service when it converts its charter. Additional risks may arise. For instance—

- Management and personnel may lack the experience or expertise in dealing with a wider membership base.
- Additional credit risks may arise when a new field of membership is added. Underwriting standards that were sound for a single core group of individuals may need to be rethought or redesigned to account for a broader range of borrowers.
- Increased exposure to fraudulent activity may occur. The addition of new, unknown members raises the risk of fraudulent activities such as fictitious credit applications, identity theft, check schemes, and money laundering.

- A new field of membership may create substantial growth opportunities. Management may not be experienced in or capable of managing the business growth. Growth often strains operations and employees. Critical controls could be compromised. For example, previous control responsibilities may be overlooked as employees take on additional responsibilities.

You may need to consider the above-listed risks and factors when planning your audit and assessing risks and internal control.

Predatory Lending

Regulators, politicians, community groups, and industry executives are targeting the practice of predatory lending as a major area of concern. Defining predatory lending is not easy. Predatory lending usually involves the targeting of poor, lower middle-class, and hard-pressed people who have tarnished credit histories or may not have access to lower cost sources of credit. These individuals may lack borrowing experience and adequate information. Predatory lenders take advantage of these individuals through lending practices that are unfair, deceptive, or fraudulent. Through a combination of questionable marketing tactics, collection procedures, and loan terms, predatory lenders deceive and exploit such borrowers. Predatory lenders often charge excessive fees and manipulate borrowers into loans they cannot afford to pay. Often, serious harm is inflicted upon the financial health of people who are the targets of predatory lenders.

Not the Same as Subprime Lending

Predatory lending is not equivalent to subprime lending. Responsible subprime lending has helped many people get loans and mortgages that they would otherwise have been unable to obtain due to tarnished credit histories, unstable employment, high personal debt, or other reasons. Predatory lenders may target the same borrowers as legitimate subprime lenders, but the predatory lender tends to offer loans with terms and conditions that unreasonably exploit those individuals.

Effects of Predatory Lending

As stated above, predatory lending practices often cause severe financial harm to many poor and lower middle-class people by manipulating them into paying exorbitant fees and interest rates and by leading them into default. In addition to the harm done to the borrower, predatory lending can lead to a high volume of foreclosures, undermine the reputation of financial institutions and the industry, and subject institutions, who may be indirectly involved with predatory lending, to costly litigation. Additionally, predatory practices may involve violations of fair lending statutes and other consumer protection provisions.

Where Predatory Lending Exists and an Institution's Involvement

Predatory lending exists in the home mortgage sector and in other sectors such as paycheck lenders, car title lenders, and other easy money lenders. Most predatory lending seems to occur in the subprime mortgage market. A financial institution may be directly or indirectly involved in predatory lending.

An institution's relationship with a mortgage broker may be a form of indirectly funding predatory loans. A broker can substantially influence the terms of a loan during the application phase of the loan process. Such influence can be predatory in nature through the use of deceptive or misleading practices.

Also, an institution may indirectly be involved in predatory lending by providing lines of credit to predatory lenders or by purchasing securities backed by predatory loans.

What is Being Done

In response to the concerns that have been raised over predatory lending, a task force of representatives from the federal banking agencies, the National Credit Union Administration (NCUA), the U.S. Department of Justice, the Federal Trade Commission (FTC), and the Department of Housing and Urban Development (HUD) is studying the issue and plans on developing recommendations and actions to curb predatory practices. Ideas under consideration include stricter enforcement of fair lending

rules and new laws to further regulate predatory lending. Already, the Treasury Department and HUD have issued proposals to crack down on predatory lending practices. These proposals include increased consumer education and new legislation that would outlaw certain predatory practices. State regulators are already implementing new standards and issuing fines to predatory lenders, and Fannie Mae and Freddie Mac are taking increasingly aggressive actions to ensure that their loan purchases do not encourage predatory lending.

On July 25, 2000, the OCC issued an Advisory Letter (www.occ.treas.gov/ftp/advisory/2000-7.txt) to institutions they regulate and their examining personnel. The advisory alerts appropriate individuals to abusive lending practices that may involve violations of fair lending and other consumer protection laws and regulations.

On April 5, 2000, the OTS issued an Advance Notice of Proposed Rulemaking entitled "Responsible Alternative Mortgage Lending" (www.ots.treas.gov:8765/query.html). The Notice seeks public input on potential approaches that will facilitate thrifts' efforts to responsibly address the lending needs of traditionally underserved markets, consistent with safe and sound operation.

More Government Regulation May Not Be the Answer. Addressing the problem of predatory lending will not be easy. Most predatory lenders are not subject to regulation by any of the federal financial regulators. As such, options for action are limited. Furthermore, legitimate concerns exist that the efforts now underway to curb predatory lending may lead to a curtailment of responsible subprime lending. Indeed a number of people in the industry believe that the extent of the predatory lending problem is being exaggerated. At a recent congressional hearing, some members stated that the Home Ownership and Equity Protection Act of 1994 is sufficient to deal with the predatory lending problem. History attests to the fact that more regulation is very often not the right way to solve a problem.

Credit Risk Watch

Crucial information about loan loss allowances that you need to know.

Credit quality is generally good in the industry. Notwithstanding, causes for concern about credit quality exist, as discussed in the "Industry and Economic Developments" section above. Apparently healthy loan portfolios may contain hidden losses that emerge during economic downturns or other periods of financial difficulties. In addition to the credit quality concerns and risks discussed in the "Industry and Economic Developments" section above, other signs for caution present in the industry include:

- The percentage of commercial and industrial loans that are noncurrent has been rising.
- The share of assets that mature or reprice at intervals of five years or longer continues to increase.
- The proportion of institutions' loans that represent concentrations of credit risk—their commercial loans with relatively large balances—is rising. With these loans, a small number of defaults can impair an institution's capital or income.
- The share of commercial institutions' assets that is funded by core deposits has been falling.
- The ratio of loan loss allowances to total loans is at historically low levels.

Concern About Agricultural, Construction, Realty, and Commercial and Industrial Loans

Financial institutions that loan money to farmers and ranchers may face higher risk as a result of the economic trouble confronting those agricultural producers. (See the related discussion in the "Industry and Economic Developments" section.)

If your client is a financial institution with loans to farmers and ranchers who are affected by falling commodity prices and exports, your audit procedures may need to include steps to carefully evaluate how bank management monitors such loans. These

financial institutions may have risks related to concentrations of loans to farmers and ranchers in specific geographic areas that are particularly hard hit by economic difficulties.

Also, if your client holds construction, realty, and commercial and industrial loans, these assets and the respective internal controls and monitoring systems may require special attention in your risk assessment and auditing procedures, based on the individual circumstances of the institution.

Accounting Guidance

Of particular concern to financial institutions are Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards Nos. 5, *Accounting for Contingencies*, and 114, *Accounting by Creditors for Impairment of a Loan*, as amended by FASB Statement No.118, *Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures*, SEC Financial Reporting Release No. 28, *Accounting for Loan Losses by Registrants Engaged in Lending Activities*, and the Interagency Policy Statement on the Allowance for Loan and Lease Losses (Interagency Policy Statement) jointly issued on December 21, 1993, by the federal banking regulators. For nonpublic financial institutions, the guidance in the Interagency Policy Statement requires allowance for loan losses documentation very similar to that in Release No. 28.

In addition, financial institutions and auditors need to follow the guidance in Statement of Position (SOP) 94-6, *Disclosure of Certain Significant Risks and Uncertainties*, EITF Topic D-80, *Application of FASB Statements No. 5 and No. 114 to a Loan Portfolio*, and the AICPA Audit and Accounting Guides *Banks and Savings Institutions, Audits of Credit Unions*, and *Audits of Finance Companies*.

Loan Loss Allowance Methodology and Documentation

SEC Release No. 28. Release No. 28 requires a registrant to follow a procedural discipline in determining the allowance for loan losses. The SEC staff expects a registrant to maintain allowance for loan losses documentation that indicates—

1. That a systematic methodology was employed each period in determining the amount of loan losses to be reported.

2. The rationale supporting each period's determination that the amounts reported were adequate.

Thus, even though the allowance for loan losses documentation requires numerical calculations, it is critical that financial institutions have written, qualitative narrative supporting the thought process behind the calculations in satisfying the procedural discipline required by Release No. 28.

Moreover, financial institutions should maintain a self-correcting mechanism that adjusts loss estimation methods in order to reduce differences between estimated and actual observed losses.

> **Help Desk**—See the discussion of loan loss allowances in the Current Accounting and Disclosure Issues in the Division of Corporation Finance outline dated June 30, 2000, available on the SEC Web site at www.sec.gov/offices/corpfin/acctdisc.htm.

Also note that Release No. 28 requires registrants to describe their procedural discipline in the Business section of the annual report.

Interagency Guidance Points Out Important Practices. A joint interagency letter (issued July 12, 1999, by the SEC, the Federal Deposit Insurance Corporation, FRB, OCC, and OTS) reaffirmed the following important aspects of loan loss allowance practices:

- Prudent, conservative, but not excessive, loan loss allowances that fall within an acceptable range of estimated losses are appropriate. In accordance with generally accepted accounting principles (GAAP), an institution should record its best estimate within the range of credit losses, including when management's best estimate is at the high end of the range.

- An "unallocated" or "overall general" loan loss allowance is appropriate when it reflects an estimate of probable losses incurred as of the balance-sheet date, determined in accordance with GAAP, and is properly supported.

- The loan loss allowance should take into consideration all available information existing as of the financial statement date reflecting past events and current conditions, including environmental factors such as industry, geographical, economic, and political factors.

Disclosures Related to Loan Loss Allowances

When evaluating management's discussion and analysis (MD&A) and Industry Guide 3 disclosures, remember that institutions need to fully disclose all pertinent trends, events, and uncertainties related to the allowance for loan losses. Moreover, the narrative disclosures in MD&A need to be consistent with the MD&A financial tables relating to the allowance for loan losses and loan portfolio, as well as the financial statements and related footnotes.

The discussion in MD&A should be in quantified detail, explaining the changes in the specific elements of the allowance for loan losses, including instances where the overall allowance has not changed significantly. The effects of any changes in methodology should be explained and justified.

SEC Staff Actions Concerning MD&A. If statistical data, quantitative analysis, or disclosures in a registrant filing appear inconsistent with loan loss allowances, the SEC staff will ask the institution to explain those inconsistencies:

> For example, data commonly used to evaluate the appropriateness of the loan loss allowance may indicate an inconsistency between the accounting for the allowance and the disclosure of material risks in the portfolio for which the allowance was maintained. In such a case, the SEC staff may issue comments on the filing relating to the loan loss allowance.

Additionally, disclosures in the filing should be consistent with the documentation supporting the loan loss allowance. The SEC staff questions allowances that appear too low as well as those that appear too high as compared to the disclosures made and the supporting documentation.

The SEC form letter on the allowance for loan losses issued in January 1999 provides the essential information that needs to be considered and included in the "Description of Business," MD&A, and financial statements. The form letter is available on the SEC Web site at www.sec.gov/rules/othern/banklla.txt.

FASB Viewpoints Article on Loan Loss Allowances

The April 12, 1999, issue of FASB *Viewpoints* addressed the application of FASB Statement Nos. 5 and 114 to a loan portfolio and how those Statements interrelate. The *Viewpoints* guidance discusses numerous issues includes the following questions:

- How should a creditor identify loans that are to be individually evaluated for collectibility under FASB Statement No. 114?
- How should a creditor determine it is probable that it will be unable to collect all amounts due according to the contractual terms of a loan agreement under FASB Statement No. 114?
- If a creditor concludes that an individual loan specifically identified for evaluation is not impaired under FASB Statement No. 114, may that loan be included in the assessment of the allowance for loan losses under FASB Statement No. 5?

The FASB *Viewpoints* publication can be obtained at the FASB Web site at www.fasb.org.

Current Vulnerability Due to Certain Concentrations

SOP 94-6 requires entities to disclose certain concentrations (described in paragraph 22 of the SOP) if, based on information known to management prior to issuance of the financial statements, all of the following criteria are met:

1. The concentration exists at the date of the financial statements.
2. The concentration makes the entity vulnerable to the risk of a near-term severe impact.

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

Examples of concentrations that might be found at 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.

Guidance to Help You Audit Loan Loss Allowances

When evaluating credit risk, the quality of loans, and the adequacy of loan loss allowances, auditors should consider the matters discussed in this section and determine whether there is a heightened level of audit risk. If so, it may be necessary to alter the nature, timing, and extent of audit procedures and increase the level of testing due to the matters mentioned in this section.

The evaluation of loan quality and loss allowances can be a complicated process. Auditors should read chapters 6 and 7 of the Audit and Accounting Guide *Banks and Savings Institutions*, chapters 5 and 6 of the Audit and Accounting Guide *Audits of Credit Unions*, and chapter 2 of the Audit and Accounting Guide *Audits of Finance Companies*, as applicable, for a thorough discussion of auditing procedures regarding loans and loan loss allowances.

Proposed Regulatory Actions

Proposed Federal Financial Institutions Examination Council Regulatory Policy Statement

The four federal banking agencies, under the auspices of the Federal Financial Institutions Examination Council (FFIEC), have issued a *proposed* "Policy Statement on Allowance for Loan and

Lease Losses [ALLL] Methodologies and Documentation for Banks and Savings Institutions." The four banking agencies—the Federal Deposit Insurance Corporation (FDIC), the FRB, the OCC, and the OTS—are seeking comment on this FFIEC proposal. Comments are due by November 6, 2000.

Proposal Specifics. The proposal, developed in consultation with SEC staff, provides guidance on the design and implementation of significant aspects of ALLL methodologies and supporting documentation practices.

Specifically, the proposal—

1. Clarifies that the board of directors of each institution is responsible for ensuring that controls are in place to determine the appropriate level of the ALLL.
2. States that the ALLL process must be thorough, disciplined, and consistently applied and must incorporate management's current judgments about the credit quality of the loan portfolio.
3. Emphasizes the banking agencies' long-standing position that institutions should maintain and support the ALLL with documentation that is consistent with their stated policies and procedures, GAAP, and applicable supervisory guidance.
4. Provides guidance on maintaining and documenting policies and procedures that are appropriately tailored to the size and complexity of the institution and its loan portfolio.

The proposal is not intended to change existing accounting guidance in, or modify the documentation requirements of, GAAP or guidance provided in the relevant joint interagency statements. The proposed policy statement can be obtained at www.fdic.gov/news/news/financial/2000/fil0058.html.

Consumer Loan Credit Scoring

The use of credit scores as a tool in the loan approval decision process has grown considerably lately. As loan decisions become

more automated, institutions are using credit scores to a greater extent to approve loans and determine the loan's interest rate and other terms. Traditional, more manual underwriting and evaluations of customers' credit capacity are often relied on to a lesser extent, as credit scores become the predominant factor in the loan approval decision process. The auditor and management should thoroughly understand the effect of the credit scores in evaluating current and future expected loan losses.

Assurance should be gained that the scoring system in use is reliable and properly validated. Management must have the capability to properly estimate the expected performance of each category of credit scores in their loan pricing decisions. System controls should be in place to capture and report relevant credit scoring information, including the ability to monitor performance by credit scores. The auditor may also want to gain further assurance that the scoring system in place meets regulatory requirements.

Accounting Issues in the Spotlight

The latest news on hot accounting topics.

Asset Securitizations

Asset securitization is the process by which loans and other receivables are pooled and interests in the pool are sold through underwriters in the form of asset-backed securities. From the perspective of credit originators, this market facilitates the transfer of some of the risks of ownership to parties more willing or able to manage them. By doing so, originators can access the funding markets at debt ratings often higher than their overall corporate ratings, generally giving them access to broader funding sources at more favorable rates. Further, by removing the assets and supporting debt from their balance sheets, they are able to save some of the costs of on-balance-sheet financing and to reduce potential asset-liability mismatches and credit concentrations.

Weaknesses and Risks

Significant weaknesses in the asset securitization activities at certain financial institutions have been noted recently. Such weaknesses raise concern about the basic level of understanding and controls at financial institutions that engage in securitization activities. The most frequently encountered weaknesses stem from—

1. The failure to recognize and hold sufficient capital against explicit and implicit recourse obligations that frequently accompany securitizations.
2. The excessive or inadequately supported valuation of retained interests.
3. The liquidity risk associated with overreliance on asset securitization as a funding source.
4. The absence of adequate independent risk management and audit functions.

Of particular concern are institutions that are relatively new users of securitization techniques and institutions whose senior management and directors do not have the requisite knowledge of the effect of securitization on the risk profile of the institution or are not fully aware of the accounting, legal, and risk-based capital nuances of this activity. Concern also exists that some institutions have not fully and accurately distinguished and measured the risks that have been transferred versus those retained, and accordingly are not adequately managing the retained portion.

In addition, history shows that unforeseen market events that affect the discount rate or performance of receivables supporting a retained interest can swiftly and dramatically alter its value. Without appropriate internal control and independent oversight, an institution that securitizes assets may inappropriately generate paper profits or mask actual losses through flawed valuation assumptions, inaccurate prepayment rates, and inappropriate discount rates. Liberal and unsubstantiated assumptions can result in material inaccuracies in financial statements, substantial write-downs of retained

interests, significant and harsh regulatory actions and restrictions, and potentially the demise of the sponsoring institution.

CPAs should be aware of these concerns and risks and consider them when determining the nature, timing, and extent of their testing when addressing asset securitizations on their engagements.

Critical Components of an Effective Oversight Program

As stated in the Interagency Statement on Asset Securitization Activities (see the "Recent Regulatory Actions" section of this Alert), institution managers and directors need to ensure that—

- Independent risk management processes are in place to monitor securitization pool performance on an aggregate and individual transaction level. An effective risk management function includes appropriate information systems to monitor securitization activities.
- Conservative valuation assumptions and modeling methodologies are used to establish, evaluate, and adjust the carrying value of retained interests on a regular and timely basis.
- Audit or internal review staffs periodically review data integrity, model algorithms, key underlying assumptions, and the appropriateness of the valuation and modeling process for the securitized assets retained by the institution. The findings of such reviews should be reported directly to the board or an appropriate board committee.
- Accurate and timely risk-based capital calculations are maintained, including recognition and reporting of any recourse obligation resulting from securitization activity.
- Internal limits are in place to govern the maximum amount of retained interests as a percentage of total equity capital.
- The institution has a realistic liquidity plan in place in case of market disruptions.

Accounting Guidance

FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*; FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*; the AICPA Audit and Accounting Guides *Banks and Savings Institutions, Audits of Credit Unions*, and *Audits of Finance Companies*; and EITF Topic No. D-66, *Effect of a Special-Purpose Entity's Powers to Sell, Exchange, Repledge, or Distribute Transferred Financial Assets under FASB Statement No. 125* provide accounting guidance related to asset securitizations. In September 2000, the FASB issued FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities—a replacement of FASB Statement No. 125*. This Statement revises the standards for accounting for securitizations and other transfers of financial assets and collateral and requires certain disclosures, but it carries over most of FASB Statement No. 125's provisions. FASB Statement No. 140 replaces FASB Statement No. 125. See the "Accounting Pronouncements and Guidance Update" section of this Alert for further information about FASB Statement No. 140.

In addition, FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, requires creditors to disclose assumptions used to value new or retained interests in a securitization. Management and auditors should be aware of EITF Topic D-69, *Gain Recognition on Transfers of Financial Assets under FASB Statement No. 125*, which addresses the requirements for recognition, measurement, and disclosure. Note that the FASB is assessing the effect of FASB Statement No. 140 on various EITF issues, since FASB Statement No. 140 replaces FASB Statement No. 125. Refer to the FASB Web site at www.rutgers.edu/Accounting/raw/fasb/new/index.html for updated information about those EITF issues.

New EITF Guidance on Beneficial Interests. EITF Issue 99-20, *Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets*, was issued in July 2000 and provides accounting guidance on recording interest income and impairment losses for certain asset-backed

securities. EITF Issue 99-20 nullifies EITF Issue Nos. 89-4, *Accounting for a Purchased Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate*, and 93-18, *Recognition of Impairment for an Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate.* EITF Issue No. 99-20 generally applies to securitizers who retain most or a portion of the cash flows on the securitized assets that are accounted for as debt securities.You should be familiar with the requirements, if applicable, of EITF Issue No. 99-20.

Cash-in Versus Cash-out Present Value Methods. When an institution securitizes a loan or receivable, it is often required to place the initial residual cash flows from the paydown of the trust in an overcollateralization account to enhance the credit rating on the senior tranches of the trust. Such cash will then remain in the trust as collateral until certain performance targets (for example, delinquencies or losses) are met. Once such targets are met and sustained, cash is released to the transferor.

Currently, two methods are used to present value these cash flows. The first method (cash in) assumes that the residual cash placed in the overcollateralization account are available to the entity when placed in this account. In contrast, the second method (cash out) assumes that the cash flows placed in an overcollateralization account are not considered income until such cash flows are actually received by the entity.

The SEC staff believes that "cash out" is the appropriate method to use in valuing this interest only residual. In the FASB Special Report addressing frequently asked questions about FASB Statement No. 125 (see below), the FASB staff also concludes that the "cash out" method is the more appropriate method.

Special Report Addresses Frequently Asked Questions. The FASB staff is preparing a new Special Report, *A Guide to Implementation of Statement 140 on Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities: Questions and Answers*. That report will be an updated version of its earlier

Special Report about Statement 125, the third edition of which was published in July 1999.

Interagency Guidance on Asset Securitization Activities

The FDIC, FRB, OCC, and OTS have jointly issued interagency guidelines on asset securitization. Much of the information presented in this section has been taken from those guidelines. (See the "Recent Regulatory Actions" section in this Alert for further information.)

Auditing Guidance

Auditors should understand, to the extent necessary, the accounting requirements for asset securitizations as discussed above and determine that those accounting principles have been followed by the institution. Also, auditors should evaluate carefully the assumptions used in valuing residual interests in sold loans. These assumptions need to be reasonable and should not be overly optimistic or overly conservative. A determination should be made about the reasonableness of any gains or losses recorded in the financial statements. In these circumstances, auditors should consider SAS No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1, sec. 342), which provides guidance on obtaining and evaluating sufficient competent evidential matter to support significant accounting estimates. Auditors should also analyze the institution's systems and controls used to ensure the reliability of information used in the initial and continuing valuation of servicing rights and other residuals. This information may include prepayment data, rate assumptions and expected loss rates.

Accounting for Derivative Instruments and Hedging Activities

Amendment to FASB Statement No. 133

In June 2000, after numerous business entities reported problems implementing FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, the FASB issued an amendment. FASB Statement No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities*, addresses

those concerns. The newly issued provisions will help more entities easily implement FASB Statement No. 133.

The amendment to FASB Statement No. 133 relaxes restrictions on cross-currency hedges, which FASB Statement No. 133 had effectively prohibited. In addition, the amendment expands the normal purchases and normal sales exception, redefines the specific risks that can be hedged, and allows the use of intercompany derivatives as hedging instruments in certain situations.

Interest-Rate Risk

The reasoning behind the amendment provisions relates to hedges of interest-rate risk and hedges of foreign-currency-denominated assets and liabilities. Before this amendment, FASB Statement No. 133 permitted the market interest rate, defined as the risk-free rate plus the credit sector spread, to be designated as the hedged risk in a hedge of interest-rate risk. The problem was that, in some cases, the derivatives available for hedging interest-rate risk were based on a definition of interest rates that did not include the sector spread. Therefore the definition in the amendment now permits the use of a benchmark interest rate that excludes the sector spread. This enables entities to hedge interest-rate risk with available derivative products.

Hedges of Foreign-Currency Items

In addition, the amendment relaxes FASB Statement No. 133's restrictions on hedging recognized foreign-currency-denominated assets and liabilities. FASB Statement No. 133 prohibits hedging items remeasured with changes in fair value reported in earnings. That notion was extended to hedges of foreign-currency instruments remeasured at current spot exchange rates with the resulting gain or loss reported in earnings. However, a measurement anomaly existed for certain foreign-currency instruments in which remeasurement at spot exchange rates did not represent fair value. Earnings volatility resulted when the changes in those foreign-currency items were compared to changes in the derivative hedging instrument, which is required to be measured at fair

value. Such volatility is mitigated by the amendment provisions permitting recognized items to be designated as hedged items.

Possible Effects of FASB Statement No. 133 on Mortgage Lenders

Although FASB Statement No. 133 will have substantial effects on many companies, particularly affected will be mortgage lenders and servicers who use derivatives to hedge their servicing portfolios. These institutions often carry derivatives that rise in value when interest rates fall, to offset the losses that those falling interest rates cause to their servicing portfolios. Many people in the industry believe that the new accounting requirements of FASB Statement No. 133 will create much more earnings volatility at those mortgage companies, which the stock market views negatively. Nevertheless, some within the industry believe that FASB Statement No. 133 will force management of mortgage lenders and servicers to review their hedges and servicing portfolios in a more regular and disciplined manner.

FASB Statement No. 133 Implementation Guidance Available

The FASB created a task force known as the Derivatives Implementation Group (DIG) to help answer significant questions that companies will face when they begin implementing FASB Statement No. 133.

The DIG has issued guidance on numerous FASB Statement No. 133 implementation issues. This guidance can be found and downloaded at the FASB Web site at www.fasb.org. Some of the many topics addressed by the implementation group include—

- Definition of a derivative.
- Embedded derivatives.
- Scope exceptions.
- Complex combinations of options.
- Hedging foreign-currency-denominated interest payments.
- Transition provisions.

Interim Regulatory Guidance Issued Regarding FASB Statement No. 133

Under the auspices of the FFIEC, the FRB, the FDIC, the OCC, and the OTS have issued interim regulatory reporting and capital guidance on FASB Statement No. 133 derivative transactions. This guidance can be found at the Web sites of the various agencies.

Regulatory Reporting. For purposes of the Call Report, FR Y-9C, and TFR, changes in the fair value of many derivatives are to be reflected in net income. However, FASB Statement No. 133 requires that the effective portion of the change in the fair value of derivatives used in certain types of hedges (cash flow hedges) be excluded from net income and reflected on the balance sheet in a separate component of equity (referred to as "accumulated other comprehensive income" in FASB Statement No. 133). For banks and bank holding companies, those accumulated changes in fair value should be reported on the Call Report and FR Y-9C balance sheet lines captioned "Accumulated net gains (losses) on cash flow hedges." For savings associations, those accumulated changes in fair value should be reported on the same TFR line that is used to report other components of equity capital.

Regulatory Capital. Until the agencies determine otherwise, the separate component of equity resulting from cash flow hedges should not be included in regulatory capital. Additionally, the existing risk-based capital treatment for derivatives remains in effect, pending further review. In other words, recording a derivative on the balance sheet under FASB Statement No. 133 will not change the risk-weighted asset amount for that derivative. The implementation of FASB Statement No. 133, however, may still affect an institution's regulatory capital. Changes in the fair value of derivatives that are recognized in net income will be included in undivided profits (retained earnings for bank holding companies and savings associations), which is a component of Tier 1 capital. Furthermore, the on-balance-sheet reporting of derivatives may affect the total assets reported by banking organizations with derivatives, directly affecting the institution's leverage ratio.

The agencies are evaluating the impact of FASB Statement No. 133 on regulatory reporting and capital in conjunction with other supervisory issues. However, pending the completion of that analysis, banking organizations should follow the regulatory reporting guidance and capital treatment summarized in this Alert and more fully described on the Web sites of the appropriate regulatory agencies. You may want to monitor the Web sites of the FFIEC and other regulatory agencies to keep abreast of developments in this area.

Risk Management of Derivatives

OCC Bulletin 99-2, *Risk Management of Financial Derivatives and Bank Trading Activities—Supplemental Guidance*, summarizes risk management and control issues associated with a broad range of banking activities involving financial derivatives, including hedge funds and highly leveraged institutions. The bulletin identifies the following risk management systems issues:

1. Price risk management
2. Credit risk management
3. Transaction risk management
4. Compliance risk management
5. Corporate risk oversight

National bank examiners use OCC Bulletin 99-2 for guidance when reviewing the design of national banks' risk management systems. Bulletin 99-2 can be obtained on the OCC Web site at www.occ.treas.gov.

In addition, the OTS has revised its handbook sections on derivatives and hedging activities to more effectively address risk management of derivatives.

Formal Documentation Under FASB Statement No. 133

Upon adoption of FASB Statement No. 133, an entity is required to designate all hedging relationships anew and must comply with the formal documentation requirements of the standard as

of the date of adoption. The standard stresses the need for the formal documentation to be prepared contemporaneously with the designation of the hedging relationship. The items the formal documentation must identify include the following:

- The entity's risk management objectives and strategies for undertaking the hedge
- The nature of the hedged risk
- The derivative hedging instrument
- The hedged forecasted transaction
- A description of how the entity will assess hedge effectiveness

When the hedged item is a forecasted transaction, the documentation of the hedged item must be sufficiently specific that when a transaction occurs, it is clear whether or not that particular transaction is the hedged transaction. The documentation also must specify the method to be used for assessing hedge effectiveness. FASB Statement No. 133 requires that an entity use the chosen method consistently throughout the hedge period to (a) assess, at inception of the hedge and on an on-going basis, whether it expects the hedging relationship to be highly effective in achieving offset and (b) determine hedge ineffectiveness.

The SEC staff has challenged the appropriateness of hedge accounting when registrants have not complied with FASB Statement No. 133's formal documentation requirements.

Transfers of Securities at Date of Initial Application

Under the transition provisions of FASB Statement No. 133 (see paragraph 54), an entity may transfer, at the date of initial application of FASB Statement No. 133, any debt security classified as held-to-maturity pursuant to FASB Statement No. 115 into the available-for-sale category or the trading category. Such reclassification shall not call into question an entity's intent to hold other debt securities to maturity in the future. The transition provisions further require that the unrealized holding gain or loss on a transferred held-to-maturity security be reported as part of the

cumulative-effect-type adjustment of net income if transferred to the trading category, or as part of the cumulative-effect-type adjustment of accumulated other comprehensive income if transferred to the available-for-sale category.

The SEC staff believes that any security transferred from held-to-maturity pursuant to the adoption of FASB Statement No. 133 and sold in the same reporting quarter should have been transferred to the trading category. Thus, any unrealized gain or loss on the security that exists on the date of transfer would be reported in net income as part of the cumulative effect of adopting FASB Statement No. 133 and not included in the gain or loss on the sale of the security. The FFIEC has issued identical guidance to institutions supervised by the FDIC, FRB, and OCC in supplemental instructions to the Call Report.

Assisting Your Client with the Implementation of FASB Statement No. 133

CPAs may be engaged to provide professional guidance and support regarding an institution's implementation of the provisions of FASB Statement No. 133. These kinds of services are *nonattest* or *other* services. The terms *nonattest* or *other* services include accounting and consulting services. When your firm performs these other services for an attest client, the independence rules impose limits on the scope of your firm's services. In other words, the extent to which your firm may perform certain tasks will be limited by current AICPA and SEC rules.

AICPA Ethics Interpretation 101-3. AICPA Ethics Interpretation No. 101-3, "Performance of Other Services," of ET section 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101.05), provides guidance to CPAs who help their clients implement FASB Statement No. 133. Interpretation No. 101-3 states:

> A member in public practice or his or her firm ("member") who performs for a client services requiring independence ("attest services") may also perform other nonattest services ("other services") for that client. Before a member performs other services for an attest client, he or she must evaluate the effect of such services on his or her independence. In particular, care should be

taken not to perform management functions or make management decisions for the attest client, the responsibility for which remains with the client's board of directors and management.

A basic principle underlies the application of the AICPA rule on other services and it is: You may not serve—or even appear to serve—as a member of a client's management. For example, you may not—

- Make operational or financial decisions for the client.
- Perform management functions for the client.
- Report to the board of directors on behalf of management.

In addition, the following are examples of the types of activities that impair independence:

- Authorizing, executing, or consummating a transaction on behalf of a client
- Preparing source documents or originating data (for example, purchase orders)
- Having custody of a client's assets
- Supervising client employees in the performance of their normal recurring activities

Therefore, it is essential that your firm and the client have a clear understanding regarding your respective roles *before* undertaking engagements to perform other services.

Valuation Services. Your firm may provide valuation services if the client—

- Makes or approves all significant judgments about your firm's service.
- Can make an informed judgment on the results of your firm's service.

For instance, your firm may not undertake a valuation engagement if the client's management lacks the relevant business and industry expertise to evaluate the assumptions used in the appraisal

or valuation. Similarly, if management cannot judge the propriety of the results of your services, your firm likely would have had to make decisions on its client's behalf, meaning independence was impaired.

You should refer to the entire text of Interpretation No. 101-3 for an accurate and complete understanding of which kinds of services you may and may not perform for your attest client.

Guidance Related to Publicly Held Clients. The SEC prohibits an accounting firm from providing valuation services to clients although several practical exemptions have been allowed.

Independence Standards Board (ISB) Interpretation 99-1, *Impact on Auditor Independence of Assisting Clients in the Implementation of FAS 133*, provides guidance on the auditor independence implications of likely areas of requested assistance, solely regarding the implementation of FASB Statement No. 133. The ISB has concluded that the auditor may provide consulting services on the proper application of FASB Statement No. 133, including assisting a client in gaining a general understanding of the methods, models, assumptions, and inputs used in computing a derivative's value. To ensure, however, that the auditor's independence is not threatened, as discussed in paragraph 4 of the Interpretation, the auditor may not prepare accounting entries, compute derivative values, or be responsible for key assumptions or inputs used by the client in computing derivative values. The Interpretation includes illustrative lists of permitted and prohibited services.

ISB Exposure Draft on Appraisal and Valuation Services Deferred. The project that resulted in the aforementioned Interpretation ISB No. 99-1 made clear the need for general guidance on the extent of assistance that auditors can provide to their audit clients when providing asset valuation services without impairing their independence. Accordingly, the ISB established a task force to provide guidance on the provision of certain appraisal and valuation services by auditors and the impact on the auditor's independence. The task force's work included the creation of an exposure draft of a new standard titled, *Appraisal and Valuation*

Services. The ISB decided to defer issuing this exposure draft because the auditor independence rule-making proposals released recently by the SEC included this subject and their proposal is substantially similar to the standards being considered by the ISB. Consequently, the ISB concluded that issuing its own exposure draft at this time would not be productive. The ISB will reconsider this decision based on the outcome of the SEC's proposal.

SEC's Proposal on Providing Valuation Services. In June 2000, the SEC proposed sweeping changes to the auditor independence rules. (See the AICPA general *Audit Risk Alert—2000/2001* or the AICPA Audit Risk Alert, *SEC Developments—2000/2001*, for further information.) As part of its proposed rules governing the performance of non-audit services, the SEC addressed the performance of valuation services for a client. The proposed rule would require that the auditor is not independent if the auditor provides valuation services where there is a reasonable likelihood that the results will be audited by the auditor. The SEC's proposal is much more restrictive than existing AICPA rules. Remember that SEC rules apply only to audits of publicly held entities.

Auditing Derivatives

In September 2000, the Auditing Standards Board (ASB) issued SAS No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*, vol. 1, sec. 391). SAS No. 92 supersedes SAS No. 81, *Auditing Investments* (AICPA, *Professional Standards*, vol. 1, AU sec. 332), and is effective for audits of financial statements for fiscal years ending on or after June 30, 2001. Early application of the SAS is permitted.

Guidance for Auditors. SAS No. 92 provides guidance for auditors in planning and performing auditing procedures for financial statement assertions about derivative instruments, hedging activities, and investments in securities. The guidance in the SAS applies to 1) derivative instruments, as defined by FASB Statement No. 133, 2) hedging activities in which the entity designates a derivative or a nonderivative financial instrument as a hedge of exposure for which FASB Statement No. 133 permits hedge

accounting, and 3) debt and equity securities, as those terms are defined in FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities.* Matters addressed by SAS No. 92 include—

- The need for special skills or knowledge
- Consideration of audit risk and materiality
- Designing substantive procedures based on risk assessment

SAS No. 92 also discusses hedging activities and management representation issues.

Audit Guide to Complement SAS No. 92. An audit guide to complement the SAS will be issued by the ASB soon after the SAS. The guide provides practical guidance for implementing the SAS on all types of audit engagements. The suggested audit procedures contained in the guide do not increase or otherwise modify the auditor's responsibilities, rather, they are intended to clarify and illustrate the application of the requirements of SAS No. 92. The objective of the guide is both to explain SAS No. 92 by providing an in-depth look, and to provide practical illustrations through the use of case studies. (More information on the audit guide is presented in the "Auditing Pronouncements and Guidance Update" section of this Alert.)

Fair Value Accounting

The FASB has a project underway to provide guidance for measuring and accounting for all financial assets and liabilities at fair value in the financial statements. For several years, the FASB has been considering the issue of the most relevant measurement attribute for financial instruments. In December 1999, the FASB issued the Preliminary Views, *Reporting Financial Instruments and Certain Related Assets and Liabilities at Fair Value,* for comment.

Also, representatives of the FASB are participating in a Joint Working Group of Standard Setters (JWG), which is developing a paper on accounting for financial instruments that is much broader in scope than the Preliminary Views. The JWG plans to

complete its paper before the end of 2000, and the FASB and the other participating standard-setters expect to issue it and request comments. When a reasonably complete draft is available, the FASB will discuss the paper and decide the form in which to issue it. The FASB will not deliberate the individual decisions in the paper, which differs in many respects from both existing GAAP and the proposals in the recent Preliminary Views. Consequently, the paper will be issued as an Invitation to Comment, a Special Report, or a similar document, rather than as an exposure draft.

In the later part of 2000, the FASB will discuss the results of an analysis of the comment letters on the Preliminary Views. However, the FASB does not expect to begin redeliberation of issues discussed in the Preliminary Views until after the JWG paper is issued.

Many members of the lending and depository institutions industry oppose fair-value accounting. In their opinion, requiring an institution to record at fair-value assets that the institution intends to hold and products that do not trade in an active secondary market does not make sense. Since financial institutions are not managed on a fair-value basis, many in the industry believe that fair-value accounting would be misleading to financial statement users. In addition, many in the industry take issue with the definitions of what factors should be included and excluded in determining the fair value of various assets and liabilities included in the balance sheets of financial institutions. There is a lack of consensus on what is a financial asset and a lack of generally agreed-upon measurement methodologies for assigning values to those items.

You can keep abreast of this fair value accounting project at the FASB's Web site at www.fasb.org.

Deferred Compensation Plans

Many credit unions have implemented various retirement plans for executives such as split dollar life insurance plans and 457 deferred compensation plans. The auditor should ensure the credit union has properly accrued for its retirement benefit liability.

Generally, the present value of an employee's expected future benefits is to be expensed over the employee's employment period with a systematic and rational method. FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, FASB Statement No. 87, *Employers' Accounting for Pensions*, FASB Technical Bulletin 85-4, *Accounting for Purchases of Life Insurance*, and Accounting Principles Board (APB) Opinion No. 12, *Omnibus Opinion—1967* provide guidance in this area.

In Focus Specials

Privacy

What is all the talk about privacy issues about?

Protecting the privacy of customers has emerged as a major issue within the lending and depository institutions industry. Technology allows the easy accumulation and distribution of personal financial data as well as theft of these data. The growing demands and inter-relatedness of the marketplace have increased institutions' and other companies' need for profiling the financial situations and purchasing habits of consumers. This information technology is key to e-commerce and customer relationship management. Recently, privacy issues have received spotlight attention due to some high-profile news stories. In one case, a major institution sold confidential financial information from its files to third-party marketers. The story made national news, causing the institution and several other institutions to stop the practice and prompting the state attorney general to file suit against the institution.

Privacy Risk

Concerns over privacy tend to focus on the following points:

- Personal information transmitted over the Internet and other networks
- Third-party access to personal information

- The extensive collection of sensitive, personal information necessary to carry on data mining and customer relationship management activities

Privacy Regulations and Legislation

The Financial Services Modernization Act of 1999, better known as Gramm-Leach-Bliley (GLB), contains privacy provisions that apply to financial institutions and their treatment of nonpublic personal information. These privacy provisions were inserted into GLB as a consequence of the notoriety privacy began receiving.

New Interagency Privacy Regulation

In connection with GLB, the FDIC, OCC, FRB, and OTS issued an interagency final regulation to implement provisions of GLB that protect the privacy of consumers' nonpublic personal information. The rule takes effect on November 13, 2000, but financial institutions have until July 1, 2001 to be in mandatory compliance with the regulation.

The new regulation on the privacy of consumers' financial information—

- Requires a financial institution to provide notice to customers about its privacy policies and practices.
- Describes under what conditions a financial institution may disclose nonpublic personal information about consumers to nonaffiliated third parties.
- Provides an "opt out" method for consumers to prevent the financial institution from disclosing that information to nonaffiliated third parties.

Protected Information. Under the regulation, restrictions on sharing information with nonaffiliated third parties apply to "nonpublic personal information" about a consumer. Nonpublic personal information is "personally identifiable financial information" that is provided by a consumer to a financial institution, results from any transaction with or service performed for the consumer, or is otherwise obtained by the financial institution.

The regulation excludes "publicly available information" from the definition of nonpublic personal information. Publicly available information is any information that an institution has a reasonable basis to believe is lawfully made available to the general public from government records, widely distributed media, or disclosures to the public required to be made by federal, state, or local law.

Privacy Policy Notice. Under the regulation, financial institutions must provide a clear and conspicuous notice that accurately reflects their privacy policies and practices. The notice must be given to any individual who becomes a customer of the financial institution by the time the customer relationship is established, and annually as long as the relationship continues. Also, the notice must be given to any consumer who does not become a customer before nonpublic personal information about the consumer may be shared with nonaffiliated third parties.

Opt Out Requirement. Before an institution can share nonpublic personal information with nonaffiliated third parties, consumers must be given a reasonable opportunity to "opt out" from having that information shared. The opt out notice must be given to:

1. Customers as a part of the initial notice of the financial institution's privacy policies and practices, or prior to sharing nonpublic personal information about them with nonaffiliated third parties.
2. Individual consumers who do not become customers of the financial institution, and former customers, before nonpublic personal information about them may be shared with nonaffiliated third parties.

Exceptions. The regulation does provide certain exceptions that permit a financial institution to share nonpublic information with third parties without providing privacy or opt out notices. These exceptions include disclosures of nonpublic personal information made in connection with certain processing and servicing transactions; with the consent of or at the direction of the consumer; to protect against potential fraud or unauthorized transactions; and to respond to judicial process.

New NCUA Privacy Regulations

Similar to the other agencies, the NCUA issued a new privacy regulation as required by the GLB that applies to all federally insured credit unions. Non-federally insured credit unions are subject to FTC privacy regulations. Generally, the new privacy rules are similar to the interagency rules described above and have the same effective dates as those interagency rules.

SEC Privacy Regulation

Also in connection with the requirements of GLB, the SEC has adopted Regulation S-P, *Privacy of Consumer Financial Information.* The SEC's rules, to the extent possible, are consistent with and comparable to the rules adopted by the other agencies.

Other Privacy Regulations and Laws

Institutions should also be aware of existing state privacy regulations and emerging regulations. Privacy is a new and growing concern, and new rules likely will continue to develop. Also, under the federal privacy law, if the FTC determines state laws and regulations provide greater consumer protection, those requirements will be incorporated into the federal requirements. Several states have recently passed or proposed various privacy regulations.

> **Help Desk**—Further information about the new privacy regulation can be found at the Web sites of the various agencies. For instance, visit the SEC Web site at www.sec.gov/rules/final/34-42974.htm, or the Federal Reserve Board site at www.federalreserve.gov/boarddocs/press/boardacts/2000/20000510/default.htm.

Possible Legislative and Regulatory Activity in the Future

Legislative and regulatory efforts are underway to go beyond GLB and enact tougher privacy laws and regulations. The Treasury Department is working on a wide-ranging study of privacy issues and the House Banking Committee recently addressed, and eventually postponed, action on more stringent privacy legislation.

In addition, the U.S. House of Representatives is set to consider a bill (H.R. 4049) to establish a "Commission for the Comprehensive Study of Privacy Protection" that includes an AICPA amendment requiring the Commission to report on third-party verification as an enforcement mechanism. Third-party verification means that an objective third party examines an institution's privacy policy to make sure that its privacy claims are true. The House Government Reform Committee approved the AICPA's amendment to the bill before clearing the bill for a vote by the full House. If H.R. 4049 becomes law, the Commission also would study a broad spectrum of privacy issues—online privacy, identity theft, privacy in the workplace, and the protection of health, medical, financial, and governmental records.

Security Standards for Customer Information

Recently, the NCUA issued a proposed Appendix A, *Guidelines for Safeguarding Member Information,* to Section 748 of the rules governing credit union security programs. Similarly, the FRB, OTS, OCC, and FDIC issued proposed guidelines on Security Standards for Customer Information. These additional rules are to be finalized in Autumn 2000. The proposed rules expand security requirements to include an information security program. The required objectives of the information security program are to ensure the security and confidentiality of member information, protect against any anticipated threats or hazards to the security or integrity of such information, and protect against unauthorized access to or use of member information.

Considerations for Auditors and Business Opportunities

Auditor Considerations. As with any significant legal or regulatory requirement, the auditor should obtain appropriate representations from management that the institution has taken steps to ensure compliance and test those representations as considered necessary. Noncompliance could result in significant financial and reputational risk to the institution.

Beyond the Audit. Since the accounting profession's stock-in-trade is confidential financial information, it is conceivable that the

regulatory agencies could adopt regulations subjecting CPAs in public practice to the privacy rules applicable to financial institutions with respect to consumer information. However, the proliferation of current and upcoming privacy statutes and regulations also opens up business opportunities for the profession.

Public Practice Opportunities. CPAs who work in public practice should be aware of the requirements of GLB and the related regulations. Clients may seek advice from CPAs regarding the operational and system requirements related to implementing the privacy requirements and other aspects of GLB. In addition, the recent focus on privacy creates numerous service opportunities for the practitioner in his role as adviser to clients. As more and more institutions migrate to e-commerce environments or engage in information-sharing practices, the need for consultative advice and assurance on all aspects of operations affected by these changes becomes paramount to clients and potential clients.

Providing Assurance on Privacy Systems. To mitigate risks, institutions may seek assurance services that test the efficacy of their privacy systems. *WebTrust*™ and *SysTrust*™ assurance services are pioneering efforts in this area. Privacy consulting—both creating privacy policies and systems as well as internal controls—is also an area where the accounting profession's expertise can put CPAs front and center in the effort to guard public and business interests.

Opportunities for CPAs in Industry. With the growing prominence of privacy issues, CPAs working in financial institutions should take notice of the privacy issues that affect their employers in both the online and offline worlds. These issues might take the form of new laws and regulations and the best practices that are being followed by the industry to ensure that customer confidence and trust are kept at the highest levels possible. Best practices include accepted industry standards and practices such as posting privacy policies on a Web site in a conspicuous place or establishing effective internal controls to ensure that privacy policies are not violated. For more information on best practices, the CPA working in industry might look to the AICPA *WebTrust* program.

An extensive discussion about e-commerce.

E-commerce is an increasingly powerful force affecting the financial services industry. More and more financial institutions are using the Internet or other computer networks as an information resource or delivery channel. Nearly forty percent of all financial institutions now provide some form of web site through which they can communicate with customers, and nearly fifteen percent provide web sites that can be used to conduct financial transactions. These numbers are growing rapidly. Moreover, a large percentage of community-sized institutions plan on providing their customers with electronic financial services, including electronic bill payment and loan processing, over the next three years.

E-commerce encompasses a variety of services and products, including—

- Banking online (for example, obtaining account information, making transfers, and paying bills)
- Online lending transactions and loan servicing, including mortgages
- Business-to-business transactions conducted through web-based portals
- Cash management services
- Online insurance sales
- Online investing and brokerage services

Indeed, providing e-commerce services and products to customers, whether consumer or business customers, is viewed by many in the industry as a necessity.

Forces Driving Institutions to Develop E-Commerce Products and Services

What is driving the desire of so many institutions to develop e-commerce services and products? To be sure, some of the desire to expand into electronic commerce is due to the ubiquitous

enthusiasm for any product or service that uses the Internet. But many in the industry believe that individual and business customers are looking to conduct their financial business electronically. They believe that an increasing number of customers, especially more educated and active customers, will want access to financial services anytime, anywhere. In addition, companies in all industries are looking to the Internet to conduct their business-to-business commerce more efficiently and cost effectively. Furthermore, e-commerce is becoming more important to financial institutions due to the increasing competition from the telecommunications industry and systems and software developers. Those factors are driving financial institutions to develop their electronic commerce services and products.

Consumer Usage Low/Business Potential Great

Currently, online financial services makes up a small part of most institutions' business. Although the availability of e-commerce services for consumers is growing rapidly, the number of households conducting financial transactions online remains relatively small. But while relatively few households have found a compelling reason to switch to online financial services, the Internet holds much greater potential for providing financial services to businesses.

Blending Old and New

Independent on-line financial institutions have been less than successful. Customers still prefer to have a concrete place to go where they can resolve their financial transactions and problems. Institutions are learning that a blend of online services and brick-and-mortar services currently provides the best recipe for success.

Help Desk—For further information on e-commerce, read the AICPA E-Business Risk Alert and visit the following Web sites:

- OCC—www.occ.treas.gov/netbank/netbank.htm
- FDIC—www.fdic.gov/regulations/information/index.html
- OTS—www.ots.treas.gov/ebanking.html

Risks Associated With E-Commerce

The opportunities presented by e-commerce can pose significant risks to financial institutions. Risks and concerns include—

- Attackers or competitors may attempt to circumvent a system's security to obtain access to confidential data, impersonate legitimate customers, steal proprietary information, intentionally corrupt information, misappropriate funds, and so on.
- Transactions traveling through a network are likely to be subject to numerous processing steps, translations, and other processes. These activities introduce such risks as unintentional errors, lost transactions, and duplication of transactions.
- Electronic messages lack traditional identifiers (for example, letterheads, logos, authorizing signatures, face-to-face contact, and the like) and thereby increase the risk that you may unintentionally deal with the wrong party or with someone impersonating another party.
- The use of digital signatures and other encryption technology may mitigate transaction authentication risks. These technologies often require the services of a trusted individual or trusted system to verify that keys and digital signatures actually belong to a designated individual (similar to a notary public function or a securities signature guarantee). There is the risk of abuse of this trusted relationship and a related need for assurance regarding the activities of the trustee (organization, individual, system, and so on).
- Hackers may launch distributed denial of service attacks. These attacks can disrupt an institution's online services and cause serious financial repercussions and adversely affect an institution's reputation.

Of late, many institutions have reported an increase in outside penetration of their systems, denial of service attacks, unauthorized system access by employees, and theft of proprietary information.

Security

Management is responsible for creating policies and procedures and systems capable of securing their e-commerce business. E-commerce security is a very complicated area. Security focuses on numerous issues including authentication, communication integrity, and nonrepudiation. Authentication is about ascertaining the true identity of the parties involved in an electronic transaction. Communication integrity is about ensuring the accuracy and completeness of the information sent between the e-commerce parties. Nonrepudiation involves having strong and substantial evidence of the identity of a party sufficient to prevent a party from successfully denying the origin, submission or delivery of the message, and the integrity of its contents.

Defense Checklist. Appendix A to this Alert contains a checklist for best practices for e-commerce self defense. CPAs can help clients by offering these "e-sabotage" prevention tips.

OCC Bulletin 2000-14. In response to the various risks presented by e-commerce activities, the OCC has issued Bulletin 2000-14. This Bulletin provides guidance to financial institutions on how to prevent, detect, and respond to intrusions into bank computer systems. Bulletin 2000-14 requires, among other things, management to test their information system networks regularly. As appropriate, auditors should be aware of the requirements of this bulletin. Additionally, practitioners with the necessary skills may be able to assist management in implementing Bulletin 2000-14.

Advice to Help You Audit in an E-Commerce Environment

Electronic banking may allow for unauthorized access to an institution's financial information processing systems and databases. Therefore, you may want to evaluate and assess the institution's internal control over and assess the control risk associated with access to the financial systems and databases supporting the preparation of financial statements. When making these evaluations, you may consider—

- Controls over user access to financial information processing systems, including program changes, and access to data files.
- Controls over the accurate conversion of data to new or upgraded systems and the implications for financial reporting.
- New technology developments and budgets for technology upgrades.

Testing Controls. Almost all auditors will find it necessary to test the controls over electronic banking. You may consider the use of computer-assisted auditing techniques to assess the ability of unauthorized access into the institution's financial information technology. Moreover, you may want to consider using continuous audit practices to test the effectiveness of controls. A continuous audit is defined as a methodology that enables auditors to provide written assurance on a subject matter using a series of auditors' reports issued simultaneously with, or a short period of time after, the occurrence of events underlying the subject matter. (The AICPA has published a Research Report titled *Continuous Auditing*, which can be obtained by calling the AICPA at 1-888-777-7077 and asking for Product No. 022510kk.)

Specific Standards to Consult. SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit*, as amended, provides valuable guidance to auditors who are assessing internal control surrounding electronic commerce. Additionally, SAS No. 31, *Evidential Matter*, as amended by SAS No. 80, *Amendment to Statement on Auditing Standards No. 31*, Evidential Matter (AICPA, *Professional Standards*, vol. 1, AU sec. 326) provides guidance for auditors who have been engaged to audit an entity's financial statements when significant information is transmitted, processed, maintained, or accessed electronically. In addition, the AICPA Auditing Procedure Study *The Information Technology Age: Evidential Matter in the Electronic Environment* provides additional guidance on applying SAS No. 31 in the audit of financial statements of an institution where significant information is transmitted processed, maintained, or accessed electronically.

Adequate Skills and Training. SAS No. 1, *Codification of Auditing Standards and Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 210.01, "Training and Proficiency of the Independent Auditor"), states that the audit is to be performed by a person or persons having adequate technical training and proficiency as an auditor. With that guidance in mind, you need to consider that electronic evidence may exist in a form that demands specialized skills to access and interpret. Auditors without such skills are likely to require the assistance of a specialist. SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 336) provides guidance if a technology specialist is necessary on an engagement.

Internet Service Provider. If a client's e-commerce transactions are processed by an outside Internet service provider, you may need to consider the guidance in SAS No. 70, *Service Organizations.*

In addition to the above matters, you may need to consider the following points when conducting your audit of e-commerce transactions:

1. Audit evidence that exists in electronic form may only exist at a certain point in time. Therefore, performing certain procedures after year-end may be too late.
2. Performing only substantive tests of electronic evidence may not provide sufficient competent evidential matter. Without testing the internal control surrounding the electronic evidence, a lack of credibility may not be recognized by the auditor.
3. An auditor may need to use special software tools such as report writers, and data extraction software.

Accounting Considerations

A number of accounting matters that often assume increased importance in electronic commerce environments are discussed below.

Web Site Development Costs. EITF Issue No. 00-2, *Accounting for Web Site Development Costs*, provides guidance on how the

costs incurred in developing a Web site should be accounted for. The Issue contains a detailed listing of specific costs and how to account for each one. You should read the full text of the EITF Issue for a complete understanding of how to account for web site development costs. Some main points of EITF Issue 00-2 are—

- Hardware costs are outside the scope of EITF Issue 00-2 and should be accounted for normally in accordance with GAAP.
- Costs relating to software used to operate a Web site should be accounted for under SOP 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use,* unless a plan exists or is being developed to market the software externally, in which case the costs relating to the software should be accounted for pursuant to FASB Statement No. 86, *Accounting for the Costs of Computer Software to be Sold, Leased, or Otherwise Marketed.*
- Fees paid to a firm to host a Web site generally would be expensed over the period of benefit.
- Planning stage costs should be expensed as incurred.
- Costs of developing initial graphics should be accounted for pursuant to SOP 98-1 for internal-use software.
- Accounting for Web site content (information included in the Web site) will be addressed in a future EITF issue.
- Costs incurred during the operating stage, including training, administration, and maintenance, should be expensed as incurred.
- Costs incurred in the operating stage that involve upgrades and enhancements that add functionality should be expensed or capitalized based on the general model of SOP 98-1.

Customer Acquisition Costs. Institutions may spend substantial amounts of money soliciting customers to gain market share for their e-commerce activities. These costs may take on different forms such as direct response advertising, paid-for URL links,

mailings, and direct email. Advertising is one kind of customer acquisition activity. SOP 93-7, *Reporting on Advertising Costs*, provides accounting guidance for advertising costs, including direct-response advertising. Other kinds of customer acquisition activities are outside the scope of SOP 93-7. Currently, diversity in practice exists in accounting for all other customer acquisition costs. The AICPA Accounting Standards Executive Committee (AcSEC) has a project on its agenda to address the accounting for such costs. The appendix to SOP 93-7 provides a list of accounting pronouncements that AcSEC considered in determining how to account for advertising costs. That same list of accounting literature may help you to determine how to account for customer acquisition costs.

Research and Development Costs. Often, a major cost of developing e-commerce activities is research and development (R&D). FASB Statement No. 2, *Accounting for Research and Development Costs*, requires R&D costs to be expensed when incurred except for acquired R&D that is purchased from others with alternative future uses. Additionally, FASB Statement No. 2 requires disclosure in the financial statements of the total R&D costs charged to expense.

Costs of Start-up Activities and Organization Costs. SOP 98-5, *Reporting on the Costs of Start-up Activities*, defines start-up activities as:

> Those one-time activities related to opening a new facility, introducing a new product or service, conducting business in a new territory, conducting business with a new class or customer, initiating a new process in an existing facility, or commencing some new operation.

Certain costs, such as those that would be capitalizable under GAAP for ongoing enterprises, such as fixed assets and acquired intangibles, are not subject to SOP 98-5. All other costs of start-up activities, including organization costs, should be expensed as incurred.

Segment Reporting. E-commerce activities may be a reportable segment. FASB Statement No. 131, *Disclosures about Segments of*

an Enterprise and Related Information, defines an operating segment as a component of an enterprise:

1. That engages in business activities from which it may earn revenues and incur expenses.
2. Whose operating results are regularly reviewed by the enterprise's chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance.
3. For which discrete financial information is available.

An operating segment may engage in business activities for which it has yet to earn revenues; for example, start-up operations may be operating segments before earning revenues.

FASB Statement No. 131 applies to public enterprises and requires that certain disclosures be made in the financial statements about an entity's segments.

Asset Impairment. When an institution's business activities begin to be conducted through e-commerce channels, other existing channels may begin to lose significance. Other business assets and operations may lose value. The e-commerce activities of competitors also may contribute to the change in how an institution uses its assets and conducts it operations. You should be aware of the guidance set forth in FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of.* FASB Statement No. 121 states—

> An entity shall review long-lived assets and certain identifiable intangibles to be held and used for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable.

FASB Statement No. 121 requires that an entity estimate the future cash flows expected to result from the use of the asset and its eventual disposition. If the sum of the expected future cash flows (undiscounted and without interest charges) is less than the carrying amount of the asset, an impairment loss should be recognized. The impairment loss should be measured as the amount by which the carrying amount of the asset exceeds the fair value of the asset.

Remember also that some assets, such as legacy software and hardware systems, enterprise resource planning software, and network operating software, are often quickly rendered obsolete by changing technology and may have fair values significantly less than book value.

Fraud and Illegal Activities

Information and advice about money laundering and sanctions.

Money Laundering

Criminals use financial institutions to launder the proceeds of crime. Financial institutions are vulnerable because they provide a broad range of financial services that money launderers want and need. Services at high risk for money laundering include monetary instrument, international pouch (cash letters), deposit broker, and international wire transfer transactions. High-risk accounts include money services businesses, offshore private investment companies, non-discretionary private banking and international correspondent banking customers.

Definition of Money Laundering

Money laundering is the funneling of cash or other funds generated from illegal activities through legitimate businesses to conceal the initial source of the funds. Money laundering is a global activity and, like the illegal activities that give it sustenance, it seldom respects local, national, or international jurisdiction. Current estimates of the size of the global annual "gross money laundering product" range from $500 billion to $1 trillion.

Money Laundering in the Electronic Age

Recent cases underscore how criminals are increasingly using personal computers, banking software, electronic funds transfers, and the Internet to launder the proceeds of their illicit activities. Large volumes of high-speed wire transfers between institutions

on a daily basis make it exceedingly difficult for regulators, law enforcement, and financial institutions to identify money laundering activities.

Inadequate Controls Increase Risk of Money Laundering

Evidence suggests that institutions penetrated by money launderers do not have effective corporate governance for money laundering risk management, including inadequate processes for identifying unusual activity and determining whether unusual activity is really suspicious and reportable.

In a number of instances, organized crime associates were employed at the affected institutions and existing controls were inadequate to detect suspicious or improper relationships and activities involving them.

Related Laws and Regulations

The Bank Secrecy Act (BSA), enacted to address the problem of money laundering, authorizes the Treasury Department 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 31 CFR Part 103). Failure to comply with BSA reporting and recordkeeping provisions may result in the assessment of severe penalties.

The BSA contains a suspicious activity reporting (SAR) requirement. All financial institutions operating in the United States are required to report suspicious activity following the discovery of: insider abuse involving any amount, violations aggregating $5,000 or more when a suspect can be identified, violations aggregating $25,000 or more regardless of a potential suspect, or transactions aggregating $5,000 or more that involve potential money laundering or violations of the BSA. In June, 2000 the NCUA, FRB, FDIC, OCC, and OTS issued a newly revised SAR form.

The BSA also contains regulations requiring financial institutions to file currency transaction reports (CTRs) for cash transactions greater than $10,000.

BSA Compliance Deficiencies. Recent examinations by the OCC have revealed some common BSA compliance deficiencies. The OCC found that some institutions failed to adequately—

- Document and evaluate new, high-risk accounts for money laundering.
- Establish controls and review procedures for high-risk services.
- Monitor high-risk accounts for money laundering.
- Conduct adequate independent testing of high-risk accounts for the possibility of money laundering.
- Train employees to detect suspicious activity in high-risk areas.
- Review CTR filing patterns for suspicious activity.

The OCC reminds financial institutions that they must have adequate internal controls, independent testing, responsible personnel, and training to comply with the BSA.

Federal Government Initiative Looks to CPAs to Fight Money Laundering

A federal government report issued in March 2000 sheds light on how federal agencies fighting money laundering see CPAs as one day helping them prevent criminals from converting illicit gains into cash or goods that can be used legitimately. The National Money Laundering Strategy for 2000 (www.treas.gov) outlines a broad government campaign, coordinated with other nations, to fight money laundering.

Reviewing the Responsibilities of CPAs. The strategy calls for a study group consisting of the U.S. Department of Justice and Department of the Treasury, the Internal Revenue Service, the SEC, the Commodities Futures Trading Commission, and the

FDIC, to examine how best to utilize accountants and auditors in the detection and deterrence of money laundering. The study group also plans to review the professional responsibilities of lawyers and accountants regarding money laundering and make recommendations—ranging from enhanced professional education, standards, or rules to legislation—as might be needed.

Legislation Introduced. Also, a bill, the "International Counter-Money Laundering Act of 2000," which was introduced in the House of Representatives, contains provisions affecting independent auditors (for example, safe harbor for those who report suspicious activity to the authorities and a prohibition against informing suspects that their activities have been reported). However, the bill does not explicitly require independent auditors to report suspicious activities. The AICPA is analyzing the bill's provisions. You should look to further communications from the AICPA regarding the progress of these government initiatives.

Money Laundering and Financial Statements

Money laundering usually results in large quantities of illicit proceeds that need to be distanced from their source as quickly as possible without being detected. Consequently, the likelihood of detecting money laundering in connection with financial statement audits is remote. In addition, the activity is more likely to cause assets to be overstated rather than understated, with shorter-term fluctuations, rather than cumulative changes, in account balances.

Money laundering is considered to be an illegal act with an indirect effect on financial statement amounts under SAS No. 54, *Illegal Acts by Clients.* Under SAS No. 54, the auditor should be aware of the possibility that such illegal acts have occurred. If specific information comes to your attention that provides evidence concerning the existence of possible illegal acts that could have a material indirect effect on the financial statements, you should apply audit procedures specifically directed to ascertaining whether an illegal act has occurred.

You should also note that laundered funds and their proceeds could be subject to asset seizure and forfeiture (claims) by law enforcement agencies that could result in material contingent liabilities during prosecution and adjudication of cases.

Section 10A of the Securities Exchange Act of 1934. The Private Securities Litigation Reform Act of 1995, among other things, amended the Securities Exchange Act of 1934 (the Exchange Act) to add Section 10A. This section requires that each audit under the Exchange Act include procedures regarding the detection of illegal acts, the identification of related party transactions, and an evaluation of the issuer's ability to continue as a going concern. Section 10A also codified certain then-existing professional auditing standards regarding the detection of illegal acts by issuers and imposed expanded obligations on auditors to report in a timely manner to management any information indicating that an illegal act has, or may have, occurred. The auditor must ensure that the audit committee or board of directors is adequately informed with respect to an illegal act, as broadly defined by Section 10A, unless the illegal act is clearly inconsequential.

In addition, Section 10A requires the issuer to notify the SEC within one business day after the board of directors of the issuer is informed by its auditor that the auditor reasonably expects to resign from the audit engagement or to modify their audit report due to an illegal act that has a material effect on the issuer's financial statements for which appropriate remedial action has not been taken by senior management and the board of directors. If the issuer does not notify the SEC within that period, then the auditor, within the next business day, must provide a copy of the "illegal acts report" that it gave to the board (or documentation of any oral report) directly to the SEC. Section 10A provides for cease and desist and civil money penalties to be imposed against auditors who willfully fail to provide the required reports.

Financial Crimes Enforcement Network Advisories

The Financial Crimes Enforcement Network (FinCEN) is an entity within the U.S. Department of the Treasury that supports law

enforcement investigative efforts and fosters interagency and global cooperation against domestic and international financial crimes. FinCEN has issued advisories about transactions with the entities listed below. These advisories normally instruct financial institutions to give enhanced scrutiny to any transaction originating in or routed through the entities listed below. It should be emphasized that the issuance of these advisories does not mean that financial institutions should curtail legitimate business with the following entities:

- St. Vincent and the Grenadines
- St. Kitts and Nevis
- The Russian Federation
- The Philippines
- Panama
- Niue
- Nauru
- The Marshall Islands
- Liechtenstein
- Lebanon
- Israel
- Dominica
- The Cook Islands
- The Cayman Islands
- The Bahamas

Updating Federal Government Sanctions

The Department of the Treasury's Office of Foreign Assets Control (OFAC) administers sanction programs against Libya, Iraq, Cuba, the National Union for the Total Independence of Angola (UNITA), Syria, Sudan, Yugoslavia, Burma, Iran, the Taliban in Afghanistan, international terrorists, and international narcotics traffickers. Financial transactions with these regimes, entities, and individuals may be prohibited or restricted by federal law. Information concerning OFAC rules, lists of prohibited entities, and general OFAC information can be obtained on the OFAC Web site at www.ustreas.gov/ofac.

Sanctions have always been administered against North Korea as well. However on June 19, 2000, OFAC amended the Foreign Assets Control Regulations to permit new financial, trade and other transactions with North Korea and its nationals. See the OFAC Web site for information on regulations pertaining to North Korea.

Recent Regulatory Actions

What important regulatory guidance has been issued recently?

Presented below are some important recent regulatory actions. The list of regulatory actions is not comprehensive and information provided only represents summaries of the regulations. Readers should visit the web sites of the various regulatory agencies for complete listings of new regulations and for full descriptions of the regulations. Regulatory Web sites are—

- FDIC: www.fdic.gov.
- FFIEC: www.ffiec.gov.
- FRB: www.federalreserve.gov.
- NCUA: www.ncua.gov.
- OCC: www.occ.treas.gov.
- OTS: www.ots.treas.gov.
- SEC: www.sec.gov.

FDIC Issues Guidance for Examiner Review of Auditor's Workpapers

In March 2000, the FDIC released guidance for bank examiners who review workpapers prepared by a depository institution's external auditors. The guidance instructs FDIC examiners to review the workpapers when an FDIC-supervised bank of any size or any other depository institution with $500 million or more in assets has a composite safety-and-soundness rating, known as a CAMELS rating, of 4 or 5 or when they have significant concerns about an area of an FDIC-supervised bank's activities that would have fallen within the scope of the work performed by the auditor. At every examination, the FDIC examiners must obtain from the bank's management all the communications in which the auditors have identified reportable conditions and material weaknesses in internal control.

Auditing Interpretation No. 1, "Providing Access to or Photocopies of Working Papers to a Regulator," of SAS No. 41, *Working Papers* (AICPA, *Professional Standards*, vol. 1, AU sec. 9339.01–.15)

describes the steps an auditor should take in providing an examiner with access to workpapers and shows a sample of the type of letter to be sent to the regulator.

Securitizations and Participations

The FDIC and NCUA have adopted final rules on the FDIC's and NCUA's treatment of financial assets that are transferred by an insured depository institution or federally insured credit union in connection with a securitization or a participation following the FDIC's or NCUA's appointment as conservator or receiver. The rule responds to certain legal and accounting issues affecting asset-backed securitizations and participations entered into by insured depository institutions and federally insured credit unions.

Under GAAP (FASB Statement No. 125; FASB Statement No. 140 was issued in September 2000 and replaces FASB Statement No. 125. Refer to FASB Statement No. 140 for accounting guidance), one of the criteria for a transfer of financial assets to be accounted for as a sale is the "legal isolation" of the transferred assets. Financial assets are deemed to be legally isolated when they have been placed beyond the reach of the transferor and its creditors, even in the case of the bankruptcy of, or the appointment of a receiver for, the transferor. Insured depository institutions, federally insured credit unions, accountants, and other parties have raised questions about whether this isolation test would be satisfied for securitizations and participations when the FDIC or NCUA, as conservator or receiver, has the statutory power to repudiate or disaffirm the transfers. If the transferred assets are not sufficiently isolated from the insured bank, credit union, or thrift, its creditors or the receiver, the transfers would not qualify for sale treatment under GAAP and the transferred assets would continue to be reported as assets on the institution's balance sheet.

The rule responds to those questions by reassuring interested parties that, subject to certain conditions such as fraud, the FDIC or NCUA, as conservator or receiver, will not seek to reclaim, recover, or recharacterize as property of the institution or

the receivership financial assets transferred by the institution in connection with a securitization or participation. Accordingly, the rule should resolve the legal isolation issue for insured depository institutions and federally insured credit unions. The rule confirms existing FDIC and NCUA practice in dealing with securitization and participation transactions.

Prompt Corrective Action Rule and Risk-Based Net Worth Requirement Finalized

In 1998, the Federal Credit Union Act was amended to require NCUA to adopt a system of prompt corrective action for federally insured credit unions. As a separate component of that system, NCUA is required to define credit unions that are "complex" by reason of their portfolio of assets and liabilities and to develop a risk-based net worth requirement to apply to such credit unions in the "well capitalized" or "adequately capitalized" statutory net worth categories.

The NCUA has adopted final Prompt Corrective Action rules, Parts 702, 741, and 747, in response to the new requirements. Also, the NCUA issued a rule consisting of a three-step process for defining a "complex" credit union and for determining its risk-based net worth requirement under either of two methods.

Effective August 7, 2000, the final PCA rule will apply to every credit union's net worth ratio reported on call reports beginning with January 22, 2001. The risk-based net worth requirement for credit unions meeting the definition of "complex" will first apply on the basis of data in the call report due to be filed by quarterly filers on April 23, 2001, reflecting activity in the first quarter of 2001.

For more detailed information, visit the NCUA Web site at www.ncua.gov/news/proposed_regs/final_regs.html.

Final Rule Issued on Privacy

The NCUA, OTS, OCC, FRB, FDIC, and SEC have all issued final privacy rules to meet the statutory requirements of the

Gramm-Leach-Bliley Act. (See the "In Focus Special: Privacy" section of this Alert for details about the new regulations.)

Guidance Issued on Asset Securitization Activities

The FDIC, FRB, OCC, and OTS have issued joint guidelines addressing asset securitization activities. The guidelines highlight the risks associated with asset securitization and emphasize the concerns over certain retained interests generated from the securitization and sale of assets. The guidance addresses the fundamental risk management practices that should be in place at institutions that engage in securitization activity.

The guidelines address the fundamental elements of an appropriate and effective risk management program for securitization activities. In particular, the guidance sets 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 set forth in the guidance will be classified as loss and disallowed as assets of the bank for regulatory capital purposes. The guidance also 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 that present 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.

Given the risks presented by securitization activities and, in particular, the potential volatility of retained interests, the bank regulatory agencies issued proposed revisions to their capital rules for retained interests in securitizations and other transfers of financial assets on September 27, 2000.

The proposed treatment would amend the leverage and risk-based capital requirements by:

- Requiring that "dollar-for-dollar" risk-based capital be held against residual interests from securitization activities or other transfers of financial assets that are retained on the balance sheet, even if the amount exceeds the full capital charge typically held against the assets transferred.
- Restricting undue concentrations in such residual interests by placing them within the twenty-five percent Tier 1 capital sublimit already established for nonmortgage servicing assets and purchased credit card relationships. Any amounts above this limit will be deducted from Tier 1 capital.

Comments on the proposal are due by December 26, 2000.

Independent Audits for Small Banks and Thrifts

On September 28, 1999, the FFIEC issued an interagency policy statement on external auditing programs of banks and savings associations. The policy statement recommends, but does not require, that banks and thrifts with assets under $500 million undergo external audits annually and, where practicable, establish an audit committee composed entirely of outside directors. The interagency policy statement declares that the banking agencies consider an annual audit of an institution's financial statements performed by an independent public accountant to be the preferred type of external auditing program. The policy statement is aimed at smaller institutions because larger institutions are already required to undergo annual audits by independent CPAs. The policy statement is effective for fiscal years beginning on or after January 1, 2000. The NCUA, although a member of the FFIEC, did not adopt the policy.

High Loan-to-Value Residential Real Estate Lending

The FDIC, FRB, OCC, and OTS jointly issued interagency guidance on high loan-to-value (LTV) residential real estate lending on October 12, 1999. The guidance reminds institutions that

the 1992 Interagency Guidelines for Real Estate Lending Policies (Guidelines) and the supervisory LTV limits apply to these transactions. The guidance also outlines some of the other controls the agencies expect institutions to have in place when involved in this field of lending.

Credit Union Leasing Rule Issued

The NCUA has issued a final rule on leasing. The final leasing rule updates and redesignates NCUA's long-standing policy statement on leasing, Interpretive Ruling and Policy Statement (IRPS) 83-3, as an NCUA regulation. IRPS 83-3 authorizes federal credit unions to engage in either direct or indirect leasing and either open-end or closed-end leasing of personal property to their members if such leasing arrangements are the functional equivalent of secured loans. In addition, the final rule formalizes NCUA's position, set forth in legal opinion letters, that federal credit unions do not have to own the leased property in an indirect leasing arrangement if certain requirements are satisfied.

The effective date of the rule was June 30, 2000.

Credit Union Service Organization Rule Amended

The NCUA has amended Section 712.5 of the credit union service organization (CUSO) regulation by reinstating real estate brokerage services as a permissible CUSO service.

The NCUA removed real estate brokerage services from the list of permissible CUSO services in 1998. In reinstating real estate brokerage services, the NCUA recognized the importance of such services to customers.

Exam Cycle Extended for Foreign Banks

On October 22, 1999, the FRB, the OCC, and the FDIC adopted a final rule to extend the examination frequency cycle for certain U.S. branches and agencies of foreign banks. The rule makes healthy, smaller U.S. branches and agencies of foreign

banks eligible for exams every 18 months, instead of every 12 months. The extended exam cycle applies to U.S. branches or agencies of a foreign bank that have total assets of $250 million or less and have received a supervisory risk management, operational controls, compliance, and asset quality (ROCA) rating of 1 or 2. In addition, the foreign bank branch or agency must meet certain specified capital requirements and must not be subject to any formal enforcement action by U.S. regulators.

OCC Issues Final Rule on Investment Securities, Corporate Activities, and Bank Activities and Operations

The OCC issued a final rule that updates and clarifies its rules regarding investment securities, corporate activities, and bank activities and operations. Most of the changes involve the OCC's interpretations regarding national bank activities and operations. This final rule clarifies existing rules, adds new provisions based on recent statutory changes, judicial rulings, OCC decisions, and other developments, and makes technical changes. The effective date of the rule was December 6, 1999.

FFIEC Revises Uniform Retail Credit Classification and Account Management Policy

The FFIEC has revised the Uniform Retail Credit Classification and Account Management Policy issued in 1999. The policy provides guidance to institutions when they classify or write off delinquent retail loans and lines of credit.

The FFIEC revised the policy in response to comments and requests from the banking industry for clarification of the standards. In general, the revised policy provides banks and thrifts additional flexibility in working with borrowers experiencing temporary problems in the payment of their consumer loans.

The revised policy does not bar an institution from adopting a more conservative policy. Based on collection experience, when a portfolio's history reflects high losses and low recoveries, more conservative standards are appropriate and necessary. Nor does

the policy preclude examiners from classifying individual retail credit loans that exhibit signs of credit weakness regardless of delinquency status. An examiner may also classify retail portfolios, or segments thereof, where underwriting standards are weak and present unreasonable credit risk, and may criticize account management practices that are deficient.

In brief, the primary modifications to the policy include the following:

- The revised policy separates the treatment for open-end and closed-end credits in a manner that more accurately reflects industry practice.
- The revised policy permits institutions to re-age an open-end account that is placed in a workout program after receipt of three monthly payments or the equivalent cumulative amount. Re-aging open-end accounts for workout program purposes is limited to once in a five-year period and is in addition to the existing once-in-twelve-months/twice-in-five-years limitation on re-aging open-end loans.
- The revised policy provides similar treatment for both closed-end and open-end loans secured by one- to four-family residential real estate. A collateral assessment and charge-off will be required when the loan is 180 days past due.

NCUA Amends Share Insurance Rules

The NCUA issued a final rule amending its share insurance rules. The amendments simplify and clarify these rules and provide parity between them and the FDIC's deposit insurance rules. Specifically, the amendments—

- Increase available share insurance coverage on some revocable trust accounts.
- Simplify the method for determining the insurance coverage a member has in one or more joint accounts.

- Treat a revocable trust account held in connection with a living trust as any other revocable trust accounts, if the living trust meets all requirements pertaining to revocable trusts.
- Provide separate insurance coverage for qualifying joint revocable trust accounts.
- Treat Roth individual retirement accounts (IRAs) as traditional IRAs and Education IRAs as irrevocable trusts for insurance purposes.
- Liberalize insurance coverage for some kinds of public unit accounts.
- Clarify the degree of control state or local law has on share insurance determinations and revise the substance and format of the Appendix to part 745.

The rule was effective July 3, 2000.

NACHA—the Electronic Payments Association—Revises Operating Rules

NACHA, the trade association that develops operating rules and business practices for the automated clearing house network and for other areas of electronic payments, modified the rules compliance audit requirements within the *NACHA Operating Rules* to—

1. Require audits of rules compliance to be completed more frequently; audits must be completed annually rather than every three years.
2. Provide greater coverage of rules provisions within the audit requirements.
3. Require completion of an annual audit of rules compliance by third-party service providers that act on behalf of participating DFIs.
4. Require retention of documentation by participating DFIs and third-party service providers that the annual audit has been completed. The modifications were effective December 17, 1999.

Auditing, Attestation, and Quality Control Pronouncements and Guidance Update

What new auditing pronouncements and other matters do you need to be aware of?

For a full listing and description of all new auditing and attestation standards, read the AICPA general *Audit Risk Alert—2000/2001*). The summaries presented below are for informational purposes only and should not be relied on as a substitute for a complete reading of the applicable guidance. Also, *proposed* pronouncements and exposure drafts are not authoritative standards and cannot be used as a basis for changing GAAS. The purpose of proposed pronouncements and exposure drafts is to solicit comments from preparers, auditors, users of financial statements, and other interested parties.

SAS No. 88, *Service Organizations and Reporting on Consistency*

In December 1999, the AICPA ASB issued SAS No. 88, *Service Organizations and Reporting on Consistency* (AICPA, *Professional Standards*, vol. 1, AU secs. 324 and 420). Part 1, "Service Organizations," amends SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU secs. 324.03 and 324.06–.10), to—

1. Clarify the applicability of SAS No. 70 by stating that the SAS is applicable if an entity obtains services from another organization that are part of the entity's information system. It also provides guidance on the types of services that would be considered part of an entity's information system.

2. Revise and clarify the factors a user auditor should consider in determining the significance of a service organization's controls to a user organization's controls.

3. Clarify the guidance on determining whether information about a service organization's controls is necessary to plan the audit.

4. Clarify that information about a service organization's controls may be obtained from a variety of sources.

5. Change the title of SAS No. 70 from *Reports on the Processing of Transactions by Service Organizations to Service Organizations.*

Part 2, "Reporting on Consistency," amends SAS No. 1, *Codification of Auditing Standards and Procedures* (AICPA, *Professional Standards,* vol. 1, AU sec. 420, "Consistency of Application of Generally Accepted Accounting Principles"), to—

1. Conform the list of changes that constitute a change in the reporting entity (AU sec. 420.07) to the guidance in paragraph 12 of APB Opinion No. 20, *Accounting Changes.*

2. Clarify that the auditor need not add a consistency explanatory paragraph to the auditor's report when a change in the reporting entity results from a transaction or event.

3. Eliminate the requirement for a consistency explanatory paragraph in the auditor's report if a pooling of interests is not accounted for retroactively in comparative financial statements.

4. Eliminate the requirement to qualify the auditor's report and consider adding a consistency explanatory paragraph to the report if single-year financial statements that report a pooling of interests do not disclose combined information for the prior year.

All of the amendments contained in SAS No. 88 were effective upon issuance.

SAS No. 89, *Audit Adjustments*

In December 1999, the AICPA ASB issued SAS No. 89, *Audit Adjustments* (AICPA, *Professional Standards,* vol. 1, AU secs. 310, 333, and 380), which amends three SASs to establish audit requirements designed to encourage client management to record financial statement adjustments aggregated by the auditor. It also clarifies management's responsibility for the disposition of financial

statement misstatements brought to its attention. SAS No. 89 amends SAS No. 83, *Establishing an Understanding With the Client* (AICPA, *Professional Standards*, vol. 1, AU sec. 310); SAS No. 85, *Management Representations* (AICPA, *Professional Standards*, vol. 1, AU sec. 333); and SAS No. 61, *Communication With Audit Committees* (AICPA, *Professional Standards*, vol. 1, AU sec. 380), as follows:

1. SAS No. 83 is amended to include in the understanding with the client management's responsibility for determining the appropriate disposition of financial statement misstatements aggregated by the auditor. Specifically, SAS No. 89 adds the following to the list of matters that generally are included in the understanding with the client:

   > Management is responsible for adjusting the financial statements to correct material misstatements and for affirming to the auditor in the representation letter that the effects of any uncorrected misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

2. SAS No. 85 is amended to require that the management representation letter include an acknowledgment by management that it has considered the financial statement misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented and has concluded that any uncorrected misstatements are immaterial, both individually and in the aggregate, to the financial statements taken as a whole. It also requires that a summary of the uncorrected misstatements be included in or attached to the representation letter.

3. SAS No. 61 is amended to require the auditor to inform the audit committee about uncorrected misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented, whose effects management believes are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

These amendments are effective for audits of financial statements for periods beginning on or after December 15, 1999, with early adoption permitted.

SAS No. 90, *Audit Committee Communications*

SAS No. 90, *Audit Committee Communications* (AICPA, *Professional Standards*, vol. 1, AU secs. 380 and 722), issued in December 1999, amends SAS No. 61 and SAS No. 71, *Interim Financial Information* (AICPA, *Professional Standards*, vol. 1, AU sec. 722). SAS No. 90 was issued in response to recommendation numbers 8 and 10 of the report of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, which suggest changes to GAAS.

Among other things, the amendment to SAS No. 61 requires an auditor to discuss with the audit committees of SEC clients certain information relating to the auditor's judgments about the quality, not just the acceptability, of the company's accounting principles and underlying estimates in its financial statements. It also encourages a three-way discussion among the auditor, management, and the audit committee. This amendment is effective for audits of financial statements for periods ending on or after December 15, 2000, with earlier application permitted.

The amendment to SAS No. 71 clarifies that the accountant should communicate to the audit committee or be satisfied, through discussions with the audit committee, that matters described in SAS No. 61 have been communicated to the audit committee by management when they have been identified in the conduct of interim financial reporting. This amendment also requires the accountant of an SEC client to attempt to discuss with the audit committee the matters described in SAS No. 61 before filing Form 10-Q. This amendment is effective for reviews of interim financial information for interim periods ending on or after March 15, 2000, with earlier application permitted.

SAS No. 91, *Federal GAAP Hierarchy*

At its October 1999 meeting, the AICPA Council adopted a resolution recognizing the Federal Accounting Standards Advisory Board (FASAB) as the body designated to establish GAAP for federal government entities under Rule 203 of the AICPA's Code of Conduct. Pursuant to that resolution, Statements of Federal Financial Accounting Standards issued by the FASAB since March 1993 are recognized as GAAP for applicable federal governmental entities. At its February 2000 meeting, the ASB voted to issue SAS No. 91, *Federal GAAP Hierarchy* (AICPA, *Professional Standards*, vol. 1, AU sec. 411), which amends SAS No. 69, *The Meaning of* Present Fairly in Conformity with Generally Accepted Accounting Principles *in the Independent Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 411), to recognize FASAB statements as "level A" GAAP and to establish a hierarchy for other FASAB guidance and general accounting literature.

SAS No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*

In September 2000 the ASB issued SAS No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*, vol. 1, AU sec. 391). SAS No. 92 will help auditors plan and perform auditing procedures for financial statement assertions about derivative instruments, hedging activities, and investments in securities. SAS No. 92 supersedes SAS No. 81. The guidance in the SAS applies to—

1. *Derivative instruments*, as that term is defined in FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities.*
2. Hedging activities in which the entity designates a derivative or a nonderivative financial instrument as a hedge of exposure for which FASB Statement No. 133 permits hedge accounting.
3. Debt and equity securities, as those terms are defined in FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities.*

SAS No. 92 is effective for audits of financial statements for fiscal years ending on or after June 30, 2001. Early application of the SAS is permitted.

Audit Guide to Complement SAS No. 92

An Audit and Accounting Guide to complement SAS No. 92 is to be issued by the ASB. The Guide provides practical guidance for implementing the SAS on all types of audit engagements. The suggested audit procedures contained in the Guide do not increase or otherwise modify the auditor's responsibilities, rather, the suggested procedures are intended to clarify and illustrate the application of the requirements of SAS No. 92. The Guide's objective is both to explain SAS No. 92 by examining it in-depth, and to provide practical illustrations through the use of case studies.

The Guide will include an overview of derivatives and securities and the general accounting considerations for them, as well as case studies that address topics such as the use of interest rate futures contracts to hedge the forecasted issuance of debt, the use of a put options to hedge available-for-sale securities, separately accounting for a derivative embedded in a bond, the use of interest rate swaps to hedge existing debt, the use of foreign-currency put options to hedge a forecasted sale denominated in a foreign currency, changing the classification of a security to held-to-maturity, control risk considerations when service organizations provide securities services, inherent and control risk assessment, and designing substantive procedures based on risk assessments.

SAS No. 93, *Omnibus Statement on Auditing Standards—2000*

In October 2000, the ASB issued SAS No. 93, *Omnibus Statement on Auditing Standards—2000.* The SAS—

- Withdraws SAS No. 75, *Engagements to Apply Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement* (AICPA, *Professional Standards*, vol. 1, sec. 801). The guidance in SAS No. 75 will be incorporated in Statements on Standards for Attestation Engagements

(SSAE) No. 4, *Agreed-Upon Procedures Engagements* (AICPA, *Professional Standards*, vol. 1, AT sec. 600), to consolidate the guidance on agreed-upon procedures engagements in professional standards.

- Amends SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, sec. 508), to include a reference in the auditor's report to the country of origin of the accounting principles used to prepare the financial statements and the auditing standards that the auditor followed in performing the audit.
- Amends SAS No. 84, *Communications Between Predecessor and Successor Auditors* (AICPA, *Professional Standards*, vol. 1, sec. 315), to clarify the definition of a predecessor auditor.

Interpretation No. 7, "Management's and Auditor's Responsibilities With Regard to Related Party Disclosures Prefaced by Terminology Such As Management Believes That," of SAS No. 45, *Related Parties*

Interpretation No. 7, "Management's and Auditor's Responsibilities With Regard to Related Party Disclosures Prefaced by Terminology Such As Management Believes That," of SAS No. 45, *Related Parties* (AICPA, *Professional Standards*, vol. 1, AU sec. 9334.22–.23) essentially states that a preface to a related party disclosure such as "Management believes that" or "It is the Company's belief that" does not change management's responsibility to substantiate the representation.

Accounting Pronouncements and Guidance Update

What new accounting pronouncements and other matters do you need to be aware of?

For a full listing of recently issued accounting standards, read the AICPA general *Audit Risk Alert—2000/2001*. The summaries presented below are for informational purposes only and should not be relied on as a substitute for a complete reading of the applicable

guidance. Also, *proposed* pronouncements and exposure drafts are not authoritative standards and cannot be used as a basis for changing GAAP. The purpose of proposed pronouncements and exposure drafts is to solicit comments from preparers, auditors, users of financial statements, and other interested parties.

FASB Statement No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities*

FASB Statement No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities*, amends FASB Statement No. 133 and addresses a limited number of issues causing implementation difficulties for numerous entities that apply FASB Statement No. 133. This Statement amends the accounting and reporting standards of FASB Statement No. 133 for certain derivative instruments and certain hedging activities as indicated:

1. The normal purchases and normal sales exception in paragraph 10(b) may be applied to contracts that implicitly or explicitly permit net settlement, as discussed in paragraphs 9(a) and 57(c)(1), and contracts that have a market mechanism to facilitate net settlement, as discussed in paragraphs 9(b) and 57(c)(2).

2. The specific risks that can be identified as the hedged risk are redefined so that in a hedge of interest rate risk, the risk of changes in the benchmark interest rate (*benchmark interest rate* is defined in paragraph 4(jj) of FASB Statement No. 138) would be the hedged risk.

3. Recognized foreign-currency-denominated assets and liabilities for which a foreign currency transaction gain or loss is recognized in earnings under the provisions of paragraph 15 of FASB Statement No. 52, *Foreign Currency Translation*, may be the hedged item in fair value hedges or cash flow hedges.

4. Certain intercompany derivatives may be designated as the hedging instruments in cash flow hedges of foreign currency risk in the consolidated financial statements if those

intercompany derivatives are offset by unrelated third-party contracts on a net basis.

FASB Statement No. 138 also amends FASB Statement No. 133 for decisions made by the Board relating to the DIG process. Certain decisions arising from the DIG process that required specific amendments to FASB Statement No. 133 are incorporated into FASB Statement No. 138.

FASB Statement No. 139, *Recission of FASB Statement No. 53 and Amendments to FASB Statements No. 63, 89, and 121*

FASB Statement No. 139 rescinds FASB Statement No. 53, *Financial Reporting by Producers and Distributors of Motion Picture Films.* An entity that previously was subject to the requirements of Statement 53 shall follow the guidance in AICPA SOP 00-2, *Accounting by Producers or Distributors of Films.* This Statement also amends FASB Statements No. 63, *Financial Reporting by Broadcasters,* No. 89, *Financial Reporting and Changing Prices,* and No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of.*

Statement No. 139 is effective for financial statements for fiscal years beginning after December 15, 2000. Earlier application is permitted only upon early adoption of the SOP.

FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*

This Statement replaces FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.* It revises the standards for accounting for securitizations and other transfers of financial assets and collateral and requires certain disclosures, but it carries over most of FASB Statement No. 125's provisions without reconsideration.

This Statement provides accounting and reporting standards for transfers and servicing of financial assets and extinguishments of liabilities. Those standards are based on consistent application of a financial-components approach that focuses on control. Under

that approach, after a transfer of financial assets, an entity recognizes the financial and servicing assets it controls and the liabilities it has incurred, derecognizes financial assets when control has been surrendered, and derecognizes liabilities when extinguished. This Statement provides consistent standards for distinguishing transfers of financial assets that are sales from transfers that are secured borrowings.

In addition to replacing FASB Statement No. 125 and rescinding FASB Statement No. 127, *Deferral of the Effective Date of Certain Provisions of FASB Statement No. 125*, this Statement carries forward the actions taken by Statement 125.

This Statement is effective for transfers and servicing of financial assets and extinguishments of liabilities occurring after March 31, 2001. This Statement is effective for recognition and reclassification of collateral and for disclosures relating to securitization transactions and collateral for fiscal years ending after December 15, 2000. Disclosures about securitization and collateral accepted need not be reported for period sending on or before December 15, 2000, for which financial statements are presented for comparative purposes.

This Statement is to be applied prospectively with certain exceptions. Other than those exceptions, earlier or retroactive application of its accounting provisions is not permitted.

FASB Interpretation 44, *Accounting for Certain Transactions Involving Stock Compensation*

FASB Interpretation No. 44 clarifies the application of APB Opinion No. 25 for only certain issues. It does not address any issues related to the application of the fair value method in FASB Statement No. 123. Among other issues, Interpretation No. 44 clarifies—

1. The definition of employee for purposes of applying APB Opinion No. 25.
2. The criteria for determining whether a plan qualifies as a noncompensatory plan.

3. The accounting consequence of various modifications to the terms of a previously fixed stock option or award.
4. The accounting for an exchange of stock compensation awards in a business combination.

Interpretation No. 44 was effective July 1, 2000, but certain conclusions in the Interpretation cover specific events that occured after either December 15, 1998, or January 12, 2000. To the extent that the Interpretation covers events occurring during the period after December 15, 1998, or January 12, 2000, but before the effective date of July 1, 2000, the effects of applying the Interpretation are to be recognized on a prospective basis from July 1, 2000.

Revised Audit and Accounting Guides Issued

May 1, 2000 versions of the Audit and Accounting Guides listed below are now available. The AICPA Accounting Standards Executive Committee and members of the AICPA Auditing Standards Board have found these guides to be consistent with existing standards and principles covered by Rules 202 and 203 of the AICPA Code of Professional Conduct. AICPA members should be prepared to justify departures from these guides. To order the guides, call the AICPA Order Department at 1-888-777-7077.

- Banks and Savings Institutions (Product Number 012468kk)
- Audits of Credit Unions (Product Number 012469kk)
- Audits of Finance Companies (Product Number 012467kk)

Proposed Statement of Position—*Accounting by Certain Financial Institutions and Entities That Lend to or Finance the Activities of Others*

This SOP project is to reconcile the specialized accounting and financial reporting guidance established in the existing Guides *Banks and Savings Institutions, Audits of Credit Unions, and Audits of Finance Companies.* The final provisions would be incorporated in a final Combined Guide, applicable to entities that lend

to or finance the activities of others. In May 2000, the AcSEC issued an exposure draft of this proposed SOP. Comments are due October 31, 2000. AcSEC expects to issue the SOP in the second quarter of 2001.

Proposed Statement of Position—*Accounting for Certain Purchased Loans or Debt Securities*

FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, requires that discounts on purchases of groups of loans be recognized as an adjustment of yield over an instrument's life. Practice Bulletin 6, *Amortization of Discounts on Certain Acquired Loans*, further addresses accretion of discounts on purchases of loans with credit quality issues, which involves intertwining issues of accretion of discount, measurement of credit losses, and recognition of interest income. This project has tentatively rejected the Practice Bulletin 6 methodology and adopts FASB Statement No. 114 concepts.

Go to the AICPA Web site's AcSEC Update page for more in-depth information about the issues that the project addresses.

A final SOP is expected to be issued during the fourth quarter of 2000.

Proposed Elimination of Pooling-of-Interests Accounting

The FASB has issued a proposal for public comment that would, among other things, eliminate the pooling of interests method of accounting for business combinations. The FASB tentatively decided that using the purchase method is preferable to allowing more than one method to be used when businesses combine.

Several industry groups have objected to the proposed elimination of the pooling-of-interests method of accounting for certain business combinations. They have argued, among other things, that the proposed accounting rule would preclude many business combinations that make economic and strategic sense.

For information on this issue, visit the FASB's Web site at www.fasb.org.

Resource Central

Training courses, Web sites, publications, and other resources available to CPAs.

Training Courses

The AICPA has developed a number of continuing professional education (CPE) courses that are valuable to CPAs working in or serving the lending and depository institutions industry. Those courses include—

- *Banks, Savings Institutions and Credit Unions: An Accounting and Auditing Perspective* (Product Number 736090). This course provides an excellent introduction to the banking, savings institutions, and credit union industries. It will ensure that you are up-to-date and prepared for the continuing changes in this field.
- *AICPA's Annual Accounting and Auditing Workshop* (2000-2001 Edition) (Product Number 737061 (Text) 187078 (Video)). Whether you are in industry or public practice, this course keeps you current, informed, and shows you how to apply the most recent standards.
- *SFAS 133: Derivative and Hedge Accounting* (Product Number 735180). This course helps you understand GAAP for derivatives and hedging activities. Also, you will learn how to identify effective and ineffective hedges.
- *Independence* (Product Number 739035). This new interactive CD-ROM course will review the AICPA authoritative literature covering independence standards (including the newly issued SECPS independence requirements), SEC regulations on independence, and ISB standards.

- *SEC Reporting* (Product Number 736745). This course will help the practicing CPA and corporate financial officer learn to apply SEC reporting requirements. It clarifies the more important and difficult disclosure requirements.
- *Internal Control Implications in a Computer Environment* (Product Number 730617). This practical course analyzes the effects of electronic technology on internal controls and provides a comprehensive examination of selected computer environments, from traditional mainframes to popular personal computer set-ups.

Online Library

The AICPA has launched a new online learning library—AICPA InfoBytes. An annual fee ($95 for members and $295 for non-members) offers unlimited access to over 1,000 hours of online CPE in one- and two-hour segments. Register as our guest at infobytes.aicpaservices.org.

Publications

CPAs operating in the lending and depository institutions industry may find the following publications valuable:

- *Banks and Savings Institutions Audit and Accounting Guide* (Product Number 011179kk)
- *Audits of Credit Unions Audit and Accounting Guide* (Product Number 012061kk)
- *Audits of Finance Companies* (Product Number 012467kk)
- *The ABCs of Independence Risk Alert.* A must-read primer on the fundamentals of independence. Whether you are unfamiliar with the standards or need a user-friendly refresher course, this Alert is for you.
- *SEC Alert.* Developed in conjunction with the SEC staff, this Alert provides valuable insights into the SEC staff's perspectives on numerous accounting and auditing issues.

- *E-Business Alert.* The "e-world" awaits. Are you ready? Find out what is happening in the realm of e-business and how it will affect your audits in this new Alert.
- *Auditing Estimates and Other Soft Accounting Information* (Product Number 010010kk). This practice aid provides practical guidance for handling the problems related to the audit of soft accounting information, illustrating how SAS No. 57, *Auditing Accounting Estimates,* may be applied by auditors.
- *Accounting Trends & Techniques—2000* (Product Number 009892kk). This publication offers highlights of the latest trends in corporate financial statements. Surveying over 600 public companies, this publication illustrates accounting practices and trends, including presentations and disclosures.

Hotline Help

Accounting and Auditing Technical Hotline

The AICPA Technical Hotline answers members' inquiries about accounting, auditing, attestation, compilation, and review services. Call 1-888-777-7077.

Ethics Hotline

Members of the AICPA Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. Call 1-888-777-7077.

Web Sites

Further information on matters addressed in this Audit Risk Alert is available through various publications and services offered by a number of organizations. Some of those organizations are listed in the table at the end of this section.

This Audit Risk Alert replaces the *Depository Institutions and Lending Industry Developments—1999/2000* Audit Risk Alert.

The *Lending and Depository Institutions Industry Developments* Alert is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Alert, please feel free to share those with us. Any other comments that you have about the Alert would also be appreciated. You may email these comments to rdurak@aicpa.org, or write to:

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Harborside Financial Center
201 Plaza Three
Jersey City, NJ 07311-3881

INFORMATION SOURCES

Organization	*General Information*	*Fax Services*	*Internet*	*Recorded Announcements*
American Institute of Certified Public Accountants	*Order Department* Harborside Financial Center 201 Plaza Three Jersey City, NJ 07311-3881 (888) 777-7077	*24 Hour Fax Hotline* (201) 938-3787	www.aicpa.org	*AcSEC Telephone Line* (212) 596-6008
Bank for International Settlements	Centralbahnplatz 2, Basel, Switzerland (+41-61) 280 80 80	(+41-61) 280 91 00 and (+41-61) 280 81 00	www.bis.org	
Department of Housing and Urban Development	451 7th Street SW Washington, D.C. 20410 (202) 708-1422		www.hud.gov	
Financial Accounting Standards Board	*Order Department* P.O. Box 5116 Norwalk, CT 06856-5116 (203) 847-0700, ext. 10		www.fasb.org	*Action Alert Telephone Line* (203) 847-0700 (ext. 444)

(continued)

INFORMATION SOURCES—*(continued)*

Organization	*General Information*	*Fax Services*	*Internet*	*Recorded Announcements*
Federal Financial Institutions Examination Council	*Washington,D.C.*		www.ffiec.gov	
Federal Home Loan Mortgage Corporation (Freddie Mac)	*Customer Service* 8200 Jones Branch Drive McLean, VA 22102-3107 (800) FREDDIE		www.fhlmc.org	
Federal Deposit Insurance Corporation	*Public Information Center* 801 17th Street, NW Room 100 Washington, D.C. 20434 (800) 276-6003 (202) 416-6940	*Facsimile Bulletin Board System* (804) 642-0003/2036	www.fdic.gov	*Action Update* (202) 898-7210
Federal Reserve System	*Publications Services* 20th and C Streets, NW Washington, DC 20551-0001 (202) 452-3245	*U.S. Department of Commerce STAT-USA/FAX* Some information is available to guest users. Other information requires a subscription fee. (202) 482-0005	www.frb.gov	*Federal Reserve Board Highlights* (202) 452-3206

Mortgage Bankers Association of America	*Publications Department* 1125 15th Street, NW Washington, DC 20005-2766 (800) 793-MBAA	*MBA Fax on Demand* This service is available only to MBA members. For more information, call (800) 909-6222.	www.mbaa.org	
National Credit Union Administration	*Office of Public and Congressional Affairs* 1775 Duke Street Alexandria, VA 22314		*NCUA Bulletin Board* All information is available to guest users (703) 518-6480 *NCUA World Wide Web home page* www.ncua.gov	*Newsline* (800) 755-1030 (703) 518-6339 (Washington, DC area)
U.S. Department of the Treasury—Office of the Comptroller of the Currency	*Publications Control* P.O. Box 70004 Chicago, IL 60673-0004 (202) 874-5000	*OCC Information Line* (202) 479-0141	www.ustreas.gov	
U.S. Department of the Treasury—Office of Thrift Supervision	*OTS Dissemination Branch* 1700 G Street, NW Washington, DC 20552-0001 (202) 906-5900	*PubliFax* (202) 906-5660	www.ots.treas.gov	

(continued)

INFORMATION SOURCES—*(continued)*

Organization	*General Information*	*Fax Services*	*Internet*	*Recorded Announcements*
U.S. Department of Education	*Federal Student Aid Information Center* (800) 433-3243		www.ed.gov	
U.S. General Accounting Office	*Superintendent of Documents* U.S. Government Printing Office Washington, DC 20401-0001 (202) 512-1800	*Information Line* (202) 512-2250	www.gpo.gov	
United States Securities and Exchange Commission	*Publications Unit* 450 Fifth Street, NW Washington, DC 20549-0001 (202) 942-4046 *SEC Public Reference Room* (202) 942-8078	*Information Line* (202) 942-8090 (ext. 3) (202) 942-8092 (tty)	www.sec.gov	*Information Line* (202) 942-8090 (202) 942-8092 (tty)

APPENDIX A

Best Practices for E-Commerce Self-Defense

Web-savvy CPAs can help clients by offering these e-sabotage prevention tips.

- ❑ *Conduct a risk assessment of the enterprise.* If possible, do it before implementing technical controls so that weaknesses can be eliminated before costly adjustments are needed.
- ❑ *Use firewalls to block intrusions.* Pass transmissions through a control point where they can be checked for compliance with security provisions.
- ❑ *Develop security standards.* Communicate security policy to employees so they understand their responsibilities, the penalties for violations, and what to do if they suspect online security has been breached.
- ❑ *Monitor employees' online activity.* Use systems management tools to enforce security policies consistently across multiple online environments and to automate user access. Use e-mail analysis tools to intercept and scan e-mail for possible security violations.
- ❑ *Test defenses.* Conduct a full systems audit, testing security—especially firewalls—to identify potential weak points, including remote access to systems by e-mail, the Internet, and telephone.
- ❑ *Monitor networks for unusual activity.* Determine whether installing additional security measures or systems resources, such as RAM, would reduce the impact of a hacker attack. Also, use intruder detection software to maintain overall awareness of possible threats to systems—for example, surreptitious large-scale incursions during diversionary attacks.

- ❑ ***Get an independent opinion on security measures.*** Have an objective outsider evaluate overall online security, including firewalls, antivirus software, and risk analysis tools.
- ❑ ***Consult the Internet service provider.*** Determine whether it can block attacks before they reach company systems.
- ❑ ***Limit access to e-commerce controls.*** Give access to the fewest people and the fewest systems possible for the minimum time it takes to perform essential functions. Use authentication tools, such as passwords, smart cards, and digital certificates, to verify identities online.
- ❑ ***Inform the proper authorities when systems are violated.*** Stress the importance of preserving system activity logs, which may help identify intruders.

APPENDIX B

AICPA Industry Expert Panel Created

The AICPA has developed an expert panel that focuses on identifying business reporting issues, with an emphasis on audit and accounting matters, in the financial services industry. The Financial Services Expert Panel is one of a number of industry-specific panels that have been created as part of the AICPA's effort to revamp the Institute's volunteer structure.

The Expert Panel will identify and discuss industry-specific emerging issues and their effect on CPAs, identify additional guidance, if any (both traditional and nontraditional), that members need to be effective and to protect the public, and develop plans for providing input on initiatives that should be brought to the attention of standards-setters or the AICPA prioritization mechanism, and other matters.

Joining the Expert Panel

Expert Panel members should be forward-thinking, vision-aligned, cross-functional individuals. In addition, Panel members may be non-CPA business professionals. *Cross-functional* is intended to include members with expertise in the traditional areas of accounting and auditing, as well as awareness and, perhaps, expertise beyond the traditional areas. For example, depending on the needs of the area covered by the Expert Panel, the members might have expertise in assurance services, operational and management issues, technology, corporate governance, legislation, and other areas, in addition to expertise in the traditional areas of accounting and auditing.

Rewards of Joining the Panel. Serving on the Panel is a rewarding and enriching experience. Panel members interact with other top professionals in their industry and address and resolve key forces, issues, and trends shaping the financial services world. Moreover, Expert Panel members take the knowledge and experience they

gain on the Panel with them, enriching themselves, their work, and their firms.

Panel members will serve one-year terms, generally for three consecutive years.

Apply Now. For more information on the Expert Panels or to apply, visit AICPA Volunteer Central at www.skillscape.com/aicpaonline.

www.alcpa.org