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Bank, credit union, and other depository and lending institution industry developments - 2007/08; Audit risk alerts

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AUDIT RISK ALERTS

Bank, Credit Union, and Other Depository and Lending Institution Industry Developments — 2007/08

Strengthening Audit Integrity
Safeguarding Financial Reporting

AICPA®

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Notice to Readers

This Audit Risk Alert is intended to provide auditors of financial statements of banks, credit unions, and other depository and lending institutions with an overview of recent economic, industry, technical, regulatory, and professional developments that may affect the audits and other engagements they perform.

This publication is an *other auditing publication* as defined in AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1). Other auditing publications have no authoritative status; however, they may help the auditor understand and apply the Statements on Auditing Standards.

If an auditor applies the auditing guidance included in an other auditing publication, he or she should be satisfied that, in his or her judgment, it is both relevant to the circumstances of the audit and appropriate. The auditing guidance in this document has been reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

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How This Alert Helps You

.01 This Audit Risk Alert (alert) helps you plan and perform your audits of financial institutions and other lenders. This alert can also be used by an entity's internal management to address areas of audit concern. This alert provides information to assist you in achieving a more robust understanding of the business, economic, and regulatory environment in which your clients operate. This alert is an important tool in helping you identify the significant risks that may result in the material misstatement of financial statements. Moreover, this alert delivers information about emerging practice issues and current accounting, auditing, and regulatory developments.

.02 This alert is intended to be used in conjunction with the AICPA *Audit Risk Alert—2007/08* (product no. 022338kk). This alert can be obtained by calling the AICPA at (888) 777-7077 or going online to www.cpa2biz.com. You should refer to the full text of accounting and auditing pronouncements as well as the full text of any rules or publications that are discussed in this alert.

.03 ***References to Professional Standards***. When referring to the professional standards, this alert cites the applicable sections as codified in the AICPA *Professional Standards* and not the numbered statements, as appropriate. For example, Statement on Auditing Standards (SAS) No. 54, *Illegal Acts by Clients*, is referred to as AU section 317 of the AICPA *Professional Standards*.

Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement

.04 An auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. An auditor's understanding of the entity and its environment consists of an understanding of the following aspects:

- Industry, regulatory, and other external factors
- Nature of the entity
- Objectives and strategies and the related business risks that may result in a material misstatement of the financial statements
- Measurement and review of the entity's financial performance
- Internal control, which includes the selection and application of accounting policies

.05 The financial institutions industry may be subject to specific risks of material misstatement arising from the nature of the business, the degree of regulation, or other external forces (for example, political, economic, social, technical, and competitive forces).

.06 The auditor should obtain an understanding of the entity's objectives and strategies and the related business risks that may result in material misstatement of the financial statements. Business risks result from significant conditions, events, circumstances, actions, or inactions that could adversely affect the entity's ability to achieve its objectives and execute its strategies, or through the setting of inappropriate objectives and strategies. Just as the external environment changes, the conduct of the entity's business is also dynamic, and the entity's strategies and objectives change over time. An understanding of business risks increases the likelihood of identifying risks of material misstatement. However, the auditor does not have a responsibility to identify or assess all business risks. Most business risks will eventually have financial consequences and, therefore, an effect on the financial statements. However, not all business risks give rise to risks of material misstatement.

.07 After obtaining a sufficient understanding of the entity and its environment, including its internal control, an auditor should identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions, account balances, and disclosures based on that understanding.

.08 Understanding and properly addressing, as necessary, the matters presented in this alert will help you gain a better understanding of your client's environment, better assess risks of material misstatement of the financial statements, and strengthen the integrity of your audits.

Economic and Industry Developments

The State of the Economy

.09 When planning and performing audit engagements, an auditor should understand the economic conditions facing the industry in which the client operates. Economic activities relating to factors such as interest rates, consumer confidence, overall economic expansion or contraction, inflation, and labor market conditions are likely to have an effect on the entity's financial statements being audited.

.10 The U.S. real gross domestic product (GDP), the broadest measure of economic activity, measures output of goods and services by labor and property within the United States and increases as the economy grows. According to the Bureau of Economic Analysis, GDP increased at an annual rate of 2.9 percent in 2006, consistent with the pace of growth experienced in 2005 when GDP increased by 3.1 percent. During the first quarter of 2007, GDP increased by an annual rate of only 0.6 percent. However, according to second quarter preliminary estimates, GDP increased at an annual rate of 4.0 percent.

.11 The unemployment rate remained relatively unchanged during 2006, holding between 4.4 percent and 4.8 percent, with an annual average rate of 4.6 percent representing approximately 7 million people. The 2006 rates represent the lowest annual rate and total number of jobless since 2000, according to the U.S. Department of Labor, Bureau of Labor Statistics. During the first half of 2007, the unemployment rate averaged 4.5 percent. These data further demonstrate the economic growth the United States has experienced since the beginning of 2006.

.12 After a period of rising rates during the first half of 2006, the Federal Reserve kept its target for the federal funds rate at 5.25 percent for 10 consecutive meetings (June 2006–August 2007). At that time, the Federal Reserve indicated future federal fund rate adjustments would likely depend upon the outlook for economic growth and inflation. Since its August 2007 meeting and in response to shaky financial market conditions, the Federal Reserve has taken several action steps. It announced that it would provide reserves as necessary through the open market to facilitate the orderly functioning of financial markets by promoting trading in the federal funds market at rates close to the 5.25 percent target rate. On August 17, 2007, it announced that financial market conditions had deteriorated and tighter credit conditions and increased uncertainty has the potential to restrain economic growth. Then at its September meeting, the Federal Reserve decided to lower its target for the federal funds rate 50 basis points to 4.75 percent citing increased uncertainty surrounding the economic outlook. The Federal Reserve also decided to decrease the discount rate 50 basis points to 5.25 percent to consistently keep the spread between the primary credit rate and the target federal funds rate at 50 basis points. Auditors should remain alert to developments in the financial markets and how they may affect your audit engagements.

Industry Trends and Conditions

The State of the Financial Institution Industry

.13 According to the Federal Deposit Insurance Corporation (FDIC) Quarterly Banking Profile issued for the first quarter of 2007, higher credit expense at large institutions and narrower net interest margins at smaller institutions caused a decrease in earnings of FDIC-insured institutions during the quarter. Industry net income was $36 billion for the first quarter of 2007, which is 2.5 percent less than the earnings posted in the first quarter of 2006. This is the largest year-over-year decline in quarterly earnings since 2001. Much of the decrease in income was attributable to a change in the way earnings were reported in the aftermath of large corporate restructurings. Lower operating results at a number of institutions also contributed to the earnings drop. Evidence of pressure on earnings was widespread as a majority of institutions reported lower quarterly net income.

.14 Average return on assets (ROA) for institutions for the first quarter of 2007 was 1.21 percent, compared to 1.34 percent in the first quarter of 2006. Fifty-nine percent of all institutions experienced a decline in quarterly ROA. This is the lowest first quarter ROA for the industry since 2001.

.15 Provisions for loan losses totaled $9.2 billion in the first quarter of 2007. This reflects a 54.6 percent increase compared to the first quarter of 2006. Noninterest expense also increased $3 billion during 2007 as several large banks reported higher payroll expenses. Increased interest income helped to offset these higher costs.

.16 Auditors should consider the pressures financial institutions are facing when planning and performing the audit engagement. Auditors have a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. Paragraph .32 of AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1), explains that when obtaining information about the entity and its environment, an auditor should consider whether the information indicates that one or more fraud risk factors are present. The auditor should use professional judgment in determining whether a risk factor is present and should be considered in identifying and assessing the risks of material misstatement due to fraud. Paragraph .33 of AU section 316 lists three conditions generally present when fraud exists: incentive or pressure to perpetrate fraud, an opportunity to carry out the fraud, and attitude or rationalization to justify the fraudulent action.

The State of the Banking Industry

.17 According to the FDIC's Quarterly Banking Profile, at the end of March 2007 there were 8,650 FDIC-insured commercial banks and savings institutions reporting financial results, which represented a net decline of 31 institutions compared to reporting institutions at the end of 2006. There were 41 new banks reporting during the first quarter while 72 institutions were absorbed by mergers. One FDIC-insured bank, with $15.3 million in assets, failed during the quarter. The FDIC's "problem list" increased during the quarter from 50 to 53 institutions.

.18 Total deposits grew by $70 billion, which was the smallest quarterly increase since the third quarter of 2003. Domestic deposits increased by $63.3 billion during the quarter. Interest bearing account deposits grew by $43.8 billion, which outweighed a decline in noninterest bearing deposits.

.19 As lending markets continue to show weak results, banking executives are searching for alternative uses for excess capital. Since the beginning of 2007, the challenge has been to find appropriate assets to maximize excess capital. The trend, thus far, is to utilize assets outside of the usual industry capital allocations. Banks are beginning to invest in investments like embedded derivates, which are riskier than loans. This is being done in an attempt to deploy excess capital. Another result of increased capital is the issuance of larger dividends to shareholders. The impact of increased dividends to shareholders is a decrease in each respective institution's retained earnings.

The State of Credit Unions

.20 In a June 21, 2007, letter to members, the Chairman of the National Credit Union Administration (NCUA) reported that the condition of the credit union industry remains sound. This statement is based on data from call reports submitted to the association by all federally insured credit unions. The letter points out that very strong share growth, increasing net worth dollar levels, and lower delinquency and charge-off loan ratios have all contributed to the sound state of the credit union industry. The letter explained that loan growth this quarter continued to come from the real estate portfolio. Credit unions that hold real estate portfolios are urged to continue to offer members sound products.

.21 Credit unions are encouraged to continue to assess their asset-liability management and liquidity management planning processes. Auditors should be aware of management's asset-liability and liquidity management processes when performing the audit. Understanding such processes will assist the auditor in the risk assessment. AU section 329, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1), provides guidance to auditors on analytical procedures used during the planning phase of the audit and those used as substantive tests.

NCUA and Financial Crimes Enforcement Network Host First Ever Joint Seminar on Bank Secrecy Act Compliance Programs

.22 The NCUA and Financial Crimes Enforcement Network (FinCEN) recently held a joint Web-based seminar titled "BSA: A Year in Review and Setting the Table for 2007." The goal of the seminar was to educate credit unions about their Bank Secrecy Act (BSA) obligations. More than 2,000 members of the credit union industry participated in the seminar.

The State of Financial Service Companies[1]

.23 Finance companies provide lending and financing services to consumers (consumer financing) and to business enterprises (commercial financing). A number of finance companies engage solely in consumer or commercial financing activities; others provide both types. Examples of financial service companies include insurance companies, businesses that provide financing to entice the purchase of goods, and consumer finance companies.

.24 Numerous state and federal statutes affect finance companies' operations. Some statutes apply only to specific types of activities. Regulations affecting finance companies generally are limited to matters such as loan amounts, repayment terms, interest rates, and collateral; they generally do not address financial accounting and reporting.

Delinquencies Increase in Latest Mortgage Bankers Association National Delinquency Survey

.25 The delinquency rate for mortgage loans on 1-to-4-unit residential properties stood at 5.12 percent of all loans outstanding in the second quarter of 2007 on a seasonally adjusted basis, up 28 basis points from the first quarter of 2007 and up 73 basis points from 1 year ago, according to the Mortgage Bankers Association (MBA) National Delinquency Survey.

.26 The delinquency rate does not include loans in the process of foreclosure. The percentage of loans in the foreclosure process was 1.40 percent of all loans outstanding at the end of the second quarter, which is an increase of 12 basis points from the first quarter of 2007 and 41 basis points from 1 year ago.

.27 The rate of loans entering the foreclosure process was 0.65 percent on a seasonally adjusted basis, 7 basis points higher than the previous quarter and up 22 basis points from 1 year ago. This quarter's foreclosure starts rate is the highest in the history of the survey, with the previous high being last quarter's rate.

.28 Similar to last quarter, the national delinquency and foreclosure rates are being driven by what is taking place in a few large states. Additionally, the performance of prime and subprime adjustable rate mortgages (ARMs) is contributing significantly to the overall results.

.29 As reported in the June 13, 2007, issue of *American Banker*, financial service companies will continue to reach out to the nation's rapidly growing minority community. Financial service companies are focusing on smaller cities such as Albany, New York, and Toledo, Pennsylvania, as alternatives to competing for immigrant deposits in metropolitan cities like New York City or Los Angeles.

The State of Mortgage Banking

.30 *American Banker* recently reported that home resales hit a 4-year low due to continued price decline. Many in the housing industry believe the decline in resales signifies a protracted housing slump. Another issue contributing to

[1] Practitioners may also find the AICPA's Audit Risk Alert *Insurance Industry Developments—2006/2007* helpful when auditing financial service companies. This alert will help you plan and perform your audits by identifying the significant business risks that may result in the material misstatement of your client's financial statements.

sluggish home sales is the rising number of foreclosures of properties financed with subprime debt. Auditors should consider the current real estate climate when conducting an audit of a mortgage company. Awareness of the business environment in which the institution operates could provide valuable insight on loan policies and the organization's internal controls. For example, mortgage companies that are subsidies of insured depository institutions are subject to increased scrutiny from underwriters. Pressure from reduced home sales could entice management to override internal controls. For example, a mortgage banking manager may be enticed to circumvent the company's loan application review policies to make a loan to a high risk borrower. AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement,* and AU section 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*, vol. 1), provide guidance for the auditor's consideration of an entity's internal control in an audit of financial statements. As home sales decline, many financial institutions may begin to aggressively cut expenses. Per AU section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1), auditors have a responsibility to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time not to exceed one year from the date of the financial statements being audited.

.31 Auditors should also consider whether the institution is considering or in the process of restructuring its loan origination or securitization departments. The auditor may refer to Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards Nos. 146, *Accounting for Costs Associated with Exit or Disposal Activities*, and 144, *Accounting for the Impairment or Disposal of Long-Lived Assets,* for guidance. Additional guidance for public companies is included in Securities and Exchange Commission (SEC) Staff Accounting Bulletin (SAB) No. 100, *Restructuring and Impairment Charges*, which provides guidance on the accounting for and disclosure of certain expenses and liabilities commonly reported in connection with restructuring activities and business combinations and the recognition and disclosure of asset impairment charges.

.32 On June 8, 2007, the Federal Financial Institutions Examination Council (FFIEC), which consists of the Board of Governors of the Federal Reserve System, FDIC, NCUA, Office of the Comptroller of the Currency (OCC), and Office of Thrift Supervision (OTS), published final illustrations of consumer information intended to assist institutions as they implement the consumer protection portion of the interagency guidance on nontraditional mortgage product risks. The three illustrations present examples of the types of information contemplated in the guidance. Institutions have discretion in determining whether to tailor and use the illustrations provided.

Federal Reserve Panel Announcement

.33 In June 2007, the Federal Reserve Board announced the panelists for its public hearing under the Home Ownership and Equity Protection Act. They include key players in the home mortgage market, including the subprime sector lenders, brokers, secondary market participants, consumer advocacy and community development organizations, academics and researchers, and state regulators.

.34 The focus of the public hearing is to gather information on how to develop rules to stop fraud and abusive practices in the home mortgage market. The rules must be drafted to sharply and clearly avoid the unintended consequence of restricting consumers' access to responsible subprime credit. Several states are expected to participate in the hearing to draft updated rules on predatory lending.

Small Banks Begin to Enter the Mortgage Sector

.35 As reported in the June 22, 2007, edition of *American Banker*, the recent decline of the subprime mortgage sector could allow smaller banks to emerge as players in the mortgage sector. Many of the national and large regional banks are consumed with problems and damage control as a result of risky lending. In the past, this sector was dominated by conglomerate banks.

Subprime Mortgage Update

.36 On May 17, 2007, Ben S. Bernanke, Chairman of the Board of Governors of the Federal Reserve System, commented that the rise in delinquencies among subprime ARMs was due to several causes. These causes include rising interest rates, moderate economic growth, decline in the housing market, and regional economic problems.

.37 Bernanke noted that the practices of several mortgage originators to loosen underwriting standards contributed to the problems in the subprime market. As the underlying pace of mortgage originations slowed but the demand for securities with high yield rates strengthened, some lenders loosened underwriting standards. The loosened standards undoubtedly contributed to defaults occurring within a few months of origination. Bernanke explained that mortgages sold generally pass a large amount of risk to the investor, rather than being borne primarily by the company that originated the loan, which may have contributed to the loosening of underwriting standards. In addition to weakened standards, incentive structures that tied originator revenue to the number of loans finalized, instead of the quality of loans made, are also a cause for concern.

.38 Despite subprime woes, Bernanke indicated that the market had shown signs of self-correction. Although credit spreads on new subprime securities have risen, the volume of subprime mortgage backed securities issued has slowed. That does not mean that the subprime market has evaporated. Although some subprime lenders have gone out of business, other entities such as hedge funds and investment banks have started to purchase subprime mortgage backed securities. Importantly, Bernanke pointed out that the majority of troubled lenders have not been institutions with federally maintained deposits.

.39 Auditors may need special skills or knowledge to plan and perform auditing procedures for institutions that deal with subprime mortgages. This is very important when considering whether an institution has disclosed its subprime lending activities properly. AU section 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*, vol. 1), states that for some derivatives and securities, generally accepted accounting principles (GAAP) may prescribe presentation and disclosure requirements. Furthermore, AU section 332 advises the auditor to consider the form, arrangement, and content of the financial statements (including the notes) when evaluating the adequacy of presentation and disclosure. Auditors may also consider using a specialist when determining how to audit an entity that deals in derivatives. AU section 336, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1), provides guidance on the use of a specialist during an engagement.

Subprime Strategies

.40 The rapid growth of subprime mortgages has led to the equally rapid growth of subprime mortgage repossessions. Subprime mortgage repossessions occur when a borrower who is unable to make payments must surrender the mortgage to the lender. There are several strategies that lenders can use to help ensure that they survive subprime meltdown. Examples of subprime strategies include retaining sufficient capital to withstand some subprime turn around; maximizing liquidity and if necessary cutting costs; maintaining a strong credit position; having written plans; and being willing to take action against any broker that puts together fraudulent loans.

.41 There is growing speculation that the problems and risks associated with subprime mortgages, for example, increased risk of past due credit card payments, may spread to other financial transactions. According to a June 25, 2007, article in the *Wall Street Journal* titled "Beyond Subprime, Risks Abound," the bond market is one industry that is already feeling the pressure from subprime mortgages. According to Emerging Portfolio Fund Research Global, investors pulled more than $1 billion out of high yield bond funds in the 2 weeks leading up to the June 2007 article. Another concern is the way ARMs will react as subprime woes continue to trickle down the mortgage industry.

.42 Auditors may consider the overall impact of an entity's portfolio of subprime mortgages when auditing the financial statements of a financial institution. The auditor may consider the institution's internal controls as well as policies that affect the management of subprime mortgages, for instance, the amount reported as the allowance for loan and lease losses.

Subprime Foreclosures

.43 Recently the OCC expressed concern over foreclosures due to subprime mortgages, pointing out that the cost of foreclosure extends not only to the borrower, but also to the local communities that may experience a decline in property value and those in the community who may want to refinance or obtain new financing. Leaving a property vacant during foreclosure can create a negative cycle of disinvestment and lead to decline in an entire community. On June 26, 2007, the OCC released an *Insights* report titled "Foreclosure Prevention: Improving Contact with Borrowers." The report is based on strategies banks are using to prevent foreclosures and mitigate credit loss. The OCC believes that early contact with borrowers is critical to minimizing the detrimental effects of foreclosure. If banks are able to keep homeowners in their homes, they prevent credit losses and maintain customer relationships. Another factor that is helping reduce the number of foreclosures is the use of third parties, such as nonprofits or other interested parties. As a result of third party involvement, many nonprofits are offering counseling services to at-risk homeowners across the nation. The OCC offers three strategies that financial institutions may use to reach borrowers who are behind in their mortgage payments. The first two strategies involve direct customer contact by a loan officer or interested third party, such as a nonprofit counseling agency. The third strategy depends on the borrower using a toll-free telephone number to call the loan servicer or a counseling agency. The full text of this *Insights* report can be accessed at www.occ.treas.gov/cdd/Foreclosure_Prevention_Insights.pdf.

.44 On Sept. 4, 2007, the federal financial institution regulators and the Conference of State Bank Supervisors issued a joint statement on loss mitigation strategies for servicers of residential mortgages. This statement encourages federally regulated institutions and state-supervised entities that service mortgage loans to pursue strategies to mitigate losses while preserving homeownership to the extent possible and appropriate. As a number of adjustable-rate mortgages reset, concerns remain that borrowers subject to these significant payment shocks and increased payments will be more likely to default on the loan.

.45 In the statement, the agencies acknowledge that many subprime and other mortgage loans are sold or transferred, commonly into securitization trusts, with the servicing for these securitized loans maintained by the originating institution. Questions have arisen in recent months on the ability of servicers to restructure loans in jeopardy of foreclosure without nullifying the prior sale for accounting purposes under FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. The statement reminds institutions that this authority is governed by the terms of contract documents, typically referred to as pooling and servicing agreements.

.46 This statement urges servicers to use the authority that they have under the governing documents to take appropriate steps when an increased risk of default is identified, including the following:

- Proactively identifying borrowers at heightened risk of delinquency or default, such as those with impending interest rate resets
- Contacting borrowers to assess their ability to repay
- Assessing whether there is a reasonable basis to conclude that default is "reasonably foreseeable"
- Exploring, where appropriate, a loss mitigation strategy that avoids foreclosure or other actions that result in a loss of homeownership

.47 The releases can be found at the FDIC Web site at www.fdic.gov/news/news/financial/2007.

Final Statement on Subprime Lending

.48 On June 29, 2007, the federal financial regulatory agencies (Board of Governors of the Federal Reserve System, FDIC, NCUA, OCC, and OTS) issued the *Statement on Subprime Mortgage Lending* to address issues related to ARMs. The statement can be accessed at www.federalreserve.gov/boarddocs/press/bcreg/2007/20070629/default.htm. The agencies' primary concern is the possibility of "rate or payment shock" to the borrower that may result from the expiration of a fixed introductory rate to an adjustable variable rate for the duration of the loan. The statement is also designed to protect consumers from unfair, deceptive, and other predatory practices and to ensure that consumers are provided with clear and balanced information about the risks of subprime loans.

.49 The statement addresses the need for financial institutions to maintain strong controls to manage the risks associated with these products. Institutions should develop strong controls that monitor whether actual practices are consistent with established policies and procedures. The controls should address compliance and safe guard consumer information concerns. Examples of important controls institutions may adopt include establishing criteria for hiring and training personnel, entering and maintaining relationships with third parties, and conducting ongoing due diligence on third parties.

.50 The statement describes the prudent safety and soundness and consumer protection standards that financial institutions can employ to ensure that loans are made to customers who can afford to make the payments. These standards include a fully indexed, fully amortized qualification for borrowers and cautions on risk-layering features, including an expectation that stated income and reduced documentation should be accepted only if there are documented mitigating factors that clearly minimize the need for verification of a borrower's repayment capacity. Consumer protection standards include clear and balanced product disclosures to customers and limits on prepayment penalties that allow for a reasonable period of time, typically at least 60 days, for customers to refinance prior to the expiration of the initial fixed interest rate period without penalty. It should be noted that there is no supervisory expectation for institutions to waive contractual terms with regard to prepayment penalties on existing loans. The statement reinforces the April 17, 2007, interagency *Statement on Working with Borrowers*, which encouraged institutions to work constructively with residential borrowers who are financially unable or reasonably expected to be unable to meet contractual payment obligations on their home loans. Workout arrangements that are consistent with safe and sound lending practices are generally in the long-term best interest of both the financial institution and the borrower. Auditors should be aware of and document their understanding of an institution's policies in relation to workout arrangements and potential foreclosures. The auditor should determine if the financial institution is properly disclosing any workout agreements it may have with clients. Auditors may refer to AU section 431, *Adequacy of Disclosure in Financial Statements* (AICPA, *Professional Standards*, vol. 1), when considering whether an institution has adequately disclosed the risk of foreclosure as a contingency.

Legislative and Regulatory Developments

Watters v. Wachovia—Where the Supreme Court Decision May Lead U.S. Banks

.51 In an April 2007 decision, the U.S. Supreme Court asserted that the National Bank Act and certain OCC regulations "preempt" state consumer protection laws that subject a national bank's operating subsidy to certain state licensing, reporting, and supervisory requirements. This decision was made even though many in Congress and industry question whether the OCC and OTS are equipped to properly regulate the consumer protection side of business regulation. Federal regulations have, historically, carried an automatic blanket exemption from state consumer protection regulations, and this is an advantage over local banks.

.52 As a result of the decision, state regulators must take a "hands-off" approach when dealing with national bank chains. In addition to that approach, there are questions about what a state can regulate when dealing with the "business of banking." Another interesting consideration is the fact that the OCC and federal courts have not defined what constitutes the business of banking as that business relates to national banks. Readers should remain alert to any developments.

New Regulator for Fannie Mae, Freddie Mac, and the Federal Home Loan Banks

.53 On May 22, 2007, the House of Representatives voted 313 to 104 to approve legislation HR 1427 that would create a new regulator for Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. Included in the bill was an amendment that forbids government-sponsored enterprises from purchasing mortgages from sellers that do not hold social security numbers. The amendment passed 217 to 205; it is yet to be voted on by the Senate. Readers should remain alert to any developments.

BSA and USA PATRIOT Act Regulations

.54 The Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act (USA PATRIOT Act) was passed to strengthen our nation's ability to combat terrorism and prevent and detect money laundering activities in all financial institutions. In March 2006, the USA PATRIOT Act was renewed, making permanent several sun setting provisions, extending two provisions until 2009, and incorporating a number of new right protections. Money laundering provisions of the USA PATRIOT Act described here were made permanent.

.55 Broad authority to develop anti-money laundering regulations applicable to each of the various segments of the financial services industry was delegated to the Treasury Department. Discussed in the following paragraphs are sections of the USA PATRIOT Act that directly relate to financial institution practices.

.56 Section 312 of the USA PATRIOT Act requires U.S. financial institutions to establish due diligence policies, procedures, and controls reasonably designed to detect and report money laundering through correspondent accounts of foreign banks and private banking accounts of non-U.S. citizens. On January 4, 2006, FinCEN issued a final regulation implementing Section 312 of the USA PATRIOT Act. The final rule took effect on February 3, 2006, and superseded the interim final rule issued in July 2002. On March 30, 2006, FinCEN extended the applicability date required by the January 4, 2006, final rule from April 4, 2006, to July 5, 2006, for new accounts opened by U.S. financial institutions. The effective date for existing accounts to comply with the January 4, 2006, final rule remains October 2, 2006. Highlights of the final rule include, among other matters, a requirement for U.S. financial institutions to apply due diligence to correspondent accounts maintained for certain foreign financial institutions and private banking accounts maintained for foreign individuals. The rule also establishes scope requirements.

.57 Sections 313(a) and 319(b) of the USA PATRIOT Act add sections 103.177 and 103.185 to the BSA regulations and are intended to prevent money laundering and terrorist financing through correspondent accounts maintained by U.S. financial institutions on behalf of foreign banks. Auditors should be aware of the guidelines as noted in sections 313(a) and 319(b) that do the following:

- Prohibit financial institutions from establishing, maintaining, administrating, or managing a correspondent account in the United States for, or on behalf of, a foreign shell bank.
- Require financial institutions to take reasonable steps to ensure that correspondent accounts of foreign banks are not used to indirectly provide banking services to a foreign shell bank.
- Require financial institutions to maintain records in the United States identifying the owners of each nonpublicly traded foreign bank that maintains an account in the United States and the bank's U.S. agent authorized to accept service of legal process.
- Require financial institutions to close accounts for, and cease transactions with, any foreign bank for which they are unable to obtain the required information or to assure themselves that the correspondent account is not being used to indirectly provide services to a foreign shell bank.
- Require financial institutions to maintain records for five years after an account is closed.

.58 Section 314 of the USA PATRIOT Act adds sections 103.100 and 103.110 to the BSA regulations, which establish procedures that encourage information sharing between governmental authorities and financial institutions and among financial institutions themselves. Section 314 requires a financial institution to do the following:

- Diligently search records and documents to determine whether the institution maintains or has maintained accounts or engaged in transactions with an entity or person listed in a request submitted by the FinCEN. The records search must cover all current accounts, accounts opened in the past 12 months, and financial transactions that occurred in the past 6 months.
- Notify FinCEN if an account or transaction is detected.
- Appoint a contact person.
- Maintain adequate procedures to ensure confidentiality of FinCEN requests.

.59 Section 326 of the USA PATRIOT Act requires the Secretary of the Treasury to jointly prescribe with each of the agencies, the SEC, and the Commodity Futures Trading Commission, a regulation that, at a minimum, requires financial institutions to (1) implement reasonable procedures to verify the identity of any person seeking to open an account, to the extent reasonable and practicable, (2) maintain records of the information used to verify the person's identity, and (3) determine whether the person appears on any lists of known or suspected terrorists or terrorist organizations provided to the financial institution by any government agency. This final "know your customer" regulation applies to banks, savings associations, credit unions, private banks, and trust companies.

.60 Section 326 also contains procedures for examining each domestic and foreign banking organization's customer identification program (CIP). The procedures are designed to help financial institutions fully implement the new CIP requirements and facilitate a consistent supervisory approach among the federal financial institutions regulatory agencies. On April 28, 2005, the agencies issued *Interagency Interpretive Guidance on Customer Identification Program Requirements*. This was issued to provide interpretive guidance with respect to the CIP rule.

The "Death Penalty Law"

.61 Congress is expected to vote on a new law that many in the banking industry have labeled the "Death Penalty Law." The proposed law gets its name from the nature and severity of punishment if a federally chartered financial institution is convicted of money laundering. If convicted, the financial institution will lose its charter and close. If the institution is state chartered, its insurance coverage will be terminated.

.62 Many top bank executives are lobbying the U.S. Congress in an effort to slow the passage of legislation. This is being done because executives believe the new law creates an unreasonable standard for financial institutions. For more information, access www.bankersonline.com/articles/bhv01n03/bhv01n03a10.html. AU section 317, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1), provides guidance on the auditor's responsibility when a possible illegal act, for example, an unauthorized transaction, is detected.

Basel II Update

.63 On December 26, 2006, the federal bank and thrift regulatory agencies issued a notice of proposed rulemaking (NPR) seeking comment on possible modifications to the risk based capital standards for all banks, bank holding companies, and savings associations not covered under the risk based capital framework proposed in the Basel II NPR. Comments were accepted through March 26, 2007. It should be noted that Basel II is not all inclusive because it only affects the largest banking institutions.

.64 The federal bank and thrift agencies recommend the following modifications:

- Modernize the risk based capital rules to ensure that the capital framework is able to reliably measure risk in the banking system.
- Mitigate the differences that may arise as a result of differences in capital requirements between banks that adopt Basel II and those banks that continue to apply existing capital rules.
- Ensure that implementation is simple for banks that are subject to the existing risk based capital rules.

.65 This NPR allows banking organizations to early adopt the modifications or remain subject to the agencies' current risk based capital rules. For more information, visit www.fdic.gov/news/news/financial/2006/fil06111.html.

.66 The federal bank and thrift regulatory agencies have also sought comment on proposed guidance describing the agencies' expectations and concerns about the adoption of Advanced Internal Ratings Based (IRB) Approach for credit risk and the Advanced Measurement Approaches (AMA) for operation risk under the Basel II capital framework. The proposed guidance also establishes standards for supervisory review and capital assessment under Pillar 2 of the Basel II framework. Highlights of the proposal are summarized in the following list:

- The proposed guidance is required for banking organizations that implement the proposed Basel II framework.
- The proposed new guidance should provide more direction in instances where prudential issues or industry standardization is of significant importance.
- The guidance should also provide banks with a clear description of the essential components of an acceptable IRB framework.
- The guidance also highlights supervisory standards that banks can follow to implement and maintain an AMA framework for regulatory capital purposes.
- Pillar 2 has three fundamental objectives: comprehensive supervisory assessment of capital adequacy, bank compliance with regulatory capital requirements, and bank implementation of an internal capital adequacy assessment process.
- It is important to note that the proposed guidance should not be construed as the agencies' predisposition of the Basel II NPR.

Banking Agencies Reach Agreement on Basel II Implementation

.67 The Federal Reserve, OCC, OTS, and FDIC reached an agreement regarding the implementation of Basel II in the United States. The agreement resolves the remaining major issues and should lead to finalization of a rule that implements advanced approaches for computing large banks' risk based capital requirements.

.68 The agencies agree that rules implementing the advanced approach should be finalized expeditiously and should be consistent in most regards to international approaches. The agencies also agree that two transition periods will be required to fully implement the rules. Highlights of the agencies' release are included in the following list:

- The agreement retains the NPR's transitional floor periods.
- At the end of the second transition year period, the agencies intend to publish a study that evaluates the new framework to determine if there are any material deficiencies.
- The agencies have agreed to eliminate language in the NPR concerning the 10 percent limitation on aggregate reductions in risk based capital requirements.
- The agencies believe the annual review process is consistent with recommendations of the U.S. Government Accountability Office and that it provides a prudent framework for managing the implementation of Basel II in the United States.
- The agencies also agreed to proceed with the issuance of a proposed rule that would allow all noncore banks to adopt a standardized approach under Basel II. This would eliminate the adoption of Basel 1AA.

Proposed Update of Section 12 of the Code of Federal Regulations 563.81

.69 The OTS recommended a rule change to Section 12 of the Code of Federal Regulations (CFR) 563.81. The proposal serves as a final revision of Section 12 of CFR 563. The final rule updates regulations that require savings associations to obtain approval before they may include subordinated debt securities or mandatorily redeemable preferred stock in supplementary (tier 2) capital. The final rule removes several unnecessary or outdated requirements and conforms other provisions, such as maturity period requirements and purchaser restrictions. The final rule also reconciles conflicting rules, adds appropriate statutory references, and rewrites the rule in plain language. The effective date for the final rule is April 1, 2007.

FDIC Improvement Act Filers

.70 Banking regulators continue to assess the requirements for nonpublic and nonaccelerated FDIC Improvement Act (FDICIA) filers under Part 363 of the FDICIA. FDIC is currently revising Part 363. Readers are advised to monitor the progress of the revision. In anticipation of the changes to Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards"), the AICPA's Auditing Standards Board (ASB) decided to defer the issuance of the revised AT section 501, *Reporting on an Entity's Internal Control Over Financial Reporting* (AICPA, *Professional Standards*, vol. 1), until the PCAOB issued its amendments and the ASB has time to consider them. On July 25, 2007, the PCAOB issued Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards"), which is effective for audits of internal control over financial reporting required by Section 404(b) of the Sarbanes-Oxley Act of 2002 for fiscal years ending on or after November 15, 2007. Earlier adoption is permitted at any point after SEC approval. When Auditing Standard No. 5 becomes effective, it will supersede Auditing Standard No. 2. In the interim, to avoid inconsistencies between AT section 501 and SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), which was issued in May 2006, the following conforming changes were made to AT section 501 to bring that standard into conformity with corresponding aspects of AU section 325:

- Deleting the term *reportable condition* and its definition
- Replacing the definition of the term *material weakness*
- Introducing the terms *control deficiency* and *significant deficiency* and their related definitions
- Replacing the guidance on evaluating control deficiencies with the relevant guidance from AU section 325
- Replacing the term *audit committee* with the term *those charged with governance,* defined in AU section 339, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1), to describe the party to whom the practitioner must communicate significant deficiencies and material weaknesses

- Identifying areas in which a control deficiency ordinarily is at least a significant deficiency in internal control
- Identifying indicators of a control deficiency that should be regarded as at least a significant deficiency and a strong indicator of a material weakness in internal control
- Requiring the practitioner to communicate to management and those charged with governance, in writing, significant deficiencies and material weaknesses

.71 The ASB conferred with the banking regulators on the decision to temporarily "freeze" the AT section 501 project until the PCAOB completed its revisions to Auditing Standard No. 5. Now that the standard is issued, the AT section 501 task force has resumed its work and plans to issue an exposure draft in late 2007 or early 2008. In the interim, banking regulators have indicated that they will continue to apply their previous guidance to nonpublic FDICIA institutions and nonaccelerated public FDICIA institutions subject to the FDICIA internal control reporting requirements. The FDIC has not issued any official guidance to this effect, but the FDIC's Financial Institution Letter FIL-122-2004, which outlines the requirements for nonpublic and nonaccelerated public FDICIA filers, is relevant. Auditors are urged to consult the FDIC Web site (www.fdic.gov) for official communications.

Reminder of Supervisory Guidance for Financial Institutions Affected by Hurricane Katrina

.72 On February 5, 2007, the FFIEC issued *Reminder of Supervisory Guidance for Financial Institutions Affected by Hurricane Katrina* for immediate release. The intent of the guidance is to remind financial institutions in the U.S. Gulf Coast region that the guidance outlined in Hurricane Katrina Examiner Guidance remains in effect and should be referred to when making decisions regarding payment deferrals, loan refinancing, extensions, restructurings, or other payment programs. Although loan workout programs may involve protracted payment plans, ultimately the loan should be repaid.

.73 The agencies and state supervisory authorities in Alabama, Louisiana, and Mississippi continue to remind financial institutions doing business in the Gulf Coast region that working constructively with borrowers is in the best interest of both the financial institution and the customer.

The SEC's Executive Compensation and Related Person Disclosure

.74 The SEC issued Release No. 33-8732A on August 29, 2006, which adopts amendments to the disclosure requirements for executive and director compensation, related person transactions, director independence, and other corporate governance matters and security ownership of officers and directors. These amendments apply to disclosure in proxy and information statements, periodic reports, current reports, and other filings under the Securities Exchange Act of 1934 and to registration statements under the Securities Exchange Act of 1934 and the Securities Act of 1933. The SEC is also adopting a requirement that disclosure under the amended items generally be provided in plain English. This rule is effective November 7, 2006.

.75 Additionally, on August 29, 2006, the SEC requested additional comments on a proposed amendment to the disclosure requirements for executive and director compensation, which would require disclosure for three additional highly compensated employees. The full text of the release can be viewed at www.sec.gov/rules/proposed/2006/33-8735.pdf.

SEC Disclosure Questions and Answers on Executive Compensation and Related Person Disclosure Transition

.76 Additionally, the SEC has published a set of questions and answers (Q&A) representing the staff's views on questions it has received regarding issuers' transition to compliance with the amendments and new rules adopted by the SEC in the Executive Compensation and Related Person Disclosure rulemaking. The nine Q&A cover the effective date of the new rules and early compliance with the new rules. The Q&A can be found at www.sec.gov/divisions/corpfin/faqs/execcompqa.pdf.

FDIC Rule Revisions

.77 The FDIC issued a final rule repealing Part 349 of the FDIC Rules and Regulations, Reports and Public Disclosure of Indebtedness of Executive Officers and Principal Shareholders to a State Nonmember Bank and Its Correspondent Banks. Auditors should note that repeal of the rule does not eliminate restrictions on loans made to bank executive officers and shareholders. The repeal does eliminate reporting requirements and public disclosure of insider loans.

.78 The FDIC issued a final rule on Part 328 of the FDIC Rules and Regulations, *Advertisement of Membership*. Recent amendments to the Federal Depository Insurance Reform Act of 2005 required the FDIC to prescribe an official sign that all FDIC-insured depository institutions would be required to display. The amended rule accomplishes that requirement and provides for other changes to the regulation.

.79 The FDIC also issued final rules to amend Part 327 of the FDIC Rules and Regulations. The first rule creates a new system for risk based assessments and sets assessment rates as of January 1, 2007. The other rule sets the designated reserve ratio at 1.25 percent. The amendments were made to implement the Federal Depository Insurance Reform Act of 2005. The rules are designed to make the insurance assessment system's reaction to changes in an institution's risk profile more efficient. The final rule took effect January 1, 2007.

.80 On October 16, 2006, the FDIC Board of Directors approved a final rule to implement the One Time Assessment Credit as required by the Federal Depository Insurance Reform Act of 2005. Under the final rule, eligible institutions will share in an aggregated 1-time deposit insurance assessment credit of $4,707,580,238.19. The final rule outlines who is eligible for the 1-time credit as well as the guidelines when applying the credit. The final rule took effect on November 17, 2006.

Revised Interagency Policy Statement on the Allowance for Loan and Lease Losses

.81 The OCC, Board of Governors of the Federal Reserve System, FDIC, OTS, and NCUA have revised the banking agencies' 1993 policy statement on the allowance of loan and lease losses (ALLL).

.82 The agencies' revised their policy in an effort to be more consistent with GAAP and more recent supervisory guidance. The two major revisions to the agencies' 1993 policy statement are as follows:

1. The extension of applicability to credit unions
2. A frequently asked questions section designed to assist institutions in complying with GAAP and ALLL guidance

.83 The revised policy statement applies to all depository institutions (except U.S. branches and agencies of foreign banks) that are supervised by the OCC, Board of Governors of the Federal Reserve System, FDIC, OTS, and the credit unions insured and supervised by the NCUA. U.S. branches and agencies of foreign banks continue to be subject to any separate guidance issued by their respective supervisory agency.

.84 The revised policy reiterates key concepts and requirements included in GAAP and existing ALLL guidance. The principal sources of guidance include FASB Statement Nos. 5, *Accounting for Contingencies*, and 114, *Accounting by Creditors for Impairment of a Loan—an amendment of FASB Statements No. 5 and 15*. The FASB also issued an article that presents Q&A to provide specific guidance on the application of ALLL policy. For more information, please visit www.fdic.gov/news/news/financial/2006/fil06105a.pdf. The FASB is also working on a project to address disclosures related to the allowance for loan losses for financing receivables (loans and finance leases pursuant to FASB Statement No. 13, *Accounting for Leases*). For more information, visit the FASB Web site at www.fasb.org.

.85 Because ALLL represents one of the most significant estimates in a financial institution's financial statements (and regulatory reports), auditors should develop an understanding of the estimation methodology of the institution. It is important to note that the auditor's primary concern is to determine, through audit procedures, that the loan loss estimate is not materially misstated. AU section 342, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1), provides guidance to auditors when auditing accounting estimates as described above. AU section 342 details how important it is for the independent auditor to gain an understanding of the methods used by management to make accounting estimates. The section also describes how the auditor might evaluate the reasonableness of estimates during testing.

.86 The auditor typically achieves objectives for auditing the allowances by testing management's estimates of the allowance based on available and relevant information regarding loan collectibility. The auditor is not responsible for estimating the amount of the allowance or ascertaining the collectibility of each, or any, specific loan included in an institution's loan portfolio. However, the auditor's objective of audit procedures for credit losses is to obtain sufficient appropriate audit evidence that the loan loss estimate is not materially misstated. Some questions include the following:

- Are the allowance for loan losses and the allowance for credit losses on off-balance sheet credit exposures reasonably estimated in accordance with GAAP to cover the amount of probable credit losses inherent in the loan portfolio and in off-balance sheet financial instruments, respectively, at the balance sheet date?
- Are controls over the allowance estimation process operating effectively?

- Is the allowance calculation properly documented and in accordance with current accounting and regulatory guidance?
- Are disclosures adequate?
- Is the allowance excessive, or does it imply shortfall?
- Is there directional consistency between credit quality indicators (for example, charge-offs versus delinquencies, and loan-loss provision levels versus allowance levels)?

Commercial Real Estate Update

.87 Major commercial real estate (CRE) sectors include office, hotel, industrial, multifamily, and retail. According to the FDIC, CRE debt measured $3 trillion in the first quarter of 2007, compared to $2.3 trillion in 2006. The real estate industry continues to grow, albeit at a slower rate compared to 2006. The CRE market has maintained its strength despite the consumer housing slowdown.

.88 On December 12, 2006, the FDIC, OCC, and Board of Governors of the Federal Reserve System issued joint *Guidance on Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*. The guidance reminds institutions that strong risk management practices and appropriate levels of capital are essential elements of a sound CRE lending program, particularly when an institution has a large concentration in CRE loans. Highlights include the following:

- There is growing concern that rising CRE concentrations may expose the institutions to unanticipated earnings and capital volatility in the event of adverse changes in the general CRE market.
- Guidance issued by the institutions addresses sound risk management practices for concentrations of CRE lending.
- The guidance includes criteria for supervisors, including numerical indicators for institutions with potentially significant CRE loan concentrations that may warrant more scrutiny.
- The guidance is not intended to limit banks' CRE lending because banks serve an important role in their communities by supplying credit for business and real estate development.

CRE Examination Issues and Best Practices

.89 Recently the FDIC issued an article on CRE underwriting and loan administration practices, recurring examination issues, and best practices for managing CRE portfolios in the current business environment. It is important to note that many institutions are experiencing moderate to rapid growth in CRE lending portfolios. As a result, many of the financial institutions consider such portfolios as a viable market niche. Larger financial institutions continue to use pricing advantages over smaller community banks in other areas, such as home equity lines or customer financing. Smaller community banks use their knowledge of the local market and borrowers to compete with the larger institutions.

.90 The FDIC is very concerned about the trends in underwriting and management in CRE lending. During a recent examination, it was noted that the most worrisome findings were a lack of construction supervision, weak appraisal review programs, inadequate knowledge of lending markets, and poor loan structuring. It was also noted that most institutions failed to properly monitor their CRE portfolios properly or failed to comply with the requirements of Part 365 of FDIC Rules and Regulations, *Real Estate Lending Standards*.

.91 Although many institutions have increased their exposure to CRE lending risks, they have not implemented an adequate monitoring system. Some institutions did not know what percentages of their CRE portfolio investments were concentrated as low, moderate, or more risky. Common monitoring deficiencies include failure to do the following:

- Establish exposure limits
- Prepare reports that provide sufficient relevant information
- Prepare timely concentration reports
- Track exceptions
- Track aggregate loan amounts
- Consider commitment amounts when computing loan to value limits

.92 FDIC examiners also feel that many institutions overlook the importance of market analysis. In some cases, the examiners determined that institutions had not bothered to perform market analysis of key lending areas. It was also noted that loan to value limits were not established as a supervisory tool. There were a number of instances noted by the examiners of loans structured with weak or lenient loan terms. Conditions included the following:

- Over-reliance on collateral values instead of cash flow
- Liberal use of interest or other reserves
- Loans with balloon maturities secured by undeveloped land
- Letters of credit and unsecured loans granted for the purpose of investing in real estate developments (primarily in the Southeastern United States)

.93 Lastly, examiners noted that many institutions did not maintain proper oversight over the appraisal process. The following findings were noted during the examination:

- Missing or incomplete internal reviews of appraisals
- Inadequate appraisals or violations of FDIC Rules and Regulations concerning appraisals
- Loan funding prior to receipt and review of appraisals
- Including the proposed loan amounts on appraisal engagement letters
- Extending funds to customers based on future gross sell-out values of real estate projects

.94 Although the examiners noted several deficiencies, they also discovered several "best practices" that institutions may consider implementing to control their CRE lending portfolios. Examples of the best practices are as follows:

- The Board of Directors should approve the scope of lending activities and the way real estate loans are processed, serviced, and collected. Market conditions, concentrations, and lending activity should be monitored on a consistent basis, with timely and adequate reports made to the Board of Directors.

- Internal and external factors should be considered during the formation of loan policies. Examples of factors to consider include the organization's size, strategic plan, and the expertise of the institution's staff.
- Prudent underwriting standards should be developed. The standards should consider the capacity of the borrower and the income from the underlying property to service the debt.
- Lending policies should reflect the level of risk that is acceptable to the institution's Board of Directors. Clearly measurable limits that include maximum loan amounts, maturities by type of property, amortization schedules, pricing structure, and loan to value limits should be reflected.
- Loan administration policies and procedures should address the type and frequency of financial statements required based on the type of loan. Collateral evaluations, adequate construction inspections, and other requirements may also be useful.

.95 Historically, financial institutions have generally suffered severe losses as a result of the loss of expected cash flows due to loan defaults and inadequate collateral. For example, significant credit losses on real estate loans have occurred, due largely to downturns in regional and national real estate markets but also because of other general economic conditions and higher risk lending activities. Therefore, the auditor needs to assess the existence, valuation, and ownership of the collateral supporting the client's receivables and to determine if the internal control systems have been properly designed and are effective. The auditor can observe the CRE lending at the client and plan accordingly. Some issues auditors may want to consider include, but are not limited to, those described in the following sections.

.96 Certain real estate loan arrangements, in which the lender has virtually the same risks and potential rewards as those of the owners of the property, should be classified and accounted for as investments in real estate and not CRE loans. Certain acquisition, development, and arrangements should be accounted for as investments in either real estate (in conformity with FASB Statement Nos. 66, *Accounting for Sales of Real Estate*, and 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*) or real estate joint ventures (in conformity with the provisions of Statement of Position [SOP] 78-9, *Accounting for Investments in Real Estate Ventures* [AICPA, *Technical Practice Aids,* ACC sec. 10,240]; FASB Staff Position [FSP] SOP 78-9-1, "Interaction of AICPA Statement of Position 78-9 and EITF Issue No. 04-5;" Emerging Issues Task Force [EITF] Issue No. 04-5, "Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights;" and FASB Statement No. 34, *Capitalization of Interest Cost*, as amended by FASB Statement No. 58, *Capitalization of Interest Cost in Financial Statements That Include Investments Accounted for by the Equity Method*). Additionally, provisions of FASB Interpretation No. (FIN) 46(R), *Consolidation of Variable Interest Entities (revised December 2003)*, should be considered for real estate held joint ventures or partnerships. FIN 46(R) clarified the application of Accounting Research Bulletin No. 51, *Consolidated Financial Statements*, to certain entities in which equity investors do not have the characteristics of a controlling interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support.

.97 The federal banking and thrift agencies and the NCUA require real estate appraisals for properties over defined limits. Many fair values will be based on valuations by independent appraisers.[2] In applying audit procedures to real estate loans, the independent accountant can evaluate the fair value of the underlying collateral (including those held for sale) and note contents of loan files that include collateral description and valuation. The auditor often relies on representations of independent experts, particularly appraisers and construction consultants, to assist in the assessment of real estate collateral. AU section 336 provides guidance in this area. Independent appraisals may be considered acceptable audit evidence. The quality of appraisals varies, however, and in some instances, the independent accountant may have reason to believe certain assumptions underlying appraisals are unrealistic. The independent accountant needs to understand and consider the approaches and assumptions used in obtaining the appraised value. The current downturn in the real estate market increases audit risk surrounding the valuation of receivables; the institution will have to absorb losses between actual and appraised values if credit quality deteriorates and borrowers default.

.98 Additionally, AU section 342 provides guidance on auditing accounting estimates (such as estimates of fair values, discussed previously, and estimates of loan losses). AU section 342 discusses how an independent accountant obtains an understanding of how management developed estimates, concentrating on the key factors and assumptions used. It also discusses how the independent accountant evaluates the reasonableness of those estimates. AU section 328, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*, vol. 1), establishes standards and provides guidance on auditing fair value measurements and disclosures contained in financial statements.

.99 Auditors should note management's general attitude toward CRE lending policies when considering an institution's internal controls. Strong CRE lending policies and a diligent Board of Directors could assist the independent auditor when assessing control risk. Auditors should refer to AU sections 314 and 318 for guidance when considering an entity's internal controls. Auditors should also consider management's attitude toward CRE lending policies and internal controls as they relate to the management representation letter. For guidance on management representations, auditors should refer to AU section 333, *Management Representations* (AICPA, *Professional Standards*, vol. 1).

Market Risk Capital and the Applicability of Market Risk Capital Rules

.100 The July 18, 2007, edition of the Financial Institution Letter (FIL-64-2007) reminds financial institutions that reporting a significant amount of trading assets on the institution's balance sheet or increasing the percentage

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[2] On June 22, 2006, the Federal Deposit Insurance Corporation, Federal Reserve Board, Office of the Comptroller of the Currency, Office of Thrift Supervision, and National Credit Union Administration released an interagency statement and frequently asked questions regarding revisions made to the Uniform Standards of Professional Appraisal Practice (USPAP). Under the agencies' appraisal regulations, regulated institutions must ensure that appraisals supporting federally related transactions adhere to USPAP. The interagency statement provides an overview of the USPAP revisions and the ramifications of these revisions to regulated institutions' compliance with the agencies' appraisal regulations.

of assets reported as trading may subject that institution to the market risk capital requirements of Part 325, Appendix C of the FDIC's Rules and Regulations. This rule applies to banks with trading activity of $1 billion or more, or at least 10 percent or more of total assets. Trading activity is usually reported on an institution's quarterly call report.

.101 Financial institutions should be aware of the implications and potential impact of FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115*. Application of FASB Statement No. 159 could result in institutions meeting the market risk capital requirements. The market risk capital rules require institutions to have certain risk management systems in place prior to the performance of any trading activity that is above $1 billion or at least 10 percent of total assets. Institutions that are subject to market risk capital requirements are required to measure their market risk using value-at-risk models. In addition to risk management systems, institutions should contact the FDIC in preparation for compliance with the market risk capital requirements.

.102 Auditors should consider the institution's risk management systems and controls if the institution meets the market risk capital requirements as outlined in Appendix C of the FDIC's Rules and Regulations. The auditor may inquire about the institution's risk management systems when considering the entity's internal controls. The auditor should consider whether the entity's risk management systems can be circumvented by collusion or fraud. AU sections 314 and 318 may provide some guidance when considering the entity's risk management systems. Auditors may also consider using a specialist if the institution is implementing the capital risk requirements for the first time. AU section 336 may provide guidance for the auditor considering the use of a specialist.

Audit and Attestation Issues and Developments

Fraud in the Industry

Money Laundering

.103 The U.S. Departments of Treasury, Justice, and Homeland Security joined together in issuing the 2007 National Money Laundering Strategy, a report detailing efforts to dismantle money laundering rings and terrorist financing networks and bring these criminals to justice. The 2007 strategy is based on data and analysis from the 2006 Money Laundering Threat Assessment.

.104 The 2007 strategy builds on initiatives and programs pioneered in preceding National Money Laundering Strategies. The Assistant Attorney General believes that implementation of a sound strategy is the key to success in the fight against money laundering and that constant searching by criminals for new ways to launder and hide dirty money is evidence of successful regulatory and law enforcement efforts to safeguard the banking system. With an aim at continuing these robust efforts, the 2007 strategy places an emphasis on bolstering the efficiency of the anti-money laundering processes currently in place.

.105 The 2007 strategy focuses on leveling the playing field internationally, helping to ensure that U.S. financial institutions are not disadvantaged through the implementation of controls and standards to combat money laundering and terrorist financing. Indeed, money laundering is a global threat that the United States is working to address through international bodies, including the Financial Action Task Force, and through direct private sector outreach in regions around the world. More information is available at www.treas.gov/press/releases/hp386.htm.

.106 When obtaining an understanding of a financial institution's internal control system, auditors may consider controls that focus on money laundering. AU sections 314 and 318 provide guidance on an independent auditor's consideration of an entity's internal control in an audit of financial statements.

Mortgage Fraud

.107 Lower interest rates helped create the housing boom of the early 2000s. Consumers and investors took advantage of lower interest rates to purchase, upgrade, or invest in the real estate market. To keep up with demand and work with borrowers, certain financial institutions created new, nontraditional mortgage products that increased the dollar amount of mortgage individuals who were willing to finance to purchase real estate. In effect, the products turned the real estate market into a "golden egg" search as investors armed with excess capital searched for investments.

.108 The new mortgage products also opened the door for unscrupulous individuals who figured out ways to manipulate circumstances to their advantage. For example, a mortgage broker could bundle several subprime mortgages and sell them to an unsuspecting buyer. Another example of fraud in the mortgage industry is the use of false property appraisals.

.109 In the spring of 2007, the FBI had 1,036 pending mortgage fraud investigations, a substantial increase compared to prior years. Most types of mortgage fraud fall into two categories:

- Fraud for property that typically involves a borrower who will overstate income or asset values on his or her financial statement to qualify for a property loan. When the borrower fails to met the mortgage payment, he or she sells the property at a profit based on appreciation.
- Fraud for profit that involves complicated schemes and is generally harder to detect. These types of fraud usually involve several members, including some insiders.

.110 In addition to understanding the client and proper audit planning, auditors should be alert for possible indicators that could be signs of fraud. In performing the audit, auditors should consider whether the institution has done the following:

- Established a system to monitor concentration of risk by broker and project
- Performed internal audits of loan origination documentation
- Established clearly defined quality control programs
- Established dual controls over loan origination and fund disbursement

- Conducted background checks on new employees
- Provided ongoing employee training and oversight

.111 AU sections 314 and 318 require the auditor to obtain an understanding of internal control that will enable the auditor to identify the types of potential misstatements of management's assertions, consider factors that affect the risk of material misstatement, design tests of controls where applicable, and design substantive tests. As the auditor gains an understanding of an entity's internal control, he or she may determine areas where fraud could occur. See AU section 316 for guidance on fraud related issues when conducting a financial statement audit. AU section 317 may also be useful to auditors when conducting an audit of an institution's financial statements. Auditors should also consider management's attitude toward CRE lending policies and internal controls as they relate to the management representation letter. For guidance on management representations, auditors should refer to AU section 333.

Revised Bank Secrecy Act/Anti-Money Laundering Examination Manual

.112 On August 24, 2007, the FFIEC released the revised Bank Secrecy Act/Anti-Money Laundering (BSA/AML) Examination Manual (manual). The revised manual reflects the commitment of the federal and state banking agencies and the FinCEN to provide consistent guidance on risk based policies, procedures, and processes for banking organizations to comply with the BSA and safeguard operations from money laundering and terrorist financing. The 2007 edition clarifies supervisory expectations since the July 28, 2006, update.

.113 On November 9, 2006, FinCEN released an advisory to alert financial institutions of some of the potential money laundering risks associated with providing financial services to shell companies. Although many shell companies are formed for legitimate reasons, others have been used for illicit purposes. Shell companies provide an opportunity for foreign or domestic entities to move money by wire transfer or other methods, whether directly or through a correspondent banking relationship, without company owners disclosing their true identities or the nature of the transaction. Billions of dollars have been moved globally by shell companies. Banks often face the following challenges when filing suspicious activity reports involving shell companies:

- Inability to obtain information necessary to identify originator or beneficiaries of wire transfers
- Payments that do not state a specific purpose or contract number
- Multiple high volume payments or transfers between shell companies with no apparent legitimate business purpose
- An unusually large number and variety of beneficiaries that receive wire transfers from one company
- Goods or services listed on transfer reports that do not match the industry in which the entity works

.114 To safeguard against the risk of money laundering by shell companies, financial institutions should assess the risks involved with each shell company relationship and take steps to ensure that the risks are appropriately and effectively identified and managed in accordance with their BSA obligations. All financial institutions should periodically evaluate internal policies, controls, systems, and training programs designed to prevent, detect, and report possible money laundering involving shell companies. Auditors may consider documenting the controls an entity has in place concerning money laundering and other suspicious activity when documenting their understanding of internal controls. See AU sections 314 and 318 for guidance on the independent auditor's consideration of an entity's internal control in an audit of financial statements in accordance with generally accepted auditing standards (GAAS).

.115 On July 13, 2007, FinCEN issued guidance for financial institutions with account relationships that law enforcement may have an interest in ensuring remain open, notwithstanding suspicious or potential criminal activity in connection with the account. The intent of the guidance is to combat money laundering terrorist financing and other crimes. FinCEN acknowledges that the right to open or close an account remains with each financial institution, each using their standards and policies.

.116 When a law enforcement agency requests that an account remain open, it should be in writing. The requests should come from the U.S. Attorneys Office or be issued by a supervisory agent. The written request should indicate that the agency has requested the account remain open and the purpose of the request. The request should also state the duration for which the account should remain open, which should not exceed six months. Although there is no record keeping requirement under the BSA for this type of correspondence, FinCEN recommends that financial institutions maintain such requests. If the financial institution is aware that the account is under investigation, FinCEN recommends the institution contact law enforcement before making any decision regarding the status of the account. Auditors should be aware of the institution's policies, procedures, and processes that address identification of suspicious activity in accordance with the BSA/AML compliance program.

.117 On June 22, 2007, the FDIC Chairman applauded FinCEN for addressing the need to tailor administration of the BSA to the many different risk profiles of community banks. The Chairman welcomed the continued opportunity to continue working with FinCEN and other regulatory agencies to ensure that BSA guidance and procedures are efficient and effective for all banks.

.118 Financial institutions often face common problems when it comes to the BSA. Examples include a lack of written policies, failure to conduct periodic transaction reviews in a timely matter, lack of an independent and sufficiently knowledgeable reviewer, and failure to include overall integrity of the program within the review.

Third Party Risks

.119 The FDIC is increasingly concerned with the use of third party entities that act as agents between consumers and financial institutions, especially community banks. Although third party entities can provide a valuable service to consumers and financial institutions, they can also increase the risk faced by the financial institutions. Successful third party relationships start with understanding of potential risks and proper strategic management. For example, a team of risk management examiners could discover suspicious activity reports during an engagement. The information and evidence they uncover could also provide evidence of unfair or deceptive practices. That evidence could be very useful to compliance auditors.

.120 The term *third party* is broadly defined to include any entity or individual that has entered into a business relationship with an insured depository institution. Examples of third parties include banks (affiliated or not), a regulated institution, and a nonregulated institution, foreign or domestic. Third parties are usually deeply involved in the delivery of financial services to the consumer. The third party can be positioned either directly or indirectly between the financial institution and the consumer. The FDIC is concerned that the use of third parties in financial transactions increases the level of risk for financial institutions and creates potential adverse effects for consumers. The FDIC believes that third party risks transcend all examination disciplines and necessitate close communication between examination teams.

.121 As the role and scope of financial services expands, so to does the role of the third party. Listed below are some pervasive examples of services provided by third parties. Auditors should be aware and document these relationships when performing an audit:

- Perform functions on the institution's behalf.
- Provide customer access to various products and services.
- Increase the financial institution's revenue through the third party's products, such as loan review or asset and liability management.

.122 Some of the risks associated with third party involvement are based on the underlying activity itself, for example, helping consumers secure loans. Other types of risk associated with third party involvement are less noticeable. It is important to remember that a more complex financial service has the potential to increase third party risk. Third party risk is described in the following broad categories:

- Strategic risk is described as the risk that arises from ill-advised business decisions or the failure to implement consistent business strategies that could mitigate potential risk. In general, financial transactions should provide a return commensurate with the level of risk they expose the financial institution to.
- Reputation risk is the risk of negative public perception that is often caused by breaches in institution policy or standards. Negative publicity from a third party, even one not involved with the institution, can be harmful.
- Transaction risk is the risk that the institution will not be able to deliver products and services to the customer. Auditors should be aware of weak controls that could affect the institution's ability to conduct business.
- Credit risk is the risk that a third party or other creditor necessary to the third party relationship is unable to comply with the terms of the contractual agreement. Auditors may examine documents that confirm the institution monitors third party activities to ensure that credit risk is understood and is within established limits.
- Compliance risk is the risk that the institution or other third party is not in compliance with the rules, laws, regulations, and internal policies of contractual obligations. Company oversight serves as a key control for compliance risk.

- Other risks include liquidity, interest rate shifts, rapid price changes, and foreign currency rate changes. Before an institution enters into a third party relationship, it is important for the institution to consider potential risks.

.123 Each institution's audit department should provide comprehensive, independent reviews of all third party arrangements, as well as any underlying activities. Findings should be presented to the institution's Board of Directors as soon as possible to ensure that appropriate action is taken. During an audit of a financial institution that conducts transactions with third parties, auditors should evaluate the results of audit procedures carefully. The auditor may encounter specific information that may raise questions concerning possible illegal acts. AU section 317 lists the following as examples of possible illegal acts:

- Unauthorized transactions or improperly recorded transactions
- Unusual payment of fines or penalties to government or regulatory entities
- Large payments to consultants, affiliates, or employees
- Excessive sales commissions or agent fees
- Unexpected payments made to government officials
- Failure to file tax returns or pay government duties or similar fees that are common in the financial industry

.124 Furthermore, AU section 317 states that auditors who become aware of information concerning a possible illegal act should obtain an understanding of the nature of the act, the circumstances in which it occurred, and sufficient other information to evaluate the effects on the financial statements. The auditor should contact management one level above those involved. Based on the results of the additional testing and the responses from management one level higher than those involved, the auditor may be forced to issue a qualified or even an adverse audit opinion.

.125 AU section 326, *Audit Evidence* (AICPA, *Professional Standards*, vol. 1), states the auditor must obtain sufficient appropriate audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit. Auditors should be aware of the institution's third party arrangements and test them to support their audit opinion.

Accounting Issues and Developments

FASB Statement No. 157

.126 In September 2006, the FASB issued FASB Statement No. 157, *Fair Value Measurements*, to provide enhanced guidance for using fair value to measure assets and liabilities. This statement defines fair value and expands disclosures about fair value measurements. The statement applies whenever other standards require (or permit) assets or liabilities to be measured at fair value. The statement does not expand the use of fair value in any new circumstances.

.127 Prior to this statement, there were different definitions of fair value, and guidance for applying those definitions was dispersed among many accounting pronouncements. Difference in the existing guidance created inconsistencies that added to the complexity in applying GAAP. FASB Statement No. 157

provides increased consistency and comparability in fair value measurements. Expanded disclosures about the use of fair value to measure assets and liabilities should provide users of financial statements with better information about the use of fair value in the financial statements, the inputs used to develop the measurements, and the effect of the measurements on earnings (or changes in net assets) for the period. The statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Early adoption is permitted. Readers can access the full text of FASB Statement No. 157 on the FASB's Web site at www.fasb.org. The following items are common areas in a financial institution that may be affected by FASB Statement No. 157:

- Other real estate (required to be carried at lower of cost or fair value less costs to sell)
- Loans evaluated under FASB Statement No. 114 (observable market price or the fair value of collateral)
- Loans held for sale
- Interest rate lock commitments
- Derivatives
- Intangibles and goodwill
- Assets acquired and liabilities assumed in purchased business
- Securities
- Servicing rights (SRs)
- Branches held for sale
- FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, footnote disclosures

FASB Statement No. 159

.128 Subsequent to the issuance of FASB Statement No. 157, the FASB issued FASB Statement No. 159. This statement is expected to expand the use of fair value measurement, which is consistent with the FASB's long-term measurement objectives for accounting for financial instruments. FASB Statement No. 159 allows entities to choose to measure many financial instruments and certain other items at fair value. The statement permits an entity to elect the fair value option on an instrument-by-instrument basis, and once the election is made, it is irrevocable. This statement's objective is to improve financial reporting by providing entities with an opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. In addition, FASB Statement No. 159 establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. The statement does not eliminate disclosure requirements included in other accounting standards, such as the requirements for disclosures about fair value measurements included in FASB Statement Nos. 107 and 157.

.129 FASB Statement No. 159 is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007, provided the entity also elects to apply the provisions of FASB Statement No. 157. The choice to adopt early should be made within 120 days of the beginning of the fiscal year of adoption (for calendar year end entities, by April 2007), provided the entity has not yet issued financial statements, including required notes to those financial statements, for any interim period of the fiscal year of adoption. The FASB and SEC have expressed concern in the way some early adopters have applied the transition provisions of the standard. The AICPA Center for Audit Quality (CAQ) issued an alert on this development in April 2007. The alert advises auditors to exercise appropriate professional skepticism when evaluating if a principles-based standard such as this is applied in a good faith manner consistent with those objectives and principles. Specifically the alert warns auditors to "be alert for circumstances in which an entity proposes to adopt FAS 159 in a manner that is contrary to the principles and objectives outlined in the standard." The alert can be accessed at www.thecaq.org/newsroom/pdfs/CAQPressRelease_041807a.pdf. Readers can access the full text of FASB Statement No. 159 on the FASB's Web site at www.fasb.org.

SOP 07-01, *Clarification of the Scope of the Audit and Accounting Guide* Investment Companies *and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies*

.130 In June 2007, the Accounting Standards Executive Committee (AcSEC) issued SOP 07-01, *Clarification of the Scope of the Audit and Accounting Guide Investment Companies and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies* (AICPA, *Technical Practice Aids*, ACC sec. 10,930). The SOP provides guidance for auditors when trying to determine whether an entity is within the scope of the AICPA Audit and Accounting Guide Investment Companies. In addition, the SOP also contains disclosure requirements for parent companies and equity method investors in investment companies that retain investment company accounting in the parent company's consolidated financial statements or the financial statements of an equity method investor. The SOP is effective for fiscal years beginning on or after December 15, 2007, with earlier application encouraged.

FASB Interpretation No. 48

.131 FIN 48, *Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109*, clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. This interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This interpretation provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition.

.132 The evaluation of a tax position in accordance with this interpretation is a two-step process. The first step is recognition. The enterprise determines whether it is more likely than not that a tax position will be sustained upon examination, including resolution of any related appeals or litigation processes, based on the technical merits of the position. In evaluating whether a tax position has met the more-likely-than-not recognition threshold, the enterprise should presume that the position will be examined by the appropriate taxing authority that would have full knowledge of all relevant information. The second step is measurement. A tax position that meets the more-likely-than-not recognition threshold is measured to determine the amount of benefit to recognize in the financial statements. The tax position is measured at the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement.

.133 Differences between tax positions taken in a tax return and amounts recognized in the financial statements will generally result in one or both of the following:

1. An increase in a liability for income taxes payable or a reduction of an income tax refund receivable
2. A reduction in a deferred tax asset or an increase in a deferred tax liability

.134 An enterprise that presents a classified statement of financial position should classify a liability for unrecognized tax benefits as current to the extent that the enterprise anticipates making a payment within one year, or within the operating cycle if it is longer. An income tax liability should not be classified as a deferred tax liability unless it results from a taxable temporary difference (that is, a difference between the tax basis of an asset or a liability as calculated using this interpretation and its reported amount in the statement of financial position). This interpretation does not change the classification requirements for deferred taxes.

.135 Tax positions that previously failed to meet the more-likely-than-not recognition threshold should be recognized in the first subsequent financial reporting period in which that threshold is met. Previously recognized tax positions that no longer meet the more-likely-than-not recognition threshold should be derecognized in the first subsequent financial reporting period in which that threshold is no longer met. Use of a valuation allowance as described in FASB Statement No. 109 is not an appropriate substitute for the derecognition of a tax position. The requirement to assess the need for a valuation allowance for deferred tax assets based on the sufficiency of future taxable income is unchanged by this interpretation.

FSP FIN 48-1, "Definition of Settlement in FASB Interpretation No. 48"

.136 On May 2, 2007, the FASB issued FSP FIN 48-1, "Definition of Settlement in FASB Interpretation No. 48." This FSP amends FIN 48 to provide guidance on how an enterprise should determine whether a tax position is effectively settled for the purpose of recognizing previously unrecognized tax benefits.

.137 Specifically, the FSP amends FIN 48 to clarify that a tax position could be effectively settled upon examination by a taxing authority. Assessing whether a tax position is effectively settled is a matter of judgment. When making a settlement determination, an enterprise should make a position-by-position assessment for all positions in a particular tax year.

.138 The guidance outlined in the FSP shall be applied upon the initial adoption of FIN 48. An enterprise that applied FIN 48 in a manner consistent with the provisions of this FSP would continue to apply the provisions in this

FSP from the date of initial adoption of FIN 48. An enterprise that did not apply FIN 48 in a manner consistent with this FSP is required to retrospectively apply the provisions in this FSP to the date of the initial adoption of FIN 48.

.139 To help financial statement preparers, auditors, and tax advisers meet this new requirement, the Accounting Standards, Auditing and Attest Standards, and Tax Teams have developed a practice guide on accounting for uncertain tax positions under FIN 48. Tax positions can only be recognized if they meet a more-likely-than-not threshold of being realized if challenged by a taxing authority with full knowledge of the facts. If this level of certainty is not met, no tax benefit can be booked. Even if it is met, only the amount that has a greater than 50 percent chance of being sustained may be booked. Specific financial statement disclosures are required with respect to uncertain tax positions. The AICPA's 13-page practice guide includes highlights of FIN 48 and its implications for in-house accountants, auditors, and tax advisers. It is not authoritative but is intended to assist members in quickly understanding the requirements of FIN 48. The practice guide is available without charge to all AICPA members. For more information, please visit the AICPA Web site at www.aicpa.org.

Deferred Acquisition Costs on Internal Replacements

.140 In September 2005, AcSEC issued SOP 05-1, *Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection With Modifications of Exchanges of Insurance Contracts* (AICPA, *Technical Practice Aids*, ACC sec. 10,920). The SOP provides guidance on accounting by insurance enterprises for deferred acquisition costs on internal replacements of insurance and investment contracts other than those specifically outlined in FASB Statement No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*. This SOP was effective for internal replacements occurring in fiscal years beginning after December 15, 2005, with earlier adoption encouraged. Retrospective application to previously issued financial statements is not permitted.

Request to Withdraw SEC SAB No. 105

.141 SAB No. 105, *Application of Accounting Principles to Loan Commitments*, was released in 2004 to address questions about the proper valuation of loan commitments that are derivatives under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended by FASB Statement No. 149, *Amendment to Statement 133 on Derivative Instruments and Hedging Activities*. SAB No. 105 intends to prohibit entities from incorporating expected future cash flows related to the associated servicing on a loan underlying a derivative loan commitment, or any other internally developed intangible asset, in valuing a commitment.

.142 The MBA believes that the release of FASB Statement No. 159 broadens the scope of SAB No. 105 by permitting entities to report nonderivative loan commitments at fair value beginning in 2008 for most companies. This includes commitments to originate nonmortgage loans. There is also the belief that many people may undoubtedly conclude that SAB No. 105 correctly applies GAAP to derivative loan commitments; therefore, it must also be correct to apply the SAB to other loan commitments, regardless of the fair value guidance of FASB Statement No. 157.

.143 Because FASB Statement No. 157 requires reporting entities to incorporate the cash flows that market participants would consider in pricing loan commitments, which is contrary to the guidance in SAB No. 105, an entity's valuation models produce more accurate representations of fair values of loan commitments than would be true if the cash flows were excluded. Based on this belief, the MBA believes the SAB should be withdrawn as soon as possible to avoid the risk of widespread confusion in implementation of FASB Statement Nos. 157 and 159. On July 6, 2007, the MBA formally requested a meeting with the SEC to discuss withdraw of SAB No. 105. Auditors and banking professionals should monitor this situation.

Securitization and Sale of Nontraditional Products

.144 Higher yielding nonconforming or nontraditional products as well as subprime loans are being securitized and sold in the secondary market. Upon securitization, derivatives are being added to make the securities more attractive to investors. Auditors need to carefully evaluate those derivatives to see whether they qualify as passive derivatives permitted for a qualifying special-purpose entity (QSPE) under FASB Statement No. 140. Note that FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments*, amended FASB Statement No. 140 to eliminate the prohibition on a QSPE from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. For additional information, see the section of this alert titled "Changes to FASB Statement No. 140."

Obtaining Legal Opinions

.145 Increased numbers of securitizations means an increased need for legal opinions. Paragraph 27 of FASB Statement No. 140 states that "[t]he nature and extent of supporting evidence required for an assertion in financial statements that transferred financial assets have been isolated—put presumptively beyond the reach of the transferor and its creditors, either by a single transaction or a series of transactions taken as a whole—depend on the facts and circumstances. All available evidence that either supports or questions an assertion shall be considered. That consideration includes making judgments about whether the contract or circumstances permit the transferor to revoke the transfer. It also may include making judgments about the kind of bankruptcy or other receivership into which a transferor or SPE might be placed, whether a transfer of financial assets would likely be deemed a true sale at law, whether the transferor is affiliated with the transferee, and other factors pertinent under applicable law." After the issuance of FASB Statement No. 140, the ASB issued Interpretation No. 1, "The Use of Legal Interpretations As Audit Evidence to Support Management's Assertion That a Transfer of Financial Assets Has Met the Isolation Criterion in Paragraph 9(a) of Financial Accounting Standards Board Statement No. 140," of AU section 336. Readers may wish to refer to that auditing interpretation when evaluating the need to obtain a legal opinion.

Changes to FASB Statement No. 140

.146 Effective for fiscal years starting subsequent to September 15, 2006, with early application permitted in certain cases, FASB Statement No. 140 has been amended by two new FASB Statements, FASB Statement Nos. 155

and 156, *Accounting for Servicing of Financial Assets*. Another exposure draft, *Accounting for Transfers of Financial Assets*, will also affect FASB Statement No. 140 and is expected to be issued during the fourth quarter of 2007.

.147 FASB Statement No. 155 amends FASB Statement No. 133 to permit fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation and clarifies which interest-only strips and principal-only strips are not subject to FASB Statement No. 133 requirements. Consequently, the statement resolves issues surrounding FASB Statement No. 133's Implementation Issue No. D1, "Recognition and Measurement of Derivatives: Application of Statement 133 to Beneficial Interests in Securitized Financial Assets," and amends FASB Statement No. 140 in the process.

The Old FASB Statement No. 140	***FASB Statement No. 155 Influence***
Paragraphs 35(c)(2) and 40	Amended by paragraphs 4 and 5 of FASB Statement No. 155
Background. Derivatives Implementation Group (DIG) Implementation Issue No. D1 allowed a temporary exemption for derivative accounting for beneficial interests in QSPEs and stated, "Holders of beneficial interests in securitized financial assets that are not subject to paragraph 14 or paragraph 362 of FASB Statement No. 140 are not required to apply FASB Statement No. 133 to those beneficial interests until further guidance is issued." **FASB Statement No. 140 Prohibition.** The old FASB Statement No. 140 prohibited a QSPE from holding a derivative financial instrument that pertained to a derivative beneficial interest (or a beneficial interest that included an embedded derivative). **Why?** Before the prohibition, the Implementation Issue No. D1 temporary exemption discussed above allowed entities to circumvent derivative accounting by transferring derivatives or hybrids into QSPEs.	**FASB No. 155 Amendments to FASB No. 133.** • Amends paragraph 14 to eliminate the temporary exemption for interests in securitized financial assets provided by Implementation Issue No. D1. (Prospective application required: Implementation Issue No. D1 guidance remains effective for instruments recognized prior to the effective date of FASB Statement No. 155.) • Amends paragraph 14 to require interest holders to evaluate whether instruments are freestanding derivatives or a hybrid financial instrument subject to FASB Statement No. 133 bifurcation requirements. • Amends paragraph 14 to clarify that concentrations of credit risk in the form of subordination are not embedded derivatives. This is important because if redistributed credit risk constituted an embedded derivative, many securitizations would have been affected.

The Old FASB Statement No. 140	*FASB Statement No. 155 Influence*
	Amendment to FASB Statement No. 140. Amends paragraphs 35 and 40 of FASB Statement No. 140 to eliminate the prohibition. Because the Implementation Issue No. D1 temporary exemption was eliminated, the prohibition is no longer necessary because each interest holder needs to evaluate whether instruments are freestanding derivatives or hybrid financial instruments subject to FASB Statement No. 133 bifurcation requirements. Evaluation of all potential derivative instruments categories in securitizations is now captured. Because securitizations provide many ways to redistribute to investors the cash flows of the underlying assets, the potential exists for many securitization interests to be hybrid financial instruments. FASB Statement No. 133 contains an impracticability exception, which FASB Statement No. 155 retained. (If an entity is unable to reliably identify and measure an embedded derivative that must be bifurcated, the entire contract must be measured at fair value with changes in fair value recognized in earnings. Although this exception has been used rarely, it may now be used more frequently due to the complexity of instruments that will no longer receive the temporary exemption under Implementation Issue No. D1.)

.148 FASB Statement No. 156 also amends FASB Statement No. 140 with respect to the accounting for the servicing of financial assets. FASB Statement No. 156 requires an entity to recognize a servicing asset or servicing liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract. The statement also requires that all separately recognized SRs be initially measured at fair value, if practicable. For each class of separately recognized servicing assets and liabilities, the guidance permits an entity to choose either of the following subsequent measurement methods: (1) the amortization of servicing assets or liabilities in proportion to and over the period of estimated net servicing income or net servicing loss or (2) the reporting of servicing assets or liabilities at fair value at each reporting date and reporting changes in fair value in earnings in the period in which the changes occur. The guidance also requires additional disclosures for all separately recognized SRs.

.149 Concepts surrounding FASB Statement No. 156 changes to FASB Statement No. 140 are summarized below. Not all changes are included. For complete guidance, refer to the standard.

The Old FASB Statement No. 140	***FASB Statement No. 156 Influence***
Paragraph 10 states, "Upon *completion* of any transfer (including sales)"	Amended by paragraph 4(c) of FASB Statement No. 156
Continue to carry in the statement of financial position any retained interest in the transferred asset, including *servicing assets*, beneficial interests in assets transferred to a QSPE in a securitization, and retained undivided interests. Allocate the previous carrying amount between the assets sold, if any, and the *retained interests*, if any, based on *their relative fair values* at the date of transfer.	Initially recognize and measure at *fair value*, if practicable servicing assets and servicing liabilities that require recognition under the provisions of paragraph 13. Allocate the previous carrying amount between the assets sold, if any, and the interests that *continue to be held by the transferor*, if any, based on their relative fair values at the date of transfer. Continue to carry in the statement of financial position any interest it continues to hold in the transferred assets, including, if applicable, beneficial interests in assets transferred to a QSPE in a *securitization* and any *undivided interests.*
Paragraphs 11 and 56, "Sales" (other paragraphs are involved as well.)	Amended by paragraph 4(d) and 4(j) of FASB Statement No. 156
Describes sale treatment. Derecognize all assets sold and recognized all assets obtained and liabilities incurred. SRs are recorded at allocated carrying amounts and treated as retained interests in transferred assets; hence the term *retained interest* is used.	Adds servicing assets to the definition of proceeds. The proceeds from a sale include SRs. Therefore, the gain or loss on sale is altered by the value of the SR and depends in part on both (*a*) the previous carrying amount of the financial assets involved in the transfer, allocated between the assets sold and the retained interests that continue to be held by the transferor based on their relative fair value at the date of transfer, and (*b*) the proceeds received. The phrase *interests that continue to be held by the transferor* has replaced the term *retained interest* throughout FASB Statement No. 140. FASB Statement No. 156 requires SRs to be initially recorded at fair value and treated as sale proceeds, if applicable, not as retained interests.

The Old FASB Statement No. 140	*FASB Statement No. 156 Influence*
Paragraph 13, "Recognition and Measurement for Obligations Undertaken"	Amended by paragraph 4(e) and 4(f) of FASB Statement No. 156
For transfers/sales, recognize SRs unless the assets were transferred to a QSPE in a guaranteed mortgage securitization, and all resulting securities are retained and classified as held to maturity debt under FASB Statement No. 115. To recognize servicing rights, use the relative allocation method at the date of obligation and amortize using the amortization method only. *For purchases/assumptions*, the SRs should be initially measured at fair value, presumptively at the price paid and then subsequently value the right using amortization method only.	*For all situations*. Always initially value servicing rights at fair value, if practicable. This includes all transfers (accounted for as sales), transfers of financial assets to QSPE in a guaranteed mortgage securitization in which the transferor retains all securities and classified them as available for sale or trading; or purchases/assumptions (transactions that do not relate to financial assets of the servicer or its consolidated affiliates). Paragraph 13 is also amended to discuss the new choice of two methods for subsequent valuation, the fair value method, and the former amortization method.
Paragraph 17, Overview of Disclosures (Description not inclusive)	Amended by paragraph 4(h) of FASB Statement No. 156 Overview (Description not inclusive)
• Collateral disclosures • For SR under amortization method (only method allowed) — Disclose SR recognized and subsequently amortized (only method allowed). — Disclose fair value of recognized SRs and fair value methodology. — Disclose valuation allowance activity. — Disclose risk characteristics of the underlying financial assets used to stratify SRs for purposes of measuring impairment.	• Collateral disclosures are unchanged. • For SR under amortization method, similar disclosures to column one. (However, note that disclosures surrounding the activity for each class and respective location of income statement changes, as well as valuation techniques, are now required.) • New for SR under fair value method: — Activity for each class and where the changes are reported in the income statement. — Description of valuation techniques or other methods used to estimate fair value of each class.

(continued)

The Old FASB Statement No. 140	*FASB Statement No. 156 Influence*
	— Fair value for each class at beginning and end for each class measured under the amortization method. • New for both methods: — Management's basis for determining its classes of servicing assets/liabilities (relates to the choice of two subsequent valuation methods per paragraph 13A). — Amount of fees earned each period. — Disclosure surrounding inherent risks of SRs and instrument used to mitigate fair value income statement effects.

FASB Projects Updates for FASB Statement No. 140

.150 The FASB issued proposed FSP FAS 140-d, "Accounting for Transfers of Financial Assets and Repurchase Financing Transactions," on July 24, 2007. The objective of the proposed FSP is to provide implementation guidance on whether there are circumstances that would permit a transfer of a financial asset separately from repurchase financing. A repurchase financing is a repurchase agreement relating to a previously transferred asset between the same counterparties. The repurchase financing may be agreed upon at the time of the initial transfer or may occur at a later date. The comment period for this project runs through September 14, 2007. The FASB plans to address comments received and issue a final FSP during the fourth quarter of 2007. For more information on this FASB project, please visit the following Web site: www.fasb.org/project/repurchase_financing_agreements.shtml.

.151 The FASB is also working a project that addresses practice issues related to the permitted activities of a QSPE, isolation criteria, and other issues that arose during redeliberations on the amendment of FASB Statement No. 140 to improve the comparability of financial statements. The FASB decided that removing the QSPE concept from FASB Statement No. 140 is an approach worthy of research. The FASB recommends that staff consider amending paragraph 9(b) on the remaining criteria in paragraph 9 be included in the research for this project. The FASB expects to issue an exposure draft containing potential amendments to FASB Statement No. 140 in the fourth quarter of 2007. For more information, please visit the following Web site: www.fasb.org/project/transfers_of_financial_assets.shtml.

Clarification of FASB Statement No. 140

.152 On June 15, 2007, members of the U.S. House of Representatives Committee on Financial Services sent a letter to the Chairman of the SEC. The representatives are concerned with current lending practices and the recent collapse of the subprime market. Specifically, the representatives are concerned with the number of foreclosures and the impact of FASB Statement No. 140 on loan modifications. One solution presented by the representatives was to make loan modifications and, where possible, forbear foreclosure.

.153 The representatives asked for SEC expertise on FASB Statement No. 140. They asked if FASB Statement No. 140 clearly addresses whether a loan held in trust can be modified when default is reasonably foreseeable or only once a delinquency or default has already occurred. The representatives believe that the lack of clarity may be leading some institutions to withhold making some loan modifications that may benefit borrowers and bondholders for fear of being in violation FASB Statement No. 140. The SEC is currently looking into this issue. For more information on this issue, readers should refer to the SEC Web site at www.sec.gov.

.154 On July 24, 2007, the SEC responded to the Committee on Financial Services. The letter outlined one approach servicers may take in response to anticipated residential mortgage loan defaults. The approach is to modify the terms of the mortgage loan when default is "reasonably foreseeable," rather than when a default or delinquency has already occurred. The letter also explains that said loan modifications undertaken when loan default is reasonably foreseeable should be consistent with the nature of modification activities that would have been permitted if a default had occurred.

The Hybrid and Servicing Ripple Effect

.155 In addition to the effects on FASB Statement No. 140 discussed in the previous section, the implementation of FASB Statements No. 155 and No. 156 will affect a number of GAAP issues, including but not limited to DIG Issues, EITF Issues, and Technical Bulletins.

FASB Statement No. 158

.156 FASB Statement No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*, improves financial reporting by requiring an employer to recognize the overfunded or underfunded status of a defined benefit postretirement plan (other than a multiemployer plan) as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income of a business entity or changes in unrestricted net assets of a not-for-profit organization. This statement also improves financial reporting by requiring an employer to measure the funded status of a plan as of the date of its year-end statement of financial position, with limited exceptions.

.157 The required date of adoption of the recognition and disclosure provisions of this statement differs for an employer that is an issuer of publicly traded equity securities (as defined) and an employer that is not. An employer with publicly traded equity securities is required to initially recognize the funded status of a defined benefit postretirement plan and to provide the required disclosures as of the end of the fiscal year ending after December 15, 2006.

An employer without publicly traded equity securities is required to recognize the funded status of a defined benefit postretirement plan and to provide the required disclosures as of the end of the fiscal year ending after June 15, 2007.

Ratification of EITF Issue Nos. 06-4 and 06-5

.158 In September 2006, the FASB ratified EITF Issue Nos. 06-4, "Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements" and 06-5, "Accounting for Purchases of Life Insurance—Determining the Amount That Could Be Realized in Accordance with FASB Technical Bulletin No. 85-4, *Accounting for Purchases of Life Insurance*." EITF Issue No. 06-4 requires that policyholders recognize a liability for the postretirement benefits provided through endorsement split-dollar life insurance. The liability to recognize is dependent upon whether the company is deemed to have promised a death benefit to the participant or to maintain the split-dollar arrangement for the participant's benefit. EITF Issue No. 06-5 provides guidance for calculating policy amounts that could be realized and recognized as assets on the policyholder's balance sheet. Both EITF Issue Nos. 06-4 and 06-5 will be effective for fiscal years beginning after December 15, 2007. The company does not anticipate that these issues will have a material effect on its financial statements.

EITF Issue No. 06-10

.159 The EITF reached consensus that an employer should recognize a liability for post retirement benefits related to a collateral assignment split-dollar life insurance arrangement in accordance with FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, or Option 12 if the employer has agreed to maintain a life insurance policy on the employee during retirement. Examples of evidence to be considered when determining the arrangement include written agreements, communication between the employee and employer, and past practices of the employer. Similarly, if the employer has provided the employee with a death benefit, the employer should accrue a liability for the actuarial present value of the future death benefit as of the employee's expected retirement date, in accordance with FASB Statement No. 106 or Option 12. The consensus for EITF Issue No. 06-10, "Accounting for Collateral Assignment Split-Dollar Life Insurance Arrangements," is effective for fiscal years beginning after December 15, 2007, included interim periods within those fiscal years.

Other Literature Important to Financial Institutions

.160 FASB Statement No. 156 also amends paragraphs 9 and 10 of FASB Technical Bulletin No. 87-3, *Accounting for Mortgage Servicing Fees and Rights*; paragraph 8(h) of SOP 01-6, *Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others* (AICPA, *Technical Practice Aids*, ACC sec. 10,850); the FASB Special Report titled *A Guide to Implementation of Statement 140 on Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities—Questions and Answers—Fourth Edition (cumulative); Special Report on Statement 140 on Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities Index of All Q&As Affected by Statement 156 As of March 17, 2006;* and sections of the AICPA Audit and Accounting Guide *Depository and*

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

FSP FIN 39-1

.161 FSP FIN 39-1, "Amendment of FASB Interpretation No. 39," issued in April 2007, amended certain aspects of FIN 39, *Offsetting of Amounts Related to Certain Contracts*. The FSP amends paragraph 10 of FIN 39 to permit a reporting entity to offset fair value amounts recognized for the right to reclaim cash collateral (a receivable) or the obligation to return cash collateral (a payable) against fair value amounts, including amounts that approximate fair value, recognized for derivative instruments executed with the same counterparty under the same master netting arrangement. This FSP applies to instruments that meet the definition of a derivative in FASB Statement No. 133, including those that are not included in the scope of FASB Statement No. 133 (for example, a financial guarantee or weather derivatives), and indicates that application of the guidance in the FSP is an accounting policy decision and should be consistently applied. Upon adoption of this FSP, a reporting entity is permitted to change its accounting policy to offset or not offset fair value amounts recognized for derivative instruments under master netting arrangements.

.162 The FSP is effective for fiscal years beginning after November 15, 2007, with early application permitted, and is applied as a change in accounting principle through retrospective application for all financial statements presented, unless it is impracticable to do so.

FSP FAS 140-2, Paragraphs 40(b) and 40(c)

.163 Paragraph 35 of FASB Statement No. 140 provides conditions that must be met for a trust or other legal entity to be considered a QSPE. One condition is that a QSPE may hold only passive derivative financial instruments that pertain to beneficial interests issued or sold to parties other than the transferor, its affiliates, or its agents.

.164 Constituents have questioned whether paragraphs 40(b) and 40(c) would require a QSPE to become disqualified if the amount of beneficial interests held by outside parties is reduced to less than the total notional amount of the related derivative financial instruments because of events that were not anticipated at the inception of the QSPE. Constituents have also questioned whether purchases of beneficial interests by the transferor, its affiliates, or its agents in connection with treasury, market-making, or trading activities would disqualify a qualifying QSPE.

.165 FSP FAS 140-2, "Clarification of the Application of Paragraphs 40(b) and 40(c) of FASB Statement No. 140," answers these questions by concluding that paragraph 40(b) and 40(c) requirements must be met when beneficial interests are *initially* issued by the QSPE or when a passive derivative financial instrument needs to be replaced upon the occurrence of a specified event *outside the control* of the transferor, its affiliates, or its agents. For additional specifics, see the FSP available at www.fasb.org, which was effective upon issuance on November 5, 2005.

DIG Issues

.166 FASB Statement No. 155 amends paragraphs 14, 16, 44, and 200A-D of FASB Statement No. 133. Consequently, the following DIG issues are affected: DIG Implementation Issue Nos. A1, B1, B2, B4, B5, B6, B10, B11, B15, B17, B20, B23, B24, B29, B30, B35, B36, B37, B39, C4, and D1. FASB Statement No. 156 amends footnote 9 to paragraph 21 as well as paragraph 56 of FASB Statement No. 133. The statement affects DIG Implementation Issue Nos. B12, B36, D1, F1, F8, and J7.

FASB Implementation Issue No. B-40

.167 In January 2007, the FASB posted Implementation Issue No. B40, "Embedded Derivatives: Application of Paragraph 13(b) to Securitized Interests in Prepayable Financial Assets," which clarifies the circumstances in which a securitized interest in prepayable financial assets would not be subject to the conditions in paragraph 13(b) of FASB Statement No. 133. They responded that a securitized interest in prepayable financial assets would not be subject to the conditions in paragraph 13(b) of FASB Statement No. 133 if it meets both of the following criteria:

- The right to accelerate the settlement of the securitized interest cannot be controlled by the investor.
- The securitized interest itself does not contain an embedded derivative (including an interest-rate-related derivative) for which bifurcation would be required other than an embedded derivative that results solely from the embedded call options in the underlying financial assets.

.168 The objective of this guidance is to provide a narrow scope exception from paragraph 13(b) of FASB Statement No. 133 for securitized interests that contain only an embedded derivative that is tied to the prepayment risk of the underlying prepayable financial assets and that meet the criteria listed in the previous paragraph. For more information, please visit the following Web site: www.fasb.org/derivatives/issueb40.

EITF Issues

.169 FASB Statement No. 155 affects EITF Issue Nos. 85-9, 85-29, 86-15, 86-28, 90-19 , 96-12, 97-15 98-5, 99-20, 00-19, 03-7, instrument C of Issue No. 90-19, and 88-11. FASB Statement No. 156 affects EITF Issues No. 85-13, 87-34, 88-11 (nullified), 88-22, 89-2, 90-18, 90-21, 90-2, 02-9, 02-12, and Topic D-69.

Hybrid Financial Instruments

.170 FASB Statement No. 133 requires transactions to be evaluated for embedded derivatives. If the derivative is present, it has to be bifurcated if the following three criteria are met: (1) the economics of the derivative are not clearly and closely related to the economics of the host instrument, (2) the instrument is not measured at fair value through earnings, and (3) the terms of the derivative meet the definition of a derivative under FASB Statement No. 133. The host is accounted for based on applicable literature (for example, cost amortization) while the derivative is accounted for at fair value through earnings unless it is designated as a FASB Statement No. 133 hedge.

.171 If an embedded derivative is present but not closely and clearly related to its host instrument, the entity must apply FASB Statement No. 155. The statement allows the entity a choice in accounting for embedded derivates requiring bifurcation. An entity can elect to either bifurcate the embedded derivative or carry the entire instrument at fair value with changes that pass through the income statement. Thus far, holders of embedded derivatives have been disappointed in the choices.

.172 FASB Statement No. 155 is effective for all financial instruments acquired or issued after the beginning of the fiscal year that begins after September 15, 2006. Auditors should be aware that FASB Statement No. 155 applies to securities purchased after adoption or securities that have a remeasurement event, for example, a business combination. Only securities purchased after adoption are evaluated to determine if there is an embedded derivative and whether or not that derivative should be bifurcated from its host.

FASB Statement No. 156

.173 FASB Statement No. 156 amends FASB Statement No. 140 with respect to the accounting for separately recognized servicing assets and servicing liabilities. The statement requires an entity to recognize a servicing asset or servicing liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract under certain circumstances.

.174 FASB Statement No. 156 requires all separately recognized servicing assets and servicing liabilities to be initially measured at fair value, if practicable. It permits an entity to choose either of the amortization or fair value methods for each class of separately recognized servicing assets and servicing liabilities.

.175 At its initial adoption, it permits a one-time reclassification of available-for-sale securities to trading securities by entities with recognized SRs, without calling into question the treatment of other available-for-sale securities under FASB Statement No. 115, provided that the available-for-sale securities are identified in some manner as offsetting the entity's exposure to changes in fair value of servicing assets or servicing liabilities that a servicer elects to subsequently measure at fair value.

.176 The statement also requires separate presentation of servicing assets and servicing liabilities subsequently measured at fair value in the statement of financial position and additional disclosures for all separately recognized servicing assets and servicing liabilities.

.177 An entity should adopt this statement as of the beginning of its first fiscal year that begins after September 15, 2006. For more information, please visit the FASB Web site at www.fasb.org.

Recent Auditing and Attestation Pronouncements and Related Guidance

.178 Presented in the following table is a list of recently issued auditing and attestation pronouncements and related guidance. For information on auditing and attestation standards issued subsequent to the writing of this alert, please refer to the AICPA Web site at www.aicpa.org/Professional+Resources/Accounting+and+Auditing. You may also look for announcements of newly issued standards in the *CPA Letter*, *Journal of Accountancy*, and in the quarterly electronic newsletter, *In Our Opinion*, issued by the AICPA Auditing Standards team, available at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Opinion. As a reminder, AICPA auditing and attestation standards are applicable only to audits and attestation engagements of nonissuers.

.179 The PCAOB establishes auditing and attestation standards for audits of issuers. Refer to the PCAOB Web site at www.pcaob.org for information about its activities. You may also review the *SEC and PCAOB Alert—2007/08* (product no. 022498kk), which summarizes recent developments at both the SEC and PCAOB. This alert can be obtained by calling the AICPA at (888) 777-7077 or by going online to www.cpa2biz.com.

Recent Auditing and Attestation Pronouncements and Related Guidance	
SAS No. 114, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*, vol. 1, AU sec. 380) Issue Date: December 2006 (Applicable to audits conducted in accordance with generally accepted auditing standards [GAAS])	This standard replaces SAS No. 61, *Communication With Audit Committees* (AICPA, *Professional Standards*, vol. 1, AU sec. 380A). The standard requires the auditor to conduct two-way communication with those charged with governance about certain significant matters related to the audit and also establishes standards and provides guidance on which matters should be communicated, who they should be communicated to, and the form and timing of the communication. It is effective for audits of financial statements for periods beginning on or after December 15, 2006.
SAS No. 113, *Omnibus Statement on Auditing Standards—2006* (AICPA, *Professional Standards*, vol. 1) Issue Date: November 2006 (Applicable to audits conducted in accordance with GAAS)	This standard does the following: • Revises the terminology used in the 10 standards of SAS No. 95, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 150A), to reflect terminology in SAS No. 102, *Defining Professional Requirements in Statements on Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 120) • Adds a footnote to the headings before paragraphs 35 and 46 in SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), to provide a clear link between the auditor's consideration of fraud and the auditor's assessment of risk and the auditor's procedures in response to those assessed risks • Replaces throughout the SASs the term *completion of fieldwork* with the term *date of the auditor's report* • Changes the convention for dating the representation letter by requiring that it be dated as of the date of the auditor's report

Recent Auditing and Attestation Pronouncements and Related Guidance—continued

SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325) Issue date: May 2006 (Applicable to audits conducted in accordance with GAAS)	This standard supersedes SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325A). It establishes requirements and provides extensive guidance about communicating matters related to an entity's internal control over financial reporting identified while performing an audit of financial statements. SAS No. 112 also requires that certain communications be in writing. It is effective for periods ending on or after December 15, 2006.
SAS Nos. 104–111, the risk assessment standards Issue Date: March 2006 (Applicable to audits conducted in accordance with GAAS)	See the "AICPA Risk Assessment Standards" section in this alert.
Statement on Standards for Attestation Engagements (SSAE) No. 14, *SSAE Hierarchy* (AICPA, *Professional Standards*, vol. 1, AT sec. 50) Issue Date: November 2006	This SSAE identifies the body of attestation literature, clarifies the authority of attestation publications issued by the AICPA and others, specifies the extent of familiarity a practitioner needs to have with various kinds of attestation publications when conducting an attestation engagement, and amends the 11 attestation standards to reflect the terminology used in SSAE No. 13, *Defining Professional Requirements in Statements on Standards for Attestation Engagements* (AICPA, *Professional Standards*, vol. 1, AT sec. 20). It is effective when the subject matter or assertion is as of or for a period ending on or after December 15, 2006.
Interpretation No. 1, "Communicating Deficiencies in Internal Control Over Compliance in an Office of Management and Budget (OMB) Circular A-133 Audit" (AICPA, *Professional Standards*, vol. 1, AU sec. 9325.01–.04), which interprets AU section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1) Issue Date: July 2007 (Interpretive publication)	This auditing interpretation interprets AU section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1), and addresses how the definitions of the terms *control deficiency*, *significant deficiency*, and *material weakness* should be adapted and applied in the context of reporting on internal control over compliance in a single audit.

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Recent Auditing and Attestation Pronouncements and Related Guidance—continued	
Interpretation No. 1, "Use of Electronic Confirmations" (AICPA, *Professional Standards*, vol. 1, AU sec. 9330.01–.06), which interprets AU section 330, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1) Issue Date: March 2007 (Interpretive publication)	This auditing interpretation interprets AU section 330, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1), and addresses the issue of electronic confirmations.
AICPA Technical Practice Aid (TPA) Technical Questions and Answers (TIS) section 9100.06, "The Effect of Obtaining the Management Representation Letter on Dating the Auditor's Report" (AICPA, *Technical Practice Aids*) Issue Date: May 2007 (Nonauthoritative)	This question and answer discusses whether the auditor is required to have the signed management representation letter in hand as of the date of the auditor's report. The question and answer indicates that although the auditor need not be in physical receipt of the representation letter on the date of the auditor's report, management will need to have reviewed the final representation letter and, at a minimum, have orally confirmed that they will sign the representation letter, without exception, on or before the date of the representations.
TIS section 8350.01, "Current Year Audit Documentation Contained in the Permanent File" (AICPA, *Technical Practice Aids*) Issue Date: May 2007 (Nonauthoritative)	This question and answer discusses whether the provisions of SAS No. 103, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339), related to documentation completion and retention, apply to current year audit documentation maintained in the permanent file. The question and answer indicates that SAS No. 103 does apply to current year audit documentation maintained in a permanent file, or, for that matter, maintained in any type of file, if the documentation serves as support for the current year's audit report.
AICPA Professional Issues Task Force (PITF) Practice Alert (PA) 03-1, *Audit Confirmations* (AICPA, *Technical Practice Aids*, PA sec. 16,240) Revised: June 2007 (Nonauthoritative)	This PA responds to practitioners' current concerns about audit confirmations and includes discussion of improving confirmation response rates, negative versus positive confirmation requests, nonresponses to positive confirmations, responses to positive confirmation requests indicating exception, and use of electronic confirmations among other topics.
AICPA PITF PA 07-1, *Dating of the Auditor's Report and Related Practical Guidance* (AICPA, *Technical Practice Aids*, PA sec. 16,290) Issue Date: January 2007 (Nonauthoritative)	This PA provides guidance regarding application of certain provisions of SAS No. 103, primarily related to dating the auditor's report.

Recent Auditing and Attestation Pronouncements and Related Guidance—continued	
PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* Issue Date: July 2007 (Applicable to audits conducted in accordance with PCAOB standards)	This standard replaces the PCAOB's previous internal control standard, Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*. This principles-based auditing standard is designed to increase the likelihood that material weaknesses in internal control will be found before they result in material misstatement of a company's financial statements, and, at the same time, eliminate procedures that are unnecessary. Auditing Standard No. 5 is required to be used by registered audit firms for all audits of internal control over financial reporting no later than for fiscal years ending on or after November 15, 2007. Earlier adoption is permitted and encouraged.
PCAOB Rule 3525, *Audit Committee Pre-approval of Non-audit Services Related to Internal Control Over Financial Reporting* Issue Date: July 2007 (Applicable to audits conducted in accordance with PCAOB standards)	This rule requires a registered public accounting firm that seeks pre-approval of an issuer audit client's audit committee to perform internal control-related nonaudit services that are not otherwise prohibited by the act or the rules of the SEC or the PCAOB to describe, in writing, to the audit committee the scope of the proposed service, discuss with the audit committee the potential effects of the proposed service on the firm's independence, and document the substance of the firm's discussion with the audit committee. These requirements parallel the auditor's responsibility in seeking audit committee pre-approval to perform tax services for an audit client under PCAOB Rule 3524. This rule is effective for audits of fiscal years ending on or after November 15, 2007.
PCAOB Conforming Amendments to the Interim Auditing Standards Issue Date: July 2007 (Applicable to audits conducted in accordance with PCAOB standards)	In conjunction with the PCAOB's adoption of Auditing Standard No. 5, the PCAOB also adopted a number of conforming amendments to its interim standards. The conforming amendments can be found in Appendix 3 of PCAOB Release No. 2007-005A at www.pcaob.org/Rules/Docket_021/2007-06-12_Release_No_2007-005A.pdf. These amendments are effective for audits of fiscal years ending on or after November 15, 2007, the same effective date of Auditing Standard No. 5.

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Recent Auditing and Attestation Pronouncements and Related Guidance—continued	
PCAOB Report, *Report on the Second-Year Implementation of Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* Issue Date: April 2007 (Applicable to audits conducted in accordance with PCAOB standards)	This report is based on PCAOB inspections that looked at parts of approximately 275 audits of internal control over financial reporting by registered public accounting firms. Inspections focused on four areas: integrating the audits of financial statements and internal control, using a top-down approach, using the work of others, and assessing risk.
PCAOB Report, *Observations on Auditors' Implementation of PCAOB Standards Relating to Auditors' Responsibilities With Respect to Fraud* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, "Section 300—Report on the Initial Implementation of Auditing Standard No. 2") Issue Date: January 2007 (Applicable to audits conducted in accordance with PCAOB standards)	This report focuses on aspects of the PCAOB's interim auditing standards that address the auditor's responsibility with respect to fraud, specifically AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *PCAOB Standards and Related Rules*). This report does not change or propose to change any existing standard nor is the PCAOB providing any new interpretation of existing standards.
PCAOB Staff Questions and Answers, *Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees* Issue Date: April 2007 (Applicable to audits conducted in accordance with PCAOB standards)	Topics covered include the following: • The application of Rule 3522 (a) when conditions of confidentiality are imposed by tax advisors who are not employed by or affiliated with the registered public accounting firm • Whether a public accounting firm can advise an audit client on the tax consequences of structuring a particular transaction • Whether a registered public accounting firm's independence is affected by the IRS's subsequent listing of a transaction that the firm marketed, planned, or opined in favor of, as described in Rule 3522(b) • Clarification that the auditor must evaluate whether a person is in a financial reporting oversight role at affiliates and not just the audit client itself • Clarification of the term *other change in employment event* as it relates to Rule 3522(c)

Recent Auditing and Attestation Pronouncements and Related Guidance—continued

PCAOB Staff Questions and Answers, *Auditing the Fair Value of Share Options Granted to Employees* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, "Section 100—PCAOB Staff Questions and Answers") Issue Date: October 2006 (Applicable to audits conducted in accordance with PCAOB standards)	The guidance provides direction for auditing a company's estimation of the fair value of stock options granted to employees pursuant to FASB Statement No. 123 (revised 2004), *Share-Based Payment*, which became applicable for financial statements of companies with fiscal years ending on or after June 15, 2006.

The Auditor's Communication With Those Charged With Governance

.180 In December 2006, the ASB issued SAS No. 114, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*, vol. 1, AU sec. 380), which supersedes SAS No. 61, *Communication With Audit Committees* (AICPA, *Professional Standards*, vol. 1, AU sec. 380A). The new SAS establishes standards and provides guidance to auditors on matters required to be communicated with those charged with governance in relation to an audit of financial statements and is effective for audits of financial statements for periods beginning on or after December 15, 2006. SAS No. 61 established communication requirements applicable to entities that either have an audit committee or that have otherwise formally designated oversight of the financial reporting process to a group equivalent to an audit committee. However, SAS No. 114 broadens the applicability of the SAS to audits of the financial statements of all nonissuers regardless of size, ownership, or organizational structure.

.181 SAS No. 114 recognizes the importance of effective two-way communication to the audit. It provides a framework for the auditor's communication with those charged with governance and identifies specific matters to be communicated, many of which are generally consistent with the requirements in SAS No. 61. However, SAS No. 114 does include certain additional matters to be communicated and provides additional guidance on the communication process. Among other matters, SAS No. 114 adds requirements to communicate an overview of the planned scope and timing of the audit. It also requires significant matters communicated with those charged with governance to be documented.

Identifying Those Charged With Governance

.182 The SAS uses the term *those charged with governance* to refer to those with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity, including overseeing the entity's financial reporting process. The SAS uses the term *management* to refer to those who are responsible for achieving the objectives of the enterprise and who have the authority to establish policies and make decisions by which those objectives are to be pursued.

.183 The auditor should determine the appropriate person(s) within the entity's governance structure with whom to communicate. The appropriate person(s) may vary depending on the matter to be communicated. Governance structures vary by entity, reflecting influences such as size and ownership characteristics.

.184 Since there is such diversity, it is not possible for SAS No. 114 to specify for all audits the person(s) with whom the auditor is to communicate particular matters. Furthermore, in some cases the appropriate person(s) with whom to communicate may not be clearly identifiable from the engagement circumstances, for example, entities where the governance structure is not formally defined, such as some family-owned entities, some not-for-profit organizations, and some government entities. The auditor's understanding of the entity's governance structure and processes obtained in accordance with SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1, AU sec. 314), is relevant in deciding with whom to communicate matters. When the appropriate person(s) with whom to communicate are not clearly identifiable, the auditor and the engaging party should agree on the relevant person(s) within the entity's governance structure with whom the auditor will communicate.

Communicating Internal Control Related Matters Identified in an Audit

.185 In May 2006, the AICPA ASB issued SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325). SAS No. 112 establishes standards and provides guidance on communicating matters related to an entity's internal control over financial reporting (internal control) identified in an audit of financial statements. SAS No. 112 supersedes SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*, as amended. The new SAS is applicable whenever an auditor expresses an opinion on financial statements (including a disclaimer of opinion) and is effective for audits of financial statements for periods ending on or after December 15, 2006. Among other things, SAS No. 112 does the following:

- Requires the auditor to communicate control deficiencies that are *significant deficiencies* or *material weaknesses* in internal control. The terms are defined in the SAS. The term *reportable condition* is no longer used. When SAS No. 112 was issued the terms *significant deficiencies* and *material weaknesses* were consistent with PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*. However, with the adoption of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements,* the PCAOB redefined these terms, which now differ from SAS No. 112.

- Provides guidance on evaluating the severity of control deficiencies identified in an audit of financial statements and requires that the auditor conclude whether prudent officials, having knowledge of the same facts and circumstances, would agree with the auditor's classification of the deficiency.

- Identifies areas in which control deficiencies ordinarily are to be evaluated as at least significant deficiencies, as well as indicators that control deficiencies should be regarded as at least a significant deficiency and a strong indicator of a material weakness.
- Requires the auditor to communicate significant deficiencies and material weaknesses identified in the audit, in writing, to management and those charged with governance. This includes the significant deficiencies and material weaknesses that were communicated in previous audits if they have not yet been remediated.
- Indicates that the communication must be in writing and is best made by the report release date (the date on which the auditor grants permission for the client to use the auditor's report in connection with the financial statements), but should be made no later than 60 days following the *report release date*.
- Contains illustrative written communications to management and those charged with governance.

How Revisions of SAS No. 112 Affect Practice

.186 As auditors gain a better understanding of what needs to be communicated to management and those charged with governance, there may be more control deficiencies that are identified as significant deficiencies and material weaknesses, and communicated to management and those charged with governance. Auditors may emphasize and therefore spend more time evaluating identified control deficiencies than in the past.

Discussions With Management and Others

.187 The new requirements of SAS No. 112 may change perceptions regarding the auditor's role in the client's internal control. Auditors may have to explain to clients that the auditor *cannot* be a part of their internal control. Only the client—not the auditor—can correct control deficiencies. However, a CPA firm other than the auditor who does not provide attest services for the client can be part of a client's internal control. This may raise new questions regarding the role of outsourcing in achieving management's internal control objectives.

.188 Auditors may be called upon to hold discussions with management and other users of the auditor's written communication, such as regulators, to explain why the nature and extent of the internal control matters communicated to management and those charged with governance are different from the matters communicated in prior years. One reason is that the criteria have changed because of the introduction of the term *significant deficiencies* and its definition as well as a new definition of material weaknesses. Another reason is that auditors have to include significant deficiencies and material weaknesses, identified and communicated in previous years, in written communication as long as these deficiencies have not been remediated. Auditors may need to explain to management and other users that the auditors are required to inform them of the significant deficiencies and material weaknesses every year as long as those deficiencies still exist.

.189 Auditors may also need to hold discussions with management and other users who ask how the auditors were able to express an unqualified opinion on the financial statements when material weaknesses in internal control were present. Auditors may wish to explain that the audit was designed to provide reasonable assurance that the financial statements are free from material misstatements. Internal control should be designed to prevent or detect material misstatements. As previously stated, the auditor cannot be part of a client's internal control system. Auditors can express an unqualified opinion on the financial statements even though material weaknesses in internal control are present, because sufficient procedures were performed and appropriate audit evidence was obtained to afford reasonable assurance that the financial statements are free from material misstatement. However, these procedures do not *correct or remediate* control deficiencies; the deficiencies in internal control could still result in a material misstatement not being prevented, detected, and corrected by the client.

Issues for Audits of Smaller Entities

.190 One issue that may arise in audits of smaller entities is the possibility of increased costs as a result of the auditor time spent documenting his or her evaluation of internal control and evaluating identified control deficiencies.

.191 Another issue that may cause concern is the extent to which the auditor may be involved in the drafting of an entity's financial statements. It is a strong indication of material weakness in internal control if a client has ineffective controls over the preparation of its financial statements such that client controls are absent or controls are not effective in preventing, detecting, or correcting material misstatements in the preparation of financial statements, including the related notes. Although the auditor can propose adjustments and assist in assembling or drafting the financial statements, the auditor cannot establish or maintain the client's controls, including monitoring ongoing activities, since doing so would impair independence.[3] How an auditor responds to a client's internal control weakness, in terms of designing and carrying out auditing procedures, does not affect or mitigate a client's internal control weakness. Just as an auditor's response to detection risk is independent of the client's control risk, so too the auditor's response to a client's control weakness by assisting in drafting the financial statements does not change that control weakness.

.192 The new requirements of SAS No. 112 introduce possible opportunities for auditors. Auditors can help clients evaluate the cost-benefit implications of improving their internal control, including training their personnel to be more knowledgeable. Auditors can also teach clients how to develop a risk assessment approach to designing internal control. Readers should also note that the Internal Control Task Force of the ASB is revising SAS No. 112 in response to the adoption of PCAOB Auditing Standard No. 5 and International Standards on Auditing.

.193 The AICPA has published the AICPA Audit Risk Alert titled *Understanding SAS No. 112 and Evaluating Control Deficiencies* (product no. 022536kk) to assist in implementation of this SAS. This Audit Risk Alert provides specific case studies to help determine whether identified control weaknesses would constitute a significant deficiency or material weakness; it can be obtained by calling the AICPA at (888) 777-7077 or going online at www.cpa2biz.com.

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[3] See Ethics Ruling 101-3, "Performance of nonattest services," of the AICPA Code of Professional Conduct (AICPA, *Professional Standards*, vol. 2, ET sec. 101.05).

AICPA Risk Assessment Standards

.194 In March 2006, the AICPA ASB issued eight SASs referred to as the risk assessment standards (SAS Nos. 104–111). Although the SASs include many of the underlying concepts and detailed performance requirements contained in existing standards, they do create significant new requirements for the auditor. The risk assessment standards provide extensive guidance on how to apply the audit risk model when planning and performing financial statement audits, focusing on identifying and assessing the risk of material misstatements, further designing and performing tailored audit procedures in response to the assessed risks at relevant assertion levels, and improving the linkage between the risks, controls, audit procedures, and conclusions. The risk assessment standards are effective for audits of financial statements for periods beginning on or after December 15, 2006, with earlier applications permitted. The following table lists the eight SASs and their effects on existing standards.

Statement on Auditing Standards	***Effect on Existing Standards***
SAS No. 104, *Amendment to Statement on Auditing Standards No. 1,* Codification of Auditing Standards and Procedures *("Due Professional Care in the Performance of Work")* (AICPA, *Professional Standards*, vol. 1, AU sec. 230)	This statement amends SAS No. 1, *Due Professional Care in the Performance of Work* (AICPA, *Professional Standards*, vol. 1, AU sec. 230A).
SAS No. 105, *Amendment to Statement on Auditing Standards No. 95,* Generally Accepted Auditing Standards (AICPA, *Professional Standards*, vol. 1, AU sec. 150)	This statement amends SAS No. 95, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 150A).
SAS No. 106, *Audit Evidence* (AICPA, *Professional Standards*, vol. 1, AU sec. 326)	This statement supersedes SAS No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 326A).
SAS No. 107, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312)	This statement supersedes SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312A).
SAS No. 108, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311)	This statement supersedes SAS No. 1, *Appointment of the Independent Auditor* (AICPA, *Professional Standards*, AU sec. 310), and supersedes SAS No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311A).

(continued)

Statement on Auditing Standards	*Effect on Existing Standards*
SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1, AU sec. 314)	This statement supersedes SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319).
SAS No. 110, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*, vol. 1, AU sec. 318)	This statement supersedes SAS No. 45, *Substantive Tests Prior to the Balance Sheet Date* (AICPA, *Professional Standards*, vol. 1, AU sec. 313), and together with SAS No. 109, supersedes SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319).
SAS No. 111, *Amendment to Statement on Auditing Standards No. 39,* Audit Sampling (AICPA, *Professional Standards*, vol. 1, AU sec. 350)	This statement amends SAS No. 39, *Audit Sampling* (AICPA, *Professional Standards*, vol. 1, AU sec. 350A).

Key Provisions of the Risk Assessment Standards

.195 Whether due to error or fraud, the new risk assessment standards require the auditor to understand and respond to the risks of material misstatement. That understanding should identify risks to the client's business and the mitigating controls in place. The risk assessment standards place an even greater emphasis on the understanding and testing of internal control. Auditors may no longer simply default to a maximum control risk. Although this does not mean auditors are required to test and rely on controls as part of their audit strategy, they should assess how all five components of internal control over financial reporting relate to the client that they are auditing (see the Committee on Sponsoring Organizations of the Treadway Commission's (COSO) framework, www.coso.org/key.htm). These standards may significantly affect the formality of your risk assessment and documentation and may vary greatly from what auditors have previously done. Implementation of the SASs will most likely result in significant changes to firm audit methodologies and the training of personnel. Therefore, it is recommended that auditors allow ample time in advance of the required implementation date. Readers can obtain the SASs and the related AICPA Audit Risk Alert titled *Understanding the New Auditing Standards Related to Risk Assessment* (product no. 022526kk) by calling the AICPA at (888) 777-7077 or going online at www.cpa2biz.com.

Companion Audit Guide

.196 In December 2006, the AICPA published the Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* (product no. 012456kk). This guide helps auditors understand and implement the risk assessment standards. It includes practical guidance, examples, and an in-depth case study. The guide can be ordered by calling the AICPA at (888) 777-7077 or going online at www.cpa2biz.com.

Audit Documentation Technical Practice Aids

.197 In May 2007, the ASB issued two Technical Practice Aid (TPA) Technical Questions and Answers (TIS) related to SAS No. 103, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339), which was issued in December 2005.

.198 TIS section 9100.06, "The Effect of Obtaining the Management Representation Letter on Dating the Auditor's Report" (AICPA, *Technical Practice Aids*) discusses whether the auditor is required to have the signed management representation letter in hand as of the date of the auditor's report. This question and answer indicates that although the auditor need not be in physical receipt of the representation letter on the date of the auditor's report, management will need to have reviewed the final representation letter and, at a minimum, have orally confirmed that they will sign the representation letter, without exception, on or before the date of the representations. The auditor will need to have the signed management representation letter in hand prior to releasing the auditor's report because, since management's refusal to furnish written representations constitutes a limitation on the scope of the audit sufficient to preclude an unqualified opinion.

.199 TIS section 8350.01, "Current Year Audit Documentation Contained in the Permanent File" (AICPA, *Technical Practice Aids*) discusses whether the provisions of SAS No. 103 related to documentation completion and retention, apply to current year audit documentation maintained in the permanent file. This question and answer indicates that SAS No. 103 does apply to current year audit documentation maintained in a permanent file, or for that matter, maintained in any type of file, if the documentation serves as support for the current year's audit report.

Practice Alert No. 07-1, *Dating of the Auditor's Report and Related Practical Guidance*

.200 A key provision of SAS No. 103 is the amendment to paragraphs .01 and .05 of AU section 530, *Dating of the Independent Auditor's Report* (AICPA, *Professional Standards*, vol. 1), to require that the auditor's report not be dated earlier than the date on which the auditor has obtained sufficient appropriate audit evidence to support the opinion on the financial statements. As defined in the footnote to paragraph .01 of AU section 530, sufficient appropriate audit evidence includes, among other things, evidence that the audit documentation has been reviewed and that the entity's financial statements, including disclosures, have been prepared and that management has asserted that they have taken responsibility for them. Application of the rules may require revising the process used by audit firms at the end of fieldwork to include a field review of the audit working papers and financial statements. For some firms an additional visit to the client's office to update subsequent event analysis and management's representations may be required as well.

.201 The Professional Issues Task Force (PITF) issued this practice alert to provide guidance to auditors of nonissuers regarding the following:

- The audit report date

- Evidence supporting financial statement amounts and disclosures, specifically relating to attorney letters, obtaining waivers, and consideration and evaluation of subsequent events
- Financial statement preparation and management's assertions
- Evidence that the audit documentation has been reviewed

.202 Readers may access the practice alert at www.aicpa.org/download/auditstd/pract_alert/pa_2007_1.pdf. Readers should also note the PITF is currently working on a practice alert that addresses auditing and other considerations related to electronic information which it plans to issue during the third quarter of 2007.

PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements*

.203 In May 2007, the PCAOB adopted Auditing Standard No. 5, which was later approved by the SEC on July 25, 2007. This standard replaces Auditing Standard No. 2. Auditing Standard No. 5 is principles-based and presents a risk-based, top-down approach designed to increase the likelihood that material weaknesses will be found before resulting in a material misstatement of a company's financial statements, while eliminating unnecessary procedures. The standard was also designed to make audits more scaleable for smaller or less complex companies. The PCAOB worked closely with the SEC to coordinate Auditing Standard No. 5 with the guidance to public company management that was approved by the SEC in May 2007. Mark Olson, PCAOB Chairman, stated "The new standard is more risk based and scalable, which will better meet the needs of investors, public companies, and auditors alike."

.204 This new standard is required for all audits of internal control for fiscal years ending on or after November 15, 2007. However, early adoption is permitted and encouraged. For more information, readers may refer to the *SEC and PCAOB Alert—2007/08* (product no. 022498kk).

Recent AICPA Independence and Ethics Pronouncements

.205 The AICPA *Independence and Ethics Alert—2007/08* (product no. 022478kk) contains a complete update on new independence and ethics pronouncements. This alert can be obtained by calling the AICPA at (888) 777-7077 or going online at www.cpa2biz.com. Readers should obtain this alert to be aware of independence and ethics matters that will affect their practice.

Recent Accounting Pronouncements and Related Guidance

.206 Presented in the following table is a list of recently issued accounting pronouncements and related guidance. For information on accounting standards issued subsequent to the writing of this alert, please refer to the AICPA Web site at www.aicpa.org and the FASB Web site at www.fasb.org. You may also look for announcements of newly issued standards in the *CPA Letter* and *Journal of Accountancy*.

Recent Accounting Pronouncements and Related Guidance	
FASB Statement No. 159 (February 2007)	*The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115*
FASB Statement No. 158 (September 2006)	*Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106, and 132(R)*
FASB Statement No. 157 (September 2006)	*Fair Value Measurements*
FASB Interpretation No. 48 (June 2006)	*Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109*
FASB Emerging Issues Task Force (EITF) Issues (Various dates)	Go to www.fasb.org/eitf/agenda.shtml for a complete list of EITF Issues.
FASB Staff Positions (FSPs) (Various dates)	Go to www.fasb.org/fasb_staff_positions/ for a complete list of FSPs.
AICPA Statement of Position (SOP) 07-1 (AICPA, *Technical Practice Aids*, ACC sec. 10,930)	*Clarification of the Scope of the Audit and Accounting Guide* Investment Companies *and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies*
TIS section 6140.20–.22 (AICPA, *Technical Practice Aids*) (Nonauthoritative)	These questions and answers discuss not-for-profit organizations fund-raising expenses.
TIS section 6931.08–.10 (AICPA, *Technical Practice Aids*) (Nonauthoritative)	These questions and answers discuss various employee benefit plan topics.
TIS section 6300.25–.35 (AICPA, *Technical Practice Aids*) (Nonauthoritative)	These questions and answers discuss various issues related to SOP 05-1, *Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection With Modifications or Exchanges of Insurance Contracts*.
AICPA Practice Guide (Nonauthoritative)	"Practice Guide on Accounting for Uncertain Tax Positions Under FIN 48"

.207 Of the accounting pronouncements and related guidance listed in the previous table, those having particular significance to the financial institutions industry are discussed throughout this alert. The AICPA general *Audit Risk Alert—2007/08* and other AICPA industry-specific alerts also contain summaries of recent pronouncements that may not be discussed here. To obtain copies of AICPA literature, call (888) 777-7077 or go online at www.cpa2biz.com.

On the Horizon

.208 Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. Presented in the following sections is brief information about some ongoing projects that have particular significance to the financial institutions industry or that may result in significant changes. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing existing standards.

.209 The following table lists the various standard-setting bodies' Web sites, where information may be obtained on outstanding exposure drafts, including downloading exposure drafts. These Web sites contain much more in-depth information about proposed standards and other projects in the pipeline. Many more accounting and auditing projects exist in addition to those discussed here. Readers should refer to information provided by the various standard-setting bodies for further information.

Standard-Setting Body	***Web Site***
AICPA Auditing Standards Board (ASB)	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Auditing+Standards+Board/
AICPA Accounting Standards Executive Committee (AcSEC)	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/
Financial Accounting Standards Board (FASB)	www.fasb.org
Public Company Accounting Oversight Board (PCAOB)	www.pcaob.org
Professional Ethics Executive Committee (PEEC)	www.aicpa.org/Professional+Resources/Professional+Ethics+Code+of+Professional+Conduct/Professional+Ethics/
Securities and Exchange Commission (SEC)	www.sec.gov

Help Desk—The AICPA's standard-setting committees publish exposure drafts of proposed professional standards exclusively on the AICPA Web site. The AICPA will notify interested parties by e-mail about new exposure drafts. To be added to the notification list for all AICPA exposure drafts, send your e-mail address to service@aicpa.org. Indicate "exposure draft e-mail list" in the subject header field to help process your submission more efficiently. Include your full name, mailing address, and, if known, your membership and subscriber number in the message. The AICPA Web site also has connecting links to the other standard-setting bodies listed here.

Auditing Pipeline—Nonissuers

ASB Clarity Project

.210 The ASB has formed a Clarity Task Force to address concerns over the clarity, length, and complexity of generally accepted auditing standards. In March 2007, the ASB approved for exposure a discussion paper titled *Improving the Clarity of ASB Standards*. This discussion paper seeks feedback on proposed changes to the standards, including:

- Establishing objectives for each of the standards, and the auditor's obligations related to the objectives.
- Structural and drafting improvements to make the standards easier to read and understand.
- Inclusion, in the explanatory material of the standards, special considerations related to audits of public entities and small entities.
- Establishing a glossary of terms that would be presented in a separate section of the codification of the standards.

.211 The period to comment ended June 15, 2007. The discussion paper can be accessed at www.aicpa.org/download/auditstd/Clarity_of_ASB_Standards_Discussion_Memo.pdf.

Convergence With International Standards

.212 The ASB has created a number of task forces charged with monitoring specific activities of the International Auditing and Assurance Standards Board (IAASB) and working toward convergence with international auditing standards. The ASB has commented on several exposure drafts of International Standards on Auditing (ISA). The status of these and other ASB projects can be monitored online at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Auditing+Standards+Board/.

Proposed Statement on Standards for Attestation Engagements Regarding Reporting on an Entity's Internal Control Over Financial Reporting

.213 In January 2006, the ASB issued a revised exposure draft of a proposed Statement on Standards for Attestation Engagements (SSAE) that would supersede Chapter 5, "Reporting on an Entity's Internal Control Over Financial Reporting," of SSAE No. 10, *Attestation Engagements: Revision and Recodification* (AICPA, *Professional Standards*, vol. 1, AT sec. 501), as amended. This proposed SSAE establishes standards and provides guidance to the practitioner who is engaged to issue or does issue an examination report on the effectiveness of an entity's internal control over financial reporting as of a point in time (or on an assertion thereon). As mentioned previously, in May 2007, the PCAOB adopted Auditing Standard No. 5, which replaces Auditing Standard No. 2. Knowing the forthcoming changes would be relevant to the revision of AT section 501, the ASB previously decided to defer to issuance of a final revised AT section 501 until the PCAOB issued its amendments and the ASB had time to consider them. The Internal Control Task Force of the ASB is responsible for this revision. Readers may monitor progress on the AICPA Web site at www.aicpa.org.

Proposed Amendment to SAS No. 69, The Meaning of *Present Fairly in Conformity With Generally Accepted Accounting Principles*

.214 In May 2005, the ASB issued an exposure draft introducing a proposed SAS titled Amendment to Statement on Auditing Standards No. 69, The Meaning of *Present Fairly in Conformity With Generally Accepted Accounting Principles, for Nongovernmental Entities*. This proposed SAS, which applies only to nongovernmental entities, has been issued in response to the FASB's proposed Statement of Financial Accounting Standards titled *The Hierarchy of Generally Accepted Accounting Principles*. The FASB proposal moves responsibility for the GAAP hierarchy for nongovernmental entities from the auditing literature (SAS No. 69 [AICPA, *Professional Standards*, vol. 1, AU sec. 411]) to the accounting literature. The proposed SAS deletes the GAAP hierarchy for nongovernmental entities from SAS No. 69. The ASB decided to coordinate the provisions and effective date of this exposure draft with the proposed FASB statement, which can be obtained at www.fasb.org. The ASB will issue its final SAS coincidentally with the FASB's and PCAOB's issuance of their final standards.

Auditing Pipeline—Issuers

.215 Guidance issued by the PCAOB is included in the section of this alert titled "Recent Auditing and Attestation Pronouncements and Related Guidance." For more information regarding recent developments at both the SEC and PCAOB, readers may refer to the *SEC and PCAOB Alert—2007/08* (product no. 022498kk), mentioned previously.

Accounting Pipeline

.216 Presented below are accounting projects and pronouncements currently in process. Some of the proposed pronouncements discussed in the prior year alert have not been finalized as of the date of this writing, and thus are included again.

Business Combinations

.217 Phase one of the business combination project resulted in the issuance of FASB Statement No. 141, *Business Combinations*, and FASB Statement No. 142, *Goodwill and Other Intangible Assets*. In those statements, the FASB eliminated the use of the pooling of interests method of accounting for business combinations and addressed purchase accounting guidelines for acquired intangible assets and goodwill and goodwill impairment. The objective of phase two of this project is to standardize business combination accounting through the convergence of the FASB and International Accounting Standards Board (IASB) accounting standards and by reconsidering the existing guidance for the purchase method of accounting for business combinations. Among the main proposals are the following:

- All acquisitions of businesses be measured at the fair value of the business acquired.
- Substantially all the assets acquired and liabilities assumed of the acquired business be recognized and measured at their fair values at the acquisition date.

- Entities that follow U.S. GAAP and international standards apply substantially the same accounting requirements for their business combinations.

.218 In June 2005, the FASB and IASB (the Boards) issued a number of exposure drafts, for which comment periods ended in October 2005. Redeliberations began in January 2006 and were completed in June 2007. The Boards expect to issue final statements during the fourth quarter of 2007. Four standards are expected to be issued:

- Proposed FASB Statement No. 141(R) and International Financial Reporting Standard (IFRS) No. 3(R), *Business Combinations*
- Proposed FASB Statement No. 160, *Consolidated Financial Statements, Including Accounting and Reporting of Noncontrolling Interests in Subsidiaries*
- Proposed International Accounting Standard (IAS) Statement No. 27(R)

.219 Readers should remain alert to the final issuances and visit the FASB Web site for further information.

Fair Value

.220 During phase one of the FASB's fair value option project, the FASB issued FASB Statement No. 159, which was previously discussed. In phase two of the project, the FASB will consider allowing the fair value option for certain nonfinancial assets and nonfinancial liabilities and deposit liabilities of depository institutions, which are excluded from the scope of FASB Statement No. 159. Deliberations on phase two are expected to begin in the third quarter of 2007. Readers should remain alert to developments by visiting the FASB Web site.

Derivative Disclosures

.221 In December 2006, the FASB issued an exposure draft titled *Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133*. The comment period for this exposure ended in March 2007 and the FASB has begun redeliberations to consider significant issues raised by respondents. The objective of this project is to provide guidance on enhanced disclosure requirements and balance sheet and income statement display of derivatives accounted for in accordance with FASB Statement No. 133 including how and why an entity uses derivative instruments; how derivative instruments and related hedged items are accounted for under FASB Statement No. 133; and how derivative instruments affect an entity's financial position, results of operations, and cash flows. Readers can monitor the progress of this project on the FASB Web site.

Transfers of Financial Assets

.222 The FASB is working on a project to amend FASB Statement No. 140 to address issues related to the permitted activities of a QSPE, isolation criteria, and other issues that arose during redeliberations on the amendment of FASB Statement No. 140 to improve comparability of financial statements. In August 2005, the FASB issued exposure draft, *Accounting for Transfers of Financial Assets*, which was a revision of a June 2003 exposure draft. During 2007, the FASB expects to address issues related to the permitted activities of a

QSPE and then issue another exposure draft during the fourth quarter of 2007 containing potential amendments to FASB Statement No. 140. See the FASB Web site for complete information.

Earnings Per Share

.223 The FASB and IASB have been working together to resolve differences between FASB Statement No. 128, *Earnings per Share*, and IAS Statement No. 33, *Earnings per Share*. This project is part of the larger FASB project, Short-term International Convergence, which has resulted in the issuance of a number of FASB Statements. Currently the FASB and IASB are addressing significant differences that remain relating to instruments that can be settled in cash or shares and are classified as a liability on an entity's balance sheet. The FASB and IASB are considering modifications to the treasury stock method and several scoping issues in which either the FASB or IASB has issued or may issue more detailed implementation guidance on earnings per share that may create a convergence difference. The FASB and IASB are expected to issue an exposure draft for public comment during the third quarter of 2007. This exposure draft will be the third exposure draft the FASB has issued on the earnings per share project. The project and current exposure draft can be reviewed on the FASB Web site.

FASB Codification and Retrieval Project

.224 The goal of this FASB project is to create a single, authoritative codification of U.S. GAAP. The codification will integrate and topically organize all relevant accounting guidance issued by the U.S. standard setters (FASB, AICPA, EITF, and the SEC). The codification will have a three layered structure: topic, subtopic, and section. The FASB has structured the topics into three primary areas: overall presentation, transactional (or financial statement account), and industry. The overall presentation area addresses presentation of financial information, but does not address items such as recognition, measurement, or derecognition. The transactional or financial statement account area addresses accounting recognition, measurement, or derecognition. The industry area includes guidance unique to the industry. A codification draft is expected in 2007 and will have an extended verification period to ensure that it accurately reflects U.S. GAAP. Once the FASB addresses respondent comments, the codification will become the single authoritative source of U.S. GAAP and will supersede all existing standards. Readers can track progress of the Codification and Retrieval Project on the FASB Web site at www.fasb.org/project/codification&retrieval_project.shtml.

GAAP Hierarchy

.225 This proposed statement would identify the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental companies that are presented in conformity with U.S. GAAP (or the GAAP hierarchy). The GAAP hierarchy is currently presented in AICPA AU section 411. However, the FASB believes that the GAAP hierarchy should be directed specifically to companies because it is the company, not the auditor, who is responsible for selecting its accounting principles for financial statements. Accordingly, the FASB concluded that the GAAP hierarchy should reside in the accounting literature established by the FASB. The FASB decided to carry forward the GAAP hierarchy as set forth in AU section 411, subject to certain modifications. The FASB staff will coordinate with the AICPA (as previously discussed in the "Auditing Pipeline—Nonissuers" section) to ensure that each of the documents has a uniform effective date. Readers should be alert for the issuance of a final statement.

Proposed FASB EITFs and FSPs

.226 ***Proposed FASB EITF Issues***. Numerous open issues are under deliberation by the EITF. Readers should visit the FASB Web site at www.fasb.org/eitf/agenda.shtml for complete information.

.227 ***Proposed FSPs***. A number of proposed FSPs are currently in progress. Readers should visit the FASB Web site at www.fasb.org/fasb_staff_positions/ for complete information.

Resource Central

.228 The following are various resources that practitioners engaged in the depository and lending institutions industry may find beneficial.

Publications

.229 Practitioners may find the following publications useful with respect to the depository and lending industry:

- Audit and Accounting Guide *Depository and Lending Institutions: Banks and Savings Institutions, Credit Unions, Finance Companies, and Mortgage Companies* (2007) (product no. 012737kk)
- Audit Guide *Analytical Procedures* (2007) (product no. 012557kk)
- Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* (2006) (product no. 012456kk)
- Audit Guide *Auditing Derivative Instruments Hedging Activities, and Investments in Securities* (2007) (product no. 012527kk)
- Audit Guide *Auditing Revenue in Certain Industries* (2007) (product no. 012517kk)
- Audit Guide *Audit Sampling* (2007) (product no. 012537kk)
- Audit Guide *Service Organizations: Applying SAS No. 70, as Amended* (2007) (product no. 012777kk)
- AICPA *Audit Risk Alert—2007/08* (product no. 022338kk)
- Audit Risk Alert *Compilation and Review—2007/08* (product no. 022308kk)
- Audit Risk Alert *Independence and Ethics—2007/08* (product no. 022478kk)
- Audit Risk Alert *SEC and PCAOB Alert—2007/08* (product no. 022498kk)
- Audit Risk Alert *Understanding the New Auditing Standards Related to Risk Assessment* (product no. 022526kk)
- Audit Risk Alert *Understanding SAS No. 112 and Evaluating Control Deficiencies* (product no. 022536kk)
- *Checklist and Illustrative Financial Statements for Depository and Lending Institutions* (product no. 008916kk)
- Audit and Accounting Practice Aid *Illustrative Disclosures on Derivative Loan Commitments* (product no. 006642kk)

- *Audit and Accounting Manual* (2007) (product no. 005137kk)
- *Accounting Trends & Techniques, 61st Edition* (product no. 009899kk)

AICPA reSOURCE: Accounting and Auditing Literature

.230 The AICPA has created your core accounting and auditing library online. AICPA reSOURCE is now customizable to suit your preferences or your firm's needs. Or, if you prefer to have access to the entire library, that is available too. Get access—anytime, anywhere—to the AICPA's latest *Professional Standards*, *Technical Practice Aids*, Audit and Accounting Guides (more than 20), Audit Risk Alerts (more than 15), and *Accounting Trends & Techniques*. To subscribe to this essential online service for accounting professionals, go to www.cpa2biz.com.

Continuing Professional Education

.231 The AICPA offers a number of continuing professional education (CPE) courses that are valuable to CPAs working in public practice and industry, including the following:

- *AICPA's Annual Accounting and Auditing Update Workshop* (2007 Edition) (product no. 736183kk [text] or 187191 [DVD]). Whether you are in industry or public practice, this course keeps you current and informed and shows you how to apply the most recent standards.
- *SEC Reporting* (product no. 736774kk [text] or 186755 [DVD]). Confidently comply with the latest SEC reporting requirements with this comprehensive course. It clarifies new, difficult, and important reporting and disclosure requirements while giving you examples and tips for ensuring compliance.

Among the many courses, *Audits of Banks and Other Financial Institutions* (self study) (product no. 733440) specifically relates to the banking and lending institutions industry. Visit www.cpa2biz.com for a complete list of CPE courses.

Online CPE

.232 AICPA CPExpress (formerly AICPA InfoBytes), offered exclusively through CPA2Biz.com, is AICPA's flagship online learning product. AICPA CPExpress now offers a free trial subscription to the entire product for up to 30 days. AICPA members pay $149 for a new subscription and $119 for the annual renewal. Nonmembers pay $369 for each. Divided into 1-credit and 2-credit courses that are available 24 hours a day, 7 days a week, AICPA CPExpress offers hundreds of hours of learning in a wide variety of topics.

.233 To register or learn more, visit www.cpa2biz.com.

Webcasts

.234 Stay plugged in to what is happening and earn CPE credit right from your desktop. AICPA Webcasts are high quality, two-hour CPE programs that bring you the latest topics from the profession's leading experts. Broadcast live, they allow you to interact with the presenters and join in the discussion. If you cannot make the live event, each Webcast is archived and available on CD-ROM.

CFO Quarterly Roundtable Series

.235 The CFO Quarterly Roundtable Webcast Series, brought to you each calendar quarter, covers a broad array of "hot topics" that successful organizations employ and subjects that are important to the CFO's personal success. From financial reporting and budgeting and forecasting to asset management and operations, the roundtable helps CFOs, treasurers, controllers, and other financial executives excel in their demanding roles.

SEC Quarterly Update Series

.236 The SEC Quarterly Update Webcast Series, brought to you each calendar quarter, showcases the profession's leading experts on what is "hot" at the SEC. From corporate accounting reform legislation and new regulatory initiatives to accounting and reporting requirements and corporate finance activities, these hard-hitting sessions will keep you "plugged in" to what is important. A must for preparers in public companies and practitioners who have public company clients, this is the place to be when it comes to knowing about the areas of current interest at the SEC.

Member Service Center

.237 To order AICPA products, receive information about AICPA activities, and find help on your membership questions, call the AICPA Service Operations Center at (888) 777-7077.

Hotlines

Accounting and Auditing Technical Hotline

.238 Do you have a complex technical question about GAAP, other comprehensive bases of accounting, or other technical matters? If so, use the AICPA's Accounting and Auditing Technical Hotline. AICPA staff will research your question and call you back with the answer. You can reach the Technical Hotline at (888) 777-7077.

Ethics Hotline

.239 In addition to the Technical Hotline, the AICPA also offers an Ethics Hotline. Members of the AICPA's Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. You can reach the Ethics Hotline at (888) 777-7077.

Industry Conference

.240 The AICPA sponsors an annual conference on banks and savings institutions in the winter. The National Conference on Banks & Savings Institutions is a three-day conference designed to update attendees on recent developments related to all banking operations. This is the only conference where both community banks and large banking institutions can acquire the critical understanding of current banking issues on emerging audit, accounting, and regulatory developments. Speakers will focus on issues and updates as well as forecasts and trends in the banking industry. For further information about the conference, call (888) 777-7077 or visit www.cpa2biz.com.

AICPA CAQ

.241 The CAQ (formerly the Center for Public Company Audit Firms) was created to serve investors, public company auditors and the markets. The CAQ's mission is to foster confidence in the audit process and to aid investors and the capital markets by advancing constructive suggestions for change rooted in the profession's core values of integrity, objectivity, honesty, and trust.

.242 To accomplish this mission, the CAQ works to make public company audits even more reliable and relevant for investors in a time of growing financial complexity and market globalization. The CAQ also undertakes research, offers recommendations to enhance investor confidence and the vitality of the capital markets, issues technical support for public company auditing professionals, and helps facilitate the public discussion about modernizing business reporting. The CAQ is a voluntary membership center that supports member firms that audit or are interested in auditing public companies with education, communication, representation, and other means. To learn more about the CAQ, visit http://thecaq.aicpa.org.

AICPA Industry Expert Panel—Depository Institutions

.243 For information about the activities of the Depository Institution Industry Expert Panel, visit the AICPA Web site at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/expertpanel_depository.htm.

Industry Web Sites

.244 The Internet covers a vast amount of information that may be valuable to auditors of financial institutions, including current industry trends and developments. Some of the more relevant sites for auditors with financial institution clients include those shown in the following table.

Organization	*Web Site*
Federal Deposit Insurance Corporation	www.fdic.gov
Financial Crimes Enforcement Network	www.fincen.gov
Mortgage Bankers Association	www.mbaa.org
National Credit Union Administration	www.ncua.gov
Office of the Comptroller of the Currency	www.occ.treas.gov

.245 The financial institution practices of some of the larger CPA firms may also contain industry-specific auditing and accounting information that is helpful to auditors.

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.246 This Audit Risk Alert replaces *Bank, Credit Union, and Other Depository and Lending Institution Industry Developments—2006/07*.

.247 The Audit Risk Alert *Bank, Credit Union, and Other Depository and Lending Institution Industry Developments* is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Audit Risk Alert, please feel free to share them with us. Any other comments that you have about the Audit Risk Alert would also be appreciated. You may e-mail these comments to kbiser@aicpa.org or write to:

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APPENDIX—Additional Web Resources

Here are some useful Web sites that may provide valuable information to accountants.

Web Site Name	*Content*	*Web Site*
American Institute of CPAs (AICPA)	Summaries of recent auditing and other professional standards as well as other AICPA activities	www.aicpa.org www.cpa2biz.com
AICPA Accounting Standards Executive Committee (AcSEC)	Issues SOPs, guides, Practice Bulletins containing financial, accounting, and reporting recommendations, among other things	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards
AICPA Accounting and Review Services Committee (ARSC)	Develops and issues review and compilation standards and interpretations	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Accounting+and+Review+Services+Committee
AICPA Professional Issues Task Force (PITF)	Accumulates and considers practice issues that appear to present concerns for practitioners and for disseminating information or guidance, as appropriate, in the form of practice alerts	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Professional+Issues+Task+Force
Economy.com	Source for analysis, data, forecasts, and information on the United States and world economies	www.economy.com
The Federal Reserve Board	Key interest rates	www.federalreserve.gov
Financial Accounting Standards Board (FASB)	Summaries of recent accounting pronouncements and other FASB activities	www.fasb.org
USA.gov	Portal through which all government agencies can be accessed	www.usa.gov

Web Site Name	*Content*	*Web Site*
Government Accountability Office (GAO)	Policy and guidance materials, reports on federal agency major rules	www.gao.gov
Governmental Accounting Standards Board (GASB)	Summaries of recent accounting pronouncements and other GASB activities	www.gasb.org
International Accounting Standards Board (IASB)	Summaries of International Financial Reporting Standards and International Accounting Standards	www.iasb.org
International Federation of Accountants (IFAC)	Information on standards-setting activities in the international arena	www.ifac.org
Public Company Accounting Oversight Board (PCAOB)	Information on accounting and auditing the activities of the PCAOB and other matters	www.pcaob.org
Securities and Exchange Commission (SEC)	Information on current SEC rulemaking and the EDGAR database	www.sec.gov