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# Financial institutions industry developmelnts: Including depository and lending institutions and brokers and dealers in securities - 2009; Audit risk alerts

American Institute of Certified Public Accountants

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Financial Institutions Industry Developments: Including Depository and Lending Institutions and Brokers and Dealers in Securities — 2009

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A U D I T R I S K A L E R T

2009

# Financial Institutions Industry Developments:

Including Depository and  
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Brokers and Dealers in  
Securities

STRENGTHENING AUDIT INTEGRITY  
SAFEGUARDING FINANCIAL REPORTING



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AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

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## Notice to Readers

This Audit Risk Alert is intended to provide auditors of financial statements of financial institutions, including depository and lending institutions and brokers and dealers (broker-dealers) in securities, with an overview of recent economic, industry, technical, regulatory, and professional developments that may affect the audits and other engagements they perform. Because broker-dealers in securities often deal in commodity futures or function as commodity pool operators, this Audit Risk Alert expands the discussion of recent developments to include matters that may affect the audits of commodity entities as well. This Audit Risk Alert also can be used by an entity's internal management to address areas of audit concern.

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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*Technical Manager*  
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## How This Alert Helps You

**.01** This Audit Risk Alert (alert) helps you plan and perform your audits of depository, lending, and other financial institutions, and also can 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 environments in which your clients operate. This alert is an important tool to help you identify the significant risks that may result in the material misstatement of financial statements and delivers information about emerging practice issues and current accounting, auditing, and regulatory developments. 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.

**.02** Certain accounting guidance referenced in this alert has been codified into the Financial Accounting Standards Board (FASB) *Accounting Standards Codification*<sup>™</sup> (ASC). On June 30, 2009, FASB issued FASB Statement No. 168, *The FASB Accounting Standards Codification<sup>™</sup> and the Hierarchy of Generally Accepted Accounting Principles—a replacement of FASB Statement No. 162*, which is codified in FASB ASC 105, *Generally Accepted Accounting Principles*. On the effective date of this statement, FASB ASC became the source of authoritative U.S. accounting and reporting standards for nongovernmental entities, in addition to guidance issued by the Securities and Exchange Commission (SEC). FASB ASC superseded all then-existing, non-SEC accounting and reporting standards for nongovernmental entities. All other nongrandfathered, non-SEC accounting literature not included in FASB ASC became nonauthoritative. See the discussion of FASB ASC in the "Accounting Issues and Developments" section of this alert.

## Audit Risk

**.03** It is essential that the auditor understand the meaning of audit risk and the interaction of audit risk with the objective of obtaining sufficient appropriate audit evidence. In AU section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1), *audit risk* is broadly defined as the risk that the auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated. At the account balance, class of transactions, relevant assertion, or disclosure level, audit risk consists of the risks (both inherent risk and control risk) that the relevant assertions related to balances, classes, or disclosures contain misstatements (whether caused by error or fraud) that could be material to the financial statements when aggregated with misstatements in other relevant assertions related to balances, classes, or disclosures and the risk (detection risk) that the auditor will not detect such misstatements.

**.04** The auditor's combined assessment of inherent risk and control risk is described as the risks of material misstatement. The auditor should use information gathered by performing risk assessment procedures, including the audit evidence obtained in evaluating the design of controls and determining whether they have been implemented, as audit evidence to support the risk assessment. The auditor should use the risk assessment to determine the nature, timing, and extent of further audit procedures to be performed.

**.05** As set forth in paragraph .12 of AU section 312, the auditor may reduce audit risk by determining overall responses and designing the nature,

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timing, and extent of further audit procedures. Furthermore, paragraph .19 of AU section 312 explains that the auditor should seek to reduce audit risk at the individual balance, class, or disclosure level in such a way that will enable the auditor to express an opinion on the financial statements as a whole at an appropriately low level of audit risk.

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

**.06** AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), establishes requirements and provides guidance about implementing the second standard of field work, as follows: "The auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures." Obtaining this understanding is further complicated by the rapidly changing economic environment. In accordance with paragraph .04 of AU section 314, the auditor's primary consideration is whether the understanding that has been obtained is sufficient to assess risks of material misstatement of the financial statements and to design and perform further audit procedures.

**.07** The auditor's understanding of the entity and its environment consists of an understanding of the following:

- 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

**.08** Appendix A of AU section 314 contains examples of matters that the auditor may consider in obtaining an understanding of the entity and its environment relating to the categories previously discussed. Understanding the effects of the current economic climate on each specific audit client is a key step in designing the audit plan.

**.09** Business risks result from conditions, events, circumstances, actions, or inactions that could adversely affect the entity's ability to achieve its objectives and execute its strategies. The setting of inappropriate objectives and strategies also results in business risks. Just as the external environment changes, the handling of the entity's business also is 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.

**.10** Additionally, financial institutions are subject to specific risks of material misstatement arising from the nature and complexity of the business,

the degree of regulation, and other external forces (such as, political, economic, social, technical, and competitive forces). 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. 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 Developments

### The Current Economic Crisis

.11 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, availability of credit, consumer confidence, overall economic expansion or contraction, inflation, and labor market conditions are likely to have an effect on an entity's financial statements, which has been particularly true in the financial institutions industry during the current economic crisis.

.12 Currently, the U.S. economy continues to experience instability. According to the National Bureau of Economic Research, the U.S. economy has been in a recession since December 2007. The length and severity of this recession remains unclear. However, certain positive signs have emerged, and therefore, economists have begun to consider the likelihood and speed of economic recovery. Some key occurrences that exhibit the extent of the economic crisis include the following:

- U.S. real gross domestic product (GDP), the broadest measure of economic activity, continues to decrease, although the reduction was smaller in the second quarter of 2009.
- The number of jobless claims remains high.
- The Federal Reserve Board (Federal Reserve) has maintained the federal funds interest rate at a historically low level.
- Federal government intervention in the private sector has increased significantly. Numerous financial institutions and automakers have received bailouts from the government.
- Millions of households owe more on their mortgages than their homes are currently worth. In addition, the number of residential home foreclosures continues to increase.
- The financial markets continue to experience instability—historic lows followed by rallies. In March 2009, the S&P 500 and Dow Jones Industrial Average (Dow) reached their 12-year lows and NASDAQ closed at its lowest point since October 2002. However, subsequent to the March low, the Dow had risen 54 percent by October 22, 2009.

**4****Audit Risk Alert****Key Economic Indicators**

.13 These key economic indicators further illustrate the severity of the recessionary period the United States is experiencing.

.14 The GDP measures output of goods and services by labor and property within the United States. It increases as the economy grows or decreases as it slows. According to an estimate from the Bureau of Economic Analysis, real GDP decreased at an annual rate of 0.7 percent in the second quarter of 2009. This data indicates a moderation in the slowing of the economy seen in the fourth quarter of 2008 and first quarter of 2009, which experienced decreases of 6.3 percent and 5.5 percent, respectively.

.15 The unemployment rate began to level out from June through September 2009. During that period it remained between 9.4 percent and 9.8 percent. An unemployment rate of 9.8 percent represents approximately 15.1 million people. Since the start of the recession in December 2007, the number of unemployed persons has increased by as much as 7.6 million, or 4.9 percentage points.

.16 As of March 2009, the Federal Reserve had decreased the target for the federal funds rate more than 5.0 percentage points to less than 0.25 percent. The Federal Reserve noted in its September 23, 2009, press release "that economic conditions are likely to warrant exceptionally low levels of the federal funds rate for an extended period."

**Government Intervention to Curtail the Economic Crisis**

.17 The U.S. government has taken unprecedented actions to prevent worsening economic conditions, including passing the American Recovery and Reinvestment Act (Recovery Act) and the Emergency Economic Stabilization Act of 2008 (EESA), facilitating the sale of ailing banks and dramatically increasing the monetary programs available from the Federal Reserve.

**The American Recovery and Reinvestment Act of 2009**

.18 In February 2009, President Obama signed legislation designed to work hand in hand with the EESA to stimulate the U.S. economy. The Recovery Act is designed primarily to combat the rising unemployment trends, put more money in the hands of consumers, and reduce the likelihood that state and local governments will need to raise taxes significantly. According to the White House press release, the legislation will do the following:

- Create or save 3.5 million jobs in the next 2 years
- Provide direct tax relief to working and middle class families
- Double the U.S. renewable energy generating capacity over 3 years
- Stimulate private investment in renewable energy through tax credits and loan guarantees
- Invest \$150 billion in U.S. infrastructure projects
- Provide funds to U.S. state and local governments to support health and education programs

.19 Many of the provisions of this legislation took effect immediately in an effort to stimulate consumer spending and boost the economy. The total cost of the spending in the Recovery Act is \$787 billion, which is in addition to the \$700 billion in the EESA. Many economists are concerned that further

financial support may be necessary before an economic recovery is possible. Additionally, the federal government developed the Web site [www.recovery.gov](http://www.recovery.gov) to facilitate a transparent process to ensure accountability for the execution of the package.

### ***Other Government Intervention***

.20 The passage of the Recovery Act came shortly after the passage of the EESA, which was signed into law in October 2008. As stated in section 2 of the EESA bill, it "provide[s] authority and facilities that the Secretary of the Treasury can use to restore liquidity and stability to the financial system of the United States" to ensure the economic well-being of Americans. Primary components of the EESA bill include the following:

- An allocation of \$700 billion to stabilize the U.S. financial system
- The creation of an oversight board, executive compensation rules, and other corporate governance rules for any entities that receive government aid
- An increase of the statutory limit on public debt from \$10.0 trillion to \$11.3 trillion
- A temporary increase of Federal Deposit Insurance Corporation (FDIC) insurance limits to \$250,000. (On May 20, 2009, President Obama signed into law the Helping Families Save Their Homes Act, which extended the \$250,000 basic deposit insurance limit to December 31, 2013.)
- The creation of a tax modification for Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac) stock losses
- The requirement of the SEC to conduct a study on FASB's fair value accounting guidance<sup>1</sup>

.21 In addition to bailout funds targeting financial institutions, a \$17.4 billion rescue package for the U.S. automakers was issued in December 2008. The funds, which were distributed to General Motors (GM) and Chrysler in the first half of 2009, did not, however, prevent the automakers from filing for bankruptcy. Chrysler filed for bankruptcy by the end of April 2009, and GM filed on June 1, 2009. Through bankruptcy restructurings, the U.S. government became a 61 percent stakeholder in GM and an 8 percent stakeholder in Chrysler. The U.S. Department of Treasury (Treasury) expects an aggressive sale of its stake in GM with expectations of an initial public offering in 2010, whereas a timetable for a sale in Chrysler has not yet been announced.

.22 The complete effects of the Recovery Act, as well as the other government interventions, will take time to be felt throughout the economy; however, the primary goal is to increase market confidence and liquidity.

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<sup>1</sup> In the comprehensive study on fair value accounting, the Securities and Exchange Commission (SEC) staff did not recommend a suspension of fair value accounting standards. Rather, the staff recommended improving existing fair value accounting standards and related guidance. As noted in the report, the staff's research reflected that fair value accounting provides transparent financial information to investors, and better guidance can and should be provided to assist those responsible for making fair value measurement judgments. For the full text of the SEC report, visit [www.sec.gov/news/studies/2008/marktmarket123008.pdf](http://www.sec.gov/news/studies/2008/marktmarket123008.pdf).

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Audit Risk Alert

## Industry, Legislative, and Regulatory Developments

.23 The following paragraphs address certain effects of the economic crisis on the following industries: banking and savings institutions, credit unions, mortgage banking, and brokers and dealers (broker-dealers) in securities. Each section provides a brief background of the state of the industry and the related programs and actions initiated by government agencies to address certain aspects of the economic crisis.

### Banks and Savings Institutions

.24 The banking and savings industry continues to confront unprecedented challenges as a result of the events related to the financial crisis. The following statistics from the *FDIC Quarterly*<sup>2</sup> highlight some of the effects on this industry.

**Historical Trends for FDIC-insured Institutions  
as of June 30, 2009**

	YTD 2009	2008	2007
Commercial Banks	6,995	7,085	7,283
Savings Institutions	1,200	1,220	1,251
Problem Institutions <sup>3</sup>	416	252	76
Failed Institutions	45 <sup>4</sup>	25	3

.25 These statistics and other reports show that, although some banks are coping with the crisis, others have experienced significant repercussions and a growing number of insured institutions are no longer in operation.

.26 The number of failed institutions increased significantly beginning in 2008, including the largest bank failure in FDIC history, when Washington Mutual was closed by the Office of Thrift Supervision (OTS) in the fall of 2008 and appointed the FDIC as receiver. Additional weaknesses in financial institutions became apparent during this time with the increase in government assistance for certain institutions, the failure of Lehman Brothers Holdings Inc., and the consolidation of the nation's largest investment banks and bank holding companies (BHCs), including certain acquisitions partially funded through government assistance.

<sup>2</sup> Readers are encouraged to obtain the most recent *FDIC Quarterly* and other Federal Deposit Insurance Corporation (FDIC)-insured institution statistics at [www2.fdic.gov/qbp/qbpSelect.asp?menuItem=QBP](http://www2.fdic.gov/qbp/qbpSelect.asp?menuItem=QBP).

<sup>3</sup> Federal regulators assign a composite rating to each financial institution, based upon an evaluation of financial and operational criteria. The rating is based on a scale of one to five in ascending order of supervisory concern. *Problem institutions* are those institutions with financial, operational, or managerial weaknesses that threaten their continued financial viability. Depending upon the degree of risk and supervisory concern, they are rated either a four or five. The number and assets of problem institutions are based on FDIC composite ratings.

<sup>4</sup> The number of failed institutions continues to increase on a weekly basis. As of October 19, 2009, the number of failed institutions in 2009 was 99. The FDIC Web site provides additional information on the failed institutions and the estimated cost to the Deposit Insurance Fund.



## Financial Institutions Industry Developments—2009

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**.27** As noted in *FDIC Supervisory Insights* (Summer 2009)<sup>5</sup>, the current credit crisis revealed the implications of excessive risk concentrations to banks' balance sheets and other detrimental lending practices. The recent economic crisis has shown that credit concentrations may be adversely affected by several significant risks that could prove to be damaging to institutions that are not well capitalized. For example, financial institutions heavily concentrated in residential real estate have been the most vulnerable to the decline in home values and the increase in unemployment. In addition, financial institutions heavily concentrated in commercial real estate and construction and development loans may be inordinately susceptible to corporate defaults and the possibility of a slow recovery.

**.28** According to the OTS, the nation's thrifts essentially broke even in the second quarter of 2009, posting a slight profit of \$4 million, an improvement from losses of \$5.4 billion in the fourth quarter of 2008 and losses of \$1.62 billion in the first quarter of 2009. However, the number of problem thrifts—those with composite examination ratings of 4 or 5 on a scale of 1 to 5 with 1 being the best rating—rose to 40 from 31 in the previous quarter. The level of troubled assets also continued to rise—to 3.52 percent of assets, up from 3.35 percent in the previous quarter and 2.68 percent in the prior-year second quarter. Although the ratio of troubled assets is slightly below the record of 3.86 percent in the first quarter of 1991, the profile of troubled assets has changed substantially since that year. At the end of 1990, mortgages for commercial real estate loans, such as nonresidential mortgages, multifamily complexes, and construction loans, made up 68 percent of savings institutions' troubled assets, while one-to-four family residential properties were 23 percent of troubled assets and nonmortgage loans were 12 percent. In the first quarter of 2009, mortgages on one-to-four family residential properties accounted for 68 percent of troubled assets, commercial real estate loans were 22 percent, and the remaining 10 percent were nonmortgage loans.

**.29** In addition to the effects of the financial crisis on banking and savings institutions, Fannie Mae and Freddie Mac experienced dramatic repercussions and were placed into conservatorship of the Federal Housing Finance Agency in 2008. The Treasury acquired \$1 billion of preferred shares in each government sponsored entity (GSE), effectively wiping out the equity owners and preferred shareholders. As of September 2009, both Fannie Mae and Freddie Mac continue to operate under conservatorship and both GSEs continue to struggle. Fannie Mae lost more than \$28 billion in the first 6 months of 2009 and Freddie Mac lost nearly \$10 billion in the second quarter of 2009.

**.30** The losses to equity and preferred shareholders of the GSEs, losses from the bankruptcy of Lehman Brothers Holdings Inc., and prospective losses from the potential bankruptcy of other large financial institutions sharply increased the degree of risk aversion in the financial markets. Credit spreads in interbank lending markets spiked, and banks found it more difficult to fund their operations.

**.31** To address the risk aversion and instability in financial markets, the Troubled Assets Relief Program (TARP), which includes the Capital Purchase

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<sup>5</sup> The *FDIC Supervisory Insights* publication from Summer 2009 provides a chronology of the more significant events and developments affecting financial institutions during 2008 and concludes with a discussion of areas of supervisory focus going forward. This publication is located on the FDIC Web site at [www.fdic.gov/regulations/examinations/supervisory/insights/sisum09/si\\_sum09.pdf](http://www.fdic.gov/regulations/examinations/supervisory/insights/sisum09/si_sum09.pdf).

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Program (CPP) and the Public-Private Investment Program (PPIP), and other programs supported by U.S. financial regulatory agencies, including programs supporting the GSEs, provided \$6.8 trillion in temporary loans, liability guarantees, and asset guarantees in 2008. By the end of the first quarter of 2009, the maximum capacity of new government support programs in place or announced exceeded \$13 trillion.

**.32** The EESA authorized the Treasury to create TARP with an original intent to use \$700 billion to purchase illiquid mortgage assets from banks. As part of TARP, the CPP injected \$250 billion of capital into financial institutions. Through the CPP, the Treasury is investing in viable banks to build up their capital bases, which should allow these banks to provide credit, and thereby, increase the flow of funds in the financial markets. (See the "United States Department of Treasury" section for additional information regarding the repayment of the TARP funds).

**.33** The government continues to provide financial support to the GSEs through Preferred Stock Purchase Agreements, which will provide up to \$200 billion for each GSE, a Mortgage-Backed Securities (MBS) purchase program, and a credit facility. These programs were designed to (a) promote stability in financial markets, (b) improve the availability of mortgage credit to homebuyers, and (c) ensure investor confidence in the GSEs. The authority to make purchases under the GSE MBS program expires on December 31, 2009, and, according to the Treasury, it does not expect to use the credit facility in fiscal year 2010. Through support of the GSEs, the government has supported an increase in the flow of mortgage credit and insulated mortgage rates from the rapid increases and fluctuations in the cost of other credit.

**.34** Considering these regulatory actions and programs and others discussed in this section, recent results may reflect little change in lending activity. The Treasury conducts a monthly bank lending survey based on data from the top 22 recipients of government investments through the CPP. As of August 2009, total origination of new loans at the 22 surveyed institutions decreased 20 percent from July to August. In August, the institutions originated approximately \$234.7 billion in new loans. (The press release and most recent survey results can be found at [www.financialstability.gov](http://www.financialstability.gov).)

**.35** The weaknesses in the banking and savings institutions industry continue to significantly affect the financial system and credit markets and thus contribute to the overall economic situation.

***United States Department of Treasury***

**.36** As noted in the previous sections, the Treasury is focused on a plan for financial stability, which includes several programs such as the CPP, the PPIP, and others discussed throughout this alert. See the section, "On the Horizon—Legislative and Regulatory," for the Treasury's proposal to restructure the financial regulatory system.

***Capital Purchase Program***

**.37** Through the CPP, the Treasury provided capital to viable banks through the purchase of banks' preferred shares with warrants attached for future Treasury purchases of common stock. The Treasury invested less than \$250 billion in U.S. banks that were healthy, but were considered to need additional capital for stability or lending. Since its inception in October 2008, the

CPP has provided capital to large, regional, and small financial institutions in more than 48 states and Puerto Rico and the District of Columbia. The Treasury, FDIC, Federal Reserve, Office of the Comptroller of the Currency (OCC), and OTS are in the process of analyzing and evaluating the applications that have been received for the CPP.

**.38** In June 2009, the Treasury determined that 10 of the nation's largest banks were eligible to repay \$68 billion received from TARP by redeeming the preferred shares the government acquired in them last fall. This decision was made based on results of the stress tests and in consultation with the primary banking supervisor of each institution. The stress tests encompassed a comprehensive capital assessment exercise—known as the Supervisory Capital Assessment Program (SCAP)—with each of the 19 largest U.S. BHCs. Under SCAP, the Federal Reserve analyzed the selected BHCs in more adverse scenarios—individually and in the aggregate—that included the BHC's estimates of (a) losses and loss rates across select categories of loans, (b) resources available to absorb those losses, and (c) the resulting necessary additions to capital buffers. Any BHC needing to augment its capital buffer at the conclusion of SCAP had until June 8, 2009, to develop a detailed capital plan, and has until November 9, 2009, to implement that capital plan. Results of stress tests and the determination that certain banks did not need to raise additional capital contributed to the Federal Reserve's decision to approve the repayment of TARP funds.

**.39** The June 2009 announcement represents the first major repayment of TARP funds. Prior to this point, only community-based lenders had redeemed the government's preferred shares in the aggregate amount of \$1.9 billion. Banks receiving TARP funds also have the ability to repurchase the warrants at fair market value. Each bank is required to have an independent advisor determine the fair market value, which would then need to match the fair market value determined by the Treasury before the warrants could be repurchased. If differences in the fair values of the warrants cannot be resolved by the bank and the Treasury, each selects an appraiser to determine a mutually agreeable value. If the 2 appraisers cannot come to an agreement, they agree on a third appraiser to value the warrants. The 3 values are then averaged, not including outliers, to determine fair market value. The bank also has the option of not repurchasing the warrants; in these instances, the Treasury will sell the warrants through an auction process, which will help determine their fair value. The Treasury noted that it has no intention to hold onto the warrants until their expiration.

**.40** A common valuation method for warrants includes options models, such as the Black-Scholes model. This model has 6 inputs: stock price, strike price, risk-free interest rate, dividend yield, time to maturity, and implied volatility. The warrants issued to the government have a 10-year maturity, and based on the assumptions used, the output fair values can vastly differ.

**.41** Inclusive of the initial dividend payment and warrant repurchases by the 10 banks, the White House indicated the government would make a profit on its investment in these banks. The Treasury contends the returns should also be considered from a nonfinancial standpoint, in regard to the financial stability provided by TARP funding.

**.42** The motivation for repayment is driven by the restrictions associated with TARP funds, including compensation restrictions, limits on the hiring of

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foreign workers, dividend increases, and restrictions on company perks (such as conferences and corporate jets). In addition, the repayments have resulted in a positive attitude toward and boost of confidence in these banks as the ability to repay government funds and the ability to be released from government restrictions give the impression that these banks have healthier balance sheets and the strength to rebound from the recent economic crisis. Additionally, some analysts have said the restrictions placed on these banks put them at a disadvantage to both hedge funds and other banks that lured away talented employees.

.43 Additional details and frequently asked questions (FAQs) regarding the CPP and the CPP repayment can be found at [www.financialstability.gov/roadtostability/capitalpurchaseprogram.html](http://www.financialstability.gov/roadtostability/capitalpurchaseprogram.html).

***Public-Private Investment Program***

.44 To address the challenge of legacy assets, the Treasury, in conjunction with the FDIC and the Federal Reserve, announced PPIP on March 23, 2009, as part of its efforts to improve the balance sheets of financial institutions and ensure available credit. Using \$75 to \$100 billion in TARP capital and capital from private investors, PPIP should generate \$500 billion in purchasing power to buy legacy assets with the potential to expand to \$1 trillion over time. PPIP has 2 parts, the Legacy Loans Program (LLP) and Legacy Securities Program (LSP). The assets available for purchase in the LLP will be determined by the banks, their primary regulators, the FDIC, and the Treasury. The FDIC conducts an auction for the authorized pool of loans, provides financing through the FDIC Guarantee, and oversees the control and management of the purchased assets by the private investors. The LSP consists of 2 related parts designed to attract private capital by providing debt financing from the Federal Reserve under the Term Asset-Backed Securities Loan Facility (TALF) and through matching private capital raised for dedicated funds. At the time of this writing, 5 investment funds had each raised at least \$500 million of committed equity capital from private investors. Additional funds were expected to be announced through October 2009. Further details and FAQs on this program can be found at [www.financialstability.gov/roadtostability/publicprivatefund.html](http://www.financialstability.gov/roadtostability/publicprivatefund.html).

***Federal Reserve***

.45 The Federal Reserve has taken unprecedented actions in response to the financial crisis since the emergence of the crisis in 2007. The Federal Reserve implemented a number of programs designed to support the liquidity of financial institutions and foster improved conditions in financial markets.

***Open Market Operations***

.46 The reduction in the target federal funds rate to effectively zero demonstrated the dramatic response of monetary policy and the severity of the economic situation. In addition, the Federal Reserve expanded its traditional tool of open market operations to support the functioning of credit markets through the purchase of longer-term securities for the Federal Reserve's portfolio. For example, the Federal Reserve expects to purchase up to \$1.25 trillion of agency MBS and up to \$200 billion of agency debt by the first quarter of 2010. In addition, the Federal Reserve will have purchased \$300 billion of Treasury securities by the end of October 2009. In a September 23, 2009, press release, the Federal Reserve stated that it will continue to evaluate the timing and overall

amounts of its purchases of securities in light of the evolving economic outlook and conditions in financial markets.

### *Liquidity Swaps*

.47 The Federal Reserve has entered into agreements to establish temporary reciprocal currency arrangements (central bank liquidity swap lines) with a number of foreign central banks. The temporary swap lines include dollar liquidity lines and foreign currency liquidity lines. The dollar liquidity swap lines were announced in December 2007 and the foreign currency liquidity swap lines were announced on April 6, 2009. The *foreign currency liquidity swap lines* were designed to provide the Federal Reserve with the capacity to offer liquidity to U.S. institutions in foreign currency, should a need arise in the future. So far, the Federal Reserve has not drawn on these swap lines.

### *Term Asset-Backed Securities Loan Facility*

.48 In late 2008, the Federal Reserve announced the creation of TALF. Under TALF, the Federal Reserve Bank of New York will lend up to \$200 billion to holders of certain AAA-rated asset backed securities (ABS) backed by newly and recently originated consumer and small business loans through December 31, 2009. The intent of this facility is to increase credit availability for student loans, auto loans, credit card loans, and loans guaranteed by the Small Business Administration (SBA). (The Treasury announced plans to purchase up to \$15 million in securities backed by SBA loans.)

.49 In March 2009, the Federal Reserve announced that the eligible collateral for loans extended by TALF was expanded to include ABS backed by mortgage servicing advances, loans or leases related to business equipment, leases of vehicle fleets, and floorplan loans. In May 2009, the maturities of TALF loans were extended to five years (from three) and eligible collateral under TALF was expanded further to include commercial mortgage-backed securities (CMBS) and securities backed by insurance premium finance loans. Certain CMBS issued prior to January 1, 2009 (legacy CMBS), in addition to newly and recently issued CMBS, are eligible collateral under TALF.

.50 During the economic crisis, CMBS issuance halted, which weakened the economy further. The inclusion of newly and recently issued CMBS should, ideally, stimulate commercial lending, which may prevent defaults on current commercial property loans, increase the capacity of current holders of maturing mortgages to make additional loans, and facilitate the sales of distressed properties. The inclusion of certain legacy CMBS is intended to promote price discovery and liquidity for legacy CMBS. The goal of the improvements to the legacy CMBS markets is to promote new issuances of CMBS, which helps borrowers purchase commercial properties or helps current owners of commercial property refinance on better terms. Overall, the commercial real estate market is still relatively unstable, which may ease with the recent changes to TALF. According to JPMorgan Chase & Co. estimates, there were \$237 billion in CMBS sales in 2007 and only \$12.2 billion in 2008. The last date of a CMBS sale was in June 2008.

.51 The first deadline for investors to apply for loans to buy new CMBS through TALF was June 16, 2009, and there were no applicants. The 2 main cited reasons for the lack of applicants include the slow ramp up of the securitization process and the slow discovery process by investors and originators.

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These reasons are consistent with the first launch of TALF in March 2009—the first 2 months received under \$5 billion in requests, yet the next 2 months received requests that exceeded \$10 billion. Also, a typical CMBS deal can take up 6 months from when a loan is originated to when it is securitized. The first deadline for requests for loans to buy legacy CMBS through TALF was July 16, 2009. Investors requested \$669 million in TALF loans using legacy CMBS as collateral.

.52 On August 17, 2009, the Federal Reserve and the Treasury approved extending TALF loans against newly issued ABS and legacy CMBS through March 31, 2010, and approved TALF lending against newly issued CMBS through June 30, 2010. The Federal Reserve will continue to monitor financial conditions and will consider whether circumstances warrant a further extension.

***Other Federal Reserve Liquidity Programs***

.53 On June 25, 2009, the Federal Reserve announced extensions of and modifications to a number of its liquidity programs through early 2010. In light of noted improvement in financial conditions and reduced usage of some facilities, the Federal Reserve will reduce the size and change the terms of some facilities. Specifically, the Federal Reserve approved extension through February 1, 2010, of the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility, the Commercial Paper Funding Facility, the Primary Dealer Credit Facility, and the Term Securities Lending Facility. The expiration date for TALF, as addressed previously, was extended through March 31, 2010. The Term Auction Facility does not have a fixed expiration date. The authorization for the Money Market Investor Funding Facility, which expires on October 30, 2009, was not extended, due to the improvement in the market. (For additional details regarding the extensions of and modifications to these programs, see the press release dated June 25, 2009, on the Federal Reserve Web site, [www.federalreserve.gov/monetarypolicy/20090625a.htm](http://www.federalreserve.gov/monetarypolicy/20090625a.htm).)

***Federal Deposit Insurance Corporation***

.54 In addition to the joint programs that have been initiated with the FDIC and other regulatory agencies, the FDIC took action in response to the economic crisis by establishing the Temporary Liquidity Guarantee Program (TLGP). The FDIC also continues to assist in the resolution of failed banking institution and finalized guidelines for private capital investors interested in acquiring or investing in failed institutions currently in receivership. In addition, the increase in recent and expected failures of FDIC-insured institutions has significantly increased losses to the Deposit Insurance Fund (DIF). As a result, the FDIC has re-evaluated the funding needs of DIF and has implemented certain changes.

.55 In regard to regulatory reporting, the FDIC finalized amendments to Title 12 *Part 363—Annual Independent Audits and Reporting Requirements* of U.S. *Code of Federal Regulations* (Part 363), which sets forth annual independent audit and reporting requirements for insured depository institutions with \$500 million or more in total assets.

***Temporary Liquidity Guarantee Program***

.56 On October 23, 2008, the FDIC announced the creation of the TLGP to provide a temporary guarantee for certain newly issued senior unsecured

debt issued by banks and their eligible affiliates. The TLGP also fully insures certain noninterest bearing deposit transaction accounts. Participating institutions are assessed fees for the guaranteed amount they have outstanding under both programs. All entities that participate in the FDIC's TLGP are subject to supervisory oversight, and compliance with the TLGP requirements is monitored in conjunction with the FDIC's examination program. On March 17, 2009, the FDIC adopted an interim rule to extend the debt guarantee component of the TLGP and impose surcharges on existing rates for certain debt issuances (see the FDIC Financial Institution Letter [FIL]-14-2009, "Extension of Temporary Liquidity Guarantee Program: Interim Rule"). On August 26, 2009, the FDIC adopted a final rule extending the Transaction Account Guarantee portion of the TLGP through June 30, 2010 (see the FDIC FIL-48-2009, "Transaction Account Guarantee Extension: Third Quarter 2009"). Readers are encouraged to visit the FDIC's TLGP Web site at [www.fdic.gov/regulations/resources/tlgp/index.html](http://www.fdic.gov/regulations/resources/tlgp/index.html) for additional information regarding the monthly reporting requirements and reporting instructions. This Web site also provides the most recent proposed and final amendments and modifications to this program.

#### *Acquisitions of Failed Banks*

**.57** On August 26, 2009, the FDIC adopted a final "Statement of Policy on the Acquisition of Failed Insured Depository Institutions." The policy statement provides guidance to investors interested in acquiring or investing in the deposit liabilities of failed banks or thrifts and addresses the standards the acquiring investor will be expected to meet in order to qualify to bid on a failed institution. In the policy statement, the FDIC reduced the minimum leverage ratio that will apply to banks that are owned by private equity investors and that are formed in connection with resolving failed banks from 15 percent to 10 percent. The leverage ratio will apply for a minimum of 3 years. Other conditions established by the FDIC in this statement, among others, would prohibit loans to certain affiliates.

**.58** The policy statement was issued to aid in attracting private investment capital for the purpose of purchasing deposits, assets, or both, of a failing bank. According to the policy statement, the FDIC sought to ensure a balance in a number of different areas, including the level of capital required for these private institutions and whether these owners would be a source of strength to the banks and thrifts in which they have invested. The final statement of policy was added to the Federal Register Vol. 74, No. 169 on September 2, 2009. Readers are encouraged to read the final statement of policy on the FDIC Web site at [www.fdic.gov/regulations/laws/federal/2009/09FinalSOP92.pdf](http://www.fdic.gov/regulations/laws/federal/2009/09FinalSOP92.pdf).

#### *Loss Sharing Arrangements*

**.59** Loss share agreements are a way for the FDIC to sell assets of a failed bank. Loss sharing is a feature that the FDIC first introduced into selected purchase and assumption transactions in 1991. Under *loss sharing*, the FDIC agrees to absorb a portion of the loss on a specified pool of assets in order to maximize asset recoveries and minimize FDIC losses. Loss sharing reduces the immediate cash needs of the FDIC, is operationally simpler and more seamless to failed bank customers, and moves assets into the private sector quickly. Through August 2009, the FDIC has entered into 53 loss sharing agreements, with \$80 billion in assets under loss share. The estimated savings exceed \$11 billion, compared to an outright cash sale of those assets.

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The FDIC Web site includes questions and answers regarding loss sharing at [www.fdic.gov/bank/individual/failed/lossshare/index.html](http://www.fdic.gov/bank/individual/failed/lossshare/index.html).

*Deposit Insurance Assessments*

**.60** On February 27, 2009, the FDIC adopted a final rule modifying the risk-based assessment system and setting initial base assessment rates beginning April 1, 2009. On May 22, 2009, the FDIC adopted a final rule imposing a 5-basis point special assessment on each insured depository institution's assets minus tier 1 capital as of June 30, 2009. The special assessment was collected on September 30, 2009. See the FDIC FIL-12-2009, "Deposit Insurance Assessments: Final Rule on Assessments; Amended FDIC Restoration Plan; Interim Rule on Emergency Special Assessment," and the FDIC FIL-23-2009, "Special Assessment: Final Rule," at [www.fdic.gov](http://www.fdic.gov). See the FDIC's deposit insurance assessments Web site at [www.fdic.gov/deposit/insurance/assessments/index.html](http://www.fdic.gov/deposit/insurance/assessments/index.html) for additional information regarding the actual assessments per risk category.

**.61** On September 29, 2009, the FDIC adopted a "Notice of Proposed Rule-making" that would require insured institutions to prepay their estimated quarterly risk-based assessments. To meet the FDIC's liquidity needs and to ensure that the deposit insurance system remains directly industry-funded, the FDIC is proposing to require all institutions to prepay their estimated risk-based assessments for the fourth quarter of 2009 on December 30, 2009. Additionally, institutions are expected to pay for all of 2010, 2011, and 2012, at the same time that institutions pay their regular quarterly deposit insurance assessments for the third quarter of 2009. The FDIC also voted to adopt a uniform three-basis point increase in assessment rates effective on January 1, 2011, and extend the restoration period from seven to eight years. Comments were due October 28, 2009. Readers are encouraged to read the full text of the notice of proposed rule-making, which includes information regarding how institutions should record the prepaid assessment, at [www.fdic.gov/news/board/Sept29no3.pdf](http://www.fdic.gov/news/board/Sept29no3.pdf).

**.62** According to the proposal, liquid assets of DIF have been used to protect depositors of failed institutions and have been exchanged for less liquid claims against the assets of failed institutions. As of June 30, 2009, while total assets had increased to almost \$65 billion, cash and marketable securities had fallen to about \$22 billion. The FDIC estimates that total prepaid assessments would amount to approximately \$45 billion.

*Annual Independent Audits and Reporting Requirements;  
Final Rule Amending Part 363*

**.63** On July 20, 2009, the final rule amending Part 363 of the FDIC's regulations was published in the Federal Register (Vol. 74, No. 137). Part 363 applies to insured depository institutions with total assets above certain thresholds and requires annual independent audits, assessments of the effectiveness of internal control over financial reporting, and compliance with laws and regulations pertaining to insider loans and dividend restrictions, the establishment of independent audit committees, and related reporting requirements. The asset size threshold for reporting on an institution's internal control is \$1 billion and the threshold for the other requirements generally is \$500 million. The final rule was implemented largely as proposed, but with certain modifications in response to the comments received. The FDIC FIL-33-2009, "Annual Audit Reporting Requirements: Final Amendments to Part 363," issued on June 23, 2009, provides a summary of the final rule and highlights certain



amended annual and other reporting requirements (see the FDIC FIL-33-2009 at [www.fdic.gov/news/news/financial/2009/fil09033.html](http://www.fdic.gov/news/news/financial/2009/fil09033.html)). Readers are also encouraged to visit the FDIC Web site for the full text of the final rule and the supplementary information.

**.64** The final rule applies to Part 363 Annual Reports with filing deadlines on or after the effective date of these amendments, August 6, 2009. Generally, under the amended guidance, the filing deadline for Part 363 is 120 days after the end of the fiscal year for an institution that is neither a public company nor a subsidiary of a public company, and 90 days after the end of the fiscal year for an institution that is a public company or a subsidiary of public company. The compliance date for the provision of the final rule that requires institutions' boards of directors to develop and adopt written criteria pertaining to audit committee member independence is delayed until December 31, 2009. The provision of the final rule that requires the consolidated total assets of a holding company's insured depository institution subsidiaries to comprise 75 percent or more of the holding company's consolidated total assets in order for an institution to be eligible to comply with Part 363 at the holding company level is effective for fiscal years ending on or after June 15, 2010. For additional information on the reporting requirements under Part 363, see the "Audit and Attestation Issues and Developments" section of this alert.

### Credit Unions

**.65** As with other financial institutions, federally insured credit unions were significantly affected by the economic crisis during 2009. The National Credit Union Administration's (NCUA's) Letter to Credit Unions, Letter No. 09-CU-18, *Financial Trends in Federally Insured Credit Unions January 1–June 30, 2009*, showed that the delinquent loan ratio and the loan loss ratio continued to increase during this time period. The increase in provision for loan and lease losses significantly affected the operating results. Credit unions remain concentrated in real estate loans, which indicate that the credit quality of loans will remain an ongoing concern. However, the overall net worth of all federally insured credit unions remains strong as the total dollars of net worth increased in the first half of 2009 compared to year-end 2008. Readers are encouraged to visit [www.ncua.gov](http://www.ncua.gov) for the most recent results regarding financial trends in federally insured credit unions.

### National Credit Union Administration

**.66** In 2009, the NCUA initiated and completed certain significant and unprecedented actions to promote stability in the credit union industry. To stabilize the corporate system and ensure member service, in early 2009, the NCUA infused \$1 billion from the National Credit Union Share Insurance Fund (NCUSIF) into U.S. Central Federal Credit Union (U.S. Central), the wholesale corporate credit union that provides services to other corporate credit unions, and placed the corporate credit unions, U.S. Central, and Western Corporate Federal Credit Union (WesCorp), into conservatorship to preserve retail credit union deposits.

**.67** The NCUA took further steps to address the crisis and developed a detailed strategy to mitigate future losses as outlined in the NCUA Letter to Credit Unions, Letter No. 09-CU-02, "Corporate Credit Union System Strategy," dated January 2009. The NCUA's strategy included a temporary NCUSIF guarantee of member shares in corporate credit unions. The guarantee covered

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all shares, with the exception of membership and paid in capital accounts. This guarantee, along with several additional provisions, was incorporated into the Credit Union Insurance Stabilization Act (the Stabilization Act), which became law on May 20, 2009.

**.68** The Stabilization Act included several provisions to reflect the NCUA's corporate credit union stabilization strategy. The Stabilization Act did the following:

- Created a temporary corporate credit union stabilization fund (stabilization fund) to mitigate stabilization costs
- Extended the \$250,000 share and deposit insurance ceiling enacted as part of the EESA through 2013
- Provided the NCUSIF authority to assess premiums over 8 years to rebuild the equity ratio in the fund
- Increased NCUA borrowing authority to \$6 billion
- Established NCUA emergency borrowing authority of \$30 billion

*Temporary Corporate Credit Union Stabilization Fund*

**.69** The stabilization fund provides immediate support to insured credit unions for corporate credit union stabilization actions. Components of the stabilization fund include the following:

- Administered by the NCUA and is separate from the NCUSIF;
- May borrow from the Treasury and must repay all advances plus interest to the Treasury within seven years from the time of the first advance;
- The NCUA has discretion in setting the time and amount of repayments; and
- The NCUSIF is prohibited from paying dividends to federally insured credit unions while the stabilization fund has an outstanding balance. Any dividends will be paid to the stabilization fund.

**.70** On June 18, 2009, the NCUA approved the following actions to release the NCUSIF from its corporate stabilization obligations:

- The stabilization fund would pay the NCUSIF \$1 billion for assignment of the capital note extended to U.S. Central.
- The stabilization fund would be responsible for liabilities arising from the Temporary Corporate Credit Union Share Guarantee Program (TCCUSGP) and the Temporary Corporate Credit Union Liquidity Guarantee Program (TCCULGP). Specific corporate loss reserves were also assumed by the stabilization fund.

**.71** As a consequence to actions taken by the NCUA to stabilize the corporate credit union system, each federally insured credit union should have recorded a special assessment equal to 0.30 percent of insured shares (\$100,000 per account) and an impairment of their NCUSIF deposit of approximately 69 percent. See Technical Questions and Answers (TIS) section 6995.01, "Financial Reporting Issues Related to Actions Taken by the National Credit Union Administration on January 28, 2009 in Connection with the Corporate Credit Union System and the National Credit Union Share Insurance Fund" (AICPA, *Technical Practice Aids*), for additional considerations regarding the recording of the premium assessment and impairment.

.72 As a result of the stabilization fund and the recent NCUA actions, credit unions were instructed to consider the following for regulatory reporting as of June 30, 2009 (for additional guidance see the NCUA Letter to Credit Unions, Letter No. 09-CU-14, "Corporate Stabilization Fund Implementation," dated June 2009):

- *NCUSIF Premium Estimate.* Based on the amount needed to fund the NCUSIF after the implementation of the stabilization fund, the NCUA determined that the recalculated special assessment for credit unions was equal to 0.15 percent of insured shares (\$250,000 per account). Therefore, credit unions should adjust the special assessment originally recorded. The current special assessment was subject to change prior to the actual collection in the fall of 2009.
- *NCUSIF Capitalization Deposit.* Due to the implementation of the stabilization fund, the NCUSIF was no longer legally obligated to support the TCCUSGP, the TCCULGP, and the \$1 billion note extended to U.S. Capital and the NCUSIF was been fully restored. As a result, an amount equal to 0.69 percent of each insured credit union's insured shares was passed back and credited to each insured credit union's NCUSIF deposit account as a recapitalized NCUSIF deposit. Credit unions that recorded an impairment charge for the insured shares should have reflected a fully refundable 1 percent of insured shares deposit asset on their regulatory reports as of June 30, 2009. This benefit to insured credit unions—passing back funds and simultaneously recapitalizing their deposit without their additional cash outlay—is considered income. The previous impairment is not reversed, rather the recapitalization results in nonoperating income, which is offset by the increase in the NCUSIF deposit to its pre-impairment balance.

#### *Capital Investments in Corporate Credit Unions for Other-Than-Temporary Impairment*

.73 As noted previously, on March 20, 2009, NCUA placed U.S. Central and WesCorp into conservatorship and appointed itself conservator of both credit unions. To address the status of the paid-in capital (PIC) and membership capital (MCA) accounts at these corporate credit unions and how those accounts are applied to absorb losses that U.S. Central and WesCorp are each required to recognize, NCUA issued a letter to credit unions in May 2009 (see the NCUA Letter to Credit Unions, Letter No. 09-CU-10, "Matters Related to "Paid-in Capital" and "Membership Capital" of Corporate Credit Unions"). The letter stated that it is the responsibility of the board of directors and management of a credit union, in consultation with its independent accountants, to judge whether their credit union's PIC and MCA are impaired as defined by U.S. generally accepted accounting principles (GAAP) and, if so, whether the impairment is other-than-temporary, thus warranting a charge against current period earnings. TIS section 6995.02, "Evaluation of Capital Investments in Corporate Credit Unions for Other-Than-Temporary Impairment" (AICPA, *Technical Practice Aids*), provides an additional discussion of the issues.

.74 On September 11, 2009, the NCUA announced the release of U.S. Central's 2008 audited financial statements. The press release stated that,

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effective June 2009, all paid-in-capital and 63.7 percent of MCA had been depleted. Invested corporate credit unions should consider the capital depletion as they make impairment judgments in their financial reports. Should a corporate credit union member determine a retained earnings deficit, it will need to deplete its contributed capital to bring the retained earnings deficit to zero. As with the corporate credit unions, natural person members of corporates will then need to consider the capital depletion as they make impairment judgments related to their financial reports. The press release also encourages credit unions to contact their independent auditors for guidance. Readers are encouraged to read the full text of this press release and the "U.S Central 2008 Audited Financial Statements Questions and Answers," which is available online at [www.uscentral.org/default.asp?content=fininfo](http://www.uscentral.org/default.asp?content=fininfo).

**Mortgage Banking**

**.75** The events related to the financial crisis significantly affected the mortgage banking industry in various aspects. Similar to all financial institutions, several of the larger mortgage lenders became insolvent or were acquired by larger banking institutions. Bank of America acquired Countrywide Financial, which made Bank of America the nation's largest mortgage lender and loan servicer. In addition, IndyMac Bancorp, which was the largest Alt-A mortgage lender in California, declared chapter seven bankruptcy and the lender's assets were purchased primarily by private equity firms. Consolidation in the industry, including certain government assisted acquisitions, heightened the complexities of financial reporting particularly related to application of FASB Statement No. 141 (Revised 2007), *Business Combinations*, which is codified in FASB ASC 805, *Business Combinations*, and Statement of Position (SOP) 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer* (AICPA, *Technical Practice Aids*, ACC sec. 10,880), which is codified in FASB ASC 310-30. (See the "Accounting Issues and Developments" section for additional information on business combinations.)

**.76** The fundamental aspects of mortgage banking were also considerably affected. Mortgage banking activities of financial institutions consist primarily of the purchase or origination of mortgage loans for sale to secondary market investors and the subsequent servicing of these loans, which may include loan modifications, supervising of foreclosures, and property dispositions. Thus, mortgage banking activities may be affected by changes in interest rates, housing market activity, foreclosure rates, availability of credit, and the stability of secondary mortgage markets, among other external factors, in addition to those items previously mentioned.

**.77** The following paragraphs address the current market conditions related to interest rates, housing market activity, and foreclosure rates. The availability of credit and the stability in the secondary mortgage markets is addressed in previous sections of this alert.

**.78** As noted previously, the federal funds interest rate set by the Federal Reserve continues to remain at historical lows. In addition, the Federal Reserve continues to buy longer-term treasuries that will help maintain low long-term interest rates and mortgage rates. The low interest rates allow many customers to originate new mortgages or refinance their existing mortgages, leading to an increase in origination and service fee income for financial institutions. During the first half of 2009, many institutions experienced significant increases

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in origination levels, with certain institutions experiencing historic levels of origination activity.

.79 The housing market continues to experience challenging times with varied expectations regarding a potential turnaround in the near future. According to the National Association of Realtors (NAR), the *pending home sales index*<sup>6</sup>, a forward-looking indicator based on contracts signed in August 2009, rose 6.4 percent to 103.8 percent from a reading of 97.6 percent in July, and is 12.4 percent above August 2008 when it was 92.4 percent. The index is at the highest level since March 2007, when it was 104.5 percent. Lawrence Yun, NAR chief economist, stated that the rise in pending home sales shows buyers are returning to the market and signing contracts, but deals are not necessarily closing because of long delays related to short sales and issues regarding complex new appraisal rules. He noted that many first-time buyers are rushing to beat the deadline for the \$8,000 tax credit, which expires December 1, 2009.

.80 With increased unemployment, foreclosure rates have increased to dramatically high levels. RealtyTrac's August 2009 *U.S. Foreclosure Market Report* showed foreclosures—default notices, scheduled auctions, and bank repossessions—were reported on 358,471 U.S. properties during the month, a decrease of less than 1 percent from the previous month but still an increase of nearly 18 percent from August 2008. The report also shows 1 in every 357 U.S. housing units received a foreclosure filing in August 2009. Through the first half of 2009, according to RealtyTrac's *Midyear 2009 U.S. Foreclosure Market Report*, 1.9 million foreclosure filings were made, representing 1 in 84 U.S. households, an increase of more than 15 percent from the first half of 2008. RealtyTrac expects repossession activity to increase in the coming months as foreclosure delays and moratoria implemented by various state laws come to an end. Regions with the fastest and greatest growth during the real estate boom have also fallen faster and harder during this downturn. Properties receiving foreclosure filings are highly concentrated in Nevada, Florida, and California.

### ***Making Home Affordable Loan Modification Program***

.81 The Treasury, working with the GSEs, Federal Housing Administration, the FDIC, and other federal agencies, implemented the Making Home Affordable (MHA) loan modification program, which offers assistance to homeowners by giving them the opportunity to refinance home mortgages and reduce monthly payments. The MHA program offers two options for borrowers: (a) refinancing mortgage loans through the Home Affordable Refinance Program (HARP), and (b) modifying mortgage loans, through the Home Affordable Modification Program (HAMP). Through a refinance under HARP, Fannie Mae and Freddie Mac will allow refinancing mortgage loans that they own or that they guaranteed in MBS.

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<sup>6</sup> The pending home sales index is a leading indicator for the housing sector, based on pending sales of existing homes. A sale is listed as *pending* when the contract has been signed but the transaction has not closed, though the sale usually is finalized within 1 or 2 months of signing. The National Association of Realtors notes that an index of 100 is equal to the average level of contract activity during 2001, which was the first year to be examined as well as the first of 5 consecutive record years for existing home sales.

.82 Loans that are eligible for the HAMP program include the following:

- Loans originated on or before January 1, 2009.
- First-lien loans on owner-occupied properties with unpaid principal balances up to \$729,750. Higher limits allowed for owner-occupied properties with 2–4 units.

.83 Borrowers are also required to verify income, financial hardship, and owner occupancy. The program provides financial incentives to lenders and servicers to modify mortgages for borrowers who have not yet missed payments and when the servicer determines that the borrower is at imminent risk of default. Financial incentives for lenders and servicers include (a) a share in the cost of reductions in monthly payments, (b) an upfront fee of \$1,000 for each modification plus pay for success fees on still performing loans of \$1,000 per year, and (c) a onetime bonus incentive payment to lenders or investors, or both, and to servicers for modifications made while a borrower is still current on mortgage payments. Homeowners who make their payments on time are eligible for up to \$1,000 of principal reduction payments each year for up to 5 years. For additional terms and conditions, see the MHA summary guidelines at [www.treas.gov/press/releases/reports/guidelines\\_summary.pdf](http://www.treas.gov/press/releases/reports/guidelines_summary.pdf).

.84 On July 9, 2009, the Secretaries of the Treasury and of Housing and Urban Development wrote the CEOs of participating servicers requesting the CEOs add staff, improve borrower response times, and streamline the application process to meet a 500,000 trial modification goal by November 1, 2009. According to a press release on October 8, 2009, the milestone of 500,000 trial modifications was met 1 month early due to the push from the Obama Administration. For the latest developments regarding this program, visit [www.financialstability.gov](http://www.financialstability.gov).

.85 In an interagency press release from the Federal Reserve, FDIC, NCUA, OCC, and OTS (collectively, the banking agencies), dated March 4, 2009, the banking agencies encouraged all federally regulated financial institutions that service or hold residential mortgage loans to participate in the MHA program. In a subsequent joint press release dated June 26, 2009, the banking agencies (excluding the NCUA) announced the interim final rule that addresses mortgage loans modified under the MHA program. According to the interim final rule, these modified loans would retain the risk weight applicable before modification as long as the loan continues to meet other applicable criteria. The interim final rule provides a common interagency capital treatment for mortgage loans modified under the MHA program. This rule was effective June 30, 2009.

.86 The increase in mortgage modifications through the MHA program and other loan modification programs has significantly affected regulatory and financial reporting considerations for participants. Additional considerations as a result of participation may include the effects on troubled debt restructurings, representations and warranty estimates, qualified special purpose entities (QSPEs) and consolidation accounting, fair value accounting for debt securities, and accounting for the allowance for loan and lease losses (ALLL). Other considerations for servicers of collateralized MBS are the effects on the regulatory reporting and disclosure requirements under SEC Regulation AB. For more information on these additional considerations, see the "Audit and Attestation Issues and Developments" section of this alert.

.87 These loss mitigation efforts by lenders and servicers have added a considerable amount of strain on the mortgage banking industry. As noted previously, the Treasury increased pressure on the leaders and servicers participating in the MHA program to increase staffing, improve response times, and streamline processes. These loan modification programs require substantial resources from all areas within financial institutions and may require additions to system capabilities to complete underwriting procedures, among other necessary procedures. In addition, regulatory oversight, specifically oversight from Freddie Mac, has increased with the compliance evaluations related to these programs.

### **Brokers and Dealers in Securities**

.88 The failure of the SEC and other related self-regulating associations to identify the Bernard L. Madoff Investment Securities LLC Ponzi scheme, other scandals, and industry failures has prompted a push toward regulatory reform (see the "On the Horizon—Legislative and Regulatory" section of this alert for additional information regarding the proposed regulatory reform by the Obama Administration). As with other industry subsets within the financial services industry, the securities industry continues to face repercussions of the economic crisis and is currently facing significant challenges regarding how the industry should be governed.

.89 Similar to the FDIC's DIF and the NCUA's NCUSIF, the Securities Investor Protection Corporation (SIPC) fund balance has been depleted and is expected to remain at unacceptably low levels due primarily to the funds required to assist those affected by the failure of Madoff Investment Securities, a former registered securities broker-dealer and SIPC member. As a result of the fund requirements, SIPC advised its members of an increase in the assessment rates, effective April 1, 2009, which could be a significant fee for broker-dealer entities. The SIPC assessment is addressed further in the "Securities Investor Protection Corporation" section of this alert.

.90 The economic conditions related to banking and savings institutions mentioned previously also have had a significant effect on the securities industry as poor economic conditions affect the value of securities. The upward movement of the Dow, as noted previously, may reflect encouraging signals and possible increased activity in this industry.

.91 The securities industry is primarily regulated by the SEC, the Public Company Accounting Oversight Board (PCAOB), Financial Industry Regulatory Authority (FINRA), the SIPC, and the Commodity Futures Trading Commission (CFTC). This industry also is affected by actions carried out by the Federal Reserve, the Treasury, and other regulatory and governmental agencies. Additional information related to the financial reporting FAQs recently issued by the PCAOB and the SEC for this industry is included in the "Audit and Attestation Issues and Developments" section of this alert.

### **Securities and Exchange Commission**

.92 As indicated in the AICPA Audit and Accounting Guide *Brokers and Dealers in Securities*—2009, the SEC has an anti-money laundering (AML) source tool available on its Web site. It is a compilation of key AML laws, rules, and guidance applicable to broker-dealers. The tool organizes the key AML compliance materials and provides related source information. It can be accessed at [www.sec.gov/about/offices/ocie/amlsourcetool.htm](http://www.sec.gov/about/offices/ocie/amlsourcetool.htm).

.93 See the "On the Horizon—Legislative and Regulatory" section of this alert for additional information regarding certain proposed and expected actions of the SEC, such as the proposed amendment to the SEC Custody Rule, the proposal to restrict short selling, the proposal on flash orders, and other SEC related issues that have not been finalized.

### **Financial Industry Regulatory Authority**

#### *FINRA Rules*

.94 The recent consolidation of the National Association of Securities Dealers (NASD) and the member regulation, enforcement, and arbitration functions of the New York Stock Exchange (NYSE) have resulted in one security regulatory organization. The newly created entity, FINRA, has proposed new, consolidated rules in phases for approval by the SEC as part of the consolidated FINRA rulebook. In April and May 2009, the SEC approved eight new, consolidated FINRA rules, which were effective August 17, 2009.

.95 FINRA has posted a rule conversion chart on its Web site to help firms become familiar with the new rules. The rule conversion chart is located at [www.finra.org/ruleconversionchart](http://www.finra.org/ruleconversionchart). Auditors should monitor issues and related guidance on the FINRA Web site due to changing conditions.

#### *FINRA Examination Priorities*

.96 FINRA has issued its 2009 examination priorities letter to highlight new and existing areas of particular significance to this year's examination program. In addition to specific examination priorities, the letter also addresses some general concerns given the current market environment. FINRA provides these areas of potential examination focus to help firms assess their compliance and supervisory programs. Readers are encouraged to read the examinations priorities, which can be found at [www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p118113.pdf](http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p118113.pdf).

#### *Investment Banking Representative*

.97 The SEC approved amendments to NASD Rules 1022 and 1032, which are effective November 2, 2009, and will require individuals whose activities are limited to investment banking and principals who supervise such activities, to pass the new Limited Representative—Investment Banking Series 79 qualification examination. Individuals who are registered as a general securities representative (and take the Series 7 exam) and engage in the member firm's investment banking business as described in NASD Rule 1032(i) may opt in to the new registration category by May 3, 2010 (within six months of the effective date).

### **Securities Investor Protection Corporation**

#### *SIPC Increases Assessment for Brokers and Dealers*

.98 Broker-dealers registered with the SEC, with some limited exceptions, are required to be members of the SIPC. The SIPC imposes an assessment upon members to maintain its fund and to repay any borrowings by the SIPC. For a number of years, the assessment on members was a flat rate of \$150. In March 2009, the SIPC determined that the SIPC fund balance would likely remain less than \$1 billion for a period of 6 months or more. Therefore, beginning April 1, 2009, the SIPC reinstated an assessment rate of one quarter of 1 percent of



each member's SIPC net operating revenues. The SIPC assessment forms and payments are due semi-annually based on the member's fiscal year-end.<sup>7</sup>

**.99** Certain broker-dealers are excluded from membership in the SIPC and therefore are not subject to SIPC assessment. The 2009 Form SIPC-3, "Certification of Exclusion From Membership," notes that broker-dealers carrying out transactions in security futures products only and whose principal place of business (determined by the SIPC) is outside the U.S. and its territories are excluded from membership. In addition, broker-dealers whose business is exclusively (a) the distribution of shares of registered open-end investment companies or unit investment trusts, (b) the sale of variable annuities, (c) the business of insurance, or (d) the business of rendering investment advisory services to one or more registered investment companies or insurance company separate accounts, are excluded from membership in the SIPC.

**.100** SEC Rule 17a-5(e)(4) (the rule) requires that a registered broker-dealer file a report covered by an independent accountants' report, supplemental to the annual audited statement report concerning the status of the broker-dealer's membership in the SIPC. The supplemental report should cover the SIPC annual general assessment reconciliation or exclusion from membership forms, and should include certain procedures specified in section (iii) of the rule. This report requirement did not apply while the SIPC assessment rate was the minimum assessment of \$150; however, with the assessment rate being restored to one quarter of 1 percent of a member's SIPC net operating revenues, the reports will be required. The Audit and Accounting Guide *Brokers and Dealers in Securities*—2009 provides an illustrative example of the agreed upon procedures report required for those broker-dealers subject to the SIPC assessment.<sup>8</sup> This report, "Independent Accountants' Report on Applying Agreed-Upon Procedures Related to an Entity's SIPC Assessment Reconciliation," is also available at the Stockbrokerage and Investment Banking expert panel section of the AICPA Web site at [www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/expertpanel\\_stockbroker\\_investbank.htm](http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/expertpanel_stockbroker_investbank.htm).

### **Internal Revenue Service**

**.101** The EESA, in addition to the provisions previously discussed, includes new rules for determining and reporting the basis of certain securities that will significantly affect broker-dealers and related entities in the securities industry. The new reporting requirements are in sections 6045(g) and (h), 6045A, and 6045B of the Internal Revenue Code, which are specifically included in the Energy Improvement and Extension Act of 2008, a division of the EESA. The new reporting requirements and basis rules generally begin to take effect on January 1, 2011. Currently, financial firms are only required to report the gross proceeds of their clients' stock and mutual fund sales on 1099 forms. The

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<sup>7</sup> Special transitional assessment year rules apply for the first year of the revised assessment rate. After the transition period, Securities Investor Protection Corporation (SIPC) assessment forms and instructions will be mailed to members semi-annually and should be filed in accordance with the member's fiscal year. See the SIPC Web site at [www.sipc.org/members/members.cfm](http://www.sipc.org/members/members.cfm) for more information.

<sup>8</sup> At the issue date of this alert, an illustration of an independent accountants' report required under SEC Rule 17a-5(e)(4) that covers an entity's exclusion from SIPC membership was being developed. When the illustrative report is available, it will be posted on the AICPA Web site at the Stockbrokerage and Investment Banking expert panel section at [www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/expertpanel\\_stockbroker\\_investbank.htm](http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/expertpanel_stockbroker_investbank.htm).

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IRS has relied primarily on individual investors to produce cost basis numbers on schedule D forms. As a result of the new rules, financial institutions will be required to track investors' cost basis for stocks acquired after Jan. 1, 2011; mutual fund shares and dividend reinvestment plans bought beginning in 2012; and debt instruments, options and other securities in 2013. If a client switches accounts to a new institution, the information will need to be transferred.

**.102** Under the new rules, every broker that is required to file a return under section 6045(a) from the sale of a covered security will be required to include in the return the customer's adjusted basis in the security and whether any gain or loss with respect to that security is long-term or short-term. The new rules add to the existing rules that require reporting of gross proceeds from certain sales transactions, affect the timing for reporting gross proceeds from short sales, and extend the reporting requirement to transactions in options.

**.103** To prepare for the new rules and reporting requirements, broker-dealers, banks, mutual funds, and other financial entities may be required to make substantial changes to internal operations such as updating front- and back-office client interfaces, securities files, tax-lot accounting systems, and reporting platforms. Broker-dealers and taxpayers may encounter difficulty determining basis of securities involved with corporate spinoffs, recapitalizations, and mergers. Taxpayers receiving securities by gift, upon death with a stepped-up basis, or through direct purchase from an issuing company, and who later transfer the securities into a brokerage account, also may face potential compliance issues. Other potential challenging issues may include the treatment of short sales, wash sales when the taxpayer has multiple brokerage accounts, dividend reinvestment plans, and securities purchased in foreign currencies.

**.104** In February 2009, the IRS released Notice 2009-17, which indicated that the IRS intends to issue additional guidance regarding important details relating to the new cost basis reporting law. The notice included questions for public comment for 36 specifically listed topics, such as those previously mentioned. Comments were due on March 2, 2009. Readers are encouraged to visit the IRS Web site at [www.irs.gov](http://www.irs.gov) for additional developments.

**Commodities**

**.105** Global futures and options contract volume was down comparing the first 6 months of 2009 to the same period in 2008. In the first 6 months of 2009, volume on U.S. futures exchanges was 3.2 billion contracts, an 11 percent decrease from the same period in 2008. Volume traded on foreign exchanges amounted to 5.2 billion contracts in the first 6 months of 2008. Trading volume in interest rate and equity products continued to account for more than half of worldwide trading volume.

**.106** The shrinkage in futures volume and markets activities is further reflected in decreased customer funds held by entities registered with the CFTC as futures commission merchants (FCMs) for trading on U.S. and foreign futures and options exchanges. The total amounts required under CFTC regulations to be held in segregated or secured accounts on behalf of FCM customers decreased by \$40 billion from approximately \$215 billion as of June 30, 2008, to approximately \$175 billion as of June 30, 2009.

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## **Commodity Futures Trading Commission**

### *CFTC Annual "Dear CPO" Letter*

.107 On January 26, 2009, CFTC staff issued its annual letter to commodity pool operators (CPOs) outlining key reporting issues and common reporting deficiencies found in annual financial reports for commodity pools. The CFTC anticipates issuing a similar letter in January 2010. The letter emphasizes the CFTC staff's concerns and, accordingly, may alert the auditor to high-risk issues that could affect assertions contained in the financial statements of commodity pools. CFTC staff also suggests that CPOs share the letter with their independent auditors. Major concerns addressed in the letter include the following:

- Due dates of commodity pool financial filings and late filings
- Complex entities and Complex Capital Structures
- Requests for limited relief from U.S. GAAP compliance for certain offshore commodity pools
- Accounting developments, including the following:
  - FASB ASC 820, *Fair Value Measurements and Disclosures*
  - AICPA Practice Aid *Alternative Investments—Audit Considerations*
  - TIS section 6910.23, "Accounting Treatment of Offering Costs Incurred by Investment Partnerships" (AICPA, *Technical Practice Aids*)

.108 The CFTC has issued similar letters in prior years, which are available at the CFTC's Web site.<sup>9</sup> Those letters should be consulted with respect to commodity pool annual financial statements and reporting. Readers are encouraged to view the full text of this letter at [www.cftc.gov/stellent/groups/public/@iointermediaries/documents/file/cpoannualguidanceletter2008.pdf](http://www.cftc.gov/stellent/groups/public/@iointermediaries/documents/file/cpoannualguidanceletter2008.pdf) and monitor the CFTC Web site for the most recent guidance.

.109 Auditors may also consider additional CFTC guidance related to auditing regulatory supplementary schedules, maintaining minimum financial requirements and notification requirements, segregation of customer funds in multiple currencies, and foreign exchange transactions. Readers may refer to the CFTC Web site for additional details.

## **National Futures Association**

### *Foreign Currency Exchange Transactions*

.110 Although Foreign Currency Exchange Transaction (FOREX) Dealer Members (FDMs) make up less than 1 percent of the National Futures Association's (NFA's) membership, NFA expended 20 percent of its total compliance resources on them in 2008. The NFA amended and proposed to amend several of its rules governing FDMs including the following:

- Adopted rules raising the minimum net capital requirement for FDMs to \$20 million, as of May 16, 2009, and revising, as of

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<sup>9</sup> Prior letters from 1998 forward are available on the CFTC's Web site at [www.cftc.gov/industryoversight/intermediaries/guidancecporeports.html](http://www.cftc.gov/industryoversight/intermediaries/guidancecporeports.html).

November 30, 2009, the alternative net capital requirement to \$20 million plus 5 percent of the amount of customer liabilities over \$10 million, except that FDMs who exclusively use straight-through-processing for their customer transactions are exempt from this alternative requirement and need only maintain the \$20 million minimum (unless the firm is subject to a higher requirement under NFA Financial Requirements section 1, "Futures Commission Merchant Financial Requirements")

- Adopted NFA compliance rule 2-43(a), "Price Adjustments," for orders executed after June 12, 2009, which prohibits adjusting customer orders with the following two exceptions:
  - Where the adjustment settles a complaint in favor of the customer
  - If an FDM's platform exclusively uses straight-through processing such that the FDM automatically (without human intervention and without exception) enters into the identical but opposite transaction with another counterparty (creating an offsetting position in its own name) and that counterparty cancels or adjusts the price at which the position was executed
- Adopted NFA compliance rule 2-43(b), "Offsetting Transactions," effective for all FOREX orders executed after July 31, 2009, regarding offsetting positions in customers' accounts to show clearly whether customers are profiting or losing money
- Adopted rules regarding hypothetical performance results, weekly reports, customer account trading authority, written policy requirements for rollover charges, confirmations, monthly statements, and supervision of electronic trading systems

### *Commodity Pools*

.111 NFA adopted the following compliance rules applicable to CPOs:

- Rule 2-45, "Prohibition of Loans by Commodity Pools to CPOs and Related Entities," prohibits a CPO from permitting a commodity pool to use any means to make a direct or indirect loan or advance of pool assets to the CPO or any other affiliated person or entity.
- Rule 2-46, "CPO Quarterly Reporting Requirements," which will be effective when NFA completes the necessary programming changes, requires a CPO, within 45 days after the end of each quarterly reporting period, to report the following:
  - The identity of the pool's administrator, carrying broker(s), trading manager(s), and custodians,
  - A statement of changes in net asset value for the quarterly reporting period,
  - Monthly performance for the 3 months comprising the quarterly reporting period, and
  - A schedule of investments identifying any investment that exceeds 10 percent of the pool's net asset value at the end of the quarterly reporting period.

## On the Horizon—Legislative and Regulatory

.112 The following paragraphs provide certain legislative and regulatory items that have been proposed by governmental and regulatory bodies. The proposals include comprehensive changes to the financial regulatory system as well as other more specific proposals that may also have significant effects on financial institutions.

### *Regulatory Reform*

.113 In June 2009, the administration revealed proposed rules that will significantly shape the new marketplace. The proposed rules will change the level of oversight the U.S. government has on financial markets and give the Federal Reserve more tools to oversee the economy. The proposed rules are intended to prevent the reoccurrence of another economic crisis. (At the time of this writing, the proposed rules have yet to be addressed by Congress, and readers are cautioned that the final rules, if passed, may differ significantly). Five key objectives established in the new proposal include the following:

- Require strong supervision and regulation of all financial firms
- Provide the government with tools to effectively manage financial crises
- Strengthen consumer protection
- Strengthen regulation of core markets and market infrastructure
- Improve international regulatory standards and cooperation

### *Require Strong Supervision and Regulation of All Financial Firms*

.114 This first objective would be achieved through the creation of a new national bank supervisor, the creation of a financial services oversight council of regulators, the elimination of the federal thrift charter and loopholes in the Bank Holding Company Act, and finally, a new level of power given to the Federal Reserve to supervise and regulate any financial firm that is "found to pose a threat to our economy's financial stability based on their size, leverage, and interconnectedness to the financial system." Critics worry whether the Federal Reserve has the required expertise to oversee commercial banks, investment banks, big hedge funds, private equity funds, and other financial institutions. Additionally, advisers to hedge funds and other private pools of capital (including private equity funds and venture capital funds) will be required to register with the SEC once their assets under management exceed a modest threshold. Lastly, accounting standards will be reviewed to determine how financial firms should be required to employ more forward-looking loan loss provisioning practices and fair value accounting standards will be reviewed to identify changes that could provide market participants with fair value information and greater transparency regarding expected cash flows of investments.

### *Provide the Government With Tools to Effectively Manage Financial Crises*

.115 The second objective would be achieved primarily by preventative actions. This includes imposing more stringent capital, activities, and liquidity requirements on large, interconnected firms, requiring large financial firms to prepare and continuously update a credible plan for the rapid resolution of the firm in the event of severe financial distress, and providing the government

with emergency authority to resolve any large, interconnected firm in an orderly manner. To invoke this authority, the Treasury must determine that the firm is in default or in danger of defaulting, the failure of the firm would have serious adverse effects on the financial system, and the use of the special resolution authority would avoid or mitigate these adverse effects.

#### *Strengthen Consumer Protection*

.116 The third objective would be achieved by the creation of a new Consumer Financial Protection Agency. This agency would have broad authority to protect consumers of credit, savings, payment, and other consumer financial products and services, and to regulate all providers of such products and services. For example, this agency would have the authority to reform mortgage laws. This agency would aim to improve and simplify disclosures so consumers have a clear understanding of the benefits and costs associated with a transaction. It would also define standards for "plain vanilla" products that are simple and have straightforward pricing. Although this will create a safer financial marketplace for consumers, critics claim the simplified products would make it difficult for financial firms to distinguish themselves and would stifle innovation for financial products. On the other hand, many see the underlying cause of our economic crisis to be a system that allowed consumers to enter into loans that they should not have qualified for or loans that had terms they did not understand.

#### *Strengthen Regulation of Core Markets and Market Infrastructure*

.117 The fourth objective would primarily be achieved through bringing comprehensive regulation to the derivatives markets, tightening regulation on credit rating agencies, and changing securitization laws. All credit default swap and other over-the-counter (OTC) derivative markets would be subject to regulation for the first time. They also would be required to be centrally cleared and executed on exchanges and other transparent trading venues. Customized OTC derivatives also will require higher capital charges. By implementing these regulations, the derivative markets would become much less profitable. Further, many derivatives are customized and complicated, which suggest possibly they will not be able to be regulated, which would undermine the goals of the regulation. The SEC will continue to tighten regulation on credit rating agencies to ensure firms have robust policies and procedures to manage and disclose conflicts of interest. Regulators also will aim to reduce their use of credit ratings in regulations and supervisory practices. In regard to securitization, the originator or sponsor of a securitization must retain five percent of the credit risk of securitized exposures. This securitization rule is aimed to align the motives of loan originators with the end investor of a mortgage security; both parties would now have a stake in ensuring the borrowers will not default on their loans.

#### *Improve International Regulatory Standards and Cooperation*

.118 Lastly, the fifth objective would be met by numerous actions. These include strengthening the international capital framework, subjecting foreign financial firms operating in the U.S. to the same standards as U.S. firms, improving oversight of global financial markets, and enhancing supervision of internationally active financial firms.

### *Debate Surrounding Proposed Regulation*

.119 The overall sentiment about the administration's plan is that it is ambitious and that reform is definitely needed; however, many special interest groups have strong opposing views about varying aspects of this plan. Further, the question of how these reforms may diminish profits and growth of the financial sector has been raised. The four most debated aspects of the plan include the consumer protection agency, the five percent stake in securitizations, the dramatically increased power of the Federal Reserve, and the regulation of the derivative markets.

### *Regulatory Reform for Broker-Dealers*

.120 As suggested in a May 5, 2009, speech by SEC Commissioner Elisse Walter, broker-dealers and investment advisers are regulated under different statutes and at times by different regulatory bodies (for the most part). Yet, they often provide practically indistinguishable services to retail investors and at the same time direct them to those products. As SEC Chairwoman Mary L. Schapiro told Congress in March 2009, "[The SEC is] studying whether to recommend legislation to break down the statutory barriers that require a different regulatory regime for investment advisers and broker-dealers, even though the services they provide often are virtually identical from the investor's perspective."

.121 The Obama Administration has proposed legislation to strengthen the SEC's authority and would give the SEC authority to require a fiduciary duty for any broker-dealer or investment adviser who gives investment advice about securities, aligning the standards based on activity rather than legal distinctions that are no longer meaningful. In addition, the SEC would be empowered to examine and ban forms of compensation that encourage financial intermediaries to steer investors into products that are profitable to the intermediary, but are not in the investors' best interests. The legislation outlines steps to establish consistent standards for all those who provide investment advice about securities, to improve the timing and the quality of disclosures, and to require accountability from securities professionals. The legislation would also establish a permanent Investor Advisory Committee.

### *Proposal to Amend the SEC Custody Rule*

.122 The SEC is proposing amendments to the custody rule under the Investment Advisers Act of 1940. The amendments, among other things, would require registered investment advisers who have custody of client funds or securities to undergo an annual surprise examination by an independent public accountant to verify client funds and securities. In addition, unless client accounts are maintained by an independent qualified custodian (for example, a custodian other than the adviser or a related person), the adviser or related person must obtain a written report from an independent public accountant that includes an opinion regarding the qualified custodian's controls relating to custody of client assets. Finally, the amendments would provide the SEC with better information about the custodial practices of registered investment advisers. Comments were due to the SEC on July 28, 2009.

### *Proposal to Restrict Short Selling*

.123 In April 2009, the SEC released a proposal for public comment on five alternate approaches to restricting short selling. *Short selling* is selling

securities not owned by the investor, attempting to purchase replacements at a lower price, and making a profit on the difference in the price the investor agrees to sell it for versus the price at which the investor expects to buy it. This is a profitable strategy when the stock price is declining. SEC Chairwoman Schapiro noted the following in her April 8, 2009 speech:

The [SEC] has long held the view that short selling provides the market with important benefits, including market liquidity and pricing efficiency. But, short selling may also be used to illegally manipulate stock prices. One example is the "bear raid" where an equity security is sold short in an effort to drive down the price of the security by creating an imbalance of sell-side interest. In addition, unrestricted short selling can exacerbate a declining market in a security by increasing pressure from the sell-side, eliminating bids, and causing a further reduction in the price of a security by creating an appearance that the security price is falling for fundamental reasons, when the decline, or the speed of the decline, is in fact being driven by other factors.

.124 This is not the first time restrictions on short selling have been considered or implemented. The SEC piloted short selling restrictions and studied the effects from May 2005 through August 2007. The current relevance of those studies has been called into question, however, as the economic crisis has dramatically changed the markets since then. Additionally, in July 2007, the *uptick rule* contained in Rule 10a-1 of the amended Securities Exchange Act of 1934 (Exchange Act), which prevented bear raids was eliminated. The *uptick rule* prohibited any short sale unless that price was higher than the prior sale price. This essentially permitted short selling only if there had been an increase (or uptick) in a stock's price. As the economic crisis was deepening in the second half of 2008, the SEC issued numerous temporary emergency orders restricting or prohibiting short selling. It is difficult to determine, however, how much these emergency orders helped the markets and if the timing of these releases were ideal. Some believe bear raids contributed to the steep drops in stock prices of many financial institutions and, in some cases, the demise of these institutions. The SEC also noted that some investors said they feel less confident in investing in the markets without additional restrictions on short selling.

.125 The 5 alternatives in the proposed release on short selling fall into 2 categories, including the marketwide permanent approach and the security specific temporary approach. The marketwide permanent approach has 2 proposed alternative rules. The first is the *uptick rule* and the second is a modified version of the *uptick rule* that changes the price comparison from the last sale price to the current best national bid. The security specific temporary approach has 3 alternative proposed rules. The first is the *circuit breaker halt rule*, which prohibits short sales on an individual security (absent an exception) for the remainder of the trading day if its price has declined by at least 10 percent from the prior day's closing price. The next 2 alternatives are the same as the marketwide permanent approach proposed rules, except that the restrictions under each would be triggered only if an individual security's price has declined by at least 10 percent from the prior day's closing price. Comments to the SEC were due in mid-June 2009. Readers should be alert for a final release on short selling.

### ***Proposal on Flash Orders***

.126 On September 17, 2009, the SEC unanimously proposed a rule amendment that would prohibit the practice of flashing marketable orders.



Currently, flash orders are permitted as result of an exception to rule 602 of SEC Regulation National Market System. The SEC voted to propose the elimination of the flash order and if adopted, the proposed amendment would effectively prohibit all markets, including equity exchanges, options exchanges, and alternative trading systems, from displaying marketable flash orders.

**.127** *Flash orders* allow certain members to receive information about orders before the public. The flash strategy takes a stock order after it has been verified against a market's main order book, and flashes it to a select group of participants, who have a fraction of a second to act on the order before it is routed to other exchanges. Critics say flash orders give a select group of high speed traders a window into the direction of the market, giving these traders the ability to trade at lightning speeds ahead of less advanced investors. Flash order advocates say the orders help traders get better prices through improved market liquidity. Advocates contend that a ban could cause trading volume to drop on the exchanges that permit flash as traders look for better execution in alternative, less transparent venues. Readers are encouraged to monitor the SEC Web site for additional developments regarding this topic.

### ***Minimum Adjusted Net Capital Requirements of Futures Commission Merchants and Introducing Brokers***

**.128** The CFTC proposed to amend its regulations that prescribe minimum adjusted net capital (ANC) requirements for FCMs and Introducing Brokers (IBs). The amendments would do the following:

- Increase the required minimum dollar amount of ANC as defined in the regulations, which an FCM must maintain from \$250,000 to \$1 million
- Increase the required minimum dollar amount of ANC that IBs must maintain from \$30,000 to \$45,000
- Incorporate into the computation of an FCM's margin-based minimum ANC requirement, customer and noncustomer positions in OTC derivative instruments that are submitted for clearing by the FCM to derivatives clearing organizations or other clearing organizations
- Subject FCM proprietary cleared OTC derivative positions to capital deductions in a manner that is consistent with the capital deductions required by the CFTC's regulations for FCM proprietary positions in exchange-traded futures contracts and options contracts
- Increase, in the FCM capital computation, the applicable percentage of the total margin-based requirement for futures, options, and cleared OTC derivative positions in customer accounts from 8 percent to 10 percent, and in noncustomer accounts, from 4 percent to 10 percent

### ***CPO Reporting***

**.129** The CFTC proposed to amend rules governing the periodic account statements that CPOs are required to provide to commodity pool participants and the annual financial reports that CPOs are required to provide to

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commodity pool participants and file with the NFA. The amendments proposed would include the following:

- Permit, under certain circumstances, use of International Financial Reporting Standards (IFRSs) in the preparation of commodity pool annual reports
- Specify detailed information that must be included in the periodic account statements and annual reports for commodity pools with more than one series or class of ownership interest
- Clarify that the periodic account statements must disclose either the net asset value per outstanding participation unit in the pool or the total value of a participant's interest or share in the pool
- Extend the time period for filing and distributing annual reports of commodity pools that invest in other funds
- Codify existing CFTC staff interpretations regarding the proper accounting treatment and financial statement presentation of certain income and expense items in the periodic account statements and annual reports
- Streamline annual reporting requirements for pools ceasing operation
- Clarify and update several other requirements for periodic and annual reports prepared and distributed by CPOs

***Retail FOREX Regulation***

.130 Pursuant to the CRA, the CFTC is expected to propose extensive implementing regulations with respect to retail FOREX transactions and the registration and regulation of retail foreign exchange dealers (RFED), a new category of registrant, established by the CRA. The CRA stated that RFEDs and certain other intermediaries must be NFA members and register with the CFTC subject to such terms as the CFTC may prescribe. Among other requirements, the CRA established a \$20 million minimum capital requirement in ANC for RFEDs and FCMs that offer retail FOREX.

.131 For current information on the status of the mentioned CFTC proposals, readers should refer to the CFTC Web site at [www.cftc.gov](http://www.cftc.gov) under the "Law and Regulation" tab.

***Proposed Interagency Guidance on Funding and Liquidity Risk Management***

.132 The banking agencies have proposed interagency guidance to provide consistent expectations on sound practices for managing funding and liquidity risk. The guidance summarizes the principles of sound liquidity risk management that the banking agencies have issued in the past and, where appropriate, brings these principles into conformance with the international guidance recently issued by the Basel Committee on Banking Supervision. In particular, the guidance re-emphasizes the importance of cash flow projections, diversified funding sources, stress testing, a cushion of liquid assets, and a formal well-developed contingency funding plan as primary tools for measuring and managing liquidity risk. For a summary of the proposed interagency guidance as well as the proposal in its entirety, see the FDIC FIL-37-2009, "Funding and Liquidity Risk Management: Proposed Interagency Guidance," at [www.fdic.gov/news/news/financial/2009/fil09037.html](http://www.fdic.gov/news/news/financial/2009/fil09037.html).

## Audit and Attestation Issues and Developments

### Considering Audit Risks Arising From Current Economic Conditions

**.133** The recent economic conditions and regulatory actions described in this alert may cause additional risk factors that had not previously existed or did not have a material effect on audit clients in prior years. Some risks that may affect a financial institution in the current economic environment are as follows:

- Constraints on the availability of capital and credit
- Going concern and liquidity issues
- Marginally achieving explicitly stated strategic objectives
- Use of off-balance-sheet financing and the effect of the increase in loan modification on QSPEs, special purpose entities, joint ventures, or other complex financing arrangements
- Counterparty defaults
- Volatile real estate and business markets
- Market instability, which can cause significant measurement uncertainty, including accounting estimates and fair value measurements (for example, the valuation of loans, securities, and other financial instruments in markets when there has been a significant decrease in the volume and level of activity)
- Credit deterioration and decrease in collateral values
- Credit concentrations, especially in residential and commercial real estate
- Participation in loss mitigation programs (for example, the MHA program) and the potential effects on ALLL and troubled debt restructurings
- Assessing the need for and measuring of representation and warranty reserves
- Participation in governmental recovery programs
- Regulatory capital adequacy requirements
- Other regulatory changes and requirements

**.134** Although many of these risks are not new to businesses, consideration of the ways a client is affected by external forces is part of obtaining an understanding of the entity and its environment and will allow the auditor to plan and perform the audit to address those risks. As noted in paragraph .17 of AU section 312, some possible audit responses to significant risks of material misstatement include increasing the extent of audit procedures, performing procedures closer to year-end, or increasing audit procedures to obtain more persuasive evidence. Additionally, given the constantly changing status of economic conditions that could affect your client, auditors should consider modifying audit procedures to ensure that risks are still adequately addressed.

**.135** Although it is impossible to predict and include all accounting, auditing, and attestation issues that may affect your engagements, this alert covers the primary areas of concern given the current economic conditions. Continue to remain alert to economic, legislative, and regulatory developments, as well

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as the associated accounting, auditing, and attestation issues as you perform your engagements.

**Auditing Liquidity Restrictions**

**.136** TIS section 1100.15, "Liquidity Restrictions" (AICPA, *Technical Practice Aids*), addresses potential accounting and auditing implications when a fund or its trustee imposes restrictions on a nongovernmental entity's ability to withdraw its balance in a money market fund or other short term investment vehicle. See the "Accounting Issues and Developments" section for additional detail regarding this accounting question and answer publication.

**.137** Auditors confronted by the issues addressed in this TIS section should consider whether any additional disclosures made by management include forward-looking statements that are not required by GAAP and, therefore, may not be audited. Auditors also should consider whether the inability to withdraw funds can pose significant challenges to the entity's liquidity and, therefore, affect the entity's ability to continue as a going concern. Restrictions on liquidity also may be an appropriate matter to communicate to those charged with governance. Finally, the auditor should consider if he or she wishes to emphasize any liquidity restrictions in the auditor's report. For further details, see the question and answer at [www.aicpa.org/download/acctstd/TIS1100\\_15.pdf](http://www.aicpa.org/download/acctstd/TIS1100_15.pdf).

**Auditing Alternative Investments**

**.138** The AICPA Practice Aid *Alternative Investments—Audit Considerations* is a useful tool for auditors that focuses on the existence and valuation assertions associated with alternative investments, but also discusses general considerations pertaining to auditing alternative investments, management representations, disclosure of certain significant risks and uncertainties, and reporting. As defined in the foreword of the practice aid, *alternative investments* are

investments for which a readily determinable fair value does not exist . . . includ[ing] private investment funds meeting the definition of an investment company . . . such as hedge funds, private equity funds, real estate funds, venture capital funds, commodity funds, offshore fund vehicles, and funds of funds, as well as bank common/collective trust funds.

**.139** You can access the full text of this practice aid on the AICPA's Web site at [www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Practice+Aids+and+Tools/alternative\\_investments.htm](http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Practice+Aids+and+Tools/alternative_investments.htm).

**.140** Given the state of the economy, many funds are imposing limitations on redemptions, and some have unwound. As this occurs, the fair value measurements applied to these investments may increase audit risk and fall under increased scrutiny.

**Auditing Fair Value Measurements**

**.141** In addition to understanding the looming questions relative to fair value accounting, auditors should be aware of audit issues involving fair value accounting. Particular assets, liabilities, and components of equity are measured or disclosed at fair value in the financial statements, and it is management's responsibility to estimate fair value and disclosures on particular assets, liabilities and components of equity when fair value accounting is either

required or elected. When auditing these fair values to ensure they are in conformity with GAAP, auditors should consult AU section 328, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*, vol. 1), which establishes standards and provides guidance for auditors. Specific types of fair value measurements are not covered by AU section 328. For example, when auditing the fair value of derivatives and securities, refer to AU section 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*, vol. 1).

**.142** In regard to analyzing the sufficiency of the audit evidence, the strongest audit evidence to support a fair value is an observable market price in an active market for the identical asset or liability. If that is not available, a valuation method should incorporate observable market assumptions based on views of market participants. If observable market assumptions are not available or management, through the required level of due diligence, has determined that the observable inputs were based on markets where there has been a significant decrease in the volume and level of activity or on distressed transactions, then management should use judgment in making adjustments to the observed inputs. The auditor should obtain an understanding of the entity's process for determining fair values, as well as whether the fair value measurements and disclosures are in accordance with GAAP. During the testing procedures, the auditor also may identify any possible indicators of impairment. According to paragraph .23 of AU section 328, substantive tests of the fair value measurements may involve (a) testing management's significant assumptions, the valuation model, and the underlying data; (b) developing independent fair value estimates for corroborative purposes; or (c) reviewing subsequent events and transactions. Paragraph .26 also notes that when testing the fair value measurements and disclosures, the auditor evaluates whether management's assumptions are reasonable and reflect, or are not inconsistent with, market information. According to FASB ASC 820, under U.S GAAP, this may include evaluating the following:

- Whether there has been a significant decrease in the volume and level of activity for the asset or liability when compared with normal market activity, which may include consideration of the number of recent transactions, the date of the most recent price quotes, the consistency among price quotes, increases in implied liquidity risk premiums, increases in the bid-ask spread, and the amount of publicly available information.
- Whether the transaction was an orderly transaction, which may include consideration of the seller's financial condition, the counterparty credit position, the exposure to the market during the marketing period, and the actual transaction price.
- The reasonableness of the underlying assumptions, which may include consideration of the use of pricing services, the assumptions used by the pricing service, and the extent of testing required to verify the reasonableness of the prices provided. (For example, the auditor should understand whether the fair value measurement was determined using quoted prices from an active market, observable inputs, or fair value measurements based on a model. If the price is not based on quoted prices from an active market or observable inputs, the auditor should obtain an understanding of the model used by the pricing service and evaluate whether the

assumptions are reasonable [see the following section for additional information on pricing services].)

- The reasonableness of the determination within the fair value hierarchy of inputs.

.143 For additional information on the recent guidance issued by FASB regarding fair value measurements, see the "Accounting Issues and Developments" section of this audit risk alert.

### ***Fair Values of Securities***

.144 The guidance in AU section 332 relating to auditing the fair value of securities is fairly similar to the guidance in AU section 328; however, it does include some items of note for the auditor. As previously mentioned, quoted market prices in active markets are the best available audit evidence to support a fair value; however, when they are unavailable and the valuations of securities are obtained from a broker or dealer or another pricing service based on valuation models, the auditor should understand the underlying valuation method used (such as a cash flow projection). These prices also may be based on quoted prices from an active market or other observable inputs that will be a consideration on the auditor's procedures, as well. The process used by the pricing service in measuring fair value should be evaluated to determine the consistency with the specified valuation method (typically fair value, as defined in the FASB ASC glossary). The auditor also may determine that it is necessary to obtain quotes from more than one pricing source based on circumstances, such as an existing relationship between the entity and the valuing entity, which could inhibit objective pricing or underlying valuation assumptions that are highly subjective. In the context of FASB ASC 820, quoted prices in active markets are considered level 1 inputs.

.145 When an entity performs its own valuation, value testing procedures may include the following:

- Assessing the reasonableness
- Comparing the assumptions to industry reports or benchmarks
- Assessing the appropriateness of the model
- Calculating the value using his or her own model
- Comparing the fair value with subsequent or recent transaction
- Verifying the fair value of the liability reflects the *nonperformance risk*, the risk that the obligation will not be fulfilled, relating to the liability

.146 Whether the inputs to the entity's valuation model are observable determines their characterization as level 2 or level 3 inputs, respectively, within FASB ASC 820. When extensive judgment is needed, consider using a specialist or refer to AU section 342, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1). Additionally, when the underlying collateral of a security significantly contributes to its fair value and collectability of the security, evidence of the collateral also should be examined for existence, fair value, transferability, and the investor's right to the collateral.

.147 Paragraph .19 of AU section 328 also notes that the auditor should evaluate whether the entity's method for determining fair value measurements is applied consistently and, if so, whether the consistency is appropriate considering possible changes in the environment or circumstances affecting the

entity or changes in accounting principles. The auditor also should evaluate management's conclusions regarding other-than-temporary impairment on its securities. Examples of factors that could cause an other-than-temporary impairment, per paragraph .47 of AU section 332, include the following:

- Fair value is significantly below cost and
  - the decline is attributable to adverse conditions specifically related to the security or to specific conditions in an industry or in a geographic area.
  - the decline has existed for an extended period of time.
  - management does not possess both the intent and the ability to hold the security for a period of time sufficient to allow for any anticipated recovery in fair value.
- The security has been downgraded by a rating agency.
- The financial condition of the issuer has deteriorated.
- Dividends have been reduced or eliminated, or scheduled interest payments have not been made.
- The entity recorded losses from the security subsequent to the end of the reporting period.

**.148** Auditors should consider all facts and circumstances when determining if an other-than-temporary impairment has occurred. The auditor should obtain an understanding of management's classification process among trading, available-for-sale, and held-to-maturity based on the most recent accounting guidance that is addressed in the following section. The auditor should also consider the classifications in light of the entity's current financial position.

### Auditing Other-Than-Temporary Impairments in Debt Securities

**.149** The auditor also should evaluate management's conclusions regarding other-than-temporary impairment on debt securities under the most recent impairment accounting guidance. The "Accounting Issues and Developments" section provides additional details regarding the recognition guidance and required disclosures under the recently issued FASB Staff Position (FSP) FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments*, which was primarily codified in FASB ASC 310-10, 320-10, 325-40, and 325-20.

**.150** When evaluating whether other-than-temporary impairments of debt securities have been properly recognized and disclosed, auditors may consider whether management

- has concluded that the fair value of a debt security is less than its amortized cost.
- does not intend to sell the security and it is more-likely-than-not that it will not be required to sell prior to recovery.
- has considered all available evidence to estimate the anticipated period over which the cost basis of the security is expected to recover.
- has properly determined the difference between the present value of the cash flows expected to be collected and the amortized cost basis, which is referred to as the credit loss.

- has properly recognized the amount related to credit loss in earnings and the amount related to other matters in other comprehensive income.

**.151** In determining whether a credit loss exists, an entity should use its best estimate of the present value of cash flows expected to be collected from the debt security and might consider the methodology described in paragraphs 12–16 of FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan—an Amendment of FASB Statement No. 5 and 15* (which is codified in various paragraphs in FASB ASC 310-10, 310-30, and 310-40) for measuring an impairment on the basis of the present value of expected future cash flows. For debt securities that are beneficial interests in securitized financial assets within the scope of FASB ASC 325-40, an entity should determine the present value of cash flows expected to be collected by considering the guidance in "Pending Content" of FASB ASC 325-40-35-4(b)<sup>10</sup> for determining whether a decrease in cash flows expected to be collected from cash flows previously projected has occurred. For debt securities accounted for in accordance with FASB ASC 310-30, an entity should consider that guidance in estimating the present value of cash flows expected to be collected from the debt security.

**.152** Numerous factors to be considered when estimating whether a credit loss exists and the period over which the debt security is expected to recover include the following examples:

- The length of time and the extent to which the fair value has been less than the amortized cost
- Adverse conditions specifically related to the security, an industry, or a geographic area
- The historical and implied volatility of the fair value of the security
- The payment structure of the debt security and the likelihood of the issuer being able to make payments that increase in the future
- Failure of the issuer of the security to make scheduled interest or principal payments
- Any changes to the rating of the security by a rating agency
- Recoveries or additional declines in fair value subsequent to the balance sheet date

**.153** Because extensive judgment is needed to estimate the present value of cash flows and ultimately the credit loss, auditors may consider using a specialist or refer to AU section 342 for additional guidance.

### Auditing the Allowance for Loan and Lease Losses

**.154** As noted in the *FDIC Quarterly* Banking Profile from the second quarter of 2009, costs associated with rising levels of troubled loans and falling asset values contributed to an aggregate net loss in the second quarter of 2009 for FDIC-insured commercial banks and savings institutions. Increased expenses for bad loans were primarily responsible for the industry's loss. Insured institutions added \$66.9 billion in loan-loss provisions to their reserves during the

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<sup>10</sup> This guidance is labeled as "Pending Content" due to the transition and open effective date information discussed in Financial Accounting Standards Board (FASB) *Accounting Standards Codification*<sup>TM</sup> (ASC) 320-10-65-1. For more information on FASB ASC, please see the "Notice to Readers" in the guide.



quarter, an increase of 32.8 percent compared to the second quarter of 2008. In addition, the amount of noncurrent (90 days or more past due or in nonaccrual status) loans and leases increased for a 13th consecutive quarter, and the percentage of total loans and leases that were noncurrent reached a new record.

**.155** In light of the current economic environment, the SEC, along with other banking regulators, have recently issued reminders of the need to properly evaluate ALLL. Although no additional accounting guidance has been issued by FASB, auditors might gain familiarity with the recent regulatory issuances as applicable, and should consider the effects of the current economic environment on this allowance. Consideration of the applicable guidance and current economic conditions should be reflected in the nature, timing, and extent of testing procedures for ALLL.

**.156** The primary objectives of audit procedures for credit losses are to obtain sufficient appropriate evidence that

- the allowances for loan losses and liability for other credit exposures are accurate and appropriate in accordance with GAAP to cover the amount of probable credit losses inherent in the loan portfolio at the balance sheet date.
- allowances are not excessive, as long as the loan portfolio is reflected at net realizable value.
- credit losses and other items charged or credited to the allowance for loan losses, such as loan chargeoffs and recoveries, have been included in the financial statements at appropriate amounts.
- disclosures are adequate.

**.157** The auditor achieves those objectives by testing management's estimates of the allowance based on available and relevant information regarding loan collectability. The auditor is not responsible for estimating the amount of the allowance or ascertaining the collectability of each, or any, specific loan included in an institution's loan portfolio.

**.158** Because of the significance of loans to institutions' balance sheets, and because the estimation of loan losses is based on subjective judgments, auditors are likely to assess inherent risk related to the allowance for loan losses as high. AU section 342, discussed in further detail in the following section, establishes requirements and provides guidance to auditors in obtaining and evaluating sufficient appropriate audit evidence to test significant accounting estimates in an audit of financial statements.

**.159** The banking agencies' "Interagency Policy Statement on the Allowance for Loan and Lease Losses," reiterates key concepts and requirements included in U.S. GAAP and existing ALLL supervisory guidance. The interagency guidance suggests that estimated credit losses should reflect consideration of all significant factors that affect the collectability of the portfolio as of the evaluation date. Normally, an institution should determine the historical loss rate for each group of loans with similar risk characteristics in its portfolio based on its own loss experience for loans in that group. Although historical loss experience provides a reasonable starting point for the institution's analysis, historical losses, or even recent trends in losses, do not, by themselves, form a sufficient basis to determine the appropriate level for ALLL.

**.160** Management also should consider qualitative and environmental factors that are likely to cause estimated credit losses associated with the

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institution's existing portfolio to differ from historical loss experience, including but not limited to the following:

- Changes in lending policies and procedures
- Changes in economic and business conditions and developments that affect collectability (for example, unemployment rates)
- Changes in the volume and severity of past due loans and volume of nonaccrual loans
- Changes in the value of underlying collateral for collateral-dependent loans
- Concentrations of credit and changes in the level of such concentrations

**.161** The interagency guidance was issued in 2006 and continues to provide relevant information for determining the approach of the banking agencies regarding matters related to ALLL. In addition to the interagency policy statement, the banking agencies also provided FAQs to assist institutions in complying with U.S. GAAP and ALLL supervisory guidance.

**.162** Analytical procedures in and of themselves may not achieve an appropriate level of assurance due to the significant fluctuations in certain trends and other unusual patterns as shown by recent economic data. As such, additional attention may be warranted in the areas of modeling, loan performance tracking, and benchmarking processes as well as the documentation process for residential and commercial mortgage loss estimations. For example, models used to derive collateral valuations (auto valuation models), frequency of loss models, and loss severity models may not all have been scoped into the entity's internal control processes in prior years. In addition, multiple models or techniques may be used to establish adjustments to the modeled results that may also be considered in the internal control and substantive audit processes. As a result of current economic conditions and the increased emphasis on ALLL, the auditor may consider performing additional testing in this area.

**.163** On August 3, 2009, the FDIC issued the FDIC FIL-43-2009, "Allowance for Loan and Lease Losses: Residential Mortgages Secured by Junior Liens," which reminded financial institutions of several key points in the 2006 interagency guidance and provided specific guidance for residential mortgages secured by junior liens. Institutions were reminded that, when estimating credit losses on each group of loans with similar risk characteristics under FASB Statement No. 5, *Accounting for Contingencies*, which is codified in FASB ASC 450-20, they should consider their historical loss experience on the group, adjusted for changes in trends, conditions, and other relevant factors that affect repayment of the loans in the group as of the ALLL evaluation date. The FDIC FIL stated that the need to consider all significant factors that affect the collectability of loans is especially important for loans secured by junior liens on one-to-four family residential properties, both closed-end and open-end, in areas where there have been declines in the value of such properties. The letter notes that delaying the recognition of estimated credit losses is not appropriate and could delay appropriate loss mitigation activity, such as restructuring junior lien loans to more affordable payments or reducing principal on such loans to facilitate refinancing. The letter concluded by stating that examiners are evaluating the effectiveness of an institution's loss mitigation strategies for loans as part of their assessment of the institution's overall financial condition.

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.164 In addition, the OTS issued CEO Letter No. 304, "ALLL—Observed Practices Including Sound Practices," on May 22, 2009. The letter suggested sound practices that may be appropriate for estimating and evaluating an appropriate ALLL, including:

- At inflection points, or periods of increasing or decreasing losses, an ALLL methodology that uses lagging data (for example, historical loss rates, which are considered less predictive), is supplemented and validated with other methods that use more leading data (for example, a migration analysis).<sup>11</sup>
- ALLL methodologies for sophisticated loan products that capture the features and risk layering intrinsic to each loan product. Some examples are a change in a borrower's Fair Isaac Credit Organization score, date of interest rate resets, change in housing market prices, borrowers' payment habits, or other trends that affect loan collectability.
- With more sophisticated products such as option adjustable rate mortgages, the portfolio is segmented into multiple risk levels when forecasting delinquency and default. For example, the loan portfolio may be segmented by past payment behavior (such as, borrowers who make the minimum payment versus the fully amortizing payment), or by reset date and recast projection.
- Internal data is supplemented with external data, such as Home Price Indices, unemployment, and changes in international, national, regional, and local economic conditions, in estimating ALLL.
- Qualitative factors are applied to specific loan portfolio segments. Alignment of a qualitative factor with the specific segment of loans affected reflects the estimated change in collectability for various products and borrowers. Applying a qualitative factor uniformly to the entire loan portfolio may distort the factor's impact.
- Loss rates and delinquency rates are stress tested to
  - determine the sensitivity of the methodology to changes in primary inputs,
  - inform management of the risk of miscalculation if the credit environment changes, and
  - evaluate the appropriateness of ALLL in a range of credit environments.
- ALLL is reviewed monthly to allow an institution to identify changes in trends (for example, inflection points) much more quickly.
- The ALLL estimate is fully documented at least quarterly.
- Material changes in methodology are evaluated for approval by the board of directors.

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<sup>11</sup> A *migration (to loss) analysis* uses association-specific data to track the movement of assets through the various asset classifications to loss in order to estimate the percentage of losses that are likely to be incurred from the various categories and classifications of assets currently in the association's portfolio. See the Office of Thrift Supervision's *Examination Handbook* section 261, appendix B for more information.

.165 The OTS letter also includes observed practices that are considered weak and not in accordance with U.S. GAAP. Readers are encouraged to read these items and the full text of the letter, which can be found on the OTS Web site at <http://files.ots.treas.gov/25304.pdf>

.166 In addition, the OCC issued several questions and answers related to the ALLL in the December 2008 Bank Accounting Advisory Series. Readers are encouraged to read this publication on the OCC Web site at [www.occ.treas.gov/BAAS2008.pdf](http://www.occ.treas.gov/BAAS2008.pdf).

.167 In August 2009, the Division of Corporation Finance of the SEC sent an illustrative letter to the CFOs of certain public companies identifying a number of disclosure issues the CFOs may wish to consider in preparing Management's Discussion and Analysis (MD&A). The SEC letter notes that, although U.S. GAAP, when addressing how to account for ALLL, has not changed in recent years, the current economic environment may require entities to reassess whether the information upon which accounting decisions are based remains accurate, or reconfirm or reevaluate the accounting for these items, and reevaluate the MD&A disclosure. Item 303 of Regulation S-K requires entities to discuss, in the MD&A, any known trends, demands, commitments, events or uncertainties reasonably expected to have a material impact on the results of operations, liquidity, and capital resources. The letter also emphasizes that although determining the allowance for loan losses requires judgment, it would be inconsistent with U.S. GAAP to delay recognizing credit losses that can be estimated based on current information and events. Readers are encouraged to review the letter that is located on the SEC Web site at [www.sec.gov/divisions/corpfin/guidance/loanlossesltr0809.htm](http://www.sec.gov/divisions/corpfin/guidance/loanlossesltr0809.htm).

.168 The exposure draft *Disclosure about the Credit Quality of Financing Receivables* was issued by FASB on June 24, 2009, and is addressed in the "Accounting Issues and Developments" section of this alert.

### Auditing the Representation and Warranty Reserves

.169 The representation and warranty reserve is generally used to cover probable losses inherent with the sale of loans in the secondary market. Certain representation and warranties are made to investors at the time of sale, which permit the investor to return the loan to the seller or require the seller to cover the investor for any losses incurred by the investor while the loan remains outstanding. The probable losses may also include losses related to the inability to meet underwriting requirements of new or modified residential loans. The evaluation process for determining the adequacy of the representation and warranty reserve and the provisioning for estimated losses are generally performed by the entity on a periodic basis.

.170 As a result of the increase in loan modifications related to the MHA program and other loss mitigation efforts, entities may be confronted with certain challenges related to the representation and warranty reserve and assessing the requirement for recording and measuring the amount of the loss. Auditors may consider evaluating the entity's process for determining whether a representation and warranty reserve is necessary, the modeling techniques used to measure the reserve, and other audit considerations associated accounting estimates. Auditors may refer to AU section 342 for additional information regarding accounting estimates (see the "Auditing Accounting Estimates" section for additional information).

## Auditing Troubled Debt Restructurings

.171 As noted in the joint press release regarding the MHA program and other related guidance previously addressed, the banking agencies strongly support the goal of promoting sustainable loan modifications as an alternative to foreclosure on residential property. The result of compliance with this program has led to a significant increase in the number of residential loan modifications and the application of FASB Statement No. 114. On December 23, 2008, the Center for Audit Quality (CAQ) issued its white paper *Application of Statement of Financial Accounting Standard No. 114, Modifications to Residential Mortgage Loans that Qualify as Troubled Debt Restructurings*. The objective of the nonauthoritative white paper is to assist preparers and auditors by presenting questions related to the application of existing U.S. GAAP associated with the application of the loan impairment guidance.

.172 Restructuring of a debt constitutes a troubled debt restructuring if the creditor, for economic or legal reasons related to the debtor's financial difficulties, grants a concession to the debtor that it would not otherwise consider, as described in FASB ASC 310-40 and the FASB ASC glossary. A loan restructured in a troubled debt restructuring is an *impaired loan*; it should not be accounted for as a new loan because a troubled debt restructuring is part of a creditor's ongoing effort to recover its investment in the original loan. The effective interest rate for a loan restructured in a troubled debt restructuring is based on the original contractual rate, not the rate specified in the restructuring agreement.

.173 Certain questions in the CAQ white paper discuss how preparers and auditors consider the expected future cash flows of the impaired loan and the loan's effective interest rate under FASB ASC 310-10 and 310-40. As noted in the whitepaper, inputs into the estimate of the present value of expected future cash flows are considered separately and therefore, may create differences in the application of the guidance.

.174 In addition, on August 28, 2009, the OTS issued CEO Letter No. 315, which included Thrift Bulletin (TB) 85, Regulatory and Accounting Issues Related to Modifications and Troubled Debt Restructurings of 1-4 Residential Mortgage Loans. The TB updates Examination Handbook section 240, "Troubled Debt Restructurings," and provides guidance on the regulatory treatment and accounting for modified loans. It addresses when such modifications constitute troubled debt restructurings and how to classify, as well as risk weight for regulatory capital purposes. Readers are encouraged to read the full text of this bulletin at <http://files.ots.treas.gov/84303.pdf>. In September 2009, the NCUA issued Letter to Credit Union 09-CU-19, "Evaluating Residential Real Estate Mortgage Loan Modification Program," which provides certain financial reporting consideration for credit unions, as well as several other considerations related to loan modifications. (The letter can be found at [www.ncua.gov/Resources/LettersCreditUnion.aspx](http://www.ncua.gov/Resources/LettersCreditUnion.aspx))

.175 Auditors may consider performing procedures to identify troubled debt restructurings and evaluate whether they have been accounted for in conformity with FASB ASC 310-10 and 310-40. The risks generally associated with accounting for loan modifications may include the following:

- Modifications that are not properly authorized or not completely and accurately captured in the loan accounting system

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- Once the modification has been completed, the determination of whether the modification is a troubled debt restructuring according to the guidance in FASB ASC 310-10 and 310-40, and Emerging Issues Task Force (EITF) Issue 02-4, *Determining Whether a Debtor's Modification or Exchange of Debt Instruments Is within the Scope of FASB Statement No. 15*, which is codified in FASB ASC 470-60,<sup>12</sup> is not appropriate
- The measurement of the new loan basis under FASB ASC 310-40 is not performed or is not performed using the appropriate methodology and inputs
- The initial recognition and subsequent measurement are not appropriate

**.176** Auditors may perform risk assessment procedures to determine whether the institution's policies and procedures properly address the identification of troubled debt restructurings and recording of the modification in the loan documentation and the loan system. These procedures may include gaining an understanding of (a) the modification process, which may include an understanding of who performs the modification, the accounting systems used by the entity, how the modified loans are recorded, tracked in the system, and independently reviewed; (b) the process and policies for determining that modifications meet the definition of a troubled debt restructuring; and (c) the accounting process for measurement and recognition of the troubled debt restructuring.

**.177** In conjunction with the previously mentioned procedures, auditors may consider whether the loans were properly recorded as a troubled debt restructuring by verifying that (a) a borrower is under financial distress, and (b) a concession has been given within the guidelines of FASB ASC 470-60-55. Once the loan has been identified as a troubled debt restructuring, a key focus may be verifying that the cash flow models properly reflect the nature of the product. The cash flows models for troubled debt restructurings generally require considerable system alterations and upgrades to appropriately incorporate the recognition and measurement guidance of FASB ASC 310-40 and 470-60-55. Additional system upgrades, if necessary, may require additional audit consideration.

**.178** In addition, auditors should refer to AU section 342 when evaluating the estimations included in the measurement of impaired loans. If the auditor determines that the confirmation of the loan terms is appropriate, AU section 330, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1), discusses the relationship of confirmation procedures to the assessment of audit risk and the design of confirmation requests. For serviced loans, the auditor may obtain copies of any reports issued by the servicer's auditors under AU section 324, *Service Organizations*, (AICPA, *Professional Standards*, vol. 1), to determine that appropriate audit procedures were performed on the individual loans at the servicing organization.

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<sup>12</sup> FASB ASC 470-60-55-5 provides a model that should be applied by a debtor when determining whether a modification or an exchange of debt instruments is within the scope of FASB ASC 470-60.

## Auditing Loan Modifications Held by a QSPE

**.179** Lenders may undertake modifications of residential mortgage loans held on-balance sheet in their loan portfolios, as addressed in the preceding section, or in a securitization trust that is intended to be a QSPE.

**.180** The introduction and background section of FASB Statement No. 166, *Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140*,<sup>13</sup> indicates that FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities—a replacement of FASB Statement No. 125* (which was codified in FASB ASC 860, *Transfers and Servicing*) and related interpretative guidance are ambiguous about when an entity may modify a loan without affecting the QSPE status because the interpretive guidance states only that a servicer is permitted to work out a loan if it becomes delinquent or is in default. The guidance also requires that the discretion inherent in that decision is significantly limited and its parameters be entirely specified in the QSPE's legal documents. Many of the modifications related to the current loss mitigation efforts continue to be for loans that are not currently in default but are at risk for default, that is, it appears to be imminent or reasonably foreseeable.

**.181** In December 2007, the American Securitization Forum (ASF) issued the "Streamlined Foreclosure and Loss Avoidance Framework for Securitized Adjustable Rate Mortgage Loans" (the ASF framework). The ASF framework was developed to address large numbers of subprime loans that are at risk of default when the loans reset from their initial fixed interest rates to variable rates. The ASF framework was focused on subprime first-lien adjustable-rate residential mortgages that (a) had an initial fixed interest rate period of 36 months or less, (b) were included in securitized pools, (c) were originated between January 1, 2005, and July 31, 2007, and (d) had an initial interest rate reset date between January 1, 2008, and July 31, 2010 (subprime adjustable rate mortgage [ARM] loans). These subprime ARM loans were further organized into 3 segments.

**.182** On January 8, 2008, the SEC Office of the Chief Accountant (OCA) issued a letter in which the SEC staff stated it would not object to continued status as a QSPE if segment 2 subprime ARM loans were modified pursuant to the specific screening criteria in the ASF framework. Additionally, given the unique nature of the modifications and other loss mitigation activities that are recommended in the ASF framework, OCA expected registrants to provide sufficient disclosures in SEC filings regarding the affect that the ASF framework had on QSPEs that hold subprime ARM loans. OCA noted that the ASF framework was an interim step that may be used until FASB completed its project addressing the amendments to FASB Statement No. 140. Readers are encouraged to view the full content of this letter at [www.sec.gov/info/accountants/staffletters/hanish010808.pdf](http://www.sec.gov/info/accountants/staffletters/hanish010808.pdf).

**.183** As noted in the subsequent "Accounting Issues and Developments" section, FASB completed its project with the issuance of FASB Statement No. 166. FASB Statement No. 166 eliminates the concept of a QSPE from the derecognition model. See the "Accounting Issues and Developments" section for additional information, including the applicable effective dates.

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<sup>13</sup> At the date of this writing, this guidance has not yet been included in FASB ASC. Readers are encouraged to visit the FASB ASC Web site at <http://asc.fasb.org/home> and monitor updates.

.184 Auditors may perform internal control procedures to verify that the institution's policies and procedures properly address mortgages held by a QSPE and include procedures to determine whether a special purpose entity can maintain its qualifying status when the loans underlying the QSPE have been modified.

### **Auditing Other Real Estate Owned**

.185 Generally, the largest component of real estate owned by lenders includes assets taken in settlement of troubled loans through surrender or foreclosure. Real estate investments, real estate loans that qualify as investments in real estate, and premises that are no longer used in operations may also be included in real estate owned. The risks related to other real estate owned may increase in significance for some institutions due to the number of foreclosures on residential mortgages.

.186 General accounting guidance for other real estate owned is provided in FASB Statement No. 114; No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings* (primarily codified in FASB ASC 470-60 and 310-40); and No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* (primarily codified in FASB ASC 360-10). Sales of other real estate owned are accounted for in accordance with FASB Statement No. 66, *Accounting for Sales of Real Estate* (primarily codified in FASB ASC 360-20), whereas FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects* (primarily codified in FASB ASC 970) provides guidance on accounting for costs incurred during the development and construction period. FASB ASC 835, *Interest*, provides guidance on the capitalization of interest costs. FASB ASC 820 provides guidance on the fair value of other real estate property. Detailed reporting guidance for financial institutions is provided in the Consolidated Reports of Condition and Income (call report) instructions, which requires that other real estate owned should be accounted for under U.S. GAAP. Other guidance provided by the banking agencies is provided in the FDIC FIL-62-2008, "Other Real Estate: Guidance on Other Real Estate," and the OCC's Bank Accounting Advisory Series from December 2008. Institutions also should comply with the applicable federal and state laws and regulations pertaining to holding other real estate.

.187 Obtaining audit evidence about the carrying amount of foreclosed assets (fair values) and real estate investments (including loans that qualify as real estate investments) may involve a review of appraisals, feasibility studies, forecasts, sales contracts or lease commitments, and information concerning the track record of the developer. Being aware of the involvement of related parties may influence the design of audit procedures used by the auditor. To obtain appropriate audit evidence of progress to completion under a real estate investment or other real estate project, the auditor may also decide to perform an on-site inspection of certain properties.

.188 Estimates of the fair value of real estate assets are necessary to account for such assets. AU section 342 provides guidance on auditing accounting estimates (such as estimates of fair values), and AU section 328 establishes standards and provides guidance on auditing fair value measurements and disclosures contained in financial statements.

.189 In applying audit procedures to real estate, the auditor often relies on representations of independent experts, particularly appraisers and construction consultants, to assist in the assessment of real estate values. AU section



336, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1), provides guidance in this area.

**.190** Independent appraisals may be considered acceptable audit evidence. The quality of appraisals varies, however, and, in some instances, the auditor may have reason to believe certain assumptions underlying appraisals are unrealistic. The auditor should understand and consider the approaches and assumptions used in obtaining the appraised value. Some matters that should be considered by the auditor when evaluating an appraisal include the following:

- A rise or decline in a particular market area not reflected in an appraisal may warrant that additional procedures, or perhaps a new appraisal, be performed.
- If the date of the appraisal is substantially earlier than the audit date, a rise or decline in a particular market area between the two dates may warrant a new appraisal or the performance of additional procedures.
- Appraised values should be based on current market conditions and must be discounted for costs to complete and sell, as well as for carrying costs.
- The estimated selling prices should reflect the expectations of a sale in the reasonably near future—not in an indefinite future period.

### Auditing Accounting Estimates

**.191** As noted in paragraph .04 of AU section 342, the auditor is responsible for evaluating the reasonableness of accounting estimates made by management in the context of the financial statements as a whole. Although this alert has discussed fair value measurements at length, it is important to remember many types of accounting estimates exist in client financial statements. Some examples include ALLL, as discussed previously, the impairment analysis and estimated useful lives of long lived assets, the valuation allowance for deferred tax assets, and the actuarial assumptions in pension and other postretirement benefit costs.

**.192** Given the current economic climate, additional skepticism should be exercised when considering management's underlying assumptions used in accounting estimates. When evaluating accounting estimates, the auditor should consider both the subjective and objective factors with professional skepticism. As discussed in paragraph .09 of AU section 342, key factors and assumptions that the auditor normally concentrates on are significant to the estimate, sensitive to variations, and deviations from historical patterns, or particularly subjective and susceptible to misstatement and bias; however, it is important to consider whether historical patterns are still applicable.

**.193** For example, in the current environment, new patterns may emerge. In this economic climate, with possible increasing pressure on management to meet earnings expectations and capital requirements, a key aspect of AU section 342 is for an auditor to determine the reasonableness of management's accounting estimates with an extra degree of professional skepticism. As noted by AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1), when assessing audit differences between client estimates and audit estimates, even if they are individually reasonable, an auditor should consider whether these differences are indicative of

possible bias by management. If so, the auditor should reconsider the estimates as a whole.

**.194** The auditor should obtain an understanding of how management develops estimates and should employ one of the approaches outlined in paragraph .10 of AU section 342 in testing that process. In reviewing and testing management's process, the auditor may consider identifying controls around this process and determining if the underlying data used for the estimate are reliable and used appropriately. An auditor also may develop an estimate and compare it to management's estimate. Lastly, the auditor may review subsequent events or transactions occurring prior to the date of the auditor's report. Further, as noted in AU section 316, hindsight may provide the auditor additional insight into the existence of management bias. For further details on auditing estimates, see AU section 342.

### Using the Work of a Specialist

**.195** It may be necessary to use a specialist (such as a securities valuation expert or independent appraiser) to assist in auditing complex or subjective matters. Examples of matters in which an auditor may engage a specialist are valuation issues; reasonableness of determination of amounts derived from specialized techniques or models; or implementation of technical requirements, regulations, or legal documents. AU section 336 provides guidance to auditors in using specialists. The guidance in AU section 336 is applicable when the specialist is hired by management or if the auditor engages the specialist. However, if a specialist employed by the auditor's firm participates in the audit, AU section 311, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1), is applicable rather than AU section 336.

**.196** When using the work of a specialist, the auditor should evaluate the specialist's professional qualifications, obtain an understanding of the nature of the work performed or to be performed, and evaluate the relationship of the specialist to the client in terms of objectivity. Although the appropriateness and reasonableness of the methods and assumptions employed by the specialist are his or her responsibility, the auditor should obtain an understanding of these qualities, test the underlying data provided to the specialist, and evaluate the specialist's findings in the context of the audit and related assertions in the financial statements.

### Considering an Entity's Ability to Continue as a Going Concern

**.197** The consideration of an entity's ability to continue as a going concern is required in every audit performed under generally accepted auditing standards (GAAS) and is an especially important consideration in the current state of the economy. An entity's ability to continue as a going concern is affected by many factors related to the current uncertain economy, such as the industry and geographic area in which the entity operates, the financial health of its customers, and suppliers, and financing sources.

**.198** As explained by paragraph .02 of AU section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1), the auditor's evaluation is based on his or her knowledge of relevant conditions and events that exist at or have occurred prior to the date of the auditor's report. Therefore, this is an ongoing evaluation that extends through the date of the auditor's report.

**.199** The auditor has a responsibility to evaluate whether substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time exists. AU section 341 notes that is a period not to exceed one year beyond the date of the financial statements being audited.

**.200** Some risks related to the current state of the economy that may influence an entity's ability to continue as a going concern include the following:

- Entities may resort to short term or alternative funding sources that require more stringent terms and may be more costly.
- Entities' financial health may be weakened if subsidiaries have been affected by the economic crisis and need additional support from the corporate entity.
- Projections provided by entities based on historical data may not be reliable future predictions.
- Some entities may be hesitant to include informative and transparent going concern disclosures.
- Negative publicity regarding the institution's business practices, whether true or not, could cause a decline in the entity's customer base, costly litigation, or revenue reductions.
- Entities' financial health could be significantly weakened due to credit concentrations in residential or commercial real estate and other risks previously mentioned in this alert.

**.201** If the auditor believes a substantial doubt on the entity's ability to continue as a going concern exists, the next steps are to obtain management's plans to mitigate the effect of such conditions and then assess the likelihood that these plans can be effectively implemented. Additionally, auditors may consider posing the following questions to help make their assessment on the likelihood of management's plans to successfully mitigate their going concern risk:

- What is the strategy for extending lines of credit or refinancing any debt coming due? Have any preliminary agreements or discussions occurred?
- If negative operating trends exist, how does management plan on turning them around?
- If turnover of key personnel has occurred, what actions are being taken to replace these positions?
- What is the plan to maintain or increase the liquidity of the balance sheet?
- What are the potential tax implications of the plan?
- Are there any changes in current accounting approaches (for example, selling hold to maturity securities) that may affect the plan?
- Do any restrictions exist that could limit management's ability to carry out these plans?

**.202** If, after considering management's plan, an auditor determines a substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time remains, the auditor should communicate with those charged with governance of the entity, in accordance with AU section 341. In that instance, the auditor also should consider the effects on the entity's

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financial statements and the adequacy of the related disclosure, and an explanatory paragraph should be added to the audit report following the opinion paragraph.

**.203** Alternatively, if management's plan mitigates the risk of the entity's ability to continue as a going concern, the auditor should consider disclosing the primary conditions that gave rise to the initial doubt and management's plans. These disclosures are especially important for financial statement users to fully comprehend the entity's financial strength and ability to continue as a going concern.

**.204** FASB has undertaken a project that will relocate the guidance related to going concern from the realm of auditing standards to accounting standards.

**Considering Subsequent Events**

**.205** In September 2009, the AICPA issued TIS section 8700.02, "Auditor Responsibilities for Subsequent Events" (AICPA, *Technical Practice Aids*), which discusses the effects of the company's responsibility to disclose the date through which the subsequent events have been evaluated on the auditor's responsibilities for subsequent events. This TIS section was issued in response to FASB's issuance of FASB Statement No. 165, *Subsequent Events* (codified in FASB ASC 855, *Subsequent Events*). This new guidance is discussed in the "Accounting Issues and Developments" section of this alert. Because the auditor is concerned with events occurring through the date of his or her report that may require adjustment to or disclosure in the financial statements, the specific management representations relating to information concerning subsequent events should be made as of the date of the auditor's report. This typically will result in the same date being used for both the auditor's report and the date disclosed by management through which they have evaluated subsequent events. The auditor may consider discussing these dating requirements with management in advance of beginning the audit and include any agreed upon understanding in the engagement letter. The full TIS section can be accessed at [www.aicpa.org/download/acctstd/TIS-8700\\_02.pdf](http://www.aicpa.org/download/acctstd/TIS-8700_02.pdf).

**Considering Fraud in a Financial Statement Audit**

**.206** AU section 316 is the primary source of authoritative guidance about an auditor's responsibilities concerning the consideration of fraud in a financial statement audit. AU section 316 establishes standards and provides guidance to auditors in fulfilling their responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud, as stated in paragraph .02 of AU section 110, *Responsibilities and Functions of the Independent Auditor* (AICPA, *Professional Standards*, vol. 1).

**.207** Three conditions generally are present when fraud occurs, including:

- Management or other employees have an incentive or are under pressure, which provides a reason to commit fraud
- Circumstances exist (for example, the absence of controls, ineffective controls, or the ability of management to override controls) that provide an opportunity for a fraud to be perpetrated
- Those involved are able to rationalize committing a fraudulent act

**ARA-DEP .203**

**.208** The current economic situation may result in unexpected losses and possibly cause financing or liquidity difficulties for many entities, while the pressure to meet analysts' earnings forecasts remains intense. Additionally, management may be valuing many illiquid securities using inherently subjective methodologies. These situations may provide management additional opportunity and incentive to commit fraud.

**.209** As seen in the news recently, a number of frauds that include the three previously mentioned conditions allegedly have occurred. One of those frauds, as previously noted, is that of Madoff Investment Securities. Auditors should ensure they are properly testing for the existence of assets. Additionally, auditors should always gain an understanding of the entity's business and how profits are made. In the Madoff case, auditors are being probed about failing to question the strong, consistent annual returns by these investment funds that lacked a clear investment strategy. Because of the characteristics of fraud, the auditor's exercise of professional skepticism is important when considering the risks of material misstatement due to fraud.

### **Losses Due to Fraud**

**.210** A topic of discussion for management and their auditors is the manner in which losses due to fraud are reflected in the financial statements. Because no accounting standard exists that provides specific guidance on accounting for losses due to fraud, application of professional judgment in this matter can lead to different results. For example, some clients have determined that the losses should be reported in the current period, when the entity became aware of the fraud, whereas others are opting for a restatement of the financial statements for one or more prior periods because they believe the loss in value occurred in a prior period and, therefore, an adjustment of the prior period financial statements is appropriate. It is important that the auditor understand how the decision was reached and that proper disclosure be made in the financial statements.

**.211** Auditors also may consider whether management has properly disclosed or recognized any liability associated with the potential clawback of distributions received from a perpetrator of Ponzi schemes. In the case of Madoff Investment Securities, a possibility exists that the bankruptcy trustee may file lawsuits to recover funds distributed to investors prior to the discovery of the fraud for the purpose of redistributing the funds. Management, in conjunction with appropriate legal counsel, should determine the probability and result of such a lawsuit and disclose or accrue a potential liability, as required by FASB ASC 450, *Contingencies*.

### **Evaluating the Existence of Assets**

**.212** The Madoff case, and other recent fraud investigations, brings to light a number of risks that continually need to be considered and responded to by management and auditors. Due to the nature of securities and other financial instruments, determining and testing the ownership and existence of investments has become more difficult. Often, securities and other investments purchased on behalf of an entity are held in the name of a broker organization, which may or may not be a custodian; generally, custodians do not obtain a paper document, only an electronic record of the assets.

**.213** Some examples of risks inherent in investment transactions that may be relevant when assessing the existence of investments are as follows:

- The assets involved may not be readily available to physical inspection.
- A lack of effective, independent, third party oversight could exist.
- The information received from a broker organization in the form of monthly statements or in response to audit confirmation requests, may require further verification to assess its reliability.
- A lack of experience on the part of the client could occur with these types of transactions and, therefore, controls over existence may be nonexistent or poorly designed.
- The transactions may be complex in nature, making them difficult to understand.

**.214** Management has a responsibility to design an internal control system that is responsive to the risk of existence of assets (in addition to the valuation of assets). As part of their risk assessment procedures, auditors need to assess those controls and determine if the controls have been implemented. Depending on the results of those assessments, the auditor should design an audit strategy that takes into consideration the entity's controls, including testing those controls, if those controls are to be relied upon and used as part of the auditor's audit evidence regarding the existence assertion. If the auditor's assessment indicates that management's design or operation of controls is not effective, then those deficiencies should be communicated to those charged with governance if the control deficiency is a significant deficiency or material weakness.

**.215** Examples of procedures that can be performed by management that are designed to assess the existence of assets could include the following:

- Obtaining through site visits and documenting an understanding of existence controls placed in operation by any service organization that is utilized by the entity and periodically reassessing that understanding
- Obtaining evidence, through direct testing or a Statement on Auditing Standards (SAS) No. 70 type 2 report that the service organization's existence controls are appropriately designed and operating effectively (when obtaining evidenced through a SAS No. 70 type 2 report, management would consider user controls documented in SAS No. 70)
- Inspecting other documentation supporting the entity's interest in the security (for example, correspondence from the broker organization or trustee acknowledging transactions with the fund)

### **Communicating Internal Control Related Matters Identified in an Audit**

**.216** In October 2008, the AICPA Auditing Standards Board (ASB) issued SAS No. 115, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325). SAS No. 115 amends SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325A), and 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.

**.217** The SAS is applicable whenever an auditor expresses an opinion on financial statements (including a disclaimer of opinion), except when the auditor is performing an integrated audit and will be expressing an opinion on the effectiveness of internal control over financial reporting under AT section 501, *An Examination of an Entity's Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements* (AICPA, *Professional Standards*, vol. 1). This new standard is effective for audits of financial statements for periods ending on or after December 15, 2009, with early implementation permitted. In general, SAS No. 115 retains many of the provisions of SAS No. 112; it provides guidance to (a) enhance the auditor's ability to identify and evaluate deficiencies in internal control during an audit, and then (b) communicate to management and those charged with governance those deficiencies that the auditor believes are significant deficiencies or material weaknesses.

**.218** The key differences between SAS No. 115 and SAS No. 112 lie in the definitions of *material weaknesses* and *significant deficiencies*. Under SAS No. 112, the auditor applied criteria of likelihood and magnitude described in that standard to determine if a control deficiency reached the threshold of significant deficiency or material weakness. Under SAS No. 115, the same criteria are used; however, more judgment is allowed for in determining whether a control deficiency is a significant deficiency.

### **Definitions of Significant Deficiency and Material Weakness**

**.219** A *material weakness* is a deficiency, or combination of deficiencies, in internal control, such that a reasonable possibility exists that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. For the purpose of this definition, a reasonable possibility exists when the likelihood of the event is either *reasonably possible* or *probable* because those terms are used in FASB ASC 450-20-25-1 (originally, these terms appeared in FASB Statement No. 5).<sup>14</sup>

**.220** A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness yet important enough to merit attention by those charged with governance.

### **The Evaluation Process**

**.221** Although the auditor is not required to perform procedures specifically to identify deficiencies in internal control, during the course of the audit, the auditor may become aware of deficiencies in the design or operation of the entity's internal control. The auditor should evaluate the severity of each deficiency in internal control identified during the audit and determine whether the deficiency, individually or in combination with other deficiencies in internal control, rise to the level of significant deficiencies or material weaknesses.

**.222** The AICPA published Audit Risk Alert *Communicating Internal Control Related Matters in an Audit—Understanding SAS No. 115* (product no. 022539) to assist in understanding the requirements of this SAS. This Audit Risk Alert provides specific case studies to help determine whether identified

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<sup>14</sup> The term *reasonably possible* as used in the definition of the term *material weakness* has the same meaning as defined in FASB ASC 450-20-25-1.

control weaknesses would constitute a significant deficiency or material weakness; it can be obtained by calling the AICPA at (888) 777-7077 or visiting [www.cpa2biz.com](http://www.cpa2biz.com).

## PCAOB Developments

### *Engagement Quality Review*

.223 In March 2009, the PCAOB repropose an auditing standard on engagement quality review for public comment. The PCAOB made substantial changes to the proposed auditing standard because it was first proposed in February 2008. The proposal would supersede the PCAOB's current audit quality control standard and would apply to all audit engagements and engagements to review interim financial information conducted pursuant to the standards of the PCAOB. The proposed standard provides a framework for an engagement quality reviewer to objectively evaluate the significant judgments made by the engagement team and the conclusions reached in forming an overall conclusion about the engagement. In July 2009, the PCAOB voted to adopt this standard as Auditing Standard No. 7, *Engagement Quality Review*. This standard will be effective, subject to SEC approval, for both engagement quality reviews of audits and interim reviews for fiscal years beginning on or after December 15, 2009.

### *Concept Release on Audit Confirmations*

.224 In April 2009, the PCAOB issued a concept release for public comment on possible revisions to AU section 330, *The Confirmation Process*, (AICPA, *PCAOB Standards and Related Rules*, Interim Standards). Confirmations are typically an important source of evidence for auditors as independent third party sources verify the data on the confirmation. The PCAOB's concept release addresses the following nine areas of possible change to the current confirmation guidance:

- Expands the definition of confirmation to include direct access to information held by a third party
- Establishes a presumption that the auditor will request the confirmation of accounts receivable
- Discusses factors to consider in designing confirmation requests
- Updates the requirement for maintaining control over confirmation requests for the advances in technology
- Provides further direction on evaluating the reliability of confirmation responses
- Eliminates the ability for the auditor to omit performing alternative procedures for nonresponses to positive confirmation requests
- Considerations for when management requests an auditor to not confirm a select account, transaction, and so on
- Conducts an evaluation of disclaimers and restrictive language on confirmation responses
- Considers whether the use of negative confirmations should continue to be allowed

.225 Generally speaking, the concept release does not contemplate major changes to the confirmation process; rather it addresses developments in



technology and related risk factors. Comments were due back to the PCAOB by the end of May 2009. Readers should be alert to developments on this issue.

#### **PCAOB Staff Audit Practice Alert No. 4**

**.226** Following the issuances of FSP FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly*, FSP FAS 115-2 and FAS 124-2, and FSP FAS 107-1 and APB 28-1, Interim Disclosures about Fair Value of Financial Instruments, which has been codified in FASB ASC 270-10-50-1, 320-10, and 825-10-50, in April 2009, the PCAOB issued Staff Audit Practice Alert No. 4, *Auditor Considerations Regarding Fair Value Measurements, Disclosures, and Other-Than-Temporary Impairments* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400.04). These FSPs were codified in FASB ASC 820-10; primarily at FASB ASC 310-55, 325-40, and 320-10; and FASB ASC 270-10-50, 320-10, 825-10-50, respectively. Auditors operating under PCAOB standards for audits and reviews should be aware that some PCAOB standards include descriptions of accounting requirements that are no longer current. Auditors should disregard descriptions of accounting requirements in PCAOB standards that are inconsistent with the guidance mentioned previously. The PCAOB is planning to remove descriptions of accounting requirements from auditing standards as it replaces or substantively revises its interim standards. Further, the PCAOB has on its agenda to address the auditing standards related to auditing accounting estimates and auditing fair value measurements.

**.227** PCAOB Staff Audit Practice Alert No. 4 also noted that, in accordance with PCAOB Auditing Standard No. 6, *Evaluating Consistency of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), and in relation to a change in accounting principle due to one of these FSPs, "[a] change in accounting principle that has a material effect on the financial statements should be recognized in the auditor's report through the addition of an explanatory paragraph following the opinion paragraph."

**.228** This PCAOB staff audit practice alert also discusses auditor considerations related to: reviews of interim financial information, fair value, disclosures, and reporting. The related AU section guidance to these topics is further discussed in this alert.

#### **PCAOB Registration of Broker-Dealer Auditors**

**.229** As a result of the recent expiration of the SEC order, which granted temporary exemption to nonissuer broker-dealers from filing financial statements that have been audited by a PCAOB-registered public accounting firm, all auditors of nonissuer broker-dealers must now register with the PCAOB. Accordingly, the financial statements of nonpublic broker-dealers for fiscal years ending after December 31, 2008, must be certified by a registered public accounting firm. This registration requirement does not change the auditor requirements outlined in Rule 17a-5(g) of the Exchange Act, which requires that audits of nonissuer broker-dealers be performed in accordance with GAAS. Auditors of nonissuer broker-dealers are not subject to the PCAOB's independence rules, including the PCAOB rules on contingent fees and tax services, but they remain subject to certain SEC independence requirements, including restrictions on financial and employment relationships, contingent fees, and nonaudit services.

.230 On February 19, 2009, the PCAOB issued "Staff Questions and Answers—Registration of Broker-Dealer Auditors," (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 100.06), which addresses 11 registration questions regarding auditors of nonpublic broker-dealers. The PCAOB staff questions and answers on the registration of auditors of nonpublic broker-dealers are available on the PCAOB Web site at [www.pcaob.org](http://www.pcaob.org).

.231 Additionally, to address various questions regarding the expiration of the SEC ruling, the SEC staff of the Division of Trading and Markets and the OCA issued the "PCAOB Registration of Auditors of Non-Public Broker-Dealers Frequently Asked Questions" on February 16, 2009. The FAQs address six questions related to the registration of auditors of nonpublic broker and dealers with the PCAOB. The FAQs are available on the SEC Web site at <http://sec.gov/divisions/marketreg/faq-pcaobregbdauditors.htm>.

### Attestation Reports Required by Regulation AB

.232 Regulation AB, which was approved by the SEC in 2004, addresses the registration, disclosure, and reporting requirements for ABS under the Securities Act of 1933 and the Exchange Act. Regulation AB includes the required disclosures associated with the securities registration process, the Exchange Act reporting requirements for ABS, and requires an annual servicing assertion and accountant's attestation report. Regulation AB also requires a static pool analysis. The static pool information includes performance information for specific types of assets originated at different points in time.

.233 An *attestation report on assessment of compliance with servicing criteria for ABS* is defined in Regulation AB as a report in which a registered public accounting firm expresses an opinion, or states that an opinion cannot be expressed, concerning an asserting party's assessment of compliance with servicing criteria as required under Regulation AB and in accordance with standards on attestation engagements issued or adopted by the PCAOB AT section 601, *Compliance Attestation* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards). The report issued by the registered public accounting firm must be available for general use and not contain restricted use language.

.234 Regulation AB requires that changes with respect to the terms or status of an obligor's pool asset (for example, loan modifications) are made, reviewed, and approved by authorized personnel in accordance with the transaction agreements and related pool asset documents. Regulation AB also requires that loss mitigation or recovery actions (for example, forbearance plans, modifications and deeds in lieu of foreclosure, foreclosures and repossessions, as applicable) are initiated, conducted and concluded in accordance with the timeframes or other requirements established by the transaction agreements.

.235 Attestation engagements required by Regulation AB may be significantly affected by the increase in loss mitigation efforts, such as the loan modification efforts under the MHA program. Auditors performing attestation engagements to meet the requirements of Regulation AB may consider the increase in the number of loan modifications as a result of the MHA program and other loss mitigation efforts in a recessionary environment when determining the nature and extent of the procedures and other aspects of the engagement.

## FDIC Reporting Requirements

**.236** The following table provides certain interactions between the revised FDIC requirements, as described in Section 363.3, the AICPA's auditing standards, and the PCAOB's auditing standards. This table highlights certain items for auditors of financial institutions regarding Part 363 and is not inclusive of all guidance within Part 363 or the professional accounting standards.

<p><b>Annual audit of financial statements</b>—Section 363.3(a)</p>	<p>Each insured depository institution subject to Title 12 <i>Part 363—Annual Independent Audits and Reporting Requirements</i> of U.S. <i>Code of Federal Regulations</i> (Part 363), is required to engage an independent public accountant to audit and report on its annual financial statements in accordance with generally accepted auditing standards or the Public Company Accounting Oversight Board's (PCAOB) auditing standards, if applicable.</p>
<p><b>Internal control over financial reporting</b>—Section 363.3(b) (applicable to insured depository institutions with \$1 billion or more in total assets)</p>	<p>The auditor's attestation or report on internal control over financial reporting required under Section 363.3(b)<sup>15</sup> should be made in accordance with generally accepted standards for attestation engagements. Generally, for an institution that is not a public company or a subsidiary of a public company, the auditor's report would be made in accordance with AT section 501, <i>An Examination of an Entity's Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements</i> (AICPA, <i>Professional Standards</i>, vol. 1). For an institution that is a public company or a subsidiary of a public company, the auditor's report would be made in accordance with the PCAOB's Auditing Standard No. 5, <i>An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements</i> (AICPA, <i>PCAOB Standards and Related Rules</i>, Auditing Standards). Guideline 18A to Part 363 of the Federal Deposit Insurance Corporation's (FDIC) regulations provides additional guidance regarding the standards that auditors should follow when reporting on internal control.</p>

(continued)

<sup>15</sup> Section 363.3(b) highlights certain items that should be included in the auditor's report on internal control over financial reporting and clarifies that the report should not be dated prior to the date of management's reports.

<b>Notice by accountant of termination of services</b> —Section 363.3(c)	When the independent public accountant performing services under Part 363 ceases to be the institution's accountant, the accountant must provide the FDIC, the appropriate federal banking agency, and any appropriate state bank supervisor with written notification of such termination within 15 days after the occurrence of such an event. Guideline 20 to Part 363 provides additional guidance regarding an independent public accountant's notice of termination.
<b>Communications with audit committees</b> —Section 363.3(d)	Requirements for communications with audit committees, <sup>16</sup> consistent with the requirements under Section 363.3(d), are set forth in the applicable professional standards. The applicable AICPA <i>Professional Standards</i> , which include AU section 380, <i>The Auditor's Communication With Those Charged With Governance</i> (AICPA, <i>Professional Standards</i> , vol. 1); AU section 316, <i>Consideration of Fraud in a Financial Statement Audit</i> (AICPA, <i>Professional Standards</i> , vol. 1); AU section 325, <i>Communicating Internal Control Related Matters Identified in an Audit</i> (AICPA, <i>Professional Standards</i> , vol. 1); and AT section 501, provide guidance regarding certain matters required to be communicated to those charged with governance, such as audit committees. The PCAOB's Auditing Standard No. 5 addresses the requirements for communication of certain matters to audit committees for audits of public companies.
<b>Retention of working papers</b> —Section 363.3(e) (seven years for audits of public and nonpublic institutions)	The working papers retention requirement of Part 363, which is 7 years from the report release date unless a longer period of time is required by law, exceeds the AICPA Professional Standard's 5 year minimum retention policy. AU section 339, <i>Audit Documentation</i> (AICPA, <i>Professional Standards</i> , vol. 1), states that the auditor should adopt reasonable procedures to retain and access audit documentation for a period of time sufficient to meet the needs of his or her practice and to satisfy any applicable legal or

<sup>16</sup> Section 363.3(d) requires auditors to report, on a timely basis to the audit committee, (a) critical accounting policies and practices, (b) alternative accounting treatments within generally accepted accounting principles for policies and practices related to material items, and (c) other written communications provided to management, such as a management letter or schedule of unadjusted differences.

	<p>regulatory requirements for records retention. Such a retention period, however, should not be shorter than 5 years from the report release date.</p> <p>The working paper retention requirement of Part 363 corresponds to that of the PCAOB. PCAOB Auditing Standard No. 3, <i>Audit Documentation</i> (AICPA, <i>PCAOB Standards and Related Rules</i>, Auditing Standards), establishes a requirement for an audit documentation retention period of 7 years unless a longer period of time is required by law.</p>
<p><b>Independence—</b> Section 363.3(f)</p>	<p>Under Part 363, auditors must comply with the independence standards and interpretations of the AICPA,<sup>17</sup> the Securities and Exchange Commission (SEC), and the PCAOB. To the extent that any of the rules within any one of these independence standards (AICPA, SEC, and PCAOB) is more or less restrictive than the corresponding rule in the other independence standards, auditors must comply with the more restrictive rule.</p>
<p><b>Peer reviews and inspection reports—</b> Section 363.3(g)</p>	<p>Prior to commencing any services for an institution under Part 363, the independent public accountants must have received a peer review, or be enrolled in a peer review program, that meets acceptable guidelines. Acceptable peer reviews include peer reviews performed in accordance with the AICPA's Peer Review Standards<sup>18</sup> and inspections conducted by the PCAOB. Guideline 15 to Part 363 provides additional guidance regarding acceptable peer reviews.</p> <p>Within 15 days after the issuance of a peer review or a PCAOB inspection report or before the commencement of an audit under Part 363, the independent public accountant must file 2 copies of the peer review report and the public portion of the PCAOB inspection report, if any, with the FDIC.</p>

<sup>17</sup> The AICPA Practice Aid, *Independence Compliance: Checklists and Tools for Complying with AICPA, SEC, and PCAOB Independence Requirements* (product no. 006660), is a valuable resource for helping practitioners observe applicable independence rules. This practice aid covers both AICPA independence requirements that apply to all attestation engagements, and SEC and Public Company Accounting Oversight Board (PCAOB) independence requirements that apply to attest services provided to public companies and other entities whose financial information is filed with the SEC.

<sup>18</sup> The AICPA Web Site contains additional information regarding the AICPA's Peer Review Standards. See [www.aicpa.org/members/div/practmon/pr\\_stds.htm](http://www.aicpa.org/members/div/practmon/pr_stds.htm) for additional information regarding these standards.

## Accounting Issues and Developments

.237 Given the current economic crisis and recent actions of the FASB, auditors should consider a number of accounting and financial reporting issues and developments, such as the following:

- Transfers of financial assets
- Consolidation of variable interest entities
- Fair value, including fair value measurements in illiquid markets
- Other-than-temporary impairment
- Business combinations
- Liquidity restrictions

### FASB Statement No. 168

.238 FASB Statement No. 168, as codified in FASB ASC 105, is effective for financial statements issued for interim and annual periods ending after September 15, 2009. This new standard flattens the U.S. GAAP hierarchy to two levels: one that is authoritative (in FASB ASC) and one that is nonauthoritative (not in FASB ASC). Exceptions include all rules and interpretive releases of the SEC under the authority of federal securities laws, which are sources of authoritative U.S. GAAP for SEC registrants, and certain grandfathered guidance having an effective date before March 15, 1992. This statement creates FASB ASC 105.

.239 FASB Statement No. 168 is the final standard that will be issued by FASB in that form. It was added to FASB ASC through Accounting Standards Update (ASU) No. 2009-01, *Topic 105—Generally Accepted Accounting Principles—amendments based on—Statement of Financial Accounting Standards No. 168—The FASB Accounting Standards Codification™ and the Hierarchy of Generally Accepted Accounting Principles*, on June 30, 2009. No new standards in the form of statements, FSPs, EITF abstracts, or AICPA SOPs, for example, will be issued. Instead, FASB will issue ASUs. FASB will not consider ASUs as authoritative in their own right. Instead, they will serve only to update FASB ASC, provide background information about the guidance, and provide the basis for conclusions on changes made to FASB ASC.

.240 Nonpublic nongovernmental entities that have not previously followed the guidance included in TIS sections 5100.38–76, (AICPA, *Technical Practice Aids*), which is now included in FASB ASC as authoritative, should account for the adoption of that guidance as a change in accounting principle, on a prospective basis, for revenue arrangements entered into or materially modified in those fiscal years beginning on or after December 15, 2009, and interim periods within those years. If an accounting change results from the application of this guidance, an entity should disclose the nature and reason for the change in accounting principle in its financial statements.

### Withdrawal of U.S. GAAP Hierarchy From Auditing Standards

.241 In August 2009, the ASB voted to withdraw SAS No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*, as amended, from the auditing literature for nonissuers. This SAS was withdrawn as a result of recent pronouncements by FASB, Governmental Accounting Standards Board, and Federal Accounting Standards Advisory Board

to incorporate their respective U.S. GAAP hierarchies into their respective authoritative literature.

**.242** Interpretation No. 3, "The Auditor's Consideration of Management's Adoption of Accounting Principles for New Transactions or Events," of AU section 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*, as amended, also will be withdrawn automatically because the ASB did not direct that the interpretation be retained and moved elsewhere within the literature.

**.243** The effective date of the withdrawal will be September 2009 to reflect the effective date of FASB ASC, which is effective for financial statements for interim and annual periods ending after September 15, 2009.

**.244** Further information about recent ASB projects and activities is available at [www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Auditing+Standards+Board/](http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Auditing+Standards+Board/).

## FASB ASC

**.245** On the effective date of FASB Statement No. 168, FASB ASC became the source of authoritative U.S. accounting and reporting standards for nongovernmental entities, in addition to guidance issued by the SEC. At that time, FASB ASC superseded all then-existing, non-SEC accounting and reporting standards for nongovernmental entities. Once effective, all other nongrandfathered, non-SEC accounting literature not included in FASB ASC became nonauthoritative. This change will affect accountants and auditors alike.

**.246** FASB ASC is a major restructuring of accounting and reporting standards designed to simplify user access to all authoritative U.S. GAAP by providing the authoritative literature in a topically organized structure. FASB ASC disassembled and reassembled thousands of nongovernmental accounting pronouncements (including those of FASB, the EITF, and the AICPA) to organize them under approximately 90 topics. FASB ASC includes all accounting standards issued by a standard setter within levels A–D of the current U.S. GAAP hierarchy. FASB ASC also includes relevant portions of authoritative content issued by the SEC, as well as select SEC staff interpretations and administrative guidance issued by the SEC; however, FASB ASC is not the official source of SEC guidance and does not contain the entire population of SEC rules, regulations, interpretive releases, and staff guidance.

**.247** FASB ASC is not intended to change U.S. GAAP or any requirements of the SEC; rather, it is part of FASB's efforts to reduce the complexity of accounting standards and also to facilitate international convergence. Moreover, FASB ASC does not include governmental accounting standards. The purposes behind the codification project include the following:

- Reduce the amount of time and effort required to solve an accounting research issue
- Mitigate the risk of noncompliance with standards through improved usability of the literature
- Provide accurate information with real-time updates as new standards are released
- Assist FASB with the research and convergence efforts required during the standard setting process

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- Become the authoritative source of literature for the completed eXtensible Business Reporting Language taxonomy
- Clarify that guidance not contained in FASB ASC is not considered authoritative

.248 FASB ASC uses a topical structure in which guidance is organized into *areas*, *topics*, *subtopics*, *sections*, and *subsections*. These terms are defined as follows:

**Areas.** The broadest category in FASB ASC, which represent a grouping of topics.

**Topics.** The broadest categorization of related content, which correlate with the International Accounting Standards (IASs) and IFRSs.

**Subtopics.** Subsets of a topic, which are generally distinguished by type or scope.

**Sections.** Categorization of the content into such groups as recognition, measurement, or disclosure. The sections' structure correlates with the IASs and IFRSs.

**Subsections.** Further segregation and navigation of content below the section level.

.249 Topics, subtopics, and sections are numerically referenced. This effectively organizes the content without regard to the original standard setter or standard from which the content was derived. An example of the numerical referencing is FASB ASC 305-10-05, in which *305* is the *Cash and Cash Equivalents* topic, *10* represents the "Overall" subtopic, and *05* represents the "Overview and Background" section. Constituents are encouraged to begin using FASB ASC, which can be accessed at <http://asc.fasb.org/home>. To read more about FASB ASC, including recent developments and updates, please see the AICPA's dedicated FASB ASC Web site at [www.aicpa.org/Professional+Resources/Accounting+and+Auditing/FASB+Accounting+Standards+Codification/](http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/FASB+Accounting+Standards+Codification/).

**Referencing FASB ASC in Your Documentation**

.250 You should consider how and when your entity will begin referencing FASB ASC in your documentation (policy and procedures, technical memorandums, financial statements and filings, engagement working papers, and so on). The FASB Notice to Constituents (NTC) includes a section on referencing FASB ASC in the footnotes to the financial statements and other documents. In this notice, FASB encourages the use of plain English to describe broad topic references in the future. For example, to refer to the requirements of the *Derivatives and Hedging* topic, they suggest a reference similar to "as required by the *Derivatives and Hedging* topic of the FASB *Accounting Standards Codification*."

.251 On the other hand, FASB does suggest using the detailed numerical referencing system in working papers, articles, textbooks, and related items. The NTC also provides some detailed examples of how to reflect the numerical referencing in such documents. However, if you need to reference certain grandfathered guidance not included in FASB ASC (a listing can be found in FASB Statement No. 168), use of the old terminology would still be appropriate. The following provides additional information regarding how and when to implement the new FASB referencing system.

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- *Nonpublic entities.* For nonpublic entities without interim filings, preparers choosing to reference specific accounting guidance in financial statements would make those references to FASB ASC for the first annual period ending after September 15, 2009. For example, a nonpublic entity with a July 31, 2009, year-end would not reference FASB ASC in its financial statements, but a nonpublic entity with a December 31, 2009, year-end would reference FASB ASC in its financial statements.
- *Public entities.* The SEC recently shared with the CAQ SEC Regulations Committee some views on referencing FASB ASC in financial statements. For interim and annual financial statements for periods ending after September 15, 2009, the SEC stated that any references to specific elements of U.S. GAAP should use the FASB ASC reference. Therefore, a public entity filing financial statements for the quarter ended September 30, 2009, should reference FASB ASC in its financial statements. In addition, the SEC stated that references to specific U.S. GAAP (FASB ASC references) should be on a consistent basis for all periods presented. However, the SEC has encouraged companies to make financial statements more useful to users by drafting financial statement disclosures to avoid specific U.S. GAAP references and to more clearly explain accounting concepts.

**.252** Also, because FASB ASC is not intended to change U.S. GAAP, the consistent use of references to only FASB ASC for all periods presented (including periods before the authoritative release of FASB ASC) is appropriate.

**.253** It is prudent to expect that audit, attest, or compilation and review working papers associated with financial statements for a period ending after September 15, 2009, also would reflect FASB ASC because the underlying financial statements, which are the subjects of those engagements, reference FASB ASC.

**.254** However, if your entity will continue to follow grandfathered guidance not included in FASB ASC, it would still be appropriate to reference those standards (and not FASB ASC). The listing of all grandfathered guidance can be found in FASB Statement No. 168, as well as a listing of examples of grandfathered guidance.

**.255** Examples of disclosures using references to FASB ASC can be found at the AICPA's dedicated FASB ASC Web site: [www.aicpa.org/Professional+Resources/Accounting+and+Auditing/FASB+Accounting+Standards+Codification/](http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/FASB+Accounting+Standards+Codification/).

### Consolidation of Variable Interest Entities

**.256** In June 2009, FASB issued FASB Statement No. 167, *Amendments to FASB Interpretation No. 46(R)*,<sup>19</sup> which changes how to determine when an entity that is insufficiently capitalized or is not controlled through voting (or similar rights) should be consolidated. The determination of whether an entity is required to consolidate another entity is based on, among other things, an entity's purpose and design. This determination identifies the primary beneficiary of a variable interest entity as the enterprise that has both the following

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<sup>19</sup> See footnote 13.

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characteristics—the power to direct the activities of the variable interest entity that most significantly affect the entity's economic performance and the obligation to absorb losses of the entity that could potentially be significant to the variable interest entity or the right to receive benefits from the entity that could potentially be significant to the variable interest entity.

**.257** FASB Statement No. 167 amends FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities—an interpretation of ARB No. 51*, codified primarily at FASB ASC 810-10 to eliminate the quantitative approach previously required for determining the primary beneficiary of a variable interest entity, which was based on determining which enterprise absorbs the majority of the entity's expected losses, receives a majority of the entity's expected residual returns, or both.

**.258** Entities will be required to provide additional disclosures about involvement with variable interest entities and any significant changes in risk exposure due to that involvement. Entities will also be required to disclose how involvement with a variable interest entity affects the entity's financial statements.

**.259** FASB Statement No. 167 retains the scope of FASB Interpretation No. 46(R) with the addition of entities previously considered qualifying special purpose entities, because the concept of these entities was eliminated in FASB Statement No. 166.

**.260** This statement is effective as of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period, and for interim and annual reporting periods thereafter. Earlier application is prohibited.

**Transfers of Financial Assets**

**.261** Also in June 2009, FASB issued FASB Statement No. 166, which is a revision to FASB Statement No. 140, and will require more information about transfers of financial assets, including securitization transactions, and when entities have continuing exposure to the risks related to transferred financial assets. It eliminates the concept of a qualifying special-purpose entity, changes the requirements for derecognizing financial assets, and requires additional disclosures. The purpose of this statement is to improve the relevance, representational faithfulness, and comparability of the information that a reporting entity provides in its financial statements about a transfer of financial assets; the effects of a transfer on its financial position, financial performance, and cash flows; and a transferor's continuing involvement, if any, in transferred financial assets.

**.262** On and after the effective date, the concept of a qualifying special purpose entity is no longer relevant for accounting purposes. Therefore, formerly qualifying special-purpose entities (as defined under previous accounting standards) should be evaluated for consolidation by reporting entities on and after the effective date in accordance with the applicable consolidation guidance.

**.263** FASB Statement No. 166 also eliminates the special provisions in FASB ASC 860 and FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities* (primarily codified in FASB ASC 948-310), for guaranteed mortgage securitizations to require those securitizations to be treated the same as any other transfer of financial assets within the scope of FASB ASC 860, as amended by this statement. If such a transfer does not meet the requirements

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for sale accounting, the securitized mortgage loans should continue to be classified as loans in the transferor's statement of financial position.

**.264** FASB Statement No. 166 must be applied as of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period and for interim and annual reporting periods thereafter. Earlier application is prohibited. This statement must be applied to transfers occurring on or after the effective date; however, the disclosure provisions should be applied to transfers that occurred both before and after the effective date.

### Subsequent Events

**.265** In May 2009, FASB issued FASB Statement No. 165 and is effective for interim and annual periods ending after June 15, 2009. This statement is intended to establish general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. It requires the disclosure of the date through which an entity has evaluated subsequent events and the basis for that date (that is, whether that date represents the date the financial statements were issued or were available to be issued). The purpose of this disclosure is to alert all users of financial statements that an entity has not evaluated subsequent events after that date in the set of financial statements being presented.

**.266** In particular, this statement sets forth the following:

- The period after the balance sheet date when management of a reporting entity should evaluate events or transactions that may occur for potential recognition or disclosure in the financial statements
- The circumstances under which an entity should recognize events or transactions occurring after the balance sheet date in its financial statements
- The disclosures that an entity should make about events or transactions that occurred after the balance sheet date

**.267** FASB states that this statement should not result in significant changes in current practice with regard to the subsequent events that an entity reports, either through recognition or disclosure, in its financial statements. Further, in September 2009, the AICPA issued two TIS sections regarding this guidance. TIS section 8700.01, "Effect of FASB ASC 855 on Accounting Guidance in AU Section 560" (AICPA, *Technical Practice Aids*), notes that preparers of financial statements for nongovernmental entities are required to follow the accounting guidance in FASB ASC 855. Additionally, the accounting guidance contained in AU section 560, *Subsequent Events* (AICPA, *Professional Standards*, vol. 1), would no longer be applicable to audits of nongovernmental entities. TIS section 8700.02 is discussed in the "Audit and Attestation Issues and Developments" section of this alert. Both TIS sections can be accessed at [www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Practice+Aids+and+Tools/Recently+Issued+Technical+Practice+Aids.htm](http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Practice+Aids+and+Tools/Recently+Issued+Technical+Practice+Aids.htm).

### Fair Value

**.268** In light of the economic crisis, the guidance in FASB ASC 820 (formerly FASB Statement No. 157) has received a great deal of attention. FASB

ASC 820-10-20 defines *fair value* and establishes a framework for measuring fair value; however, it does not dictate when an entity must measure something at fair value, nor does it expand the use of fair value in any way. The need to understand fair value accounting has increased in importance as alternative investments increased in popularity and complexity.

**.269** This guidance defines *fair value* as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." A contention with this guidance is the difficulty of applying the existing guidance in an illiquid or distressed market. This difficulty has the potential to allow inconsistencies in application by accountants and auditors.

***Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly***

**.270** On April 9, 2009, FASB issued FSP FAS 157-4, which is codified in FASB ASC 820-10. The purpose of this guidance is to provide additional guidance in the application of fair value accounting when the volume and level of activity for the asset or liability have significantly decreased and when a transaction is not considered orderly; it supersedes FSP FAS 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active*. Among other points, the new guidance

- affirms that the objective of fair value when there has been a significant decrease in the volume and level of activity for the asset or liability is the price that would be received to sell the asset in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions.
- clarifies and includes additional factors for determining whether there has been a significant decrease in market activity for an asset when the market for that asset is not active.
- requires an entity to evaluate the circumstances to determine whether the transaction is orderly based on the weight of the evidence.
- includes an example that provides additional explanation on estimating fair value when the market activity for an asset has declined significantly.
- requires an entity to disclose a change in valuation technique (and the related inputs) resulting from the application of this guidance and to quantify its effects, if practicable, by major category.
- applies to all fair value measurements when appropriate.

**.271** This new guidance is effective for interim and annual reporting periods ending after June 15, 2009, and is to be applied prospectively. Early adoption was permitted for periods ending after March 15, 2009. Earlier adoption for periods ending before March 15, 2009, was not permitted. If a reporting entity elects to adopt early either FSP FAS 115-2 and FAS 124-2 or FSP FAS 107-1 and APB 28-1, the reporting entity also is required to adopt early this FSP. Additionally, if the reporting entity elects to early adopt this FSP, FSP FAS 115-2 and FAS 124-2 also must be early adopted. This FSP does not require disclosures for earlier periods presented for comparative purposes at initial adoption.

In periods after initial adoption, this FSP requires comparative disclosures only for periods ending after initial adoption.

### ***Interim Disclosures About Fair Value of Financial Instruments***

**.272** On April 9, 2009, FASB released FSP FAS 107-1 and APB 28-1. The guidance requires fair value estimate disclosures for all financial instruments to be made on a quarterly basis, providing qualitative and quantitative information. Prior to this issuance, fair values for certain assets and liabilities were disclosed annually. The guidance

- applies to all financial instruments that are within the scope of FASB ASC 825, *Financial Instruments*, and held by publicly traded companies, as defined in the FASB ASC glossary.
- requires disclosures about fair value for all financial instruments, whether recognized or not recognized in the statement of financial position, except that the disclosures about fair value prescribed in paragraphs 10–16 of FASB ASC 825-10-50 are not required for any of the financial instruments listed in FASB ASC 825-10-50-8.
- discloses the methods and significant assumptions used to estimate the fair value of financial instruments and describe changes in methods and significant assumptions, if any, during the period.

**.273** For interim reporting periods, the guidance applies to all entities but is optional for those entities that do not meet the definition of a publicly traded company. For annual reporting requirements, this guidance applies to all entities but is optional for those entities that meet the criteria in "Pending Content" of FASB ASC 825-10-50-3.<sup>20</sup> A publicly traded company should include disclosures about the fair value of its financial instruments whenever it issues summarized financial information for interim reporting periods.

**.274** This guidance was effective for interim reporting periods ending after June 15, 2009, with early adoption permitted for periods ending after March 15, 2009. An entity may have adopted early only if it also elected to adopt early FSP FAS 157-4 and FSP FAS 115-2 and FAS 124-2. This guidance does not require disclosures for earlier periods presented for comparative purposes at initial adoption. In periods after initial adoption, this guidance requires comparative disclosures only for periods ending after initial adoption.

### ***Measuring Liabilities at Fair Value***

**.275** On August 27, 2009, FASB issued ASU No. 2009-05, *Measuring Liabilities at Fair Value*. This ASU was issued to increase the consistency in the application of FASB ASC 820 to liabilities because many constituents had expressed concern. This ASU applies to all entities that measure liabilities at fair value under FASB ASC 820 and amends sections of FASB ASC 820-10.

**.276** This ASU states that, in circumstances when a quoted price in an active market for the identical liability is not available, fair value of the liability must be measured by either (a) a valuation technique that uses the quoted price of the identical liability when traded as an asset or quoted prices for

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<sup>20</sup> This guidance is labeled as "Pending Content" due to the transition and open effective date information discussed in FASB ASC 825-10-65-1. For more information on FASB ASC, please see the section "Notice to Readers" in the guide.

similar liabilities, or similar liabilities when traded as assets, or (b) another valuation technique that is consistent with the principles of FASB ASC 820, such as an income approach or a market approach. Further, if a restriction on the transference of the liability exists, the ASU clarifies that an entity is not required to factor that in to the inputs of the fair value determination. Lastly, the ASU also clarifies that a quoted price in an active market for the identical liability, or an unadjusted quoted price in an active market for the identical liability, when traded as an asset, are level 1 measurements within the fair value hierarchy. The guidance in this ASU is effective for the first reporting period (including interim periods) beginning after issuance. The full text of the ASU can be accessed from FASB's Web site at [www.fasb.org](http://www.fasb.org).

### ***Investments in Certain Entities That Calculate Net Asset Value per Share (or its Equivalent)***

**.277** In September 2009, FASB issued ASU No. 2009-12, *Fair Value Measurements and Disclosures (Topic 820): Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)*. This guidance was issued because of the complexities and practical difficulties in estimating the fair value of alternative investments. It is applicable to all reporting entities that hold an investment that is required or permitted to be measured or disclosed at fair value on a recurring or nonrecurring basis, and as of the reporting entity's measurement date, if the investment both:

- does not have a readily determinable fair value. The FASB ASC glossary states that an equity security has a readily determinable fair value if it meets any of the following conditions:
  - The fair value of any equity security is readily determinable if sales prices or bid-and-asked quotations are currently available on a securities exchange registered with the SEC or in the OTC market, provided that those prices or quotations for the OTC market are publicly reported by NASDAQ or by Pink Sheets LLC. Restricted stock meets that definition if the restriction terminates within one year.
  - The fair value of an equity security traded only in a foreign market is readily determinable if that foreign market is of a breadth and scope comparable to one of the U.S. markets referred to previously.
  - The fair value of an investment in a mutual fund is readily determinable if the fair value per share (unit) is determined and published and is the basis for current transactions.
- is in an entity that has all of the attributes specified in FASB ASC 946-10-15-2 or, if one of those attributes are not met, is in an entity for which it is industry practice to issue financial statements using guidance that is consistent with the measurement principles in FASB ASC 946, *Financial Service—Investment Companies*.

**.278** As a practical expedient, this ASU permits a reporting entity to measure the fair value of an investment within its scope on the basis of the net asset value (NAV) per share of the investment (or its equivalent) if the NAV is calculated in a manner consistent with the measurement principles of FASB ASC

946 as of the reporting entity's measurement date, including measurement of all or substantially all of the underlying investments of the investee in accordance with FASB ASC 820. If the practical expedient is used, certain attributes of the investment (such as restrictions on redemption) and transaction prices from principal-to-principal or brokered transactions will not be considered in measure the investment's fair value.

**.279** This ASU also requires disclosures by major category of investment about the attributes of investments, such as the nature of any restrictions on the investor's ability to redeem its investments at the measurement date, any unfunded commitments, and the investment strategies of the investees. The major category of investment is required to be determined based on the guidance in FASB ASC 320-10-50-1B. These disclosures are required for all investments within the scope of this ASU. The ASU adds an example of its required disclosures in FASB ASC 820-10-55-64A.

**.280** These amendments are effective for interim and annual periods ending after December 15, 2009 and are included in FASB ASC 820-10. Early application is permitted in financial statements for earlier and interim and annual periods that have not been issued. An entity may elect to early adopt the measurement amendments of this ASU and defer the adoption of the disclosure provisions of FASB ASC 820-10-50-6A until periods ending after December 15, 2009. An AICPA Practice Aid, *Alternative Investments—Audit Considerations* also is available and is a useful tool for auditors. It focuses on the existence and valuation assertions associated with alternative investments. See the "Auditing Alternative Investments" section of this alert for further details.

## Other-Than-Temporary Impairment

### *The Meaning of Other-Than-Temporary Impairment*

**.281** Determining when an investment is other-than-temporarily impaired is another topic that has received increased attention in today's economic environment. FSP FAS 115-1 and FAS 124-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*, as amended by FSP FAS 115-2 and FAS 124-2 is codified in several topics in FASB ASC, including FASB ASC 320, *Investments—Debt and Equity Securities*, and FASB ASC 325, *Investments—Other*. This guidance addresses the determination of when an investment is considered impaired, whether the impairment is other-than-temporary, and the measurement of the impairment loss. Also included in this amended guidance are accounting issues to be considered subsequent to the recognition of other-than-temporary impairments and related disclosures about unrealized losses as a result of the other-than-temporary impairment. This amended guidance applies to (a) debt and equity securities within the scope of FASB Statement ASC 320; (b) debt and equity securities within the scope of FASB ASC 958-320 that are held by an investor that reports a performance indicator; and (c) equity securities not within the scope of FASB ASC 320 and 958-320 and not accounted for under the equity method, pursuant to FASB ASC 323, *Investments—Equity Method and Joint Ventures*. The auditor also should be alert for all types of assets that can become impaired, including goodwill, deferred tax assets, and real property. Given the current economic situation, entities should be alert to values of many types of assets on the balance sheet and possible impairment issues. Readers should consult the appropriate accounting requirements for further information. For the full text of

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FSP FAS 115-1 and FAS 124-1, as amended, please visit the FASB Web site at [www.fasb.org](http://www.fasb.org).

***Recognition of Other-Than-Temporary Impairments for Debt Securities***

.282 On April 9, 2009, FASB released FSP FAS 115-2 and FAS 124-2. The purpose of this guidance is to bring greater consistency to the timing of impairment recognition and provide greater clarity to investors about the credit and noncredit components of impaired debt securities that are not expected to be sold. Among other points, the guidance

- limits its changes to existing guidance for determining whether an impairment is other than temporary to debt securities.
- replaces the existing requirement that the entity's management assert that it has both the intent and ability to hold an impaired security until recovery with a requirement that management assert that it does not have the intent to sell the security or it is more-likely-than-not it will not be required to sell the security before recovery of its cost basis.
- incorporates examples of factors from existing literature that should be considered in determining whether a debt security is other-than-temporarily impaired and how those factors interact with the requirement to assert that the entity does not intend to sell the security and it is more-likely-than-not that the entity will not be required to sell the security before recovery of its cost basis.
- requires an entity to recognize the credit component of an other-than-temporary impairment of a debt security in earnings and the remaining portion in other comprehensive income, when an entity does not intend to sell the security and it is more-likely-than-not that the entity will not be required to sell the security before recovery of its cost basis.
- requires an entity to recognize noncredit losses on held to maturity debt securities in other comprehensive income and amortize that amount over the remaining life of the security with no effect on earnings unless the security is subsequently sold or additional credit losses exist.
- addresses debt securities accounted for in accordance with FASB ASC 310-30, stipulating that credit losses should be measured on the basis of an entity's estimate of the decrease in expected cash flows, including those that result from an increase in expected prepayments.
- clarifies that existing premiums or discounts and subsequent changes in estimated cash flows or fair value should continue to be accounted for in accordance with existing guidance (for example, EITF Issue No. 99-20, "Recognition of Interest Income and Impairment on Purchased Beneficial Interests and Beneficial Interests That Continue to Be Held by a Transferor in Securitized Financial Assets," which was primarily codified in FASB ASC 325-40).
- requires an entity to present the total other-than-temporary impairment in the statement of earnings with an offset for the amount recognized in other comprehensive income.



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- requires an entity to present separately in the financial statements where the components of accumulated other comprehensive income are reported and amounts recognized therein related to held to maturity and available for sale debt securities, for which a portion of an other-than-temporary impairment has been recognized in earnings.
- modifies the disclosure requirements of certain debt and equity securities to require an entity to provide the following:
  - The cost basis of available for sale and held to maturity debt securities by major security type
  - The methodology and key inputs, such as performance indicators of the underlying assets in the security, loan to collateral value ratios, third party guarantees, levels of subordination, and vintage, used to measure the portion of an other-than-temporary impairment related to credit losses by major security type
  - A tabular rollforward of the amount related to credit losses recognized in earnings for debt securities
- modifies previous guidance to require that major security classes be based on the nature and risks of the security and additional types of securities to be included in the list of major security types listed in FASB ASC 942-320-50-2.
- requires the preceding additional disclosures, as well as all prior existing disclosures, for interim periods.

**.283** The guidance is effective for interim and annual reporting periods ending after June 15, 2009, with early adoption permitted for periods ending after March 15, 2009. Earlier adoption for periods ending before March 15, 2009, is not permitted. As discussed previously, if an entity elects to adopt early either FSP FAS 157-4 or FSP FAS 107-1 and APB 28-1, the entity also is required to adopt this FSP early. Additionally, if an entity elects to adopt this FSP early, it is required to adopt FSP FAS 157-4. This guidance does not require disclosures for earlier periods presented for comparative purposes at initial adoption. In periods after initial adoption, this guidance requires comparative disclosures only for periods ending after initial adoption. More information is available at [www.fasb.org](http://www.fasb.org).

***Disclosure of Other-Than-Temporary Impairments***

**.284** The disclosure guidance for other-than-temporary impairments was amended to require entities to disclose information regarding the types of available for sale and held to maturity debt, and equity securities held, including information about investments in an unrealized loss position for which an other-than-temporary impairment has or has not been recognized. In addition, the amended guidance requires entities to disclose the reasons that a portion of an other-than-temporary impairment of a debt security was not recognized in earnings, and the methodology and significant inputs used to calculate the portion of the total other-than-temporary impairment that was recognized in earnings.

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**.285** The recent guidance modifies the disclosure requirements of certain debt and equity securities to require an entity to provide the following:

- The cost basis of available for sale and held to maturity debt securities by major security type
- The methodology and key inputs, such as performance indicators of the underlying assets in the security, loan to collateral value ratios, third-party guarantees, levels of subordination, vintage, geographic concentration, and credit ratings, which are used to measure the portion of an other-than-temporary impairment related to credit losses by major security type (see "Pending Content" of FASB ASC 320-10-50-8A<sup>21</sup> for examples of significant inputs used to measure the amount related to credit loss)
- A tabular rollforward of the amount related to credit losses recognized in earnings for debt securities
- These additional disclosures, as well as all prior existing disclosures, for interim periods

**.286** Major security types should be disclosed based on the nature and risks of the securities. In determining whether disclosure for a particular security type is necessary and whether it is necessary to further separate a particular security type into greater detail, an entity should consider all of the following:

- (Shared) Activity or business sector
- Vintage
- Geographic concentration
- Credit quality
- Economic characteristics

**.287** Certain types of securities should be included in the list of major security types in addition to those listed in the current guidance. (See "Pending Content" in FASB ASC 942-320-50-2<sup>22</sup> for a list of major security types that should be included in the disclosure, noting that additional types may be necessary.)

**.288** As stated in "Pending Content" of FASB ASC 320-10-45-8A<sup>23</sup>, in periods in which an entity determines that a security's decline in fair value below its amortized cost basis is other than temporary, the entity should present the total other-than-temporary impairment in the statement of earnings with an offset for the amount of the total other-than-temporary impairment that is recognized in other comprehensive income, in accordance with FASB ASC 320-10-35-34D. Example 2A in FASB ASC (see FASB ASC 320-10-55-21A) provides an illustration of the presentation on the face of the financial statements:

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<sup>21</sup> See footnote 10.

<sup>22</sup> See footnote 10.

<sup>23</sup> See footnote 10.

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Total other-than-temporary impairment losses	\$(10,000)
Portion of loss recognized in other comprehensive income, net of tax	4,000
Net impairment losses recognized in earnings	\$(6,000)

**.289** In the financial statement where the components of accumulated other comprehensive income are reported, an entity should present separately, amounts recognized therein related to held to maturity and available for sale debt securities for which a portion of an other-than-temporary impairment has been recognized in earnings.

### Regulatory Capital and Other-Than-Temporary Impairment Accounting

**.290** On May 14, 2009, the OTS issued a memorandum for CEOs that provides information to institutions and examiners regarding FSP FAS 115-2 and FAS 124-2. CEO Letter No. 303, "New FASB Guidance on Other-than-Temporary Impairment," provides a brief overview of the FSP and states that the regulatory capital treatment of losses on debt securities has not changed. As noted in the memo, the new accounting guidance may result in an amount of noncredit losses on available for sale and held to maturity debt securities being recognized in other comprehensive income instead of earnings. These noncredit losses in accumulated other comprehensive income will be added back as part of unrealized losses in determining tier 1 capital on Thrift Financial Report Schedule CCR.

**.291** The OCC issued a similar statement in OCC Bulletin 2009-11, "Other-than-Temporary Impairment Accounting: OCC Advisory on Financial Accounting Standards Board Changes," dated April 17, 2009. The OCC Bulletin also states that the FSP may affect regulatory capital levels and ratios for banks reporting a noncredit component of an other-than-temporary-impairment. As discussed in more detail in the "Accounting Issues and Developments" section, with implementation of this FSP, the noncredit component of other-than-temporary-impairment on debt securities will no longer reduce bank earnings. Under existing regulatory capital requirements, the portion of other-than-temporary-impairment for debt securities that flows through other comprehensive income will not affect bank tier 1 capital. The March 31, 2009, supplemental call report instructions provide additional reporting details.

**.292** In addition, the OTS issued CEO Letter No. 320, *Accounting Considerations Related to Other-Than-Temporary Impairment of Securities*, on September 3, 2009. The CEO letter includes accounting and regulatory considerations related to other-than-temporary impairment of securities. The letter provides an example, a flowchart, and matrix for determining when securities are other-than-temporarily impaired, the appropriate measurement model, and where to record impairment (either other comprehensive income or income statement). This letter also covers supervisory expectations and notes that management should have detailed written policies that state the criteria that lead to the rebuttable presumption that other-than-temporarily impairment exists and should have robust, documented evidence to support conclusions that impaired securities are not other-than-temporarily impaired. Readers are encouraged to read the full text of this letter at <http://files.ots.treas.gov/25320.pdf>.

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### ***The Meaning of Other-Than-Temporary Impairment for Equity Securities***

**.293** Soon after the issuance of FSP FAS 115-2 and 124-2 in early April 2009, which focused on other-than-temporary impairment of debt securities, the SEC issued Staff Accounting Bulletin (SAB) No. 111 to amend and replace Topic 5.M in the SAB Series, *Other Than Temporary Impairment of Certain Investments in Debt and Equity Securities*. This SAB maintains the SEC's previous views related to equity securities and amends Topic 5.M to exclude debt securities from its scope. The phrase "other-than-temporary" impairment should not be interpreted as permanent for available for sale equity securities. When the value of one of these securities has declined, management should investigate why. Management should consider all available evidence to evaluate the realizable value of these investment assets. A few examples of factors that, individually or in combination, indicate that declines in value of an available for sale equity security is other-than-temporary (and therefore a write-down of the carrying value is required) are:

- Length of time and the extent to which the market value has been less than cost
- Financial condition and near term prospects of the issuer
- Intent and ability of the holder to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in market value.

**.294** Further, unless evidence exists to support a realizable value equal to or greater than the carrying value of the equity security classified as available for sale, a write-down to fair value accounted for as a realized loss should be recorded. The absence of evidence indicating permanent impairment is not considered appropriate evidence to support the realizable value. This loss should be included in net income in the period that it occurs and the written down value of the security becomes the new cost basis.

### ***Impairment Guidance for Beneficial Interests***

**.295** In January 2009, FSP EITF 99-20-1, *Amendments to the Impairment Guidance of EITF Issue No. 99-20*, which is primarily codified in FASB ASC 325-40 and applies to beneficial interests within the scope of FASB ASC 325-40, was issued to achieve a more consistent determination of whether an other-than-temporary impairment has occurred. Prior to the issuance of this guidance, two methods of determining whether an impairment was other than temporary existed. This guidance amends FASB ASC 325 to align the impairment guidance in FASB ASC 325 with that in FASB ASC 320-10-35.

**.296** Readers are encouraged to review the guidance contained in FASB ASC 325-40 and FASB ASC 320-10, for a complete understanding of impairment considerations for beneficial securitized interests.

### ***Business Combinations***

#### *Overview*

**.297** FASB Statement No. 141(R) becomes effective for most institutions with fiscal years beginning during 2009 as the guidance, which is codified in FASB ASC 805, applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. Early adoption is prohibited.

**.298** The objective of FASB ASC 805 is to improve the relevance, representational faithfulness, and comparability of the information that a reporting entity provides in its financial reports about a business combination and its effects. To accomplish this objective, FASB ASC 805 establishes principles and requirements for how the acquirer does each of the following:

- Recognizes and measures the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree in the financial statements
- Recognizes and measures goodwill acquired in a business combination or from a bargain purchase
- Determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the combination

**.299** FASB ASC 805 defines the key terms associated with a business combination. This guidance also requires entities to record assets acquired and liabilities assumed as a result of a business combination at fair value, as defined by the FASB ASC glossary. FASB ASC 820 provides guidance on using valuation techniques to measure fair value.

**.300** The fair value measurements for acquired receivables, including loans, required by FASB ASC 805 at acquisition are consistent with the guidance in FASB ASC 310-30 and prohibits the carrying over or creating valuation allowances in the initial accounting of all loans acquired in transfers that are within its scope, including business combinations accounted for as an acquisition.

**.301** The "Pending Content" in FASB ASC 805-20-30-4<sup>24</sup> states that the acquirer should not recognize a separate valuation allowance as of the acquisition date for assets acquired in a business combination that are measured at their acquisition date fair values because the effects of uncertainty about future cash flows are included in the fair value measure. For example, because FASB ASC 805 requires the acquirer to measure acquired receivables, including loans, at their acquisition date fair values, the acquirer does not recognize a separate valuation allowance for the contractual cash flows that are deemed to be uncollectible at that date.

**.302** FASB ASC 805 is to be applied prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. Earlier application is prohibited. Assets and liabilities that arose from business combinations whose acquisition dates preceded the application of this guidance should not be adjusted upon application of this guidance.

**.303** FASB ASC 805 requires management to make significant estimates and exercise significant judgment in accounting for assets and liabilities such as loans and leases, deposits, securities sold under repurchase agreements, and other borrowed funds as a result of a business combination. Judgmentally assigned risk ratings, appraised collateral values, expected cash flows, statistically derived loss factors, and other third party information may be used to assist in measuring fair values.

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<sup>24</sup> This guidance is labeled as "Pending Content" due to the transition and open effective date information discussed in FASB ASC 805-10-65-1. For more information on FASB ASC, please see the section "Notice to Readers" in the guide.

**.304** Entities that have entered into business combinations, including loss sharing agreements with the FDIC or other assisted acquisitions, may encounter issues related to determining and recording the unit of accounts for the individual assets acquired and the liabilities assumed. Entities may also find other accounting issues related to recording the guarantee (for assisted acquisitions such as loss sharing arrangements). Through this process, management may also consider whether certain loans acquired in the business combination meet the scope of FASB ASC 310-30. Management may find additional administrative complexities, such as loan accounting system constraints and other loan tracking and valuation issues, which may require additional accounting process, internal controls, and possibly system upgrades and additional valuation expertise. Entities should understand the additional financial reporting complexities that may be encountered when entering into assisted acquisitions.

*Business Combinations for Mutual Entities (Including Credit Unions)*

**.305** Mutual entities, such as mutual banks and credit unions, will be significantly affected by the implementation of FASB ASC 805. Mutual entities were not required to adopt FASB Statement No. 141, *Business Combinations*, or FASB Statement No. 147, *Acquisitions of Certain Financial Institutions*, until FASB issued interpretative guidance for applying the purchase method to those transactions. FASB ASC 805 provides that interpretative guidance. An entity, such as a mutual entity, that has not yet applied FASB Statement No. 141 and FASB Statement No. 147 and that had one or more business combinations that were accounted for using the purchase method, should apply the transition guidance stated in FASB ASC 805-10-65-1(c).

**.306** The application of the acquisition method is a significant change from the pooling method used by credit unions in the past and provides unique challenges because no consideration is being exchanged other than member interests.

**.307** Upon adoption of FASB ASC 805, a mutual entity that had a purchase business combination accounted for in accordance with Accounting Principles Board (APB) Opinion No. 16, *Business Combinations*, or FASB Statement No. 72, *Accounting for Certain Acquisitions of Banking or Thrift Institutions— an amendment of APB Opinion No. 17, an interpretation of APB Opinions 16 and 17, and an amendment of FASB Interpretation No. 9*, should apply the following transition provisions for goodwill and intangible assets acquired in that business combination:

- a. The entity should reclassify to goodwill (reclassified goodwill) amounts that do not meet the identifiable criteria for recognition separately from goodwill.
- b. The entity should reclassify to intangible assets the carrying amount of any intangible asset meeting all of the following conditions:
  - i. Meets the definition of *identifiable*.
  - ii. Has been recognized but reported on the face of the statement of financial position in goodwill (or as goodwill and intangible assets) or as unidentifiable intangible assets.
  - iii. Has been separately accounted for.

**.308** In addition, the entity should write off and recognize in earnings the amount of any unamortized deferred credit related to an excess over cost

arising from either a business combination or an investment accounted for by the equity method before applying FASB ASC 805.

**.309** At adoption of FASB ASC 805, mutual entities should do the following:

- a. Apply FASB Statement No. 142, *Goodwill and Other Intangible Assets*, which is primarily codified in FASB ASC 350, *Intangibles—Goodwill and Other*.
- b. Follow the transitional goodwill impairment testing guidance in FASB ASC 350 for previously recognized goodwill.
- c. Apply FASB Statement No. 144 to long-term customer-relationship intangible assets, except for servicing assets, recognized in the acquisition of a financial institution. (Servicing assets are accounted for in accordance with FASB ASC 860-50.)

**.310** See FASB ASC 805-10-65-1, for the full text of the transition guidance for mutual entities as well for all entities that have completed a business combination before or after the effective date of FASB ASC 805.

**.311** The FDIC provides additional information regarding business combinations for financial institutions under FASB ASC 805 in the Winter 2008 *Supervisory Insights*. (See [www.fdic.gov/regulations/examinations/supervisory/insights/siwin08/si\\_win08.pdf](http://www.fdic.gov/regulations/examinations/supervisory/insights/siwin08/si_win08.pdf)).

#### *Business Combinations: Related Revisions to SEC Staff Accounting Bulletin Series*

**.312** SAB No. 112, which was issued by the SEC on June 4, 2009, revises or rescinds portions of the SEC's interpretative guidance in order to make the interpretive guidance consistent with current U.S. GAAP. The principal revisions include deletion of material no longer necessary due to the issuance of FASB Statement No. 141(R) and FASB Statement No. 160, *Noncontrolling Interests in Consolidated Financial Statements—an amendment of ARB No. 51*, which is primarily codified in FASB ASC 810-10. Among other topics, Topic 2.A.5 was removed with SAB No. 112. Topic 2.A.5 provided guidance on assigning acquisition costs to loans receivable acquired in a business combination. As noted previously, FASB ASC 805 provides new guidance that requires acquired receivables, including loans, to be measured at their acquisition date fair value and precludes the acquirer from recording a separate valuation allowance at the acquisition date. The full text of SAB No. 112 is located on the SEC Web site at [www.sec.gov/interps/account/sab112.htm](http://www.sec.gov/interps/account/sab112.htm).

#### **Liquidity Restrictions**

**.313** As discussed in the "Audit and Attestation Issues and Developments" section of this alert, TIS section 1100.15 addresses the potential accounting and auditing implications of liquidity restrictions.

**.314** This question and answer section discusses some considerations for when certain restriction events occur, such as determining (a) whether any assets subject to these restrictions qualify as cash equivalents or current assets; (b) whether disclosures about the risks and uncertainties resulting from such restrictions should be made; (c) whether these restrictions may trigger violations of debt covenants and, if so, if that liability should be classified as current; (d) whether the financial statements need to be adjusted if the occurrence of

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such restriction occurs between the balance sheet date and the issuance date; and (e) whether the restriction events call into question the entity's ability to continue as a going concern.

**Interest Reserves**

**.315** For most lenders, the decision to establish a loan-funded interest reserve upon origination of a land acquisition, development, and construction (ADC) loan is based on the feasibility of the project, the creditworthiness of the borrower and guarantors, and the protection provided by the real estate and other collateral. The interest reserve account allows a lender to periodically advance loan funds to pay interest charges on the outstanding balance of the loan. The interest is capitalized and added to the loan balance. The calculation of the interest reserve depends on the size and complexity of the ADC loan.

**.316** "A Primer on the Use of Interest Reserves," an article included in the FDIC's Summer 2008 *Supervisory Insights* issue, describes the use of interest reserves in ADC lending, examines the risks this strategy presents, and identifies red flags that should alert lenders to potential problems at each stage of the ADC cycle.

**.317** This article explains that longstanding accounting concepts that govern the recognition of income are applicable to interest reserves. In general, interest that has been added to the balance of a loan through the use of an interest reserve should not be recognized as income if its collectability is not reasonably assured. This accounting concept has been incorporated into the criteria for placing an asset in nonaccrual status for purposes of the call report. The call report instructions present these criteria in the general rule in the glossary entry for "Nonaccrual Status," which provides, in part, that banks should not accrue interest on any asset for which payment in full of principal or interest is not expected.

**.318** Other guidance provided by the banking agencies includes the following:

- Federal Reserve Bank's Commercial Bank Examination Manual, Section 2100.1, *Real Estate Construction Loans—Interest Reserves*, November 1995
- FDIC FIL-22-2008, "Managing Commercial Real Estate Concentrations in a Challenging Environment," issued on March 17, 2008
- FDIC's Summer 2008 Supervisory Insights article, "A Primer on the Use of Interest Reserves" (see [www.fdic.gov/regulations/examinations/supervisory/insights/sisum08/sisum08.pdf](http://www.fdic.gov/regulations/examinations/supervisory/insights/sisum08/sisum08.pdf))
- OCC's Examining Circular from May 1985
- FDIC's *Real Lending Standards and Interagency Guidelines for Real Estate Lending Policies*, issued in 1992
- OTS's Examination Handbook, Section 213, *Asset Quality—Real Estate Lending Standards Rule*, par. 213.1–.2, January 1994

**Recognition of Capital Contributions in the Form of Cash or Notes**

**.319** On February 26, 2009, the OTS issued CEO Letter No. 293, "Recognition of Capital Contributions in the Form of Cash or Notes." This letter noted that many institutions' capital positions have been adversely affected by recent economic conditions. As a result, institutions and their holding companies



are implementing various courses of action to increase capital. Capital contributions of cash or notes may be included in regulatory capital only when the contribution is properly reported as equity under U.S. GAAP and complies with regulatory reporting guidance. Capital contributions in the form of cash are appropriately recognized as regulatory capital when received. Capital contributions in the form of a note receivable, executed prior to period-end, increase regulatory capital for that period-end only when the note is collected prior to issuance of the financial statements (including regulatory reports) for the same period. Readers are encouraged to read the full text of this letter on the OTS Web site at [www.ots.gov](http://www.ots.gov).

### Review of Deferred Tax Asset Practices

**.320** Deferred tax assets (DTAs) for U.S. banking institutions grew in dollar terms by nearly 300 percent over the 12 month period ended June 30, 2009; they now comprise on average 10.7 percent of equity and a median 5.7 percent of equity. The major contributions to this increase include the increase in the ALLL, the increase in unrealized losses on available for sale securities, the increase in other-than-temporary impairments, and the increase in net operating loss. The increase in DTAs has 2 primary implications. First, the DTAs should be evaluated for realizability. Second, the regulatory capital impact from disallowed DTAs should be understood.

**.321** In 2009, the Federal Reserve conducted a review of deferred tax assets audit workpapers for 15 institutions, covering 10 audit firms. The audit workpapers documented testing of deferred tax asset balances as of December 31, 2008. The review included an analysis of whether the capital treatment of deferred tax assets was appropriate and whether certain policy changes may be considered. The review did not include a determination of whether audits were performed in accordance with generally accepted audit standards. As of October 15, 2009, the results of this study had not been finalized and made publicly available.

**.322** Regulatory capital standards limit the amount of deferred tax assets that can be included in tier 1 capital. Generally, deferred tax assets that are dependent upon future taxable income are limited to the lesser of (a) the amount of such deferred tax assets that the bank expects to realize within 1 year of the calendar quarter-end date, based on its projected future taxable income for that year, or (b) 10 percent of the amount of the bank's tier 1 capital. Deferred tax assets that are dependent upon future taxable income are (a) deferred tax assets arising from deductible temporary differences that exceed the amount of taxes previously paid that a bank could recover through loss carrybacks if the bank's temporary differences (both deductible and taxable) fully reverse at the report date, and (b) deferred tax assets arising from operating loss and tax credit carryforwards.

**.323** The federal banking agencies exclude the amount of net unrealized holding gains and losses on available for sale securities (except net unrealized holding losses on available for sale equity securities with readily determinable fair values) from regulatory capital. When determining the regulatory capital limit for deferred tax assets, a bank may, but is not required to, adjust the amount of its deferred tax assets for any deferred tax assets and liabilities arising from available for sale debt securities for purposes of the calculating regulatory capital. A bank must follow a consistent approach with respect to such adjustments.

## Exposure Draft on Financing Receivables and the Allowance for Credit Losses

.324 On June 24, 2009, FASB issued the exposure draft, *Disclosures about the Credit Quality of Financing Receivables*<sup>25</sup> and *the Allowance for Credit Losses*, for a proposed statement of financial accounting standards. As noted in the basis for conclusion in the exposure draft, this proposed statement was written to address the following three objectives:

- a. To expand the credit quality disclosures to provide more transparent financial reporting to investors
- b. To incorporate into U.S. GAAP information that is already required to be disclosed to financial statement users by U.S. bank and securities regulators
- c. To more closely align U.S. GAAP with current IFRSs disclosure requirements

.325 This proposed statement would require enhanced disclosures about the allowance for credit losses and the credit quality of financing receivables. It also would apply to financing receivables held by all creditors, including public and nonpublic entities that prepare financial statements in accordance with U.S. GAAP. Six major categories of disclosures exist under this proposed statement exist, including allowance for credit losses, rollforward schedules of financing receivables, fair value, credit quality information, impaired financing receivables, and nonaccrual status. The disclosures for allowance for credit losses, rollforward schedules of the allowance for credit losses and for financing receivables, and fair value are disaggregated by portfolio segment. The disclosures for credit quality information, impaired financing receivables, and nonaccrual status are further disaggregated by class.

.326 This proposed statement would be effective beginning with the first interim or annual reporting period ending after December 15, 2009, with early application encouraged. Readers are encouraged to visit the FASB Web site for the full text and additional developments regarding this exposure draft. Comments were due to FASB on August 24, 2009.

.327 The current sources of guidance for the accounting for the ALLL, loan modifications, and the related disclosures include the following:

- FASB Statement No. 15
- FASB Statement No. 114
- FASB Statement No. 5, which is primarily codified in FASB ASC 450
- FASB Statement No. 13, *Accounting for Leases*, which is codified in FASB ASC 840, *Leases*
- FASB ASC 310-30
- 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), which is codified in FASB ASC 310-20

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<sup>25</sup> *Financing receivables*, as defined by the exposure draft, include loans defined as a contractual right to receive money on demand or on fixed or determinable dates that are recognized as an asset in the creditor's statement of financial position, whether originated or acquired.

**.328** See the "Audit and Attestation Issues and Developments" section for additional information regarding auditing the ALLL and troubled debt restructurings.

### Convergence With IFRSs

**.329** Since the signing of the Norwalk Agreement by FASB and the International Accounting Standards Board (IASB), the bodies have had a common goal—one set of accounting standards for international use. In this agreement, each body acknowledged its commitment to the development of high quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting. FASB and the IASB have undertaken several joint projects, which are being conducted simultaneously in a coordinated manner to further the goal of convergence of U.S. GAAP and IFRSs. These ongoing joint projects address the conceptual framework, business combinations, financial statement presentation, and revenue recognition. The "On the Horizon" section of this alert discusses these joint projects. For more information, visit [www.fasb.org](http://www.fasb.org) and [www.iasb.org](http://www.iasb.org).

**.330** In addition, the AICPA and the International Accounting Standards Committee Foundation jointly developed a conference titled, "IFRS in North America 2009: The U.S. Perspective," to be held October 29–30 in New York. The IASB's *International Financial Reporting Standard for Small and Medium-sized Entities (IFRS for SMEs)* will be addressed at the conference.

### IFRSs Roadmap

**.331** In August 2008, the SEC voted to publish for public comment a proposed roadmap that could lead to the use of IFRSs by U.S. issuers beginning in 2014. The SEC would make a decision in 2011 on whether adoption of IFRSs is in the public interest and would benefit investors. The proposed multiyear plan sets out several milestones that, if achieved, could lead to the use of IFRSs by U.S. issuers in their filings with the SEC. The top 20 companies in each industry, as determined by market capitalization, could elect to begin filing IFRSs financial statements for fiscal periods ending after December 15, 2009. If, in 2011, the SEC adopts IFRSs for all filers, the roadmap suggests mandatory filing for large accelerated filers beginning in 2014, accelerated filers in 2015, and nonaccelerated filers in 2016. The extended comment period ended in April 2009.

**.332** The full text of the roadmap can be viewed on the SEC Web site at <http://sec.gov/rules/proposed/2008/33-8982.pdf>. Users are encouraged to closely monitor the progress of this initiative.

### *International Financial Reporting Standard for Small and Medium-sized Entities*

**.333** In July 2009, the IASB issued *IFRS for SMEs*. *IFRS for SMEs* is an approximately 230-page, significantly reduced and simplified version of full IFRSs. In creating *IFRS for SMEs*, the IASB eliminated many accounting topics that are not generally relevant to private companies (for example, earnings per share and segment reporting), easing the financial reporting burden on private companies through a cost-benefit approach. *IFRS for SMEs* is a self-contained global accounting and financial reporting standard applicable to the general-purpose financial statements of, and other financial reporting by, entities that are known in many countries as SMEs.

**.334** *IFRS for SMEs* is intended to be used by entities that publish general purpose financial statements for external users and do not have public accountability. Under the IASB's definition, an entity has public accountability if it files or is in the process of filing its financial statements with a securities commission or other regulatory organization for the purpose of issuing any class of instruments in a public market or if it holds assets in a fiduciary capacity for a broad group of outsiders. Examples of entities that hold assets in a fiduciary capacity include banks, insurance companies, broker-dealers, pension funds and mutual funds.

**.335** In May 2008, the AICPA Governing Council voted to recognize the IASB as an accounting body for purposes of establishing international financial accounting and reporting principles. This amendment to appendix A of AICPA Rule 202, *Compliance With Standards* (AICPA, *Professional Standards*, vol. 2, ET sec. 202 par. .01), and Rule 203, *Accounting Principles* (AICPA, *Professional Standards*, vol. 2, ET sec. 203 par. .01), gives AICPA members the option to use IFRSs as an alternative to U.S. GAAP. As such, a key professional barrier to using IFRSs and, therefore, *IFRS for SMEs* has been removed. If eligible, CPAs may need to check with their state boards of accountancy to determine the status of reporting on financial statements prepared in accordance with *IFRS for SMEs* within their individual state.

**.336** Information about *IFRS for SMEs* and about the activities of the IASB can be found at [www.ifrs.com](http://www.ifrs.com).

### **AICPA IFRSs Web Site**

**.337** The AICPA Web site [www.IFRS.com](http://www.IFRS.com) is available to assist in both awareness building and education of IFRSs. The site provides current information regarding developments in international convergence. Developed by the AICPA, in partnership with its marketing and technology subsidiary CPA2Biz, [www.ifrs.com](http://www.ifrs.com) contains a comprehensive set of resources for accounting professionals, auditors, financial managers, audit committees, and other users of financial statements.

**.338** The Web site features tools and resources to help CPAs get acquainted with IFRSs, the surrounding issues, and available support. Resources include a history of convergence, a high level overview of the differences between IFRSs and U.S. GAAP, FAQs, articles, textbooks, continuing professional education (CPE) courses and live conference training, helpful links, and assistance for audit committee members.

### **Recent Pronouncements**

**.339** AICPA auditing and attestation standards are applicable only to audits and attestation engagements of nonissuers. The PCAOB establishes auditing and attestation standards for audits of issuers. For information on pronouncements issued subsequent to the writing of this alert, please refer to the AICPA Web site at [www.aicpa.org](http://www.aicpa.org), the FASB Web site at [www.fasb.org](http://www.fasb.org), and the PCAOB Web site at [www.pcaob.org](http://www.pcaob.org). You also may look for announcements of newly issued accounting standards in the *CPA Letter* and the *Journal of Accountancy*.

## Recent Auditing and Attestation Pronouncements and Related Guidance

.340 The following table presents a list of recently issued audit and attestation pronouncements and related guidance.

<i>Recent Auditing and Attestation Pronouncements and Related Guidance</i>	
Statement on Auditing Standards No. 116, <i>Interim Financial Information</i> (AICPA, <i>Professional Standards</i> , vol. 1, AU sec. 722) Issue Date: February 2009 (Applicable to audits conducted in accordance with generally accepted auditing standards )	This standard amends AU section 722 to accommodate reviews of interim financial information of nonissuers, including companies offering securities pursuant to Securities and Exchange Commission Rule 144A or participating in private equity exchanges. It is effective for reviews of interim financial information for interim periods beginning after December 15, 2009. Earlier application is permitted.
Interpretation No. 1, "Use of Electronic Confirmations," of AU section 330, <i>The Confirmation Process</i> (AICPA, <i>Professional Standards</i> , vol. 1, AU sec. 9330 par. .01–.08) Issue Date: April 2007 Revised Date: November 2008 (Interpretive publication)	This interpretation of AU section 330 addresses the use of electronic confirmations.
Interpretation No. 7, "Reporting on the Design of Internal Control," of AT section 101, <i>Attest Engagements</i> (AICPA, <i>Professional Standards</i> , vol. 1, AT sec. 9101 par. .59–.69) Issue Date: December 2008 (Interpretive publication)	This interpretation of AT section 101 addresses how a practitioner may report on the suitability of the design of an entity's internal control over financial reporting for preventing or detecting and correcting material misstatements of the entity's financial statements on a timely basis.
Technical Questions and Answers (TIS) section 8700.01, "Effect of FASB ASC 855 on Accounting Guidance in AU Section 560" (AICPA, <i>Technical Practice Aids</i> ) Issue Date: September 2009 (Nonauthoritative)	This question and answer addresses whether the accounting guidance in AU section 560, <i>Subsequent Events</i> (AICPA, <i>Professional Standards</i> , vol. 1), is effected by the issuance of Financial Accounting Standards Board (FASB) <i>Accounting Standards Codification</i> (ASC) 855, <i>Subsequent Events</i> .

(continued)

***Recent Auditing and Attestation Pronouncements  
and Related Guidance***

<p>TIS section 8700.02, "Auditor Responsibilities for Subsequent Events" (AICPA, <i>Technical Practice Aids</i>) Issue Date: September 2009 (Nonauthoritative)</p>	<p>This question and answer discusses whether the auditor's responsibilities under AU section 560 are changed as a result of the issuance of FASB ASC 855.</p>
<p>TIS section 9150.25, "Determining Whether Financial Statements Have Been Prepared by the Accountant" (AICPA, <i>Technical Practice Aids</i>) Issue Date: December 2008 (Nonauthoritative)</p>	<p>This question and answer publication discusses what an accountant should consider in determining whether he or she has prepared the financial statements of a nonissuer.</p>
<p>TIS section 1100.15, "Liquidity Restrictions" (AICPA, <i>Technical Practice Aids</i>) Issue Date: October 2008 (Nonauthoritative)</p>	<p>This question and answer publication discusses auditing and accounting issues related to withdrawal restrictions placed on short term investments by a money market fund or its trustee.</p>
<p>Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 6, <i>Evaluating Consistency of Financial Statements</i> (AICPA, <i>PCAOB Standards and Related Rules</i>, Auditing Standards) Issue Date: September 2008 (Applicable to audits conducted in accordance with PCAOB standards)</p>	<p>This standard and its related amendments update the auditor's responsibilities to evaluate and report on the consistency of a company's financial statements and align the auditor's responsibilities with FASB Statement No. 154, <i>Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and FASB Statement No. 3</i>, which is codified in FASB ASC 250, <i>Accounting Changes and Error Corrections</i>. This standard also improves the auditor reporting requirements by clarifying that the auditor's report should indicate whether an adjustment to previously issued financial statements results from a change in accounting principles or the correction of a misstatement. It is effective November 15, 2008.</p>
<p>PCAOB Staff Audit Practice Alert No. 4, <i>Auditor Considerations Regarding Fair Value Measurements</i>,</p>	<p>This PCAOB staff audit practice alert is designed to inform auditors about potential implications of the FASB Staff Positions on reviews of interim financial</p>

***Recent Auditing and Attestation Pronouncements  
 and Related Guidance***

<p><i>Disclosures, and Other-Than-Temporary Impairments</i> (AICPA, PCAOB Standards and Related Rules, PCAOB Staff Guidance, sec. 400.04)          Issue Date: April 2009          (Applicable to audits conducted in accordance with PCAOB standards)</p>	<p>information and annual audits. This alert addresses the following topics:</p> <ul style="list-style-type: none"> <li>• Reviews of interim financial information</li> <li>• Audits of financial statements, including integrated audits</li> <li>• Disclosures</li> <li>• Auditor reporting considerations</li> </ul>
<p>PCAOB Staff Audit Practice Alert No. 3, <i>Audit Considerations in the Current Economic Environment</i> (AICPA, PCAOB Standards and Related Rules, PCAOB Staff Guidance, sec. 400.03)          Issue Date: December 2008          (Applicable to audits conducted in accordance with PCAOB standards)</p>	<p>This practice alert is designed to assist auditors in identifying matters related to the current economic environment that might affect audit risk and require additional emphasis. The practice alert addresses the following six main areas: overall audit considerations, auditing fair value measurements, auditing accounting estimates, auditing the adequacy of disclosures, auditor's consideration of a company's entity's ability to continue as a going concern, and additional audit considerations for selected financial reporting areas.</p>

**Recent Accounting Standards Updates, Pronouncements, and Related Guidance**

.341 The following table presents a list of recently issued accounting pronouncements and related guidance.

***Recent Accounting Standards Updates, Pronouncements,  
 and Related Guidance***

<p>Financial Accounting Standards Board (FASB) <i>Accounting Standards Codification</i> (ASC) Accounting Standard Update (ASU) No. 2009-14          (October 2009)</p>	<p><i>Software (Topic 985): Certain Revenue Arrangements That Include Software Elements—a consensus of the FASB Emerging Issues Task Force</i></p>
<p>FASB ASC ASU No. 2009-13          (October 2009)</p>	<p><i>Revenue Recognition (Topic 605): Multiple-Deliverable Revenue Arrangements—a consensus of the FASB Emerging Issues Task Force</i></p>

<i>Recent Accounting Standards Updates, Pronouncements, and Related Guidance</i>	
FASB ASC ASU No. 2009-12 (September 2009)	<i>Fair Measurements and Disclosures (Topic 820): Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)</i>
FASB ASC ASU No. 2009-11 (September 2009)	<i>Extractive Activities—Oil and Gas—Amendment to Section 932-10-S99 (SEC Update)</i>
FASB ASC ASU No. 2009-10 (September 2009)	<i>Financial Services—Broker and Dealers: Investments—Other—Amendment to FASB ASC 940-325</i>
FASB ASC ASU No. 2009-9 (September 2009)	<i>Accounting for Investments—Equity Method and Joint Ventures and Accounting for Equity-Based Payments to Non-Employees—Amendments to FASB ASC 323-10-S99 and 505-50-S99</i>
FASB ASC ASU No. 2009-8 (September 2009)	<i>Earnings per Share—Amendments to FASB ASC 260-10-S99</i>
FASB ASC ASU No. 2009-7 (September 2009)	<i>Accounting for Various Topics—Technical Corrections to SEC Paragraphs</i>
FASB ASC ASU No. 2009-6 (September 2009)	<i>Income Taxes (FASB ASC 740)—Implementation Guidance on Accounting for Uncertainty in Income Taxes and Disclosure Amendments for Nonpublic Entities</i>
FASB ASC ASU No. 2009-05 (August 2009)	<i>Fair Value Measurements and Disclosures (FASB ASC 820)—Measuring Liabilities at Fair Value</i>
FASB ASC ASU No. 2009-04 (August 2009)	<i>Accounting for Redeemable Equity Instruments—Amendment to FASB ASC 480-10-S99</i>
FASB ASC ASU No. 2009-03 (August 2009)	<i>SEC Update—Amendments to Various Topics Containing SEC Staff Accounting Bulletins</i>
FASB ASC ASU No. 2009-02 (June 2009)	<i>Omnibus Update—Amendments to Various Topics for Technical Corrections</i>
FASB ASC ASU No. 2009-01 (June 2009)	<i>Topic 105—Generally Accepted Accounting Principles—amendments based on—Statement of Financial Accounting Standards No. 168—The FASB Accounting Standards</i>



<b><i>Recent Accounting Standards Updates, Pronouncements, and Related Guidance</i></b>	
	<i>Codification™ and the Hierarchy of Generally Accepted Accounting Principles</i>
FASB Statement No. 168 (June 2009) (Codified in FASB ASC 105, <i>Generally Accepted Accounting Principles</i> )	<i>The FASB Accounting Standards Codification™ and the Hierarchy of Generally Accepted Accounting Principles—a replacement of FASB Statement No. 162</i>
FASB Statement No. 167 <sup>26</sup> (June 2008)	<i>Amendments to FASB Interpretation No. 46(R)</i>
FASB Statement No. 166 <sup>27</sup> (June 2009)	<i>Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140</i>
FASB Statement No. 165 (May 2009) (Codified in FASB ASC 855, <i>Subsequent Events</i> )	<i>Subsequent Events</i>
FASB Statement No. 164 <sup>28</sup> (April 2009)	<i>Not-for-Profit Entities: Mergers and Acquisitions—including an amendment of FASB Statement No. 142</i>
FASB Statement No. 163 (May 2008) (Codified in FASB ASC 944, <i>Financial Services—Insurance</i> )	<i>Accounting for Financial Guarantee Insurance Contracts—an interpretation of FASB Statement No. 60</i>
FASB Statement No. 162 (May 2008) (Superseded by FASB Statement No. 168 in June 2009)	<i>The Hierarchy of Generally Accepted Accounting Principles</i>
FASB Statement No. 161 (March 2008) (Codified in FASB ASC 815, <i>Derivatives and Hedging</i> )	<i>Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133</i>
FASB Statement No. 160 (December 2007) (Codified in FASB ASC 810, <i>Consolidation</i> )	<i>Noncontrolling Interests in Consolidated Financial Statements—an amendment of ARB No. 51</i>

(continued)

<sup>26</sup> See footnote 13.

<sup>27</sup> See footnote 13.

<sup>28</sup> See footnote 13.

<i>Recent Accounting Standards Updates, Pronouncements, and Related Guidance</i>	
FASB Statement No. 141 (revised 2007) (December 2007) (Codified in FASB ASC 805, <i>Business Combinations</i> )	<i>Business Combinations</i>
FASB Emerging Issues Task Force (EITF) Issues (Various dates)	Go to <a href="http://www.fasb.org/eitf/agenda.shtml">www.fasb.org/eitf/agenda.shtml</a> for a complete list of EITF Issues.
FASB Staff Positions (FSPs) (Various dates)	Go to <a href="http://www.fasb.org">www.fasb.org</a> for a complete list of FSPs.
Technical Questions and Answers (TIS) section 6910.30, "Disclosure Requirements of Investments for Nonregistered Investment Partnerships When Their Interest in an Investee Fund Constitutes Less Than 5 Percent of the Nonregistered Investment Partnership's Net Assets" (AICPA, <i>Technical Practice Aids</i> ) Issue Date: August 2009 (Nonauthoritative)	This question and answer publication addresses disclosure requirements of investments for nonregistered investment partnerships and indicates that a nonregistered investment partnership should apply the guidance in paragraphs 8–9 of FASB ASC 946-210-50 when their interest in an investee fund constitutes less than 5 percent of the nonregistered investment partnership's net assets.
TIS section 6910.31, "The Nonregistered Investment Partnership's Method for Calculating Its Proportional Share of Any Investments Owned by an Investee Fund in Applying the "5 Percent Test" Described in TIS Section 6910.30" (AICPA, <i>Technical Practice Aids</i> ) Issue Date: August 2009 (Nonauthoritative)	This question and answer publication addresses the method that should be used by a nonregistered reporting investment partnership to calculate its proportional share of any investments owned by the investee fund and indicates that the calculation should be based on the percentage ownership of the investee fund. The publication also specifies that the disclosure should be made either on the face of the (condensed) schedule of investments or within the financial statement footnotes.
TIS section 6910.32, "Additional Disclosures for Nonregistered Investment Partnerships When the Reporting Investment Partnership Has Provided Guarantees Related to the Investee Fund's Debt." (AICPA, <i>Technical Practice Aids</i> ) Issue Date: August 2009 (Nonauthoritative)	This question and answer publication addresses additional disclosures for nonregistered reporting investment partnerships when the partnership has provided guarantees related to the investee fund's debt and indicates that the reporting investment partnership should disclose any guarantees it has provided on investee fund debt even though the risk of loss may be remote.

***Recent Accounting Standards Updates, Pronouncements,  
and Related Guidance***

<p>TIS section 1600.04, "Presentation of Assets at Current Values and Liabilities at Current Amounts in Personal Financial Statements" (AICPA, <i>Technical Practice Aids</i>) Issue Date: June 2009 (Nonauthoritative)</p>	<p>This question and answer publication discusses the definitions of <i>current values</i> and <i>current amounts</i> for personal financial statements.</p>
<p>TIS section 6931.11, "Fair Value Measurement Disclosures for Master Trusts" (AICPA, <i>Technical Practice Aids</i>) Issue Date: March 2009 (Nonauthoritative)</p>	<p>This question and answer publication indicates that the disclosures required by paragraphs 32–34 of FASB Statement No. 157, <i>Fair Value Measurements</i>, are required for individual investments under a master trust arrangement and are not required for the plan's total interest in the master trust.</p>
<p>TIS section 6995.02, "Evaluation of Capital Investments in Corporate Credit Unions for Other-Than-Temporary Impairment" (AICPA, <i>Technical Practice Aids</i>) Issue Date: February 2009 (Nonauthoritative)</p>	<p>This question and answer publication highlights the authoritative literature that helps a corporate credit union evaluate its membership capital shares and paid-in capital in the U.S. Central Federal Credit Union for other-than-temporary impairment charges at December 31, 2008.</p>
<p>TIS section 6995.01, "Financial Reporting Issues Related to Actions Taken by the National Credit Union Administration on January 28, 2009 in Connection With the Corporate Credit Union System and the National Credit Union Share Insurance Fund" (AICPA, <i>Technical Practice Aids</i>) Issue Date: January 2009 (Nonauthoritative)</p>	<p>This question and answer publication presents alternative views regarding whether the actions of the National Credit Union Administration constitute a type 1 or type 2 subsequent event with regard to the valuation of a federally insured credit union's National Credit Union Share Insurance Fund deposit at December 31, 2008. Additionally, this question and answer publication presents alternative views on when and how the obligation for the insurance premium should be recognized for financial reporting purposes.</p>

*(continued)*

***Recent Accounting Standards Updates, Pronouncements,  
and Related Guidance***

<p>TIS section 6910.29, "Allocation of Unrealized Gain (Loss), Recognition of Carried Interest, and Clawback Obligations" (AICPA, <i>Technical Practice Aids</i>) Issue Date: January 2009 (Nonauthoritative)</p>	<p>This question and answer publication discusses how cumulative unrealized gains (losses), carried interest, and potential clawback obligations should be reflected in the equity balances of each class of shareholder or partner at the balance sheet date when preparing financial statements of an investment partnership, in accordance with U.S. generally accepted accounting principles, in which capital is reported by investor class. In particular, this question and answer publication asks if cumulative period-end unrealized gains and losses should be allocated as if realized in accordance with the partnership's governing documents prior to the date, time, or event specified in the partnership agreement.</p>
<p>TIS section 1900.01, "Condensed Interim Financial Reporting by Nonissuers" (AICPA, <i>Technical Practice Aids</i>) Issue Date: January 2009 (Nonauthoritative)</p>	<p>This question and answer publication indicates that when preparing condensed interim financial statements, nonissuers may analogize to the guidance in article 10 of the Securities and Exchange Commission's Regulation S-X regarding form and content because Accounting Principles Board (APB) Opinion No. 28, <i>Interim Financial Reporting</i>, does not provide a reporting framework. APB Opinion No. 28 is codified primarily at FASB ASC 270, <i>Interim Reporting</i>.</p>
<p>TIS section 6300.36, "Prospective Unlocking" (AICPA, <i>Technical Practice Aids</i>) Issue Date: December 2008 (Nonauthoritative)</p>	<p>This question and answer publication discusses when an insurance company entity may change its original policyholder benefit liability assumptions.</p>
<p>TIS section 1100.15, "Liquidity Restrictions" (AICPA, <i>Technical Practice Aids</i>) Issue Date: October 2008 (Nonauthoritative)</p>	<p>This question and answer publication discusses auditing and accounting issues related to withdrawal restrictions placed on short term investments by a money market fund or its trustee.</p>

## Recent AICPA Independence and Ethics Pronouncements

**.342** Audit Risk Alert *Independence and Ethics Developments—2009* (product no. 0224709) contains a complete update on new independence and ethics pronouncements. This alert will heighten your awareness of independence and ethics matters likely to affect your practice. Obtain this alert by calling the AICPA at (888) 777-7077 or visiting [www.cpa2biz.com](http://www.cpa2biz.com).

## On the Horizon

**.343** Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. The following sections present brief information about some ongoing projects that have particular significance to the depository and lending institution or securities 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.

**.344** The following table lists the various standard setting bodies' Web sites, through which information may be obtained on outstanding exposure drafts, including downloading exposure drafts. These Web sites contain 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.

<i>Standard Setting Body</i>	<i>Web Site</i>
AICPA Auditing Standards Board	<a href="http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Auditing+Standards+Board/">www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Auditing+Standards+Board/</a>
Financial Accounting Standards Board	<a href="http://www.fasb.org">www.fasb.org</a>
Professional Ethics Executive Committee	<a href="http://www.aicpa.org/Professional+Resources/Professional+Ethics+Code+of+Professional+Conduct/Professional+Ethics/">www.aicpa.org/Professional+Resources/Professional+Ethics+Code+of+Professional+Conduct/Professional+Ethics/</a>
Public Company Accounting Oversight Board	<a href="http://www.pcaob.org">www.pcaob.org</a>
Securities and Exchange Commission	<a href="http://www.sec.gov">www.sec.gov</a>

## Auditing and Attestation Pipeline—Nonissuers

### *Auditing Standards Board Clarity Project*

**.345** In response to growing concerns about the complexity of standards, the ASB has commenced a large-scale clarity project to revise all existing auditing standards so they are easier to read and understand. Over the next two or three years, the ASB will be redrafting all of the existing auditing sections

contained in the *Codification of Statements on Auditing Standards* (AU sections of the AICPA's *Professional Standards*) to apply the clarity drafting conventions and converge with the International Standards on Auditing (IAS) issued by the International Auditing and Assurance Standards Board (IAASB). The ASB proposes that, except to address current issues, all redrafted standards will become effective at the same time. Only those standards needed to address current issues would have earlier effective dates. The ASB believes that a single effective date will ease the transition to, and implementation of, the redrafted standards. The effective date will be long enough after all redrafted statements are finalized to allow sufficient time for training and updating of firm audit methodologies. Currently, the date is expected to be for audits of financial statements for periods beginning no earlier than December 15, 2010. This date depends on satisfactory progress being made and will be amended, should that prove necessary. See the explanatory memorandum "Clarification and Convergence" and the discussion paper *Improving the Clarity of ASB Standards* at [www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Improving+the+Clarity+of+ASB+Standards.htm](http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Improving+the+Clarity+of+ASB+Standards.htm).

### **Exposure Drafts on Service Organizations**

.346 The ASB issued an exposure draft (using clarity drafting conventions) that would supersede AU section 324, which contains guidance for auditors auditing the financial statements of entities that use a service organization (user auditors) and for auditors reporting on controls at a service organization (service auditors). The proposed SAS only contains guidance for user auditors and is based on the December 2007 exposure draft of International Standard on Auditing (ISA) 402 (Revised and Redrafted), *Audit Considerations Relating to an Entity Using a Third Party Service Organization*. Guidance for service auditors will be contained in a new Statement on Standards for Attestation Engagements (SSAE), *Reporting on Controls at a Service Organization*, which was exposed for comment concurrently with this proposed SAS. AU section 324 would retain this new user auditor guidance and be renamed *Audit Considerations Relating to an Entity Using a Service Organization*. The key provisions of the proposed SAS are as follows:

- In a type 2 report, the service auditor's report would contain an opinion on the fairness of the description of the service organization's system and the suitability of the design of the controls for a period (rather than as of a specified date).
- A user auditor would be permitted to make reference to the work of a service auditor in his or her report to explain a modification of the user auditor's opinion. In those circumstances, the user auditor's report must indicate that such reference does not diminish the user auditor's responsibility for that opinion.
- A user auditor would be required to inquire of management of the user entity about whether the service organization has reported to the user entity any fraud, noncompliance with laws and regulations, or uncorrected misstatements. If so, the user auditor would be required to evaluate how such matters affect the nature, timing, and extent of the user auditor's further audit procedures.
- The proposed SAS also would be applicable to situations in which an entity uses a shared service organization that provides services to a group of related entities.

**.347** The proposed SSAE would supersede the requirements and guidance in AU section 324 for auditors reporting on controls at service organizations. It is based on the December 2007 exposure draft of International Standard on Assurance Engagements 3402, *Assurance Reports on Controls at a Third Party Service Organization*. The proposed SSAE has six provisions:

- First, as a condition of engagement performance, management of the service organization would be required to provide the service auditor with certain written assertions related to their system and design of controls.
- Second, a service auditor would be able to report on controls at a service organization other than controls that are relevant to user entities' financial reporting (such as controls related to regulatory compliance).
- The third key provision mirrors the provision of the proposed SAS, which discusses the service auditor's opinion in a type 2 report.
- Fourth, when obtaining an understanding of the service organization's system, the service auditor would be required to obtain information to identify risks that the description of the service organization's system is not fairly presented or that the control objectives stated in the description were not achieved due to intentional acts by service organization personnel.
- Next, when assessing the operating effectiveness of controls in a type 2 engagement, evidence obtained in prior engagements about the satisfactory operation of controls in prior periods does not provide a basis for a reduction in testing, even if supplemented with evidence obtained during the current period.
- Lastly, the proposed SSAE specifies the wording to be used in a service auditor's type 1 or 2 report to describe the customers to whom use of the report is restricted.

**.348** The exposure draft indicates that the proposed SAS would be effective for audits of financial statements for periods beginning on or after December 15, 2010. This is a provisional effective date; however, the actual effective date will not be any earlier. The ASB requested feedback on the effective date of the proposed SSAE. The comment period for both ended on February 17, 2009. The exposure drafts, a disposition of AU section 324 in the proposed SSAE, and a disposition of AU section 324 in the proposed SAS can all be accessed at [www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Exposure+Drafts+of+Proposed+Statements/](http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Exposure+Drafts+of+Proposed+Statements/). Constituents should be alert for developments.

### ***Exposure Draft on Auditing Accounting Estimates***

**.349** The ASB recently issued an exposure draft with clarity drafting conventions, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures (Redrafted)*, which would supersede AU sections 342 and 328. This proposed SAS is based on ISA 540, *Auditing Accounting Estimates, Including Fair Value Estimates and Related Disclosures*. This exposure draft does not significantly change or expand the guidance in AU sections 342 or 328; however it does combine the two sections.

**.350** Comments on the proposed SAS were due on November 30, 2009. The ASB was specifically seeking comments on changes resulting from applying

the clarity conventions and converging with the ISA. This proposed SAS would be effective for audits of financial statements for periods beginning on or after December 15, 2010. This effective date is provisional, but will not be any earlier. The proposed SAS can be accessed at [www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Exposure+Drafts+of+Proposed+Statements/Proposed+Statement+on+Auditing+Standards+Estimates.htm](http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Exposure+Drafts+of+Proposed+Statements/Proposed+Statement+on+Auditing+Standards+Estimates.htm).

## Auditing and Attestation Pipeline—Issues

### *PCAOB Risk Assessment Standards*

.351 In October 2008, the PCAOB proposed seven new auditing standards to update and supersede the current risk assessment standards. The PCAOB chairman noted that the proposals demonstrate the view that the risk of fraud is a central part of the audit process and not a separate consideration. The proposed standards integrate the risk assessment standards with the standard for the audit of internal control over financial reporting. Many of the IAASB's risk assessment standards were utilized in creating these proposed standards, and efforts were made to reduce any unnecessary differences. Each of these proposed standards has a statement of objective for the auditor, which was loosely adapted from the ISAs. This is an example of the move in the United States from rules-based to principles-based accounting and auditing standards because these objectives do not state required outcomes. The seven proposed standards are as follows:

- Audit Risk in an Audit of Financial Statements
- Audit Planning and Supervision
- Identifying and Assessing Risks of Material Misstatement
- The Auditor's Responses to the Risks of Material Misstatement
- Evaluating Audit Results
- Consideration of Materiality in Planning and Performing an Audit
- Audit Evidence

.352 In February 2009, the CAQ issued a comment letter on the proposed standards. Readers can review the full text of the comment letter at <http://thecaq.org/newsroom/pdfs/CAQCommentLetterPCAOBRiskAssessmentAuditStds.pdf>. The comment period for these proposed standards ended in February 2009. As with any new auditing standard or amendment to a PCAOB standard, after adoption by the PCAOB, the standards will be submitted to the SEC for approval.

## Accounting Pipeline

### *FASB and IASB Memorandum of Understanding*

.353 In September 2008, FASB and the IASB updated their "Memorandum of Understanding" (MoU), originally published in 2006, to reaffirm their respective commitments to the development of high quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting. In developing the original MoU, FASB and the IASB agreed on priorities and established milestones as part of a joint work program to develop



new common standards that improve the financial information reported to investors. FASB and the IASB agreed that the goal of joint projects is to produce common, principles-based standards, subject to the required due process. In the MoU, FASB and the IASB identified the following 11 convergence topics to focus on:

- Business combinations
- Financial instruments
- Financial statement presentation
- Intangible assets
- Leases
- Liabilities and equity distinctions
- Revenue recognition
- Consolidations
- Derecognition
- Fair value measurement
- Postemployment benefits (including pensions)

**.354** Both FASB and the IASB note that their individual and joint efforts are not limited to the preceding items, but they remain committed to the MoU. FASB and the IASB also have several other joint projects in process, including the conceptual framework project, emissions trading schemes, insurance contracts, and income taxes.

**.355** Readers also are encouraged to monitor developments on the AICPA's Web site [www.ifrs.com](http://www.ifrs.com) in addition to the FASB, IASB, and SEC Web sites. The growing acceptance of IFRSs as a basis for U.S. financial reporting could represent a fundamental change for the U.S. accounting profession.

### ***Other Accounting Projects***

**.356** Additionally, FASB has the following projects underway:

- Going concern
- Credit crisis projects that include the following:
  - Measuring liabilities under FASB ASC 820
  - Embedded credit derivatives scope exceptions
  - Recoveries of other-than-temporary impairments
  - Improving disclosures about fair value measurements
  - Applying fair value to interests in alternative investments
- Phase 2 of the applicability of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109*, for private entities (FASB Interpretation No. 48 is codified at FASB ASC 740, *Income Taxes*)
- Disclosure of certain loss contingencies
- Loan loss disclosures, as previously noted
- Disclosure framework
- Phase 2 of postretirement benefit obligations, including pensions

- Oil and gas disclosures
- Treatment of base jackpot liabilities of casinos

.357 FASB and the IASB established an advisory group, the Financial Crisis Advisory Group (FCAG), which is composed of senior leaders with international experience in financial markets. The FCAG will advise FASB and the IASB about the standard setting implications of the global financial crisis as well as changes to the global regulatory environment. Readers should refer to <http://fasb.org/fcag/index.shtml> for additional information and for access to reports recently issued by the FCAG.

## Resource Central

.358 The following are various resources that practitioners engaged in the financial institutions and securities and commodities industries may find beneficial.

## Publications

.359 Practitioners may find the following publications useful. Choose the format best for you—online, print, or CD-ROM.

- Audit and Accounting Guide *Depository and Lending Institutions: Banks and Savings Institutions, Credit Unions, Finance Companies, and Mortgage Companies* (2009) (product no. 012739 [paperback], WDL-XX [online with the associated Audit Risk Alert], or DDL-XX [CD-ROM with the associated Audit Risk Alert])
- Audit and Accounting Guide *Brokers and Dealers in Securities* (2009) (product no. 012709 [paperback], WBR-XX [online], or DBR-XX [CD-ROM])
- Audit and Accounting Guide *Investment Companies* (2009) (product no. 012629 [paperback], WIN-XX [online with the associated Audit Risk Alert], or DIN-XX [CD-ROM with the associated Audit Risk Alert])
- Audit Guide *Analytical Procedures* (2008) (product no. 012558 [paperback], WAN-XX [online], or DAN-XX [CD-ROM])
- Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* (2006) (product no. 012456 [paperback] or WRA-XX [online])
- Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (2009) (product no. 012529 [paperback] or DDI-XX [CD-ROM])
- Audit Guide *Auditing Revenue in Certain Industries* (2009) (product no. 012519 [paperback], WAR-XX [online], or DAR-XX [CD-ROM])
- Audit Guide *Audit Sampling* (2008) (product no. 012538 [paperback], WAS-XX [online], or DAS-XX [CD-ROM])
- Audit Guide *Service Organizations: Applying SAS No. 70, as Amended* (2009) (product no. 012779 [paperback], WSV-XX [online], or DSV-XX [CD-ROM])

- Audit Risk Alert *Current Economic Instability: Accounting and Auditing Considerations—2009* (product no. 0223309 [paperback], WGE-XX [online], or DGE-XX [CD-ROM])
- Audit Risk Alert *Independence and Ethics Developments—2009* (product no. 0224709 [paperback], WIA-XX [online], or DIA-XX [CD-ROM])
- *Checklists and Illustrative Financial Statements for Depository and Lending Institutions* (product no. 008919 [paperback] or WDP-CL [online])
- *Checklists and Illustrative Financial Statements for Corporations* (product no. 008939 [paperback] or WCP-CL [online])
- *Accounting Trends & Techniques, 62nd Edition* (product no. 009900 [paperback] or WAT-XX [online])
- *Audit and Accounting Manual (2009)* (product no. 0051309 [paperback], WAM-XX [online], or AAM-XX [loose leaf])
- Audit and Accounting Practice Aid *Independence Compliance: Checklists and Tools for Complying With AICPA, SEC, and PCAOB Independence Requirements* (product no. 006660 [paperback])

**.360** The recently issued AICPA Practice Aid *Audits of Futures Commission Merchants, Introducing Brokers, and Commodity Pools, Second Edition* provides guidance for audits of FCMs, introducing brokers and commodity pools (collectively referred to as commodity entities). This practice aid is intended to provide practitioners with nonauthoritative practical guidance related to the special matters unique to the regulatory, accounting, and auditing aspects of this industry. It includes an overview of the commodity industry and a discussion of a commodity entity's functions, books, and records, including regulatory recordkeeping requirements.

**.361** This second edition, prepared by the AICPA Commodity Practice Aid Task Force, has been revised to provide industry specific guidance for commodity entities. It includes exhibits containing both sample letters and sample reports to assist auditors in reporting on the financial statements and other written assertions of commodity entities.

**.362** Additional resources for accountants in business and industry are the Financial Reporting Alert series, designed to be used by members of an entity's financial management and audit committee to identify and understand current accounting and regulatory developments affecting the entity's financial reporting.

- Financial Reporting Alert *Current Economic Crisis: Accounting Issues and Risks for Financial Management and Reporting—2009* (product no. 0292009 [paperback])

### AICPA reSOURCE: Accounting and Auditing Literature

**.363** 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, you can sign up for access to the entire library. Get access—anytime, anywhere—to FASB ASC, the AICPA's latest *Professional Standards, Technical Practice Aids*, Audit and Accounting Guides, Audit Risk Alerts, *Accounting Trends & Techniques*, and more. To subscribe to this essential online service for accounting professionals, visit [www.cpa2biz.com](http://www.cpa2biz.com).

### ***AICPA Accounting Guidance Library***

**.364** AICPA reSOURCE Online now offers FASB ASC. As discussed previously in this alert, FASB ASC significantly changes the structure and hierarchy of accounting and reporting standards into a topically organized format.

**.365** In this extraordinary member value, the AICPA is offering online access to FASB ASC along with our most popular Audit and Accounting Guides for only \$659 for a one year subscription (product number WGC-XX).

**.366** This new library gives you online access to FASB ASC and the following AICPA Audit and Accounting Guides:

- *Depository and Lending Institutions*
- *Construction Contractors*
- *Employee Benefit Plans*
- *Investment Companies*
- *Life and Health Insurance Entities*
- *Not-for-Profit Entities*
- *Property and Liability Insurance Entities*

**.367** The guides have been fully conformed and linked to FASB ASC and will help ease your transition to the new structure. In addition, these guides provide a key entry point to understanding the impact of FASB ASC on your work.

**.368** While working in FASB ASC on AICPA reSOURCE Online, you will be able to do the following:

- Perform a full-text search.
- Browse by topic.
- Use quick go to navigation to a specific FASB ASC reference.
- Access a cross reference report that identifies where legacy material is now located and link directly to that content.
- View the source of the codified content.
- Join sections and subsections.
- Access an archive function of previous versions of FASB ASC content.
- See all FASB ASC content that links to a given paragraph.

**.369** Subscribe today and make the transition to the new FASB ASC at a member-only value price of \$659. Discounted multi user subscriptions are available for this library. To order, call 888-777-7077 or go to [www.cpa2biz.com](http://www.cpa2biz.com).

### **Continuing Professional Education**

**.370** The AICPA offers a number of CPE courses that are valuable to CPAs working in public practice and industry, including the following:

- *AICPA's Annual Accounting and Auditing Update Workshop (2009–2010 Edition)* (product no. 736185 [text] or 187193 [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. 736776 [text] or 186757 [DVD]). Confidently comply with the latest SEC reporting requirements with this comprehensive course. It clarifies new, difficult, and important reporting and disclosure requirements and gives you examples and tips for ensuring compliance.
- *International Versus U.S. Accounting: What in the World is the Difference?* (product no. 731667 [text]). Understanding the differences between IFRSs and U.S. GAAP is becoming more important for businesses of all sizes. This course outlines the major differences between IFRSs and U.S. GAAP.
- *The International Financial Reporting Standards: An Overview* (product no. 157220 [online] or 739750HS [CD-ROM]). This course captures a live presentation on IFRSs given to the AICPA board of directors.

**.371** Among the many courses, the following are specifically related to the depository and lending institutions industry:

- *Audits of Banks, Savings Institutions, Credit Unions, and Other Financial Institutions* (product no. 733441RZX [text]).

**.372** Visit [www.cpa2biz.com](http://www.cpa2biz.com) for a complete list of CPE courses.

### **Online CPE**

**.373** AICPA CPEExpress, offered exclusively through CPA2Biz, is the AICPA's flagship online learning product. AICPA members pay \$180 for a new subscription and \$149 for the annual renewal. Nonmembers pay \$435 for a new subscription and \$375 for the annual renewal. Divided into 1-credit and 2-credit courses that are available 24 hours a day, 7 days a week, AICPA CPEExpress offers hundreds of hours of learning in a wide variety of topics. Some topics of special interest to the depository and lending institutions include the following:

- Auditing Financial Institutions: Regulatory & Govt Supervision' plus 'Gen Audit & Reporting Issues'
- Auditing Financial Institutions: Loan Receivables
- Auditing Financial Institutions: Credit Losses
- Auditing Financial Institutions: Cash, Investments, Intangibles, Real Estate, and Deposit
- Auditing Financial Institutions: Equity, Capital and Capital Disclosures
- Auditing Financial Institutions: Income Taxes
- 2009 Public Company Update: SEC Guidance
- Consolidations and Business Combinations: Applying the Acquisition Method
- Consolidations and Business Combinations: Accounting for Non-controlling Interests
- 2009 Annual A&A Update: Recent FASB Pronouncements

**.374** To register or learn more, visit [www.cpa2biz.com](http://www.cpa2biz.com).

## Webcasts

**.375** 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*

**.376** The CFO Quarterly Roundtable Series, brought to you each calendar quarter via webcast, 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, 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*

**.377** 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.

### *IFRS Quarterly Webcast Series*

**.378** The IFRS Quarterly Webcast Series, brought to you each calendar quarter, is part of a multistep educational process to get practitioners, financial managers, and auditors up to speed on all aspects of IFRSs implementation. Over the course of the quarterly series, IFRSs will be covered in depth. International harmonization is quickly approaching, and this series will help both accountants and auditors stay abreast of the developments and changes they will need to implement.

## Member Service Center

**.379** To order AICPA products, receive information about AICPA activities, and get help with your membership questions, call the AICPA Service Operations Center at (888) 777-7077.

## Hotlines

### *Accounting and Auditing Technical Hotline*

**.380** Do you have a complex technical question about U.S. 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. The hotline is available from 9 a.m. to 8 p.m. EST on weekdays. You can reach the Technical Hotline at (877) 242-7212 or online at [www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+and+Auditing+Technical+Help/](http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+and+Auditing+Technical+Help/).

### ***Ethics Hotline***

**.381** 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 or by e-mail at [ethics@aicpa.org](mailto:ethics@aicpa.org).

### **Industry Conference**

**.382** The AICPA offers the annual National Conference on Banks & Savings Institutions in the fall of each year. The Banks and Savings conference is a three-day conference designed to update attendees on recent developments related to audit, accounting, regulatory, legislative, and tax issues affecting the industry. For further information about the conference, call (888) 777-7077 or visit [www.cpa2biz.com](http://www.cpa2biz.com).

**.383** The AICPA offers the annual National Conference on Credit Unions in the fall of each year. The Credit Union conference is a three-day conference designed to update attendees on recent developments related to the Credit Union industry. For further information about the conference, call (888) 777-7077 or visit [www.cpa2biz.com](http://www.cpa2biz.com).

**.384** The National Conference on the Securities Industry is co-sponsored by the AICPA and the Financial Management Division of the Securities Industry & Financial Markets Association (known as SIFMA) and is geared toward practitioners in public practice and in industry. This conference offers a two-day comprehensive update in industry, accounting and regulatory matters with key speakers from the SEC, Federal Reserve, FINRA, CFTC and the FASB.

### **The CAQ**

**.385** The CAQ, which is affiliated with the AICPA, was created to serve investors, public company auditors, and the markets. The CAQ's mission is to foster confidence in the audit process and 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.

**.386** 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 provides education, communication, representation, and other means to member firms that audit or are interested in auditing public companies. To learn more about the CAQ, visit <http://thecaq.aicpa.org>.

### **AICPA Industry Expert Panels**

**.387** For information about the activities of the AICPA Depository Institutions Industry Expert Panel, visit the panel's Web page at [www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/expertpanel\\_depository.htm](http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/expertpanel_depository.htm).

**.388** For information about the activities of the AICPA Stockbrokerage and Investment Banking Industry Expert Panel, visit the panel's Web page at [www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/expertpanel\\_stockbroker\\_investbank.htm](http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/expertpanel_stockbroker_investbank.htm).

### Industry Web Sites

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

<i>Organization</i>	<i>Web Site</i>
Federal Reserve Board	<a href="http://www.federalreserve.gov/">www.federalreserve.gov/</a>
Commodity Futures Trading Commission (CFTC)	<a href="http://www.cftc.gov">www.cftc.gov</a>
Federal Deposit Insurance Corporation (FDIC)	<a href="http://www.fdic.gov">www.fdic.gov</a>
Financial Crimes Enforcement Network (FinCEN)	<a href="http://www.fincen.gov/">www.fincen.gov/</a>
Financial Industry Regulatory Authority (FINRA)	<a href="http://www.finra.org/">www.finra.org/</a>
Futures Industry Association (FIA)	<a href="http://www.futuresindustry.org/">www.futuresindustry.org/</a>
Mortgage Bankers Association (MBA)	<a href="http://www.mbaa.org/">www.mbaa.org/</a>
National Credit Union Administration (NCUA)	<a href="http://www.ncua.gov/">www.ncua.gov/</a>
National Futures Association (NFA)	<a href="http://www.nfa.futures.org/">www.nfa.futures.org/</a>
Office of the Comptroller of the Currency (OCC)	<a href="http://www.occ.treas.gov/">www.occ.treas.gov/</a>
Office of Thrift Supervision (OTS)	<a href="http://www.ots.treas.gov/">www.ots.treas.gov/</a>
Securities Industry and Financial Markets Association (SIFMA)	<a href="http://www.sifma.org/">www.sifma.org/</a>

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

\* \* \* \*

**.391** This Audit Risk Alert replaces *Depository and Lending Institutions Industry Developments—2008* and *Securities Industry Developments—2008*.

**.392** The Audit Risk Alert *Financial Institutions Industry Developments, Including Depository and Lending Institutions and Brokers and Dealers in Securities* will be published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Audit Risk Alert, please feel



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free to share them with us. Any other comments that you have about the Audit Risk Alert also would be appreciated. You may e-mail these comments to [jwoods@aicpa.org](mailto:jwoods@aicpa.org) or write to

Jennifer Woods  
AICPA  
220 Leigh Farm Road  
Durham, NC 27707-8110

## Appendix—Additional Web Resources

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

<i>Web Site Name</i>	<i>Content</i>	<i>Web Site</i>
AICPA	Summaries of recent auditing and other professional standards, as well as other AICPA activities	www.aicpa.org www.cpa2biz.com www.ifrs.com
AICPA Accounting Standards Executive Committee	Summaries of recently issued guides, technical questions and answers, and practice bulletins containing financial, accounting, and reporting recommendations, among other things	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards
AICPA Professional Issues Task Force	Summaries of practice issues that appear to present concerns for practitioners and disseminate 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 analyses, data, forecasts, and information on the U.S. and world economies	www.economy.com
The Federal Reserve Board	Source of 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
Government Accountability Office	Policy and guidance materials and reports on federal agency major rules	www.gao.gov

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<i>Web Site Name</i>	<i>Content</i>	<i>Web Site</i>
International Accounting Standards Board	Summaries of International Financial Reporting Standards and International Accounting Standards	<a href="http://www.iasb.org">www.iasb.org</a>
International Auditing and Assurance Standards Board	Summaries of International Standards on Auditing	<a href="http://www.iaasb.org">www.iaasb.org</a>
International Federation of Accountants	Information on standards setting activities in the international arena	<a href="http://www.ifac.org">www.ifac.org</a>
Private Company Financial Reporting Committee	Information on the initiative to further improve FASB's standard setting process to consider needs of private companies and their constituents of financial reporting	<a href="http://www.pcfr.org">www.pcfr.org</a>
Public Company Accounting Oversight Board (PCAOB)	Information on accounting and auditing activities of the PCAOB and other matters	<a href="http://www.pcaob.org">www.pcaob.org</a>
Securities and Exchange Commission (SEC)	Information on current SEC rulemaking and the Electronic Data Gathering, Analysis, and Retrieval database	<a href="http://www.sec.gov">www.sec.gov</a>

