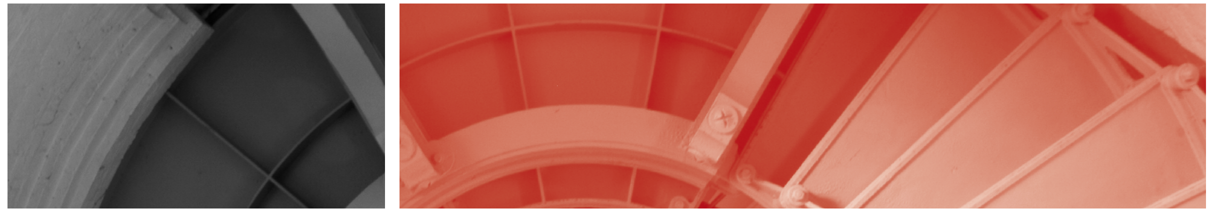
2013

Financial institutions industry developments : including depository and lending institutions and brokers and dealers in securities, 2013-14; Audit risk alerts

American Institute of Certified Public Accountants (AICPA)



AUDIT RISK ALERT

Financial Institutions Industry Developments:

Including Depository and Lending Institutions and Brokers and Dealers in Securities

2013/14

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

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Notice to Readers

This Audit Risk Alert (alert) replaces *Financial Institutions Developments: Including Depository and Lending Institutions and Brokers and Dealers in Securities—2012/13*.

This alert is intended to provide auditors of financial statements of financial institutions, including depository and lending institutions and brokers and 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. This 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-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards* (AICPA, *Professional Standards*). Other auditing publications have no authoritative status; however, they may help the auditor understand and apply generally accepted auditing standards.

In applying the auditing guidance included in an other auditing publication, the auditor should, using professional judgment, assess the relevance and appropriateness of such guidance to the circumstances of the audit. 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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The AICPA gratefully acknowledges those members of the Auditing Standards Board, the AICPA Depository and Lending Institutions Expert Panel, and the

AICPA Stockbrokerage and Investment Banking Expert Panel, who helped identify the interest areas for inclusion in this alert.

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The Audit Risk Alert *Financial Institutions Industry Developments: Including Depository and Lending Institutions and Brokers and Dealers in Securities* is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's alert, please feel free to share them with us. Any other comments you have about the alert also would be appreciated. You may e-mail these comments to A&APublications@aicpa.org.

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How This Alert Helps You

.01 This Audit Risk Alert (alert) helps you plan and perform your audits of financial institutions, including depository and lending institutions and brokers and dealers (broker-dealers) in securities, and also can be used by an entity's internal management to identify issues significant to the industry. It also 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 current accounting, auditing, and regulatory developments. For developing issues that may have a significant effect on the financial institutions industry in the near future, the "On the Horizon" section provides information on these topics, including guidance that either has been issued but is not yet effective or is in a development stage.

.02 This alert is intended to be used in conjunction with the Audit Risk Alert *General Accounting and Auditing Developments—2013/14* (product nos. ARAGEN13P [paperback], ARAGEN13E [e-book], or WGE-XX [AICPA Online Professional Library]), which explains important issues that affect all entities in all industries in the current economic climate. You should refer to the full text of accounting and auditing pronouncements, as well as the full text of any rules or publications that are discussed in this alert.

.03 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. Auditors obtain audit evidence to draw reasonable conclusions on which to base their opinion by performing the following:

- Risk assessment procedures
- Further audit procedures that comprise
    - — tests of controls, when required by generally accepted auditing standards (GAAS) or when the auditor has chosen to do so.
    - — substantive procedures that include tests of details and substantive analytical procedures.

.04 The auditor should develop an audit plan that includes, among other things, the nature and extent of planned risk assessment procedures, as determined under AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*). AU-C section 315 defines risk assessment procedures as the audit procedures performed to obtain an understanding of the entity and its environment, including the entity's internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and relevant assertion levels. As part of obtaining the required understanding of the entity and its environment, paragraph .12 of AU-C section 315 states that the auditor should obtain an understanding of the industry, regulatory, and other external factors, including the applicable financial reporting framework, relevant to the entity. This alert assists the auditor with this aspect of the risk assessment procedures and further expands the auditor's understanding of other important considerations relevant to the audit.

Economic and Industry Developments

Debt Crisis—U.S. Municipal and European Sovereign

.05 In the current environment, there continues to be an elevated level of (*a*) risk that certain issuers of state and municipal bonds and certain highly leveraged European governments could default on their debt obligations and (*b*) concern over the potential effect on price and price volatility for sovereign debt securities, currency exchange rates, and securities issued by the financial institutions that lend to these governments.

Municipal Bond Exposure

.06 Although, historically, relatively few state and local municipal bond issuers have defaulted on their bonds, the recent default and subsequent bankruptcy filing of the city of Detroit has led to concern over other cities and states facing similar fiscal crises. Cities under credit downgrade review by Moody's include Sante Fe, Cincinnati, Portland, and Minneapolis. And, cities such as Philadelphia and Chicago are having to make large payments because of significantly underfunded retirement obligations. Although some analysts, such as Standard and Poor's, view Detroit's default as idiosyncratic, deteriorating conditions characterized by sharp declines in tax revenues and increasing budget deficits may impede the ability of some municipalities to continue to make timely principal and interest payments on their obligations.

European Debt Crisis

.07 The debt crisis in the European Union (EU) continued to evolve during 2013 as austerity measures and bailout administration progressed in countries such as Spain, Greece, Italy, and Portugal. These efforts have generally tempered some concerns over the short-term collapse of these countries' governments and their respective banking systems. However, the underlying long-term and systemic risks and concerns of collapse have not been eliminated. The EU's statistics agency communicated that the August 2013 euro zone jobless rate was the highest ever recorded at 12.1 percent, and recent political instability in Portugal has raised new concerns about how austerity measures will be implemented in the future. Meanwhile, as the economy in the Republic of Cyprus continued to decline, a banking crisis occurred in 2013. The crisis was generally fueled by overleveraged banks and significant exposure to Greek and Cypriot governmental debt. The Cypriot crisis led to an EU bailout of approximately 10 billion euros, the closure of the country's second largest bank, and the "taxing" or "levying" of Cypriot bank deposits to help fund the bailout.

.08 Due to the interrelated lending relationships and the significant debt exposures between banks in Europe, losses in one country can significantly affect the stability of other countries. Losses could extend to U.S. financial institutions that have exposures to European banks, regardless of the country. For example, U.S. banks have a large exposure to French banks, which have substantial exposure to Italy, Greece, and Spain. U.S. financial institutions have taken steps to mitigate the exposure to European banks, which include reviewing and limiting counterparty exposures and building additional capital. In addition, another risk that has been discussed is that a country could leave the euro currency. Depending on the country and the conditions of the departure, such a change could have significant effects on the value of the euro currency.

.09 Paragraphs 20–21 of Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 825-10-50 explain that, except in certain scenarios, an entity should disclose all significant concentrations of credit risk arising from all financial instruments, whether from an individual counterparty or groups of counterparties. The following should be disclosed about each significant concentration:

- Information about the (shared) activity, region, or economic characteristic that identifies the concentration
- The maximum amount of loss due to credit risk that, based on the gross fair value of the financial instrument, the entity would incur if parties to the financial instruments that make up the concentration completely failed to perform according to the terms of the contracts and the collateral or other security, if any, for the amount due, proved to be of no value to the entity
- With respect to collateral, all of the following:
  - — The entity's policy of requiring collateral or other security to support financial instruments subject to credit risk
  - — Information about the entity's access to that collateral or other security
  - — The nature and a brief description of the collateral or other security supporting those financial instruments
- With respect to master netting arrangements, all of the following:
  - — The entity's policy of entering into master netting arrangements to mitigate the credit risk of financial instruments
  - — Information about the arrangements for which the entity is a party
  - — A brief description of the terms of those arrangements, including the extent to which they would reduce the entity's maximum amount of loss due to credit risk

.10 Entities should evaluate any concentrations of credit risk to determine whether these disclosures are appropriate under the circumstances.

Conclusions Over Debt Crisis

.11 Financial institutions should continue to review their portfolios for direct or indirect exposures to any affected nations in the eurozone and their financial instruments. Financial institutions should consider the effect of increased credit risk on the allowance for loan and lease losses (ALLL), fair value of financial instruments, and other-than-temporary impairment of debt securities along with the related disclosures and the disclosure related to significant risks and uncertainties. Readers may consider reviewing the Public Company Accounting Oversight Board's (PCAOB's) observations related to audit risk areas (which include deficiencies involved in ALLL and fair value measurements) and the SEC Division of Corporation Finance's disclosure guidance surrounding European sovereign debt. The PCAOB's observations can be found in the "Audit and Accounting Developments" section of this alert. The SEC European sovereign debt disclosure guidance can be accessed from the Division of Corporation Finance: Disclosure Guidance page on the SEC website at www.sec.gov.

Banks and Savings Institutions

.12 Collectively, net income for insured depository institutions (IDIs) as of June 30, 2013, has improved year-over-year for the sixteenth consecutive quarter as the benefits of reduced expenses for loan losses and rising noninterest income exceeded the declines in the net interest margin. In Martin J. Gruenberg's, Federal Deposit Insurance Corporation (FDIC) Chairman, August 29, 2013, remarks on the second quarter 2013 *FDIC Quarterly Banking Profile*, he noted that loan loss provision reductions are attributable to an overall improvement in asset quality, which was shared by institutions of all sizes. Greuenberg further noted that although allowance releases have been a primary driver of earnings growth in the industry in recent years, declines in loss provisions are anticipated to stabilize and future earnings will be increasingly dependent on interest revenues. This could bring challenges to the banking industry as narrow net interest margins and modest loan growth have made it difficult for banks to increase interest revenue.

.13 The recent rise in interest rates led to the largest nominal decline in the value of available-for-sale securities during a quarter since 1994. Although unrealized gains and losses on available-for-sale securities do not affect current earnings, they have the potential for implications on future earnings if the securities are sold. In addition, under the new Basel III capital rules, such losses will now affect regulatory capital for the 16 largest U.S. banking organizations subject to the advanced approaches requirements (beginning January 1, 2014), as well as other institutions that do not choose the accumulated other comprehensive income (AOCI) opt out election (beginning January 1, 2015). Further discussion on Basel III capital rules related to accumulated other comprehensive income can be found in the "Legislative and Regulatory Developments" section of this alert.

.14 The number of insured commercial banks and savings institutions continued to decline primarily as a result of continued bank mergers and bank failures. The year-over-year trend in bank failures has continued to improve with twenty failed insured institutions as of June 30, 2013, compared to 40 failures as of June 30, 2012. In addition, the number of insured institutions on the FDIC Problem Bank List declined for a ninth consecutive quarter and the total assets of "problem" banks also continued to fall.

OCC Semiannual Risk Perspective

.15 The Officer of the Comptroller of the Currency's (OCC's) National Risk Committee (NRC) monitors the condition of the federal banking system and emerging threats to the system's safety and soundness. The OCC's NRC has been publishing a *Semiannual Risk Perspective* to address key risks facing the banking industry. Specifically, the most recent spring 2013 report, highlighted the following risks:

- Strategic risk remains high and continues to increase for many banks as they re-evaluate their strategy and business models to generate returns amid slow economic growth, low rates, and regulatory requirements.
- Cyber threats continue to grow in sophistication and require heightened awareness and appropriate resources to identify and mitigate the associated risks.

- Although demand for domestic loans, particularly commercial loans, has improved, increased competition for limited commercial and industrial lending opportunities, specifically leveraged lending, is weakening underwriting standards.
- The low interest rate environment increases vulnerability for banks that reach for yield, as they could experience significant earnings pressure.
- Bank Secrecy Act and Anti-Money Laundering risks are on the rise as money laundering methods evolve, electronic bank fraud increases in volume and sophistication, and banks fail to evolve or incorporate appropriate controls into new products and services.

Readers are encouraged to review the full report on the OCC website at www.occ.gov.

Credit Unions

.16 Federally insured credit unions (FICUs) reported new highs in credit unions' total assets toping over $1 trillion, net worth exceeding $111 billion, and membership exceeding 95 million in 2013 according to June 2013 Call Report data submitted to and compiled by the National Credit Union Administration (NCUA). Although the number of FICUs fell, 95.2 million members belonged to a credit union, which was a new record high for the credit union industry.

.17 Despite the many encouraging trends, supervisory concerns remain in interest rate risk (IRR), liquidity risk, and concentration risk. In addition, emerging concerns have been raised over investments in less established or complex products (for example, private student loans or investments associated with credit union-funded employee benefit programs).

.18 Readers may find the most recent financial trends on FICUs, which are issued quarterly, through the 5300 Call Report Quarterly Data Web page on the NCUA website at www.ncua.gov. In addition, the NCUA provides a monthly economic update that focuses on the recent trends in the U.S. economy and their possible effects on credit unions.

Mortgage Banking

Mortgage Refinancing and Originations

.19 As mortgage rates continue to climb, it is anticipated that refinancing will continue to drop at a fairly rapid pace, because many borrowers have already locked in lower rates over the past several years. Home prices are also expected to continue to increase, and home sales indicators reflect that the inventory of homes for sale have started to grow again, both for new homes and previously owned homes. The Mortgage Bankers Association's (MBA's) measure of credit availability, the MCAI, indicates that the supply of mortgage credit has increased from May through August. In combination, the MBA believes these factors point to more purchase activity over the next year, despite the rising rates.

Mortgage Loan Delinquencies and Foreclosures

.20 According to the MBA's *National Delinquency Survey*, as of the end of the second quarter of 2013, the delinquency rate for mortgage loans on residential properties of 1 to 4 units was at a seasonally adjusted rate of 6.96

percent of all loans outstanding.[1] This rate represented a decrease of 62 basis points from 1 year ago and a decrease of 29 basis points over the prior quarter.

.21 The percentage of mortgages that entered the foreclosure process decreased to 0.64 percent during the second quarter of 2013 and reached the lowest level since the first quarter of 2007 and less than half of the all-time high of 1.42 percent in September 2009. The percentage of mortgages in the foreclosure process at the end of the second quarter was 3.33 percent, representing a 22 basis point drop from the first quarter and 94 basis points from the second quarter of 2012.

.22 Although overall foreclosure rates have been on the decline, MBA's Chief Economist and SVP of Research and Economics, Jay Brinkmann, noted that states with a judicial foreclosure system continue to bear a disproportionate share of the foreclosure backlog. For example, New York and Connecticut have seen an all-time high in new foreclosures and foreclosure percentages. And, New York's rate of new foreclosures is now almost equivalent to Florida's, which still leads the country at a 1.1 percent rate of foreclosures started during the second quarter of 2013. Brinkmann further attributed inconsistent delinquency and foreclosure rates throughout the nation to the condition of economic growth within regions.

Broker-Dealers in Securities

.23 Broker-dealers face significant challenges with a highly competitive and evolving marketplace, increasing pressure on profit margins, and the prospect of dramatically more stringent regulation as discussed throughout this alert. At an increasing pace, the SEC, the Commodity Futures Trading Commission (CFTC), the Financial Industry Regulatory Authority (FINRA), the PCAOB, and other financial regulators are proposing, refining, and implementing numerous regulations including those necessary for meeting the requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act). Broker-dealers can no longer rely on proprietary trading to generate revenue because of Section 619 of the Dodd Frank Act (commonly referred to as the Volcker Rule). Merger and acquisition (M&A) activity has been stagnant resulting in diminished M&A fee related revenues.

.24 Lasting economic uncertainties stemming from the financial crisis of 2008 and intensifying systemic pressures in response to the crisis are continuing to hinder profit margins. Opportunities to increase revenues remain elusive, and the market exerts constant pressure on pricing. During the first half of 2013, interest rates in the bond market rose, and trading volumes in the U.S. stock markets have continued on a decreasing trend. Markets are transitioning to alternative and electronic high frequency trading platforms.

.25 As of June 2013, FINRA oversaw approximately 4,200 brokerage firms, which is consistent with the number of firms in 2012 and well below the 5,000 firms registered prior to 2008. The reductions in the number of firms over the last few years are primarily the result of merger and acquisition transactions, including divestitures, acquisitions, or some other form of ownership change

[1] According to the Mortgage Bankers Association's *National Delinquency Survey*, as of June 30, 2013, the delinquency rate includes loans that are at least one payment past due but does not include loans in the process of foreclosure.

in addition to firms that have left the business. Some expect the consolidation trend to continue for the next 3 to 5 years as the larger firms acquire the smaller or mid-sized independent broker-dealers in response to the pressure on margins. As of mid-2013, FINRA was supervising approximately 630,000 registered representatives, which is consistent with 2012, but below 2008 levels, according to the FINRA website.

.26 Compliance with the Dodd-Frank Act, FINRA regulations, including off-balance sheet reporting, and other new regulatory requirements, may entail considerable investments in technology or third-party services, which will continue to add pressure to the bottom line for broker-dealers. Unless there is a significant change in the economic environment, which does not seem to be on the horizon, the mainstay business models for sales and trading will continue to be confronted with uncertainty.

Commodities

.27 Comparing the first 3 months of 2013 to the same period in 2012, we can see a one-half percent increase in global futures and options contract volume, from 5.38 billion contracts to 5.41 billion. In the first 3 months of 2013, volume on U.S. futures exchanges was 1.9 billion contracts, a 1.8 percent increase from the same period in 2012. Volume traded on foreign exchanges amounted to 3.5 billion contracts in the first 3 months of 2013, a 0.2 percent increase from the same 2012 period. These modest increases reflect the significant effect of the steep decline in the trading of Kospi options, which were at the top of the volume tables for nearly a decade. The decline resulted from the quintupling of the price of such options engendered by Korean authorities' concern that too many retail investors were speculating on the direction of the stock market.

.28 Trading volume in interest rate and equity products continued to account for well over half of worldwide trading volume.

.29 The total amounts required under CFTC regulations to be held in segregated or secured accounts (including retail foreign exchange obligations of $248 million) on behalf of futures commission merchant (FCM) customers decreased from March 31, 2012, by $5 billion to approximately $181 billion as of March 31, 2013.

.30 Volume for centrally cleared over-the-counter derivatives rebounded during the first quarter of 2013 after a relatively quiet fourth quarter at major clearinghouses.

Legislative and Regulatory Developments

Dodd-Frank Act Regulations

.31 The Dodd-Frank Act was signed into law by President Obama on July 21, 2010. It aims to promote U.S. financial stability by improving accountability and transparency in the financial system, putting an end to the notion of "too big to fail," protecting American taxpayers by ending bailouts, and protecting consumers from abusive financial services practices.

.32 Of the approximately 400 rules mandated by the act, it is estimated that 39.7 percent of the rules had been finalized as of the 3 year anniversary of the passage of the act. Furthermore, approximately 31.9 percent had not yet been proposed, and 28.4 percent have been proposed but need further action. It is clear from these numbers that regulators have considerable work yet to do in finalizing the rules mandated by the Dodd-Frank Act.

.33 The effects of the Dodd-Frank Act reforms on capital markets and credit availability are difficult to predict. The reforms have a widespread effect, and it may take years to evaluate the effects. Although strengthening transparency is an appropriate response to the recent economic recession, it is yet to be seen how the substantial regulatory changes will affect the financial system and economic recovery.

.34 Auditors should be cognizant of these changes and assess the effects of noncompliance on financial reporting and, if applicable to the engagement, internal controls over financial reporting. In addition, due to the volume of new compliance reporting requirements and disclosures, compliance costs for financial institutions could significantly increase. Thus, the new regulatory environment could lead to increased mergers and consolidations as entities consider the regulatory burden associated with the Dodd-Frank Act. Auditors should also consider the effect of regulatory compliance on the internal audit functions (that is, the potential internal audit resource limitations due to the shifted focus on regulatory compliance in comparison with financial reporting and internal control). This may be an important factor in the auditor's determination of the reliance that he or she may place on the institution's internal audit department, especially with respect to audits of internal control over financial reporting.

Appraisals for Higher-Priced Mortgage Loans

.35 In January 2013, the Board of Governors of the Federal Reserve System (Federal Reserve), the Consumer Financial Protection Bureau, the FDIC, the Federal Housing Finance Agency (FHFA), the NCUA, and the OCC issued a final rule Appraisals for Higher-Priced Mortgage Loans to establish new appraisal requirements for higher-priced mortgage loans. Higher-priced mortgages are those mortgages with an annual percentage rate that exceeds the average prime offer rate by a specified percentage.

.36 For higher-priced mortgage loans, the rule requires creditors to use a licensed or certified appraiser who prepares a written appraisal report based on a physical inspection of the interior of the property. The rule also requires creditors to disclose to applicants information about the purpose of the appraisal and provide consumers with a free copy of any appraisal report. If the seller acquired the property for a lower price during the prior six months and the price difference exceeds certain thresholds, creditors will have to obtain a second appraisal at no cost to the consumer. This requirement for higher-priced home-purchase mortgage loans is intended to address fraudulent property flipping by seeking to ensure that the value of the property legitimately increased.

.37 The rule exempts several types of loans, such as qualified mortgages, temporary bridge loans and construction loans, loans for new manufactured homes, and loans for mobile homes, trailers and boats that are dwellings. The rule also has exemptions from the second appraisal requirement to facilitate loans in rural areas and other transactions. Readers can access the full-text of this final rule from any of the respective agencies' websites.

Lending Limits

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

.39 In June 2013, the OCC finalized its lending limits interim rule, which consolidated the lending limits rules applicable to national banks and savings associations, removed the separate OCC regulation governing lending limits for savings associations, and implemented section 610 of the Dodd-Frank Act. The final rule outlines the methods that banks can choose from to measure credit exposures of derivative transactions and securities financing transactions. A bank may choose which method it will use; however, the OCC may specify that a bank use a particular method for safety and soundness reasons. Banks may request OCC approval to use a different method to calculate credit exposure for certain transactions. If the Model Method[2] is used, the OCC must approve the use of the model and any subsequent changes to an approved model. The final rule continues to provide that loans and extensions of credit, including those that arise from derivative transactions and securities financing transactions, must be consistent with safe and sound banking practices.

Derivative Transactions

.40 Banks can generally choose to measure the credit exposure of derivative transactions through

- the Conversion Factor Matrix Method.[3]
- the Current Exposure Method.[4]
- an OCC-approved internal model.

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

Securities Financing Transactions

.42 The final rule specifically exempts securities financing transactions relating to Type I securities (such as U.S. or state government obligations) from

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

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

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

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

- Locking in the attributable exposure based on the type of transaction
- Using an OCC-approved internal model
- Using the Basel Collateral Haircut Method[5]

Information for Community Banks

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

Clearing Agency Standards

.44 SEC Rule 17Ad-22, *Clearing Agency Standards*, issued in October 2012, establishes minimum requirements regarding how registered clearing agencies must maintain effective risk management procedures and controls as well as meet the statutory requirements under the Exchange Act on an ongoing basis. Each registered clearing agency should establish, implement, maintain and enforce written policies and procedures reasonably designed to meet the criteria outlined in SEC Rule 17Ad-22(d), as applicable. Additionally, a registered clearing agency that performs central counterparty services should establish, implement, maintain, and enforce written policies and procedures reasonably designed to meet the criteria outlined in SEC Rule 17Ad-22(b).

.45 In accordance with subsection (c), "Record of Financial Resources and Annual Audited Financial Statements," of SEC Rule 17Ad-22

- each fiscal quarter (based on calculations made as of the last business day of the clearing agency's fiscal quarter), or at any time upon SEC request, a registered clearing agency that performs central counterparty services should calculate and maintain a record, in accordance with SEC Rule 17a-1, of the financial resources necessary to meet the requirements of SEC Rule 17Ad-22(b)(3), and sufficient documentation to explain the methodology it uses to compute such financial resource requirement; and

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

- within 60 days after the end of its fiscal year, each registered clearing agency shall post on its website its annual audited financial statements. Such financial statements should
  - — include, for the clearing agency and its subsidiaries, consolidated balance sheets as of the end of the two most recent fiscal years and statements of income, changes in stockholders' equity and other comprehensive income and cash flows for each of the two most recent fiscal years;
  - — be prepared in accordance with U.S. generally accepted accounting principles (GAAP), except that for a clearing agency that is a corporation or other organization incorporated or organized under the laws of any foreign country the consolidated financial statements may be prepared in accordance with GAAP or International Financial Reporting Standards as issued by the International Accounting Standards Board;
  - — be audited in accordance with standards of the PCAOB by a registered public accounting firm that is qualified and independent in accordance with section 2-01 "Qualifications of Accountants" of SEC Regulation S-X; and
  - — include a report of the registered public accounting firm that complies with section 2-02 "Accountants' Reports and Attestation Reports" of SEC Regulation S-X.

.46 These amendments were effective on January 2, 2013.

Lost Securityholders and Unresponsive Payees

.47 SEC Rule 17Ad-17, *Lost Securityholders and Unresponsive Payees*, was originally issued in 1997 to address situations where recordkeeping transfer agents have lost contact with securityholders. The rule requires such transfer agents to exercise reasonable care to obtain the correct addresses of these "lost securityholders" and to conduct certain database searches to locate them. At that time, the SEC noted that such loss of contact can be harmful to securityholders because they no longer receive corporate communications or the interest and dividend payments to which they may be entitled. Additionally, the securities and any related interest and dividend payments to which the securityholders may be entitled are often placed at risk of being deemed abandoned under operation of state escheatment laws. This loss of contact most frequently results from (*a*) failure of a securityholder to notify the transfer agent of his correct address after relocating or (*b*) failure of the estate of a deceased securityholder to notify the transfer agent of the death of the securityholder and the name and address of the trustee/administrator for the estate.

.48 The Dodd-Frank Act added a requirement for the SEC to revise Rule 17Ad-17 to extend to brokers and dealers the rule's requirement that recordkeeping transfer agents search for "lost securityholders" (as defined in the rule). To comply with this requirement, the SEC issued Release No. 34-68668 in January 2013. The requirements in SEC Rule 17Ad-17(a) state that

- every broker or dealer that has customer security accounts that include accounts of lost securityholders should exercise reasonable care to ascertain the correct addresses of such securityholders. To meet this requirement, the broker or dealer should conduct two database searches using at least one information database service. The search should be conducted using the taxpayer identification number or name, if a search based on the taxpayer identification number is not reasonably likely to locate the securityholder. Such database searches must be conducted without charge to a lost securityholder and with the following frequency:

- — Between three and twelve months of such securityholder becoming a lost securityholder; and
- — Between six and twelve months after the first search for such lost securityholder.

- a transfer agent, broker, or dealer may not use a search method or service to establish contact with lost securityholders that results in a charge to a lost securityholder prior to completing the searches set forth in paragraph (a)(1) of SEC Rule 17Ad-17.

.49 The rule also outlines the circumstances in which a transfer agent, broker, or dealer is not required to conduct searches.

.50 As discussed in subsection (c) of SEC Rule 17Ad-17, a securityholder should be considered an "unresponsive payee" if a check is sent from the paying agent to the securityholder and the check is not negotiated before the earlier of the paying agent's sending of the next regularly scheduled check or the elapsing of six months (or 180 days) after the sending of the original non-negotiated check. A securityholder should no longer be considered an unresponsive payee when the securityholder negotiates the check or checks that caused the securityholder to be considered an unresponsive payee.

.51 The paying agent must provide a single written notification to each unresponsive payee no later than seven months (or 210 days) after the sending of any not yet negotiated check to inform the unresponsive payee that a check was sent and that it has not yet been negotiated. SEC Rule 17Ad-17 also (*a*) provides an exclusion for paying agents from the notification requirements when the value of the not yet negotiated check is less than $25; and (*b*) adds a provision to make clear that the notification requirements imposed on paying agents shall have no effect on state escheatment laws.

.52 These amendments were effective on March 25, 2013. The compliance date is January 23, 2014.

Regulation S–ID: Identity Theft Red Flags

.53 In April 2013 the SEC issued Rule 17-248–Subpart C, "Regulation S–ID: Identity Theft Red Flags." This final rule was issued jointly with the CFTC to require certain regulated entities to establish programs to address risks of identity theft. There are two main requirements addressed in the rules:

- Financial institutions and creditors are required to develop and implement a written identity theft prevention program designed to detect, prevent, and mitigate identity theft in connection with certain existing accounts or the opening of new accounts. The program must be appropriate to the size and complexity of the financial institution or creditor and the nature and scope of its activities. The rules include guidelines to assist entities in the formulation and maintenance of programs that would satisfy the requirements of the rules.

- There are special requirements for any credit and debit card issuers that are subject to the Commissions' respective enforcement authorities, to assess the validity of notifications of changes of address under certain circumstances.

Update on Derivatives

.54 Prior to the Dodd-Frank Act there was no comprehensive framework for regulating swap agreements. The Dodd-Frank Act addresses the gap in the regulation of over-the-counter (OTC) swaps by requiring a number of rulemakings in this area. The Act splits the responsibilities for swaps between the CFTC and the SEC. The SEC has regulatory authority over "security-based swaps," which fall under the definition of "security" under the Securities Exchange Act of 1934 (the 1934 Act) and the Securities Act of 1933 (the 1933 Act). The CFTC has primary regulatory authority over all other swaps, such as energy and agricultural swaps. The CFTC and SEC share authority over "mixed swaps," which are security-based swaps that also have a commodity component. In addition, the SEC has anti-fraud enforcement authority over swaps that are related to securities but that do not come within the definition of "security-based swap" (referred to as security-based swap agreements). To assist the SEC in this responsibility, the Dodd-Frank Act provides the SEC with access to information relating to security-based swap agreements in the possession of the CFTC and certain CFTC-regulated entities, such as derivatives clearing organizations (DCOs), designated contract markets, and swap data repositories.

.55 The rulemaking required under the Dodd-Frank Act related to swaps is extensive and involves both the SEC and CFTC. Recent rules have been finalized regarding key terms, such as swap, security-based swap, and security-based swap agreement, along with swap and security-based swap dealer (SD) and major swap and security-based swap participants.

.56 Additionally, among the Title VII requirements is central clearing of eligible OTC derivatives (including most swap agreements). Central clearing requires a central clearing party (CCP), also referred to as a DCO, that functions as an intermediary between the buyer and seller. Two distinct contracts are formed; one between the CCP and the buyer, and one between the CCP and the seller. This method is in contrast to the bilateral trading model that has historically been used in the OTC derivatives market, whereby the buyer and seller directly enter into the OTC derivative contract with no intermediary.

.57 A multiphase implementation of the central clearing requirement has occurred during 2013 for most interest rate swaps and credit default swaps regulated by the CFTC. The implementation dates varied based on the type of market participant. As outlined in the CFTC's November 28, 2012 Release No. PR6429-12, "CFTC Issues Clearing Determination for Certain Credit Default Swaps and Interest Rate Swaps," the central clearing implementation was required for swaps entered into on or after the following dates in 2013:

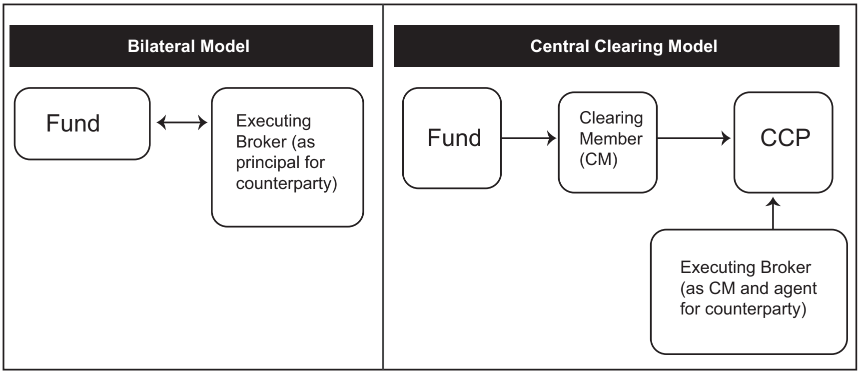
- March 11, 2013 for "phase 1" entities, including SDs, security-based SDs, major swap participants (MSPs), major security-based swap participants, or active funds.
- June 10, 2013 for "phase 2" entities, which generally include all other financial entities, with the exception of those in "phase 3" (see subsequent bullet point) and those entities who elect an exception from mandatory clearing under section 2(h)(7) of the Commodity Exchange Act (CEA). Commodity pools, private funds, and persons predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature, are included within the definition of phase 2 entities.
- September 9, 2013 for "phase 3" entities, which generally include ERISA pension plans, and all other accounts managed by third party investment managers.

.58 The following illustration summarizes the central clearing model rule writing period and implementation:

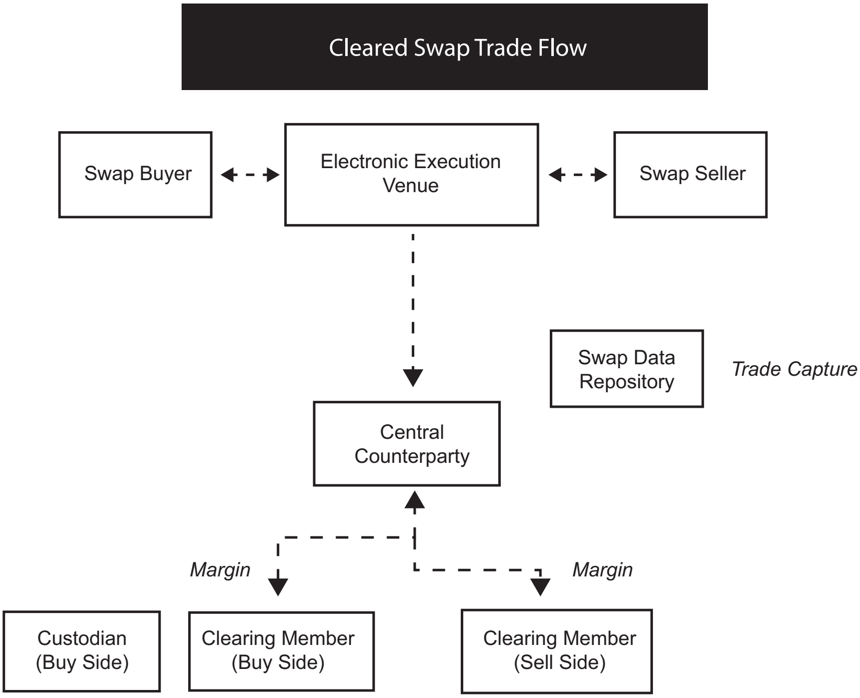
July 2010	Q1 2012	Q3/4 2012	Q1 2013	Q3 2013	Q2 2013
Dodd-Frank Financial Reform Bill signed	CCPs required to submit initial product list for clearing determination	Finalization of central clearing rules (CFTC)	Mandatory clearing for swap dealers, major swap participants, and “active funds”	Mandatory clearing for commodity pools, “private funds,” and persons predominately engaged in banking or finance	Mandatory clearing for managers of 3rd party subaccounts, pension funds, and all other persons not exempt from the clearing requirement

.59 The central clearing mandate intends to reduce counterparty default risk by incorporating a CCP margin reserve fund that guarantees the creditworthiness of both counterparties. The buyer and seller parties contribute margin requirements, through their respective clearing members, to the CCP's guarantee fund. These margin requirements include an "initial" margin requirement and subsequent "variation" margin requirements. The initial margin requirement is paid by both counterparties, through their clearing members, to the CCP when the centrally cleared swap contract is executed. This initial margin, typically in the form of cash or qualifying highly liquid, high quality short term securities, is held by the CCP in a default fund to be used in the event of default by a counterparty. Following the initiation of the contract, on a daily basis, the CCP marks the contract to market based on prevailing market prices. This incremental daily change in the derivative contract's value represents a net gain for one counterparty, and a net loss for the other counterparty. The value of the daily net loss represents the "variation" margin for that given day, which is settled daily by a cash transfer from the counterparty who incurred the net loss, via the clearing member, to the CCP.

.60 The following illustration explains the differences between the bilateral model and the central clearing model:



.61 The following illustration explains the trade flow in the central clearing model:



.62 Several accounting and reporting considerations arise in conjunction with the adoption and implementation of the central clearing requirements. These considerations may include, but are not limited to, the following:

- *Balance sheet offsetting considerations for centrally cleared derivative instruments, and related collateral, pursuant to FASB ASC 210,* Balance Sheet*, and FASB ASC 815,* Derivatives and Hedging. The terms of derivative contracts and master netting arrangements have likely been changed or amended through novation as central clearing is adopted and implemented. Entities may consider reviewing the revised and new contractual terms, and, with the assistance of legal counsel, reassess the gross or net balance sheet presentation conclusions (and related disclosure requirements established through FASB Accounting Standards Update (ASU) No. 2011-11, *Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities*). In doing so, an entity may consider the contract terms relative to the criteria in FASB ASC 210-20-45-1, which include the following:

  — Each of two parties owes the other determinable amounts
  — The reporting party has the right to set-off the amount owed with the amount owed by the other party
  — The reporting party intends to setoff
  — The right of setoff is enforceable at law

- *Principal and agent considerations for brokers or advisers who are acting as clearing members within the central clearing model.* Executing brokers may have commonly found themselves functioning as principals under the bilateral model, but may likely be considered agents between the counterparty and the CCP in the centrally cleared model. Considerations in FASB ASC 470-50-55 may be relevant guidance during an evaluation of principal and agent considerations. Executing brokers that transition from principal to agent would no longer record the derivatives on their balance sheet.
- *Initial and subsequent recognition for the various fees incurred under the central clearing model*. Fees associated with trading and management processes in the central clearing model may include, but are not limited to the following: upfront fees, clearing broker and member fees, CCP and clearing house fees (and related volume discounts), maintenance fees, and price alignment interest fees. As entities adopt and implement the central clearing requirement and such fees are incurred, entity management, and their auditors, may consider conducting an evaluation that (*a*) scrutinizes, with assistance from legal counsel as necessary, contractual arrangements and underlying terms to ensure all fees are identified and understood, then (*b*) determines the appropriate recognition method and accounting policy for each fee, based on relevant GAAP.
- *Hedge designation criteria*. FASB ASC 815 provides guidance on accounting for hedge transactions. Entities that utilize hedge accounting for existing derivative contracts may reassess the hedge designation criteria as the contract novation occurs (change from a bilateral trade contract to a centrally cleared trade contract).

Readers should consider all applicable provisions of the Dodd-Frank Act, Title VII, and related final and proposed rules of the CFTC and SEC.

CFTC Regulations

.63 As a result of the Dodd-Frank Act, the CFTC is writing rules to regulate the swaps marketplace. The CFTC is in an ongoing effort to complete this task. It has identified 38 areas where rules will be necessary. CFTC issued regulations (see www.cftc.gov/LawRegulation/DoddFrankAct/Rulemakings/

DF_1_Registration/index.htm) establishing a process for the registration of SDs and MSPs, including a provisional registration process pending effectiveness of final definitional regulations and regulations implementing compliance requirements under CEA section 4 to

- require SDs and MSPs to become and remain members of a registered futures association;
- subject push-out affiliates to the foregoing requirements, while not implementing any specific regulations with respect to their activities;
- prohibit any SD or MSP from permitting any person associated with it who is subject to a statutory disqualification to effect or be involved in effecting swaps on its behalf if the SD or MSP knows, or in the exercise of reasonable care should know, of the statutory disqualification;
- provide a limited exception to this prohibition for any person associated with an SD or MSP who has been duly listed as a principal or registered as an associated person of another registrant (for example, FCM, CPO, or CTA) notwithstanding that such person is subject to a statutory disqualification;
- provide that a statutory disqualification, for purposes of this prohibition, refers to a statutory disqualification under section 8a(2) or 8a(3) of the CEA; and
- clarify that a "person associated with a SD or MSP," for purposes of this prohibition, refers to an associated person, defined by the final regulations to mean a natural person with respect to a SD or MSP.

.64 The CFTC website contains proposals, final rules and staff no-action letters relating to compliance with this requirement.

Basel III

.65 In December of 2009, the Basel Committee approved for consultation a package of proposed measures to strengthen global capital and liquidity regulations and to strengthen the Basel II Framework. These proposed measures, commonly referred to as Basel III, aim to (*a*) improve the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source; (*b*) improve risk management and governance; and (*c*) strengthen banks' transparency and disclosures. The reforms target (*a*) bank-level, or microprudential, regulation, which will help raise individual banking institutions' resilience to periods of stress; (*b*) systemwide, or macroprudential, risks that can build up across the banking sector; and (*c*) the procyclical amplification of these risks over time. The Basel Committee's oversight body—the Group of Governors and Heads of Supervision—agreed on the broad framework of Basel III in September 2009, and the Basel Committee set out concrete proposals in December 2009. These consultative documents formed the basis of the Basel Committee's response to the financial crisis and are part of the global initiatives to strengthen the financial regulatory system that have been endorsed by the G-20 leaders. The Group of Governors and Heads of Supervision subsequently agreed on key design elements of the reform package at its July 2010 meeting and on the calibration and transition to implement the measures at its September 2010 meeting, including the definition of capital, the treatment of counterparty credit risk (CCR), the leverage ratio, and the global liquidity standard. In December 2010, the Basel Committee issued the finalized version of the Basel III rules, which were later revised in June 2011.

.66 Basel III regulations include (*a*) a tighter definition of tier 1 capital (banks must hold 4.5 percent by January 2015 and then a further 2.5 percent capital conservation buffer, totaling 7 percent); (*b*) the introduction of a leverage ratio; (*c*) a framework for countercyclical capital buffers; (*d*) measures to limit CCR; and (*e*) short and medium term quantitative liquidity ratios.

.67 In November 2011, the Basel Committee issued a final rule on the methodology for assessing global systemic importance and the amount of additional loss absorbency that global, systemically important financial institutions should maintain. The assessment methodology for determining global systemic importance is based on assessing a bank's size, interconnectedness, lack of substitutability, global activity, and complexity. The additional loss absorbency will be met with common equity tier 1 capital ranging from 1 percent to 2.5 percent, depending on the bank's systemic importance, with an empty bucket of 3.5 percent common equity tier I capital in an effort to discourage banks from becoming even more systemically important. The higher loss absorbency requirements will be introduced between January 1, 2016 and December 31, 2018, and will become fully effective on January 1, 2019.

.68 In December 2011, the Basel Committee issued, for comment, three separate proposals on the definition of capital disclosure requirements, the core principles for effective banking supervision, and the application of own credit risk adjustments to derivatives.

.69 The proposed disclosure requirements aim to improve the transparency and comparability of a bank's capital base. The proposal includes implementation of

- a common template to report the breakdown of a bank's regulatory capital when the transition period for phasing-in of deductions ends on January 1, 2018.
- a three step approach to ensure that the Basel III requirement to provide a full reconciliation of all regulatory capital elements back to the published financial statements is met in a consistent manner.
- a common template to provide a description of the main features of capital instruments.
- additional disclosure requirements, such as providing the full terms and conditions of capital instruments on banks' websites and reporting the calculation of any ratios involving components of regulatory capital.
- a modified version of the post-January 1, 2018, template addressed previously during the transitional phase.

.70 The proposal on the application of credit risk adjustments to derivatives suggests that debit valuation adjustments for OTC derivatives and securities financing transactions should be fully deducted in the calculation of tier 1 common equity. It also reviews other options for applying the underlying concept of paragraph 75 of the Basel III rules to these products and the Basel

Committee's rationale for not supporting these alternatives.[6] In July 2012, the Basel Committee issued a final rule on the treatment of credit risk adjustments on liabilities in core capital and also clarified in the final rule that adjustments to derivative liabilities for own credit cannot be offset by counterparty credit adjustments. The final rule can be found at www.bis.org/press/p120725b.htm.

.71 A compilation of documents that form the global regulatory framework for capital and liquidity and a progress report on Basel III implementation can be found on the Basel III page of the Bank for International Settlements website at www.bis.org.

U.S. Implementation of Basel III

.72 In July 2013, the OCC, the Federal Reserve, and the FDIC issued the new regulatory capital rules that implement both the Basel III capital framework issued by the Basel Committee and certain requirements imposed by the Dodd-Frank Act. The new rules also establish consolidated regulatory capital requirements for certain savings and loan holding companies. The new regulatory capital rules will replace the agencies' existing regulatory capital requirements, implement a minimum supplementary leverage ratio requirement for the large, internationally active banking organizations, and increase the quality and quantity of regulatory capital held by all banking organizations. The new rules include a revised definition of capital, a capital conservation buffer framework, and a standardized approach as well as an advanced approaches rule for calculating risk-weighted assets. The standardized approach is a non-models-based approach applicable to all U.S. banking organizations; the advanced approaches are models-based and apply only to the largest, internationally-active banking organizations, specifically those with $250 billion or more in total consolidated assets or total consolidated on-balance sheet foreign exposure of $10 billion or more (advanced approaches banking organizations). Advanced approaches banking organizations are required to calculate their capital ratios under both the standardized approach and the advanced approaches, and for advanced approaches banking organizations that have completed the parallel run process, the lower ratio is the ratio that it must use to determine compliance with the minimum capital requirements.[7] For advanced approaches banking organizations, the revised definition of capital and revised advanced approaches for measuring risk-weighted assets becomes effective January 1, 2014. Advanced approaches banking organizations must begin reporting the minimum supplementary leverage ratio on January 1, 2015 and complying with the ratio on January 1, 2018. For all other banking organizations, the revised definition of capital becomes effective January 1, 2015. The standardized approach for measuring risk-weighted assets becomes effective January 1, 2015 for all banking organizations. The capital conservation buffer becomes effective for all banking organizations on January 1, 2016.

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[6] Paragraph 75 of the Basel III rules states that a bank is required to derecognize in the calculation of tier I common equity all unrealized gains and losses that have resulted from changes in the fair value of liabilities that are due to changes in the bank's own credit risk.

[7] In 2014, advanced approaches banking organizations that have exited parallel run will use the general risk-based capital rules instead of the standardized approach.

Major Changes From the Current General Risk-Based Capital Rule and New Additional Requirements

.73 *Revisions to the minimum capital requirements and adjustments to prompt corrective action (PCA) thresholds*. The new rule implements higher minimum capital requirements, includes a new common equity tier 1 capital requirement, and establishes criteria that instruments must meet in order to be considered regulatory capital. More specifically, the new rule includes a minimum common equity tier 1 capital ratio of 4.5 percent of risk-weighted assets, a tier 1 capital ratio of 6.0 percent of risk-weighted assets (an increase from 4.0 percent), and a total capital ratio that remains at 8.0 percent of risk-weighted assets. The final rule also includes a minimum leverage ratio of tier 1 capital to average total assets of 4.0 percent. Moreover, Basel III introduces a capital conservation buffer that places limits on a banking organization's ability to make distributions and make discretionary bonus payments. Advanced approaches banking organizations are also subject to a countercyclical buffer, which acts as an extension of the capital conservation buffer, which would be activated by the banking agencies under certain economic conditions.

.74 The new rule also implements a minimum supplementary leverage ratio requirement for advanced approaches banking organizations whereby their tier 1 capital to total leverage exposure (which takes into account both on- and off-balance sheet assets) must be at least 3 percent. Advanced approaches banking organizations are required to calculate and report their minimum leverage ratio as of January 1, 2015, but they do not need to comply with the requirement until January 1, 2018.

.75 The capital thresholds for the different PCA categories will be updated to reflect the proposed changes to the definition of capital and the regulatory minimum rations. Likewise, the final rule augments the PCA capital categories by incorporating a common equity tier 1 capital measure. In addition, the final rule includes in the PCA framework the proposed supplementary leverage ratio requirement for advanced approaches banking organizations.

.76 Advanced approaches firms are required to calculate capital (the numerator of the regulatory capital ratios) under the new capital rules as of January 1, 2014, subject to transitional arrangements. During the period between January 1 and December 31, 2014, advanced approaches banking organizations in parallel run will calculate their risk-weighted assets (the denominator of the risk-based capital ratios) according to the general risk-based capital rules. Thereafter, these banking organizations will calculate their risk-weighted assets according to the standardized approach of the final rule. During the period between January 1 and December 31, 2014, advanced approaches banking organizations that have received approval from their primary federal supervisor to exit parallel run will calculate risk-weighted assets using both the general risk-based capital rules and the revised advanced approaches rules and use the lower of the two ratios for determining compliance with minimum regulatory requirements. Beginning January 1, 2015, advanced approaches banking organizations that have received approval from their primary federal supervisor to exit parallel run will calculate their risk-weighted assets using both the standardized approach and the revised advanced approaches and use the lower two ratios for determining compliance with minimum regulatory requirements.

Table 1: Transition Schedule for Regulatory Capital Levels

	1/1/14[1]	*1/1/15*	*1/1/16*	*1/1/17*	*1/1/18*	*1/1/19*
Minimum Common Equity Tier 1 Ratio	4.0%	4.5%	4.5%	4.5%	4.5%	4.5%
Capital Conservation Buffer[2]			0.625%	1.25%	1.875%	2.5%
Minimum Common Equity Tier 1 Ratio + Capital Conservation Buffer	4.0%	4.5%	5.125%	5.75%	6.375%	7.0%
Minimum Tier 1 Capital Ratio	5.5%	6.0%	6.0%	6.0%	6.0%	6.0%
Minimum Tier 1 Ratio + Capital Conservation Buffer	5.5%	6.0%	6.625%	7.25%	7.875%	8.5%
Minimum Total Capital Ratio	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%
Minimum Total Capital Ratio + Capital Conservation Buffer	8.0%	8.0%	8.625%	9.25%	9.875%	10.5%
Minimum Supplementary Leverage Ratio[3]		Disclosure begins 1/1/15 and compliance date is 1/1/18			3%	3%
Minimum Tier 1 Leverage Ratio	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%
Phase-in of deductions from Common Equity Tier 1 (including amounts exceeding the limit for deferred tax assets and mortgage servicing rights)[4]	20%	40%	60%	80%	100%	100%

[1] Only applicable to advanced approaches banking organizations as the new rule becomes effective for all other banking organizations starting January 1, 2015.
[2] See subsequent discussion of capital conservation buffers.
[3] Only applicable to advanced approaches banking organizations.
[4] See subsequent discussion of regulatory capital deductions.

.77 Beginning January 1, 2014, advanced approaches banking organizations must calculate their minimum common equity tier 1, tier 1, and total capital ratios using the definitions for the respective capital components found in the new rule. The transition provision of the new rule provides for the gradual implementation of many of the new deductions and adjustments and for the gradual removal of nonqualifying capital instruments from regulatory capital calculations. Beginning January 1, 2015, all other banking organizations must calculate their minimum common equity tier 1, tier 1, and total capital ratios using the definitions for the respective capital components found in the new rule. These calculations may be adjusted in accordance with the transition provisions for regulatory adjustments and deductions and for the nonqualifying capital instruments.

.78 *Additional improvements to the quality of regulatory capital.* The new rule also improves the quality of capital by phasing out of tier 1 capital by 2016 instruments such as trust preferred securities and cumulative preferred securities.[8] However, the new rule grandfathers the inclusion of these instruments in tier 1 capital, subject to limitations, for banking organizations that have consolidated assets of less than $15 billion as of December 31, 2009. Although new issuances from these institutions will have to meet new stricter criteria, these banking organizations may continue to include instruments issued prior to May 19, 2010, in tier 1 capital subject to current limitations. The final rule also includes new and more stringent limitations on the inclusion of minority interests, mortgage-servicing assets (MSAs), deferred tax assets (DTAs), and investments in the capital of unconsolidated financial institutions. Most regulatory capital deductions will be made from common equity tier 1 capital.

.79 *Capital Conservation Buffer.* Under the new rule, in order to avoid limitations on capital distributions, including dividend payments, and certain discretionary bonus payments to executive officers, a banking organization must hold a capital conservation buffer composed of common equity tier 1 capital above its minimum risk-based capital requirements (see table 2). This buffer will help to ensure that banking organizations conserve capital when it is most needed, allowing them to better weather periods of economic stress. The buffer is measured relative to risk-weighted assets. The capital conservation buffer requirements will be phased between 2016 and 2018 for all banking organizations.

.80 Table 2 summarizes how much a banking organization can pay out in the form of distributions or discretionary bonus payments in a quarter based on its capital conservation buffer. A banking organization with a buffer greater than 2.5 percent would not be subject to limits on capital distributions or discretionary bonus payments. However, a banking organization with a buffer of less than 2.5 percent would be subject to increasingly stringent limitations as the buffer approaches zero.

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[8] Advanced approaches depository institution holding companies may include these instruments to tier 2 capital temporarily as the instruments are subject to the phase out schedule. All other depository institution holding companies may include these instruments in tier 2 capital permanently.

Table 2: Payout Restrictions and Capital Conservation Buffer

Capital Conservation Buffer (as a percentage of risk-weighted assets)	**Maximum Payout** (as a percentage of eligible retained income)
Greater than 2.5 percent	No payout limitation applies
Less than or equal to 2.5 percent and greater than 1.875 percent	60 percent
Less than or equal to 1.875 percent and greater than 1.25 percent	40 percent
Less than or equal to 1.25 percent and greater than 0.625 percent	20 percent
Less than or equal to 0.625 percent	0 percent

.81 The new rule also prohibits a banking organization from making distributions or discretionary bonus payments during any quarter if its eligible retained income is negative in that quarter and its capital conservation buffer ratio was less than 2.5 percent at the beginning of the quarter. The eligible retained income of a banking organization is defined as its net income for the four calendar quarters preceding the current calendar quarter, based on the organization's quarterly regulatory reports, net of any distributions and associated tax effects not already reflected in net income. When the new rule is fully phased in, the minimum capital requirements plus the capital conservation buffer will exceed the PCA well-capitalized thresholds.

.82 For advanced approaches banking organizations which have exited parallel run, the conservation buffer will be calculated based upon the lower of the standardized and advanced approaches' risk-based capital ratios.

.83 *Credit ratings.* Section 939A of the Dodd-Frank Act prohibits reliance on and using references to external credit ratings in federal regulations and directs agencies to replace existing references to credit ratings with different standards of creditworthiness. As a result, the final rule replaces the current rule's ratings-based approach, which is based on credit ratings, with the simplified supervisory formula approach in order to determine the appropriate risk weights for securitization exposures. Alternatively, banking organizations may use the existing gross-up approach to assign securitization exposures to a risk weight category or choose to assign such exposures a 1,250 percent risk weight.

.84 *Regulatory capital adjustments and deductions.* Deductions from common equity tier 1 capital include goodwill and other intangibles, deferred tax assets that arise from net operating losses and tax credit carryforwards, gains on sale in connection with a securitization, any defined benefit pension fund net asset held by entities that are not depository institutions (unless the banking organizations has unrestricted and unfettered access to the assets in that fund), investments in a banking organization's own capital instruments, mortgage servicing rights (above certain levels) and investments in the capital of unconsolidated financial institutions (above certain levels).

.85 Under the final rule, MSAs and DTAs are subject to stricter limitations than those applicable under the current rule. More specifically, certain DTAs arising from temporary differences, MSAs, and significant investments in the capital of unconsolidated financial institutions in the form of common stock are each subject to an individual limit of 10 percent of common equity tier 1 capital elements and are subject to an aggregate limit of 15 percent of common equity tier 1 capital elements. The amount of these items in excess of the 10 and 15 percent thresholds are to be deducted from common equity tier 1 capital (see phase out percentages in table 1). Amounts of MSAs, DTAs, and significant investments in unconsolidated financial institutions that are not deducted due to the 10 percent and 15 percent thresholds must be assigned to the 250 percent risk weight under the final rule. In addition, the aggregate amount of a banking organization's nonsignificant investments in financial institutions (that is, where an investor banking organization owns less than 10 percent of the outstanding common stock of the investee) is subject to a limit of 10 percent of the investor's common equity tier 1 capital. To the extent that such investments do not exceed this 10 percent limitation, such investments are risk-weighted according to the general risk-based capital rules. For this purpose, nondeducted investments in trust preferred security collateralized debt obligations are treated as securitization exposures.

.86 *Accumulated other comprehensive income.* Under the final rule, the requirement to include unrealized gains and losses recognized in AOCI (with the exception of accumulated gains and losses on cash flows hedges associated with hedge items that are not measured at fair value on the balance sheet) to be included in the calculation of common equity tier 1 will only be mandatory for advanced approaches banking organizations. Those banking organizations not subject to the advanced approaches may make a one-time election not to include most elements of AOCI in regulatory capital under the new rule and instead effectively use the existing treatment under the current capital rules that excludes most AOCI elements for regulatory capital (also referred to as the AOCI opt-out election). A banking organization must make the AOCI opt-out election in the organization's first Consolidated Reports of Condition and Income (call report) or FR Y-9 series report that is filed after the organization becomes subject to the final rule.

.87 *Revised risk weights*. The new rule increases the risk weights for past-due loans, certain commercial real estate loans, and some equity exposures, and makes selected other changes in risk weights and credit conversion factors.

Advanced Approaches Rule

.88 The OCC, the Federal Reserve, and the FDIC have revised the advanced approaches rule to incorporate certain aspects of Basel III, as well as requirements introduced by the BCBS in the *2009 Enhancements* and subsequent consultative papers. The revisions require advanced approaches banking organizations to hold more appropriate levels of capital for counterparty credit risk, CVA, and wrong-way risk. The revisions also subject banking organizations to more rigorous due diligence and credit analysis requirements for securitization exposures and to enhanced disclosure requirements related to those exposures. Consistent with the requirements of section 939A of the Dodd-Frank Act, the revisions remove references to credit ratings from certain defined terms under the advanced approaches rule, as well as the ratings-based and internal assessment approaches for securitization exposures, and replaces these provisions with different standards of creditworthiness. Finally, the revisions contain a number of technical amendments to clarify and adjust existing requirements.

.89 *Counterparty credit risk.* The federal agencies have revised the advanced approaches rule to ensure that all material on- and off-balance sheet counterparty risk are appropriately incorporated into banking organizations' risk-based capital requirements as well as strengthen the oversight of CCR exposures. Specifically, the amendments

- modify the definition of financial collateral such that resecuritizations, conforming residential mortgages, and non-investment grade debt securities no longer qualify as financial collateral.
- revise the standard supervisory haircuts for securitization exposures in the EAD adjustment approach to eliminate references to credit ratings.
- adjust the holding period in the collateral haircut and simple VaR approaches and the margin period of risk in the internal models methodology (IMM) that a banking organization may use to determine its capital requirement for repo-style transactions, OTC derivative transactions, and eligible margin loans, with respect to large netting sets, netting sets involving illiquid collateral or including OTC derivatives that could not easily be replaced, or two margin disputes within a netting set over the previous two quarters that last for a certain length of time.
- amend the IMM as follows:
  - — Incorporate stress inputs by revising the capital requirement for IMM exposures to be equal to the larger of the capital requirement for those exposures calculated using data from the most recent three-year period and data from a three-year period that contains a period of stress reflected in the credit default spreads of the banking organization's counterparties.
  - — Demonstrate at least quarterly to the banking organization's primary federal supervisory that the stress period coincides with increased CDs or other credit spreads of the banking organization's counterparties, and must maintain document of such demonstration.
  - — Implement policies for the measurement, management, and control of collateral, including the reuse of collateral and margin amounts, as a condition of using the IMM.
  - — Enhance requirements for the recognition and treatment of wrong-way risk requiring banking organizations' risk-management procedures that identity, monitor, and control wrong-way risk throughout the life of an exposure to include stress testing and scenario analysis.
- increase the asset value correlation factor for wholesale exposures to (*a*) unregulated financial institutions that generate a majority of their revenue from financial activities, regardless of asset size, and (*b*) regulated financial institutions with consolidated assets of greater than or equal to $100 billion.
- require banking organizations to calculate risk-weighted assets for CVA risk electing either the simple approach or the advanced CVA approach. For a banking organization to receive approval to

use the advanced CVA approach, the banking organization needs to have the systems capability to calculate the CVA capital requirement on a daily basis but is not expected or required to calculate the CVA capital requirement on a daily basis.

- introduce capital requirements for cleared transaction with central counterparties and for default fund contributions to central counterparties by clearing member banking organizations.
- require banking organizations to base their internal collateral haircut estimates on a historical observation period that reflects a continuous 12-month period of significant financial stress appropriate to the security or category of securities. In addition, the banking organization is required to have policies and procedures that describe how it determines the period of significant financial stress used to calculate the institution's own internal estimates, and must be able to provide empirical support for the period used.

.90 *Removal of credit ratings.* The amendments implement a number of changes to definitions in the advanced approaches rule that currently reference credit ratings to align with section 939A of the Dodd-Frank Act. In addition, the final rule includes changes to the hierarchy for risk weighting securitization exposures necessitated by the removal of the ratings-based approach. Specifically, the amendments

- revise the requirements applicable to guarantees of securitization exposures so that banking organizations can recognize capital relief only where such guarantees are obtained from entities that have issued outstanding debt without credit enhancement that is investment grade.
- revise the term *investment grade* so that it no longer relies on credit ratings but an assessment by the institution that an entity or reference entity has adequate capacity to meet its financial commitments (that is, the risk of its default is low and the full and timely repayment of principal and interest is expected).
- eliminate the approach applicable to highly rated money market funds. Instead, a banking organization must use either the full look-through approach, the simple modified look-through approach, or the alternative modified look-through approach (codified in section 154 of the final regulatory capital rule) to determine the risk weight for its exposure to a money market fund.
- revise the look-through approaches for equity exposures to investment funds. For example, under the simple modified look-through approach risk weights are based on the highest risk weight assigned to an exposure under the standardized approach based on the investment limits in the fund's prospectus, partnership agreement, or similar contract that defines the fund's permissible investments.

.91 *Treatment of securitization exposures.* The amendments introduce a new definition for resecuritization exposures and revise the definition of a securitization exposure. In addition, the amendments outline certain operational requirements for traditional securitizations that need to be met in order to apply the securitization framework. Furthermore, the amendments removed the ratings-based approach and internal assessment approach for securitization exposures. The revised hierarchy for securitization exposures is as follows:

- A banking organization is required to deduct from common equity tier 1 capital any after-tax gain-on-sale resulting from a securitization and apply a 1,250 percent risk weight to the portion of a CEIO that does not constitute after-tax gain-on-sale.
- If a securitization exposure does not require deduction, a banking organization is required to assign a risk weight to the securitization exposure using the supervisory formula approach (SFA). Banking organizations are expected to use the SFA in all instances where data to calculate the SFA is available.
- If the banking organization cannot apply the SFA because not all the relevant qualification criteria are met, it is allowed to apply the simplified SFA (SSFA). The banking organization should be able to explain and justify (for example, based on data availability) to its primary federal supervisor any instances in which the banking organization uses the SSFA rather than the SFA for its securitization exposures.

.92 The revised advanced approaches amendments also

- include specific treatment for credit protection purchased provided in the form of a guarantee or credit derivative (other than an nth-to-default credit derivative) that references a securitization exposure.
- clarify how an organization may recognize a guarantee or credit derivative (other than an nth-to-default credit derivative) purchased as a credit risk mitigant for a securitization exposure held by the banking organization.
- introduce due diligence requirements for securitization exposures that banking organizations must meet in order to avoid a 1,250 percent risk weight.
- require a banking organization that provides credit protection through an nth-to-default derivative to assign a risk weight to that derivative using the SFA or the SSFA.

.93 *Treatment of exposures subject to deduction from total capital.* Under the current advanced approaches rule (in effect until January 1, 2014), a banking organization is required to deduct certain exposures from total capital, including securitization exposures such as CEIOs, low-rated securitization exposures, and high-risk securitization exposures subject to the SFA; eligible credit reserves shortfall; and certain failed capital markets transactions. Consistent with Basel III, under the amended advanced approaches rule, these exposures will be assigned a 1,250 percent risk weight, except as required under subpart B of the standardized approach, and except for deductions from total capital of insurance underwriting.

.94 *Technical amendments.* The agencies introduced a number of amendments to the advanced approaches rule that were designed to refine and clarify certain aspects of the rule's implementation including the following:

- Revising the definitions of (*a*) eligible guarantees to explicitly include a contingent obligation of the U.S. government or an agency of the U.S. government, (*b*) probability of default related to seasoning, and (*c*) qualified revolving exposure to incorporate certain charge card programs

- Clarifying the calculation of foreign exposures for applicability of the advanced-approaches rule
- Clarifying a banking organization will remain subject to the advanced approaches rule until its primary federal supervisor determines that application of the rule would not be required
- Revising the risk weight of cash items in process of collection
- Removing the one-year maturity floor for trade related letters of credit
- Revising the capital requirement for defaulted exposures that are guaranteed by the U.S. government
- Clarifying the exposure treatment for a stable value wrap
- Revising the risk weight for treatment of presold construction loans and multifamily residential loans

Capital Contributions in the Form of Notes Receivable

.95 Many FDIC-insured 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. Consequently, the role of capital planning has taken on greater importance. In this regard, it is equally important for institutions to understand the correct and accurate methodology to be used in reporting capital contributions in the form of notes receivable in their Call Reports.

.96 The accounting for capital contributions in the form of notes receivable is set forth in FASB ASC 505-10-45-2, and the glossary entry for "Capital Contributions of Cash and Notes Receivable" in the regulatory reporting instructions for both the Call Report and the Consolidated Financial Statements for Bank Holding Companies. Also, for FDIC-insured institutions, section 37(a)(2) of the Federal Deposit Insurance Act provides that the accounting principles applicable to reports or statements required to be filed with the federal banking agencies shall be uniform and consistent with GAAP. It further provides that, under certain circumstances, the appropriate federal banking agency may prescribe an accounting principle that is no less stringent that GAAP. The regulatory reporting instructions for "Capital Contributions of Cash and Notes Receivable" are consistent with GAAP.

.97 FASB ASC 505-10-45-2 states that it is generally not appropriate to record a note received as a capital contribution as an asset, except in very limited circumstances in which there is substantial evidence of ability and intent to pay within a reasonably short period of time. Consequently, the predominant practice is to offset the notes and stock in the equity section. However, such notes may be recorded as an asset if collected in cash before the financial statements are issued or are available to be issued.

.98 Prior to 2012, the instructions for the Call Report and the Consolidated Financial Statements for Bank Holding Companies did not address the accounting for capital contributions, but institutions were expected to report capital contributions in their regulatory reports in accordance with GAAP. However, the agencies often received questions about capital contributions in the form of notes receivable. To provide guidance to institutions and examiners, as well as auditors, on the appropriate regulatory reporting of these contributions, the federal banking agencies added a new glossary entry, "Capital Contributions of Cash and Notes Receivable," to the instructions for the Call Report and the Consolidated Financial Statements for Bank Holding Companies effective as of March 31, 2012.

.99 To be reported as an asset, rather than a reduction of equity capital, as of a quarter-end report date, the instructions provide that a note received as a capital contribution must be collected in cash before the financial statements are issued, as described in the instructions, and must meet the definition of an asset under GAAP by satisfying all of the following existence criteria:

- There must be written documentation providing evidence that the note was contributed to the institution prior to the quarter-end report date by those with authority to make such a capital contribution on behalf of the issuer of the note (for example, if the contribution is by the institution's parent holding company, those in authority would be the holding company's board of directors or its chief executive officer of chief financial officer);
- The note must be a legally binding obligation of the issuer to fund a fixed and stated dollar amount by a specified date; and
- The note must be executed and enforceable before quarter-end.

.100 The instructions further provide that "if a note receivable for a capital contribution obligates the note issuer to pay an amount that is variable or otherwise not specifically stated, the institution must offset the note and equity capital. Similarly, an obligor's issuance of several notes having fixed face amounts, taken together, would be considered a single note receivable having a variable payment amount, which would require all the notes to be offset in equity capital as of the quarter-end report date."

.101 Therefore, regardless of how an institution accounted for capital contributions in the form of notes receivable in its regulatory reports prior to March 31, 2012, capital contributions in the form of notes receivable must be accounted for in accordance with the instructions for the call report or the Consolidated Financial Statements for Bank Holding Companies, as appropriate, beginning with an institution's report for March 31, 2012.

Secured Consumer Debt Discharged in a Chapter 7 Bankruptcy Order

.102 Questions have arisen regarding the appropriate accounting and regulatory reporting treatment for certain secured consumer loans where (*a*) the loan has been discharged in a Chapter 7 bankruptcy under the U.S. Bankruptcy Code, (*b*) the borrower has not reaffirmed the debt, (*c*) the borrower is current on payments, and (*d*) the loan has not undergone a troubled debt restructuring (TDR) before the bankruptcy. As a result, the Federal Reserve has released supplemental instructions to form FR Y-9C, *Consolidated Financial Statements for Holding Companies*, to provide further instructions on this matter. This discussion can also be found in the *June 2013 Supplemental Instructions* to form FR Y-9C on the Federal Reserve website at www.federalreserve.gov.

.103 When a debtor files for Chapter 7 bankruptcy, a trustee is appointed to liquidate the debtor's assets for the benefit of creditors. Generally, Chapter

7 bankruptcy results in a discharge of personal liability for certain debts that arose before the petition date. A bankruptcy discharge acts as a permanent injunction of claims against the debtor, but does not extinguish certain secured debt or any existing liens on the property securing the debt.

.104 In general, for certain secured debt, the loan agreement (including the promissory note and, depending on the state, the security interest) entered into before bankruptcy remains in place after the debt has been discharged in a Chapter 7 bankruptcy. However, the lender may no longer pursue the borrower personally for a deficiency due to nonpayment. In addition, the institution's ability to manage the loan relationship is restricted. For example, after a borrower has completed Chapter 7 bankruptcy, an institution is limited with regard to collection efforts, communications with the borrower, loss mitigation strategies, and reporting on the discharged debt to credit bureaus.

.105 The accounting and regulatory reporting issues that arise for secured consumer loans discharged in a Chapter 7 bankruptcy include (*a*) whether the discharge is a TDR, (*b*) the measure of impairment, (*c*) whether the loan should be placed in nonaccrual status, and (*d*) charge-off treatment.

TDR Determination

.106 In determining whether a secured consumer debt discharged in a Chapter 7 bankruptcy constitutes a TDR, a holding company needs to assess whether the borrower is experiencing financial difficulties and whether a concession has been granted to the borrower. Under FASB ASC 310-40-15-20, a bankruptcy filing is an indicator of a borrower's financial difficulties. Determining whether a holding company has granted a concession in a Chapter 7 bankruptcy requires judgment. In assessing whether a concession has been granted, institutions should consider all relevant facts and circumstances, including the effect of changes to the legal rights and obligations of the lender and the borrower resulting from Chapter 7 bankruptcy. Changes taken as a whole that are not substantive may not be considered a concession. Holding companies should refer to the glossary of the *Instructions for Preparation of Consolidated Financial Statements for Holding Companies* for additional information on TDRs.

Measure of Impairment

.107 If a holding company has concluded that the completion of a Chapter 7 bankruptcy filing has resulted in a TDR, the loan should be measured for impairment under FASB ASC 310-10-35. When a loan is impaired, FASB ASC 310-10-35-22 states that a creditor should measure impairment based on the present value of expected future cash flows discounted at the loan's effective interest rate, except that as a practical expedient, a creditor may measure impairment based on a loan's observable market price, or the fair value of the collateral if the loan is collateral dependent. For regulatory reporting purposes, holding companies must measure impairment based on the fair value of the collateral when an impaired loan is determined to be collateral dependent. A loan is considered to be collateral dependent if repayment of the loan is expected to be provided solely by the underlying collateral and there are no other available and reliable sources of repayment. Judgment is required to determine whether an impaired loan is collateral dependent, and a holding company should assess all available credit information and weigh all factors pertaining to the loan's repayment sources.

.108 If repayment of an impaired loan is not solely dependent upon the underlying collateral, impairment would be measured based on the present value of expected future cash flows. FASB ASC 310-10-35 allows impaired loans to be aggregated and measured for impairment with other impaired loans that share common risk characteristics.

.109 Discharged secured consumer debts that are not TDRs (or are not otherwise determined to be in the scope of FASB ASC 310-10 and held for investment) should be measured collectively for impairment under FASB ASC 450-20. In estimating the ALLL under FASB ASC 450-20, holding companies should consider all available evidence and weigh all factors that affect the collectability of the loans as of the evaluation date. Factors can include the bankruptcy filing, delinquent senior liens, negative equity in the collateral and sustained timely payment performance by the borrower.

.110 Holding companies should ensure that loans are properly segmented based upon similar risk characteristics when calculating the allowance under FASB ASC 450-20. Borrowers of secured consumer debt discharged in a Chapter 7 bankruptcy generally are considered to have a higher credit risk profile than those borrowers that have not filed for Chapter 7 bankruptcy. For holding companies with significant holdings of these loans to borrowers who have completed a Chapter 7 bankruptcy, it is appropriate to segment these mortgage loans separately from pools of mortgage loans to borrowers who have not filed for Chapter 7 bankruptcy when calculating the allowance. Holding companies should follow existing regulatory guidance in calculating the ALLL including, if applicable, the *Interagency Supervisory Guidance on Allowance for Loan and Lease Losses Estimation Practices for Loans and Lines of Credit Secured by Junior Liens on 1-4 Family Residential Properties*.

.111 Regardless of the impairment method used, when available information confirms that specific loans, or portions thereof, are uncollectible, these amounts should be promptly charged off against the ALLL.

Accrual Status

.112 Holding companies should follow the glossary entry under "Nonaccrual Status" when determining whether secured consumer debt discharged in a Chapter 7 bankruptcy should be on accrual status. These instructions also address the restoration of nonaccrual assets, including any loans identified as TDRs that are in nonaccrual status, to accrual status.

.113 Consistent with GAAP and regulatory guidance, institutions are expected to follow revenue recognition practices that do not result in overstating income. For a secured consumer loan discharged in a Chapter 7 bankruptcy, whether or not it is a TDR, placing the loan on nonaccrual when payment in full of principal and interest is not expected is one appropriate method to ensure income is not overstated.

Charge-off Treatment

.114 Because of heightened risk that loans discharged through bankruptcy may be uncollectible, the interagency *Uniform Retail Credit Classification and Account Management Policy* (Uniform Retail Credit Policy) requires such loans to be charged down to collateral value (less costs to sell) within 60 days of notification from the bankruptcy court unless the institution can clearly demonstrate and document that repayment is likely to occur. To assess whether such a loan should be deemed uncollectible, a holding company should perform a credit analysis at the time a borrower whose loan is current completes Chapter 7 bankruptcy (hereafter, a postdischarge analysis). If the postdischarge analysis indicates repayment of principal and interest is likely to continue, then immediate charge down to collateral value and full application of payments to reduce the recorded investment in the loan is not required.

.115 If a credit analysis does not support that repayment of principal and interest is likely to continue, the loan should be charged down to the collateral's fair value (less costs to sell). Any balance not charged off should be placed on nonaccrual when full collection of principal and interest is not expected.

.116 As is discussed in the Uniform Retail Credit Policy, evaluating the quality of a retail credit portfolio on a loan-by-loan basis is inefficient and burdensome for the institution being examined and for examiners given the generally large number of relatively small-balance loans in a retail credit portfolio. Therefore, the type of credit analysis that is performed to assess whether repayment is likely to continue may vary depending on whether the loans are managed individually or on a homogenous pool basis.

.117 For loans managed in pools, holding companies may choose to evaluate the likelihood of continued repayment on a pool basis. In order for a pool analysis to be used, a holding company must identify various credit risk indicators that signify likelihood of continuing repayment. Such indicators might include measures of historical payment performance, loan structure, lien position, combined loan-to-value ratios, amounts paid over the minimum payment due and other pertinent factors that have been associated with payment performance in the past. Such credit risk indicators should then be considered as a whole when determining whether objective evidence supports the likelihood of continuing repayment. A holding company using pool-based analysis should also conduct ongoing monitoring to ensure the appropriateness of the credit risk indicators used to support the likelihood of continuing repayment.

.118 For all loans managed individually and any loans managed on a pool basis where the pool analysis does not support likelihood of continuing repayment, a loan-level, postdischarge credit analysis would be necessary to support likelihood of continuing repayment. A loan-level, postdischarge analysis should demonstrate and document structured orderly collection, postdischarge repayment capacity, and sustained payment performance. If likelihood of continuing repayment cannot be supported, the loan should be deemed uncollectable and charged down to collateral value (less costs to sell) within 60 days of notification from the bankruptcy court.

Bank Subsidiary Reporting Differences

.119 Generally, the FR Y-9C reports should reflect the same accounting practices as those used in its subsidiary depository institutions' Reports of Condition and Income (call reports). However, if a company adopts accounting practices for purposes of its published consolidated GAAP financial statements that are different from those used in subsidiary depository institution call reports, it should use those practices in preparation of the FR Y-9C. For example, if a holding company's depository institution subsidiary charges down certain discharged secured consumer debt for call report purposes but not for purposes of its published consolidated GAAP financial statements, it should not charge down those loans for purposes of preparing the FR Y-9C. In this situation, the holding company should explain differences in reporting between the subsidiary and the holding company in the FR Y-9C "Notes to the Income Statement—Other" and "Notes to the Balance Sheet—Other" report sections.

Additional Regulations Issued

.120 The following table lists additional regulatory rulings or guidance released in 2013 that may affect your financial institutions, including a brief description of the rule or guidance. Readers can access the regulations or guidance from any of the respective agencies' websites.

Regulators	***Title***	***Summary***	***Effective Date***
OCC, Federal Reserve, FDIC	Interagency Guidance on Leveraged Lending	Outlines for agency-supervised institutions high-level principles related to safe-and-sound leveraged lending activities, including underwriting considerations, assessing and documenting enterprise value, risk management expectations for credits awaiting distribution, stress-testing expectations, pipeline portfolio management, and risk management expectations for exposures held by the institution. This guidance applies to all financial institutions supervised by the OCC, Federal Reserve, and FDIC that engage in leveraged lending activities.	3/22/2013
OCC	Short Term Investment Funds	Revises the requirements imposed on national banks pursuant to the OCC's short term investment fund (STIF) rule. The final rule adds safeguards designed to address the risk of loss to a STIF's principal, including measures governing the nature of a STIF's investments, ongoing monitoring of its mark-to-market value and forecasting of potential changes in its mark-to-market value under adverse market conditions, greater transparency and regulatory reporting about a STIF's holdings, and procedures to protect fiduciary	7/1/2013

(continued)

Regulators	***Title***	***Summary***	***Effective Date***
		accounts from undue dilution of their participating interests in the event that the STIF loses the ability to maintain a stable net asset value.	
OCC	Community Bank Stress Testing: Supervisory Guidance	Provide guidance to national banks and federal savings associations with $10 billion or less in total assets on using stress testing to identify and quantify risk in loan principles and help establish effective strategic and capital planning processes.	
OCC	Clarification of the Treatment of Certain Sovereign and Securitization Positions	Clarity certain provisions of the market risk capital rule related to foreign exposures and measurements of a parameter used in the simplified supervisory formula approach for securitization exposures. Only applicable to those institutions supervised by the OCC that are subject to the market risk capital rule.	
Federal Reserve	Supplemental Policy Statement on the Internal Audit Function and Its Outsourcing	Provide institutions with additional guidance related to interagency guidance on the internal audit function that was issued in 2003. The supplemental guidance addresses characteristics, governance, and operational effectiveness of an institution's internal audit function. Further, it explains changes over the past years in banking regulations related to auditor independence and limitations placed on the external auditor.	
FDIC	Assessments, Large Bank Pricing	Revised definitions used to determine assessment rates for large and highly complex IDIs.	4/1/2013

Regulators	*Title*	*Summary*	*Effective Date*
NCUA	Prompt Corrective Action, Requirements for Insurance, and Promulgation of NCUA Rules and Regulations	Amends Interpretive Ruling and Policy Statement (IRPS) 87–2, as amended by IRPS 03–2, and two NCUA regulations that apply asset thresholds to grant relief from risk-based net worth and IRR requirements. The amended IRPS increases the asset threshold that identifies credit unions to which NCUA will give more robust consideration of regulatory relief in future rulemakings. The amended regulations similarly include increased asset thresholds, granting immediate and prospective relief from existing regulatory burden to a larger group of small credit unions.	2/19/2013
NCUA	Investment and Deposit Activities	Allows federal credit unions to purchase Treasury Inflation Protected Securities (TIPS). This final rule adds TIPS to the list of permissible investments for federal credit unions in Part 703 of NCUA regulations.	3/29/2013
NCUA	Loan Participations; Purchase, Sale and Pledge of Eligible Obligations; Purchase of Assets and Assumption of Liabilities	Amends its loan participation rule, eligible obligations rule, and requirements for insurance rule to clarify how the loan participation rule is to be applied and how it relates to other rules. The amendments reorganize the loan participation rule and focus on the purchase side of loan participation transactions. The amendments also expand loan participation requirements to federally insured, state-chartered credit unions.	9/23/2013

Broker-Dealers

.121 The regulatory environment under which broker-dealers operate is in the midst of significant change. The Dodd-Frank Act has initiated some of this change. Furthermore, a principle rule under which broker-dealers operate, SEC Rule 17a-5, *Broker-Dealer Reports*, has recently been revised. This alert does not cover all of the recent rulemaking due to the volume of regulatory changes, both final and proposed. Some of the significant rulemaking is discussed in the subsequent sections.

Broker-Dealer Reports

.122 In July 2013, the SEC issued Release No. 34-70073, *Broker-Dealer Reports*, which amends its broker-dealer annual reporting, audit, and notification requirements. The amendments include a requirement that broker-dealer audits be conducted in accordance with the standards of the PCAOB. The amendments further require a broker-dealer that clears transactions or carries customer accounts to agree to allow representatives of the SEC or the broker-dealer's designated examining authority (DEA) to review the documentation associated with certain reports of the broker-dealer's independent public accountant and to allow the accountant to discuss the findings relating to the reports of the accountant with those representatives, when requested in connection with a regulatory examination of the broker-dealer. Finally, the amendments require a broker-dealer to file a new form, Form Custody, with its DEA that elicits information about the broker-dealer's practices with respect to the custody of securities and funds of customers and noncustomers.

Reporting and Audit Requirements

.123 Under the amendments to the reporting and audit requirements, broker-dealers must, among other things, file with the SEC annual reports consisting of a financial report and either a compliance report (filed by those broker-dealers that have custody of customer assets) or an exemption report (filed by those broker-dealers that do not have custody of customer assets) that is prepared by the broker-dealer, as well as certain reports that are prepared by an independent public accountant covering the financial report and the compliance or exemption report. Although the compliance or exemption report and the related report of the independent public accountant are new requirements, the financial report must contain the same types of financial statements that were required to be filed under SEC Rule 17a-5 prior to these amendments (a statement of financial condition, a statement of income, a statement of cash flows, certain other financial statements, and required disclosures). In addition, the financial report must contain, as applicable, the supporting schedules that were required to be filed under SEC Rule 17a-5 prior to these amendments (a computation of net capital under SEC Rule 15c3-1, a computation of the reserve requirements under SEC Rule 15c3-3 or a statement of exemption thereto, and information relating to the possession or control requirements under SEC Rule 15c3-3).

.124 A broker-dealer that did not claim that it was exempt from SEC Rule 15c3-3 throughout the most recent fiscal year must file the compliance report, and a broker-dealer that did claim it was exempt from SEC Rule 15c3-3 throughout the most recent fiscal year (generally, a "non-carrying broker-dealer") must file the exemption report. Broker-dealers must make certain statements and provide certain information relating to the financial responsibility rules in these reports.

.125 In addition to preparing and filing the financial report and the compliance report or exemption report, a broker-dealer must engage a PCAOB-registered independent public accountant to prepare a report based on an examination of the broker-dealer's financial report in accordance with PCAOB standards. A carrying broker-dealer also must engage the PCAOB-registered independent public accountant to prepare a report based on an examination of certain statements in the broker-dealer's compliance report. A non-carrying broker-dealer must engage the PCAOB-registered independent public accountant to prepare a report based on a review of certain statements in the broker-dealer's exemption report. In each case, the examination or review must be conducted in accordance with PCAOB standards. The broker-dealer must file these reports with the SEC along with the financial report and the compliance report or exemption report prepared by the broker-dealer.

.126 The broker-dealer's annual reports also must be filed with SIPC, if the broker-dealer is a member of SIPC. In addition, broker-dealers must generally file with SIPC a supplemental report on the status of the membership of the broker-dealer in SIPC. The supplemental report must include a report of the independent public accountant that covers the SIPC annual general assessment reconciliation or exclusion from membership forms based on certain procedures specified in the rule.

.127 The PCAOB-registered independent public accountant must immediately notify the broker-dealer if the accountant determines during the course of preparing the accountant's reports that the broker-dealer is not in compliance with the financial responsibility rules or if the accountant determines that any material weakness exists in the broker-dealer's internal control over compliance with the financial responsibility rules. The broker-dealer, in turn, must file a notification with the SEC and its DEA under SEC Rules 15c3-1, 15c3-3, or 17a-11 if the independent public accountant's notice concerns an instance of noncompliance that would trigger notification under those rules. Under the amendments to SEC Rule 17a-11, a broker-dealer also must file a notification with the SEC and its DEA if the broker-dealer discovers or is notified by the independent public accountant of the existence of any material weakness (as defined in the final rule) in the broker-dealer's internal control over compliance with the financial responsibility rules.

.128 For carrying broker-dealers that are either registered as investment advisers or maintain client assets of an affiliated investment adviser and are subject to the internal control report requirement in SEC Rule 206(4)-2, the independent public accountant's report based on an examination of the compliance report will satisfy the internal control report requirement under SEC Rule 206(4)-2.

.129 Non-carrying broker-dealers (those not subject to the compliance report requirements) must comply with the internal control report requirement in SEC Rule 206(4)-2 if they are subject to that requirement.

.130 The amendments to SEC Rule 17a-5 also require that carrying or clearing broker-dealers agree to allow SEC and DEA staff, if requested in writing for purposes of an examination of the broker-dealer, to review the work papers of the independent public accountant and to allow the accountant to discuss its findings with the examiners.

Effective Dates

.131 The reporting and audit requirements amendments are effective for all broker-dealers subject to these requirements that have a fiscal year ending on or after June 1, 2014. This includes the amendments relating to the annual report requirements, with the exception of the requirement to file annual reports with SIPC, which is effective for fiscal years ending on or after December 31, 2013.

Form Custody

.132 Broker-dealers are required to file a new form, Form Custody, with their quarterly Financial and Operational Combined Uniform Single (FOCUS) report. This form is designed to elicit information concerning whether a broker-dealer maintains custody of customer and noncustomer assets, and, if so, how such assets are maintained.

.133 Form Custody comprises nine items designed to elicit information about a broker-dealer's custodial activities, each is discussed within the rule:

1. Accounts Introduced on a Fully Disclosed Basis
2. Accounts Introduced on an Omnibus Basis
3. Carrying Broker-Dealers
4. Carrying for Other Broker-Dealers
5. Trade Confirmations
6. Account Statements
7. Electronic Access to Account Information
8. Broker-Dealers Registered as Investment Advisers
9. Broker-Dealers Affiliated With Investment Advisers

Effective Dates

.134 The Form Custody amendments are effective on December 31, 2013. Consequently, broker-dealers subject to this filing requirement must begin filing Form Custody with their DEAs 17 business days after the calendar quarter or fiscal year, as applicable, ended December 31, 2013.

Financial Responsibility Rules for Broker-Dealers[9]

.135 In July 2013 the SEC issued Release No. 34-70072, *Financial Responsibility Rules for Broker-Dealers*, which, among other things, finalized rules regarding customer protection, net capital, books and records, and notification. Amendments to these rules are summarized in the following paragraphs. These rules will be effective 60 days after publication in the Federal Register.

Customer Protection Rule (SEC Rule 15c3-3)[10]

.136 The key amendments to the Customer Protection Rule will

- close a gap between the definition of *customer* in SEC Rule 15c3-3 (which does not include broker-dealers) and the definition of *customer* under the Securities Investor Protection Act (which does include broker-dealers). It does this by requiring "carrying broker-dealers" that maintain customer securities and funds to maintain

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[9] On October 17, 2013 the SEC issued Release No. 34-70701, *Order Providing Broker-Dealers a Temporary Exemption from the Requirements of Certain New Amendments to the Financial Responsibility Rules for Broker-Dealers under the Securities Exchange Act of 1934*, in which it extended the compliance date to March 3, 2014 for the following requirements to the broker-dealer financial responsibility rules adopted in SEC Release No. 34-70072: *(1)* SEC Rule 15c3-3, except paragraph (j)(1); *(2)* SEC Rule 15c3-3a; *(3)* SEC Rule 17a-3; *(4)* SEC Rule 17a-4; and *(5)* paragraph (c)(2)(iv)(E)(2) of SEC Rule 15c3-1.

[10] See footnote 9.

a new segregated reserve account for account holders that are broker-dealers.

- place restrictions on cash bank deposits for purposes of the requirement to maintain a reserve to protect customer cash under SEC Rule 15c3-3. The rule is amended to exclude cash deposits held at affiliated banks and limit cash held at nonaffiliated banks to an amount no greater than 15 percent of the bank's equity capital, as reported by the bank in its most recent call report.
- establish customer disclosure, notice, and affirmative consent requirements (for new accounts) for programs where customer cash in a securities account is "swept" to a money market or bank deposit product.

Net Capital Rule (SEC Rule 15c3-1)[11]

.137 The key amendments to the Net Capital Rule will

- require a broker-dealer to adjust its net worth when calculating net capital by including any liabilities that are assumed by a third party if the broker-dealer cannot demonstrate that the third party has the resources—independent of the broker-dealer's income and assets—to pay the liabilities.
- require a broker-dealer to treat as a liability any capital that is contributed under an agreement giving the investor the option to withdraw it. The rule also requires a broker-dealer to treat as a liability any capital contribution that is withdrawn within a year of its contribution unless the broker-dealer receives permission for the withdrawal in writing from its DEA.
- require broker-dealers to deduct from net capital (with regard to fidelity bonding requirements prescribed by a broker-dealer's self-regulatory organization [SRO]) the excess of any deductible amount over the amount permitted by SRO rules.
- clarify that any broker-dealer that becomes "insolvent," as the term is now defined in SEC Rule 15c3-1, is required to cease conducting a securities business. The companion amendment to SEC Rule 17a-11 requires insolvent broker-dealers to provide notice to regulatory authorities.

Books and Records Rules (SEC Rules 17a-3 and 17a-4)[12]

.138 The amendments to SEC Rules 17a-3 and 17a-4 require large broker-dealers to document their market, credit, and liquidity risk management controls.

Notification Rule (SEC Rule 17a-11)

.139 The amendments to SEC Rule 17a-11 proposed new notification requirements for when broker-dealers repurchase and securities lending activities exceed a certain threshold. In lieu of the notification requirement, the final rule provides that a broker-dealer may report monthly its stock loan and repurchase activity to its DEA, in a form acceptable to its DEA.

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[11] See footnote 9.

[12] See footnote 9.

Reporting of Derivatives and Other Off-Balance Sheet Items to FINRA

.140 In March 2013, FINRA issued Rule 4524 which requires each carrying or clearing broker-dealer to file, with the FOCUS filing, a supplemental schedule reporting derivatives and other off-balance sheet items (OBS) on a quarterly basis, within 22 business days of quarter-end beginning with the June 30, 2013 quarter.

.141 The supplemental information will allow FINRA to obtain more comprehensive and consistent information regarding OBS. The rule requires carrying or clearing broker-dealers to report their gross exposures, including transactions that are permitted to be netted under GAAP, such as repurchase agreements and derivatives. The rule also requires reporting of OBS related to underwriting, guarantees, and other commitments and as well as variable interest entities.

.142 Although the supplemental schedule is not covered by the audit requirements under SEC Rule 17a-5, auditors may consider reviewing the schedules as part of their planning and risk assessment process.

Commodities

Chief Compliance Officer Requirements and Reports

.143 CFTC Regulation 3.3 requires that each FCM, SD, and MSP designate an individual to serve as its chief compliance officer (CCO). It also provides the CCO with the responsibility and authority to develop, in consultation with the board of directors or the senior officer, appropriate policies and procedures to fulfill the duties set forth in the Commodity Exchange Act and CFTC regulations relating to the SD's or MSP's activities, or to the FCM's business as a FCM and to ensure compliance with the Commodity Exchange Act and CFTC regulations relating to the SD's or MSP's swaps activities, or to the FCM's business as an FCM.

.144 CFTC Regulation 3.3(f) requires that each SD and MSP furnish electronically to the CFTC a copy of the Annual Report of the SD's or MSP's CCO not more than 90 days after the end of the fiscal year of the SD or MSP.

.145 CFTC Regulation 23.600(c)(2)(ii) requires that each SD and MSP furnish copies of its Risk Exposure Reports to the CFTC within five business days of providing such reports to its senior management.

.146 CCO's reports may serve the independent auditor as a tool to assist in the assessment of an entities' compliance environment.

.147 To comply with these regulations, SDs and MSPs must submit the reports through the CFTC website, at the following address: https://forms.cftc.gov/fp/SDAndMSPReport.aspx. Reports should be filed in a readable PDF format.

.148 The CFTC Division of Swaps and Intermediary Oversight (DSIO) issued no-action letters (NALs) 12-47 and 13-32 that provide certain FCMs, SDs and MSPs with limited relief surrounding the requirement that CCOs of such entities prepare and submit an annual report, pursuant to CFTC Regulation 3.3. The NALs enumerate the subjects that must be addressed in the annual report of such firms for the fiscal year that ended on March 31, 2013. The letter also provides relief concerning the certification that a CCO must execute with respect to the annual report.

Identity Theft Risks

.149 On April 10, 2013, the CFTC and the SEC (together, the commissions) jointly issued final rules and guidelines to require certain regulated entities to establish programs to address risks of identity theft. The CFTC's rules would apply to CFTC-regulated entities that qualify as "financial institutions" or "creditors" under the Fair Credit Reporting Act. These entities must be in compliance with the requirements by November 20, 2013.

.150 Specifically, the rules require financial institutions and creditors to develop and implement a written identity theft prevention program designed to detect, prevent, and mitigate identity theft in connection with certain existing accounts or the opening of new accounts. The rules include guidelines to assist entities in the formulation and maintenance of programs that would satisfy the requirements of the rules. Further, the rules establish special requirements for any credit and debit card issuers that are subject to the commissions' respective enforcement authorities, to assess the validity of notifications of changes of address under certain circumstances.

Effective Date of Amendments to NFA Financial Requirements Section 1(a)—Adjusted Net Capital Requirement for FCMs Acting as a Counterparty to Foreign Exchange Transactions With ECPs

.151 The CFTC approved an amendment to National Futures Association (NFA) Financial Requirements Section 1(a) that requires an FCM that acts as a counterparty to a foreign exchange transaction with an eligible contract participant (ECP) to maintain adjusted net capital of at least $20,000,000. The $20,000,000 requirement is the absolute minimum requirement for those FCMs as they remain subject to the other applicable alternative calculations set forth in NFA Financial Requirements Section 1(a), which may result in a higher adjusted net capital requirement. This amendment was effective June 30, 2013. See NFA Notice to Members I-13-10 for further guidance.

Effective Date of Amendments to NFA Financial Requirements Section 4 Regarding Use of Technology to Monitor FCM Segregation Requirements

.152 NFA Financial Requirements Section 4 requires FCMs, holding customer segregated funds under certain CFTC regulations, to instruct the depositories holding these funds to report the balances in these accounts on a daily basis to a third party designated by NFA. The amendments also provide that a depository must comply with this request in order to be an acceptable depository for customer-segregated funds. AlphaMetrix360, LLC has been designated to act as the aggregator of this information.

.153 Although the NFA Financial Requirements Section 4 applies to all depositories holding customer segregated funds, NFA is implementing the process in phases. The first phase, which requires bank and trust company depositories to report end of day cash and securities balances, was effective February 15, 2013.

.154 NFA and CME are currently implementing phase 2, which requires DCOs and clearing FCMs acting as a segregated funds depository for another

FCM to report the end of day balances in all customer omnibus accounts held by DCOs and clearing FCMs directly to the designated self-regulatory organization (DSRO) of the nonclearing FCM.

.155 See NFA Notice to Members I-13-15 for further guidance.

NFA Financial Requirements Section 16 Reporting Requirements Guidance

.156 NFA Financial Requirements Section 16, which became effective on September 1, 2012, requires FCMs to submit certain financial related information to NFA on a monthly, semi-monthly, or daily basis. All of the required information has a specific due date, and FCMs are reminded that any information filed after its due date must be accompanied by a fee of $1,000 for each business day that it is late.

.157 Section 16 also requires FCMs to maintain written policies and procedures regarding the maintenance of the FCM's residual interest in its customer segregated funds account(s) as identified in CFTC Regulations. In addition, FCM's are prohibited from withdrawing more than 25 percent of such residual interest without obtaining appropriate internal approvals and filing notice with the FCM's DSRO.

.158 Section 16 was amended effective July 1, 2013 to extend the requirements to cleared swaps. See NFA Notices to Members I-12-23, I-12-29, and I-13-14 for guidance on reporting the supplementary information.

Auditing Regulatory Supplementary Schedules

.159 CFTC Regulation 1.16(d), "Audit objectives," requires that "The audit must include all procedures necessary under the circumstances to enable the independent licensed or certified public accountant to express an opinion on the financial statements and schedules." Auditors should review and test an FCM's segregation and capital computations even if the amounts are considered immaterial in relation to the financial statements taken as a whole. Indeed, when CFTC Regulation 1.16 was adopted, the CFTC commented that auditors must review such computations as part of a "proper audit."[13]

.160 CFTC staff is drafting amendments to CFTC Regulations 1.10, "Financial reports of futures commission merchants and introducing brokers," and 1.16, "Qualifications and reports of accountants," to require more robust assurances from FCMs and their independent accountants regarding, among other things, such schedules.

.161 It should be noted that the SEC proposed and finalized similar rules that include, among other things, the revocation of the requirement for a

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[13] "Accountants should be aware that in order to conduct a proper audit under these rules, they must be familiar with the act and the rules and regulations of the commission and in particular with the segregation requirements, the recordkeeping requirements, and the minimum financial regulations applicable to futures commission merchant (FCMs). The accountant must assure himself that the daily computations of the segregation requirements are being made in accordance with such requirements. In addition, the accountant must ascertain that the periodic computations of the minimum capital requirements are being done in accordance with §1.17 and are being computed monthly in accordance with §1.18. The commission anticipates that it will selectively review the FCM audits conducted by independent public accountants to monitor compliance with the auditing standard set forth in §1.16." 43 F.R. 39956 (September 8, 1978.)

report on material inadequacies in internal control. Dual registered FCMs have to comply with both SEC and CFTC regulations. If SEC proposed rules and CFTC proposed rules are effective for different periods, auditors of those dual registered entities may be required to issue separate reports.

Pool Quarterly Reports

.162 NFA Compliance Rule 2-46 requires NFA Member CPOs to file on a quarterly basis Form PQR (pool quarterly report) disclosing certain specified information with NFA for each pool (with certain exceptions) that it operates. The CFTC adopted similar requirements under CFTC Regulation 4.27, which require CPOs to file certain information on CFTC Form CPO-PQR with the CFTC on a quarterly or annual basis depending on the CPOs assets under management (AUM) and require CTAs to make an annual filing on the CFTC Form PR with the CFTC. Both the CFTC Form PQR and PR are filed with NFA through the EasyFile System.

.163 In order to simplify the process and minimize the filing of duplicative information, NFA has amended Compliance Rule 2-46. First, NFA has extended its reporting deadlines to match those provided by the CFTC. Second, NFA's Form PQR has been amended to be more comparable to the CFTC Form PQR. For example, NFA has amended the itemization threshold in the Schedule of Investment to align with the CFTC Form Schedule B. However, CPOs that are filing solely with NFA will find that NFA Form PQR will not include all of the questions included in the CFTC's form.

.164 Although the amendments to NFA Compliance Rule 2-46 also impose a new quarterly filing requirement on CTAs, NFA has not finalized the date of the first required filing. NFA will advise CTA Members of the date of the first quarterly report, and provide filing information and instructions, well in advance of that date.

.165 See NFA Notice to Members I-13-12 for further guidance.

.166 CPOs have the option of filing their PQR with the NFA using XML upload in EasyFile. The XML upload feature is not mandatory, and CPOs may still enter PQRs manually in EasyFile, including those firms that have requested and been approved to use the XML upload feature. See NFA Notice to Members I-13-20 for further guidance

CFTC Annual "Dear CPO" Letters

.167 Beginning in 1999 and continuing through 2011, the Deputy Director and Chief Accountant of the DSIO (and its predecessors) issued letters outlining key reporting issues and common reporting deficiencies found in annual financial reports of commodity pools, which are available at the commission's website.[14] Readers are encouraged to consult those letters with respect to commodity pool annual financial statements and reporting and monitor the CFTC website for the most recent guidance.

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[14] Prior letters applicable to 1998 forward are available at the Commodity Futures Trading Commission's (CFTC's) website at www.cftc.gov/industryoversight/intermediaries/guidancecporeports.html.

CFTC Division of SD and Intermediate Oversight Staff Observations

> ***Disclaimer***: The observations in the following section are not rules, regulations, or statements of the CFTC. Further, the CFTC has neither approved nor disapproved this content.

Procedure on Addressing Material Errors in Unaudited Financial Statements and Filing Amended Unaudited Financial Statements[15, 16, 17]

.168 These are the action steps to be performed by the DSRO:

a. Upon discovery of a material error within the course of a regulatory risk based examination performed by the DSRO

i. the material error, as of the risk based examination date, will be documented in the DSRO's work papers and the material error will generally be included in the formal risk based examination report issued to the firm.

ii. a historical analysis will be conducted by the firm promptly[18] upon notification of the material error by the DSRO (if the material error results in an under capital, under segregation, under secured or under cleared swaps customer situation the analysis will be performed immediately to determine its duration and magnitude). This analysis will look back from the risk based examination date to at least the date of the prior certified financial statements (the DSRO or the DSIO, upon reviewing the situation, may require the firm to perform this analysis for a longer period if the circumstances so warrant). The results of this analysis will be included in the DSRO's work papers.

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[15] "Material Error" is defined using the materiality criteria set forth in CFTC Interpretation 4-1. Note further that misclassifications and the conscious application of conservative estimates, procedures, or both (for example, the use of the most conservative haircut for a security class rather than compute security by security), absent procedural or control issues, would not be considered material errors subject to this guidance. As appropriate, such situations will be discussed by the designated self-regulatory organization (DSRO) with the CFTC Division of Swaps and Intermediary Oversight (DSIO).

[16] The procedures do not negate any notification requirements as outlined by CFTC Regulations (for example, under capital, under segregated, under secured, and under cleared swaps customer).

[17] To the extent an error is identified in a daily reporting, the DSRO should use their best judgment in determining the extent of historical and forward looking analysis to be performed. For example if it is clear that the error is limited to the manner in which the firm computes the daily filings and does not impact the monthly filings, then there would most likely be no need to perform an analysis of the effect on monthly or certified statements.

[18] For purposes of this document, "promptly" should imply a tight timeframe for the required action; however, in certain circumstances, it may be more appropriate to have a more relaxed timeframe as determined by senior management at the DSRO or the DSIO. With regards to the application of "promptly" there is an understanding that considerable time and effort may be spent researching an issue and working with the firm on investigating the matter and discussing the application of specific rules and regulations with the CFTC. However, that should not take away from the issue that an evaluation of the effect on the financial condition of the firm or protection of customer assets must be performed as soon as possible, even if it is just an estimate to enable appropriate decision making. Significant material items for which considerable time is required to investigate, research and reach a final resolution should be discussed with the DSIO during such review process.

iii. a forward looking analysis will be conducted by the firm promptly upon notification of the material error by the DSRO (if the material error results in an under capital, under segregation, under secured or under cleared swaps customer situation the analysis will be performed immediately to determine if the situation still exists). This analysis will look forward from the risk based examination date to the most recently filed monthly financial statement. The results of this analysis will be included within the DSRO's work papers.

iv. to the extent the material error was not identified by the outside CPA, the DSRO should inquire with the CPA to determine why the material error was not uncovered during the CPA's audit of the financial statements. Such inquiry should be done through the firm and the results of that inquiry and proposed action steps, if any, by the DSRO will be included in the DSRO's work papers. Further the results of such inquiry and any proposed action steps will be forwarded by the DSRO to the DSIO (DSIO Deputy Director—Examinations and the Associate Director of the CFTC Regional Office overseeing such firm) promptly upon receipt of the CPA's response.

v. the historical and forward looking analysis produced in items *a*(ii) and *a*(iii) preceding must be provided by the DSRO to the DSIO (DSIO Deputy Director—Examinations and the Associate Director of the CFTC Regional Office overseeing such firm) promptly upon receipt and review/analysis by the DSRO. Along with the analysis, a summary of the issue (including the root cause), a statement if the material error was corrected, or not, in the FCM's most recently filed monthly 1-FR/FOCUS Report, an assessment of what controls broke down, and what controls, policies and procedures the firm will be instituting to prevent future errors must be included in the DSRO's work papers and provided to the DSIO.

vi. if the material error was included in the mostly recently filed monthly 1-FR/FOCUS Report, the DSRO will require the firm to promptly correct the material error through an amended filing of its most recently filed statements.

b. Upon discovery of a material error within the course of the DSRO's monthly financial statement analysis, not related to a regulatory risk based examination

i. the monthly financial statement under analysis, containing the material error, would be amended by the firm and re-filed with the correction promptly upon notification of the material error by the DSRO; to the extent that the firm has filed a more current 1-FR/FOCUS report, that more current report should also be amended and re-filed.

ii. steps *a*(ii) and *a*(v) preceding would also be followed.

c. If the DSRO is informed by a firm that the firm discovered, in hindsight, a material error

i. the DSRO will require the firm to correct the material error through an amendment to its most recently filed monthly 1-FR/FOCUS report that contained such material error promptly upon notification of the material error.

ii. steps *a*(ii) and *a*(v) preceding would also be followed.

.169 Action steps to be performed by the DSIO upon notification of a material error by the DSRO are as follows:

a. Upon receiving the notification from the DSRO, the DSIO supervisor responsible for the firm must review all materials and discuss the situation with the DSRO, and as necessary the firm, promptly upon receipt of the information.

b. In consultation with the DSIO Deputy Director—Examinations, consider referring the case to the Division of Enforcement.

c. Upload all documents received into RSR; note if the material error affects prior periods.

.170 If a situation is identified by the DSIO, the same criteria should be applied with notification to the DSRO.

Audit and Accounting Developments

The Auditing Standards Board's Clarity Project

.171 The goal of the Clarity Project is to make GAAS easier to read, understand, and apply. As the Auditing Standards Board (ASB) redrafted the standards for clarity, it also converged the standards with the International Standards on Auditing (ISAs) issued by the International Auditing and Assurance Standards Board.

.172 At this point, auditors should have transitioned to the clarified standards that became effective for periods ending on or after December 15, 2012. The new requirements may involve planning discussions with clients, affect interim testing and other fieldwork, and require changes to the auditor's report.

.173 Although the Clarity Project was not intended to create additional requirements, some revisions have resulted in substantive changes and primarily clarifying changes that may require auditors to make adjustments in their practices.

.174 In January 2013, the AICPA issued Statement on Auditing Standards (SAS) No. 127, *Omnibus Statement on Auditing Standards—2013* (AICPA, *Professional Standards*).

.175 With the issuance of SAS No. 127, the ASB has redrafted all but one of the auditing sections, which now reflect the ASB's established clarity drafting conventions.

.176 For information on the final clarified auditing standard, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, to be released as part of the Clarity Project, see the Financial Reporting Center of www.aicpa.org.

Substantive Changes

.177 The following AU-C sections in AICPA *Professional Standards* are considered likely to affect the firms' audit methodology and engagements because they contain substantive or other changes, defined as having one or both of the following characteristics: (*a*) a change or changes to an audit methodology that may require effort to implement or (*b*) a number of small changes that, although not individually significant, may affect audit engagements:

- AU-C section 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*
- AU-C section 265, *Communicating Internal Control Related Matters Identified in an Audit*
- AU-C section 550, *Related Parties*
- AU-C section 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*
- AU-C section 700, *Forming an Opinion and Reporting on Financial Statements*
- AU-C section 705, *Modifications to the Opinion in the Independent Auditor's Report*
- AU-C section 706, *Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor's Report*

Primarily Clarifying Changes

.178 The following AU-C sections have clarifying changes that are intended to explicitly state what may have been implicit in the previous standards that, over time, resulted in diversity in practice. Certain clarified standards address management responsibilities that may need to be communicated to clients early in the planning stage. Some of these requirements may already be performed in practice, although not explicitly required by the previous standards. Most notably, certain new requirements shift the timing of requirements from the reporting stage of an audit to the planning stage. The new requirements in this section may not have a substantial effect but may result in adjustments to the timing and responsibilities of the auditor and his or her clients and will need to be reviewed by the auditor to ensure that all requirements have been properly addressed. These AU-C sections are as follows:

- AU-C section 210, *Terms of Engagement*
- AU-C section 220, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*
- AU-C section 402, *Audit Considerations Relating to an Entity Using a Service Organization*
- AU-C section 501, *Audit Evidence—Specific Considerations for Selected Items*
- AU-C section 505, *External Confirmations*
- AU-C section 510, *Opening Balances—Initial Audit Engagements, Including Reaudit Engagements*
- AU-C section 620, *Using the Work of an Auditor's Specialist*
- AU-C section 708, *Consistency of Financial Statements*

- AU-C section 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks*
- AU-C section 805, *Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts, or Items of a Financial Statement*
- AU-C section 810, *Engagements to Report on Summary Financial Statements*
- AU-C section 905, *Alert That Restricts the Use of the Auditor's Written Communication*
- AU-C section 910, *Financial Statements Prepared in Accordance With a Financial Reporting Framework Generally Accepted in Another Country*

Resources for the Clarity Standards

.179 A wealth of information about the clarity standards is available at www.aicpa.org/SASClarity. Also, two publications specifically discuss the clarity standards:

- The AICPA Audit Risk Alert *Understanding the Clarified Auditing Standards—2012* (product nos. ARACLA12P, ARACLA12E, or ARACLA12O) identifies the substantive and clarifying changes in requirements from the Clarity Project and includes a mapping schedule tracking the extant standards to the clarified standards.
- Additionally, the AICPA Audit Risk Alert *Understanding the Responsibilities of Auditors for Audits of Group Financial Statements—2013* (product nos. ARAGRP13P, ARAGRP13E, or ARAGRPO) provides additional guidance for implementing AU-C section 600.

These publications are available at www.cpa2biz.com. Additionally, see the following section, "Resource Central," for ways to obtain the codified clarity standards.

ALLL

.180 A primary concern with the ALLL continues to be the pace and magnitude of allowance releases and how lower provision expense appears to be driving income growth among certain financial institutions. Although there have been indicators of improvement in credit quality, certain credit risk indicators remain. Of particular concern is whether or not institutions are recognizing emerging areas of risk, in particular, those related to underwriting changes, a potentially rising interest rate environment, and new lending products. In Comptroller of the Currency Thomas J. Curry's remarks regarding the latest issues in the banking industry at the 2013 AICPA National Conference on Banks and Savings Institutions, he noted that with the current environment of sustained but slow growth, banks may often reach for yield by taking on additional interest rate or credit risk to maximize returns. In this environment, Curry highlighted the importance for banks to maintain adequate ALLLs. The OCC's National Risk Committee in recent years has observed a substantial amount of yield and earnings pressure, which in turn has driven competition among financial institutions for the most desirable lending relationships, resulting in the potential for loosening of underwriting standards.

In addition, there remains elevated risk among commercial real estate loans as reflected by the significant volume of workouts and modifications. The OCC's *Semiannual Risk Perspective* for spring 2013 noted that many community and midsize banks are looking for new ways to generate income and have begun to expand into product lines that require specialized risk management processes and skills, such as energy, asset-based lending, leveraged lending, indirect auto financing, leasing and equipment financing, and mortgage banking. In addition, the report highlights that uncertainties in the housing market and high levels of credit stress in residential real estate loan portfolios are diminishing lending profitability for large banks.

.181 In light of current market conditions, financial institutions should ensure they are exercising prudent judgment when considering releases of the allowance and in the determination of incurred loss estimates of the ALLL. In determining loss estimates, institutions should not solely rely on historical loss data. Instead, such historical loss data should be adjusted for all internal and external quantitative and qualitative factors that affect collectability and may cause current estimates of loss to differ from historical losses. Auditors should assess the reasonableness of the ALLL model in relation to current market conditions. This assessment should include, but is not limited to, performing inquiries to obtain an understanding of the institution's risk assessment and risk management, consideration of the design of the ALLL methodology including management's incorporation of qualitative and environmental factors, consideration of management's internal loan review controls, and testing key inputs and assumptions utilized by management. It is also important that management and auditors consider if the methodology is producing the right number (that is, the methodology for calculating the ALLL should not be overly mechanical, and institutions should step back and question whether their results make sense).

.182 Readers are encouraged to review chapter 9, "Credit Losses," in the AICPA Audit and Accounting Guide *Depository and Lending Institutions: Banks and Savings Institutions, Credit Unions, Finance Companies and Mortgage Companies*, which provides a detailed discussion on the ALLL including accounting and auditing guidance. Readers are also encouraged to review the interagency guidance released in January 2012 on junior liens as the concepts and principles contained may be applied to all types of loans. Further detail on PCAOB observations related to the ALLL can also be found at the end of this section of the alert.

TDRs

.183 Weakness in the housing market and elevated levels of nonperforming loans and delinquencies continue to indicate the potential for higher levels of loan restructurings. An audit risk includes not identifying modifications as TDRs, which leads to inaccurate disclosures and potentially understated ALLL estimates. The *OCC Mortgage Metrics Report: Disclosure of National Bank and Federal Savings Association Mortgage Loan Data* for the second quarter of 2013 contains trends in mortgage modifications for the most recent quarter and provides performance data on first-lien residential mortgages serviced by national banks and federal savings associations. Readers can access the report from the OCC website at www.occ.gov.

.184 Due to the continued high level of debt modifications, auditing TDRs continues to be a significant audit risk for many financial institutions. Based on the auditor's assessment of the risk of material misstatement, the auditor should consider designing audit procedures, that include, but are not limited to, evaluating whether management has designed and implemented effective internal controls to timely identify TDRs, whether management has appropriately identified TDRs, whether the accrual status is appropriate, and whether management has appropriately measured impairment for TDRs under FASB ASC 310-10. Auditors should also consider whether the entities have appropriate tracking and reporting processes in place to address disclosure requirements applicable to TDRs.

.185 In addition, auditors should consider reviewing substandard or watch-listed loans that have been renewed at terms similar to the original loan because these loans may involve borrowers that are experiencing some level of financial difficulty and, because of the deterioration in the loan's credit quality, may not otherwise qualify for the terms as offered in the renewal agreement. In these instances, the institution may have granted a concession because the interest rate for such a renewal is not indicative of a market rate, and, therefore, the renewal under such terms is a strong indicator that the loan should be accounted for as a TDR. In such cases, auditors should consider whether the institution has appropriately documented their conclusions regarding TDR status and appropriately accounted for renewals of this nature. When the practical expedient for collateral dependent loans is not elected, the auditor may also want to review the assumptions of projected cash flows utilized in impairment measurements to determine the reasonableness of the estimates because this will drive the allocated allowance for such loans.

Other Real Estate Owned

.186 Another significant audit risk factor for depository and lending institutions has been the extensive amount of other real estate owned (OREO). Generally, the largest component of real estate owned by lenders includes assets taken in settlement of troubled loans through surrender or foreclosure. Becoming familiar with the current risks related to OREO, along with the applicable accounting guidance, including guidance applicable to transactions by which these assets are sold and potentially derecognized (with profit or loss recognized), is important for auditors of depository and lending institutions. Examples of potential audit risks related to these assets include the following:

- Whether OREO is appropriately classified as OREO (versus a loan)
- Outdated or stale appraisals
- Appraisals in unstable market conditions
- OREO values inflated to hide loan losses
- Ineffective processes for identifying impairment losses
- The disposition of OREO and whether the OREO qualifies for derecognition or sale accounting

.187 Readers are encouraged to review chapter 11, "Real Estate Investments, Real Estate Owned, and Other Foreclosed Assets," in the AICPA Audit and Accounting Guide *Depository and Lending Institutions: Banks and Savings Institutions, Credit Unions, Finance Companies and Mortgage Companies*, which provides detailed accounting guidance on foreclosed assets. In addition, readers should be aware that FASB has recently issued an exposure draft of EITF Issue No. 13-E, *Reclassification of Collateralized Mortgage Loans Upon* *a Troubled Debt Restructuring*. See a summary of the objectives of this project in the "On The Horizon" section of this alert.

.188 FASB ASC 360-20 establishes standards for the recognition of profit on all real estate sales transactions, other than retail land sales, without regard to the nature of the seller's business. FASB ASC 360-20-40 presents the real estate derecognition guidance primarily from the perspective of the profit recognition upon a sale. This guidance also pertains to sales recognition when the seller finances the purchase.

.189 The sale of foreclosed property may be financed by a loan at less than current market interest rates. In those circumstances, the auditor may consider verifying that the gain on the sale of the loan is adjusted for its below market rate terms. In addition, depository and lending institutions may facilitate the sale of foreclosed property by requiring little or no down payment or offering terms favorable to the buyer. In such instances, the buyer's initial and continuing investments may be considered inadequate for recognition of profit by the full accrual method. FASB ASC 360-20-40 also provides guidance on alternative methods of accounting when the conditions for the full accrual method are not met.

.190 Auditors may consider the following when evaluating sales of foreclosed property:

- Whether each disposition and related financing is evaluated by management to determine whether the conditions have been met for sale derecognition and to record the transaction using a full accrual method
- For each disposition and related financing, the type of property, the composition and amount of the initial investment, whether the initial investment was funded by the buyer or another source of financing, and the percentage of the receivable to the sales price
- Whether the terms of the sale represent an option to buy the property
- Possible factors affecting the collectibility of the receivable
- The length of the financing period, the interest rate, and other terms of the financing arrangement

.191 FASB ASC 360-20-55 provides additional guidance regarding the full accrual method, as well as methods of accounting when the criteria for the full accrual method are not met. FASB ASC 360-20-55-21 includes a decision tree that provides an overview of the major provisions in FASB ASC 360-20 and includes the general requirements for recognizing a sale and all the profit on a sale of real estate at the date of sale.

.192 Auditors may also consider the following related to the recording, measurement, and derecognition of OREO:

- Whether OREO is measured and reported in accordance with the applicable guidance, including FASB ASC 310, *Receivables*; FASB ASC 360-20; and FASB ASC 820, *Fair Value Measurement*
- Whether the institution has documented written policies and procedures that may include the following:
  - — Frequency of appraisals and the selection and qualifications of appraisers

- — Disbursement of funds and the capitalization of costs
- — Review and monitoring of marketing efforts
- — Nature and amount of financing
- — Estimates of costs to sell
- — Capitalization of interest
- — Proper authorizations for specific transactions
- — Estimation of the fair value of real estate assets
- — Accounting for dispositions, including whether derecognition (sale) and profit recognition are appropriate

.193 Estimates of the fair value of real estate assets are necessary to account for such assets. AU-C section 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* (AICPA, *Professional Standards*), addresses the auditor's responsibilities related to accounting estimates, including fair value accounting estimates and related disclosures, in an audit of financial statements. Many fair values will be based on valuations by independent appraisers. In applying audit procedures to real estate, the auditor often relies on representations of independent experts, particularly appraisers and construction consultants, to assist in the assessment of real estate values. AU-C section 500, *Audit Evidence* (AICPA, *Professional Standards*), addresses the auditor's use of the work of an individual or organization possessing expertise in a field other than accounting or auditing whose work in that field is used by the entity to assist the entity in preparing the financial statements (termed a management's specialist). If information to be used as audit evidence has been prepared using the work of a management's specialist, paragraph .08 of AU-C section 500 states that the auditor should, to the extent necessary, taking into account the significance of that specialist's work for the auditor's purposes,

- evaluate the competence, capabilities, and objectivity of that specialist;
- obtain an understanding of the work of that specialist; and
- evaluate the appropriateness of that specialist's work as audit evidence for the relevant assertion.

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

.195 The auditor should also consider whether management's internal controls related to the process to review appraisals is appropriate because the estimate is ultimately management's responsibility.

.196 Readers should also refer to supervisory guidance that has been issued by the banking agencies regarding appraisal and evaluation guidelines, foreclosure management, rental of residential OREO properties, and questions and answers on the management of OREO. Readers can access this guidance from any of the agencies' websites.

Acquired Loans

.197 The application of FASB ASC 310-30 requires that each loan should be evaluated individually to determine whether the loan meets the scope criteria of FASB ASC 310-30-15-2. FASB ASC 310-30 permits an entity the option to aggregate and pool loans possessing common risk characteristics that are acquired together or during the same fiscal quarter. The term common risk characteristics is defined in FASB ASC 310-30-20 as loans with similar credit risk (for example, evidenced by similar Fair Isaac Company scores, an automated rating process for credit reports) or risk ratings, and one or more predominant risk characteristics, such as financial asset type, collateral type, size, interest rate, date of origination, term, and geographic location. In other words, the pooling of loans is permitted to be done on the basis of as few as, but no less than, two common attributes with similar credit risk or risk ratings as one required element and at least one predominant risk characteristic as the other required element.

.198 For example, it would not be appropriate to aggregate loans based solely on the collateral type of the loans without regard to their credit risk profile or risk rating.

.199 In addition, when applying audit procedures to acquired loans with deteriorated credit quality, auditors should understand the assumptions and inputs utilized by management in estimating cash flows, including situations in which management utilized a third-party vendor or software to estimate cash flows. The auditor should also assess the internal controls related to the model used to estimate cash flows. AU-C section 500 addresses the auditor's use of the work of an individual or organization possessing expertise in a field other than accounting or auditing whose work in that field is used by the entity to assist the entity in preparing the financial statements (termed a management's specialist). Further guidance on the auditor responsibilities when utilizing the work of a management's specialist is found in discussion of OREO audit risks within this section of the alert.

U.S. Department of Housing and Urban Development—Consolidated Audit Guide Update

.200 The *Consolidated Audit Guide for Audits of HUD Programs* (HUD guide) provides guidance for program-specific audits of entities that are subject to the U.S. Department of Housing and Urban Development's (HUD's) financial reporting standards.

.201 The HUD guide is in the process of being updated, with each chapter being released upon completion. Since May 2012, revisions have been made to four chapters. Those chapters and the dates of update are as follows:

- Chapter 1, "General Audit Guidance," January 2013
- Chapter 2, "Reporting Requirements and Sample Reports," January 2013 (chapter issued without illustrative reports) and March 2013 (illustrative reports released)
- Chapter 6, "Ginnie Mae Issuers of Mortgage-Backed Securities Audit Guidance," May 2012 and April 2013

- Chapter 7, "FHA-Approved Lenders Audit Guidance," December 2012

.202 Note that some of the changes are interrelated, especially the changes to chapters 1, 2, and 7.

.203 Chapter 1 of the HUD guide was revised as a result of a change to chapter 2; that is, the elimination of separate compliance reporting on nonmajor programs for Federal Housing Administration- (FHA-) approved lenders. This change required a revision to the chart in chapter 1 that indicates values to be used in making major program determinations. The revision changes the threshold for FHA-approved lenders from $2 million to no dollar amount, with the provision that for audits of lenders having combined originations and a servicing portfolio of less than $2 million, the opinion on compliance need only cover certain chapter 7 compliance requirements. The revisions are effective for audits of entities with fiscal years ending on or after March 31, 2013.

.204 Chapter 2 of the HUD guide was updated for, among other things, the 2011 revision of *Government Auditing Standards* and AICPA clarified auditing standards. The transmittal letter of the chapter 2 update provides a list of the significant changes to that chapter, which include

- new background information on the reporting standards and requirements applicable to an audit performed under the guide.
- revised report issuance and distribution requirements.
- revised instructions relating to the required reporting package, including required auditor's reports and auditee prepared documents that are to be included in the reporting package.
- the suggested auditor's reports on internal control and compliance were restructured to make the format consistent with the AICPA's Audit Guide Government Auditing Standards *and Circular A-133 Audits*. Suggested reports are
  - — Independent Auditor's Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with *Government Auditing Standards*
  - — Independent Auditor's Report on Compliance for Each Major HUD Program and Report on Internal Control Over Compliance Required by the *Consolidated Audit Guide for Audits of HUD Programs*
- separate reporting on compliance with respect to nonmajor HUD programs has been eliminated.
- separate reporting on compliance with specific requirements applicable to fair housing and nondiscrimination has been eliminated.[19]

.205 The revisions to chapter 2 are effective for audits of entities with fiscal years ending on or after March 31, 2013. If early application is elected,

[19] The transmittal letter content reminds auditors that auditors continue to be required to report instances of noncompliance that could have a material effect on the audit.

this guidance may be used for audits of entities with fiscal years ending on or after December 31, 2012.

.206 Illustrative reporting examples were issued in March 2013 as a separate update to chapter 2. The AICPA Government Audit Quality Center website has a link to the illustrative HUD reports, updated for both AICPA clarified auditing standards and the 2011 revision of *Government Auditing Standards*.

.207 Chapter 6 of the HUD guide was reissued in its entirety to reflect changes in requirements and reporting formats related to audits of Government National Mortgage Association (Ginnie Mae) issuers of mortgage backed securities. Significant changes to that chapter include the following:

- Updates to net worth requirements
- Outlines new liquidity requirements and capital requirements for all issuers
- Provides a list of unacceptable assets for the computation of adjusted net worth
- Provides updated reporting formats and an illustrative report

.208 Although this chapter was formally issued in May 2012, some requirements and guidance found in chapter 6 were effective on October 1, 2011. The chapter in its entirety was effective upon issuance. More recently, a transmittal letter issued in April 2013 updated chapter 6 to reflect the requirement for the electronic submission of audit reports (to conform to the updated *Ginnie Mae Mortgage-Backed Securities Guide*). This change is effective upon issuance.

.209 The updates to chapter 7 merged the content of former chapters 7–8, thus eliminating chapter 8 from the HUD guide. Updated chapter 7 applies to all approved supervised and nonsupervised lenders. A number of technical changes were made to wording, and additional information was added related to certain reporting and submission requirements. In addition, compliance requirements and suggested audit procedures were restructured. The updated chapter 7 was effective upon issuance.

.210 The HUD audit guide is available at www.hudoig.gov/reports-publications/audit-guides/consolidated-audit-guides.

Accounting for Mortgage Purchase Programs

.211 Under some mortgage purchase program, a bank may provide funding to a mortgage loan originator, which closes a residential mortgage loan in the originator's name. Upon closing the loan, the originator generally executes a takeout commitment with a secondary market investor to purchase the mortgage loan from the originator at a subsequent date. Simultaneously or shortly after funding, the bank purchases the mortgage loan or an interest in it from the originator. The understanding between the originator and the bank is that the bank will own the loan for a brief period of time until the sale to the secondary market investor occurs. Although the arrangement between the originator and the bank is structured as though the originator sells the loan to the bank, it functions very similarly to a mortgage warehouse line of credit and generally does not meet the requirements for sale accounting in FASB ASC 860, *Transfers and Servicing*. The funded amount is repaid to the bank by the proceeds from the subsequent sale of the mortgage loan by the originator in the secondary market. In return for the funding it receives from the bank under the mortgage purchase program, the originator pays a yield to the bank based on the par value of the bank's ownership interest in the mortgage loan, and related fees. In certain cases, the yield to the bank is greater than the yield on the underlying mortgages.

.212 Some originators and banks have inappropriately accounted for the transfer of the loan from the originator to the bank under these programs as purchases or sales rather than secured financings as required by FASB ASC 860, if the criteria for sales treatment are not met.

.213 In making the determination of whether mortgage purchase program transactions qualify for sales treatment, consideration should generally first be given to whether the transferred ownership interest in the underlying loan is less than 100 percent. If this is the case, FASB ASC 860-10-40-6A should be evaluated to determine whether the portion of the loan transferred from the originator to the bank meets the definition of a participating interest. If the transferred portion does not meet the definition of a participating interest (which it generally would not due to the disproportionate sharing of cash flows and other reasons), the transfer should be recorded as a secured financing.

.214 If the transferred portion of the financial asset meets the definition of a participating interest, or if the transaction represents a transfer of an entire financial asset, the next step is to determine whether each of the three conditions of FASB ASC 860-10-40-5 have been met to demonstrate that the transferor (the originator in this case) has surrendered control over the transferred loan and therefore met the requirements for sales treatment.

FASB ASC 860-10-40-5 Conditions	***Considerations***
The loan is isolated from the originator, and placed beyond the reach of the originator even in bankruptcy or other receivership.	It is normally necessary for the parties to obtain a legal opinion to determine if legal isolation occurs.[20]
The bank has the right to pledge or exchange the loan it received, and no condition constrains the bank from taking advantage of its right to pledge or exchange the loan and provides more than a trivial benefit to the originator.	The existence of the pre-arranged takeout commitment generally causes the arrangement to fail this criterion as it constrains the bank and provides more than a trivial benefit to the originator.
The originator does not maintain effective control over the transferred assets.	In many cases, this criterion is failed due to the originator's continuing involvement in the mortgage loans including repurchase requirements and the involvement in conducting the sale of the loan to the secondary market investor.

[20] See Interpretation No. 1, "The Use of Legal Interpretations as Audit Evidence to Support Management's Assertion That a Transfer of Financial Assets Has Met the Isolation Criterion in Paragraphs 7-14 of Financial Accounting Standards Board *Accounting Standards Codification* 860-10-40," of AU-C section 620, *Using the Work of an Auditor's Specialist* (AICPA, *Professional Standards*, AU-C sec. 9620 par. .01–.21)

.215 For programs that do not meet the requirements for sale accounting in FASB ASC 860, there may be important implications for the calculation of risk weighted assets as well as compliance with legal lending limits. Readers may refer to the Supplemental Instructions to the September 2013 Call Report located on the FDIC website at www.fdic.gov for further information on purchased loans originated by others.

.216 The accounting treatment of the transfer of the loan from the originator to the bank should be symmetrical, with both parties treating it either as a secured financing arrangement or a sale/purchase transaction, depending on whether the preceding criteria for sale treatment are met. Inappropriately accounting for these mortgage purchase transactions as sales/purchases can have numerous ramifications to both parties including, but not limited to, the following:

- Originator (transferor/seller)
  - — Loans are inappropriately removed from the balance sheet. (If the transfer fails sale accounting, the cash received from the bank should have been reflected as a secured borrowing.)
  - — The originator recognizes a gain (or loss) on sale rather than continuing to recognize interest income on the loans.
  - — The originator does not recognize interest expense for the secured borrowing recorded when sale treatment is not achieved.
  - — Potential for inappropriate regulatory reporting including overstating of asset-based capital ratios depending on the reporting and capital requirements relevant to the entity.
  - — Mortgage purchase program is not appropriately reported in the cash flow statement.
- Bank (transferee/purchaser)
  - — Loans are inappropriately reflected as mortgage loans held for sale rather than a loan to the originator.
  - — Mortgage purchase program is not appropriately reported in the cash flow statement.
  - — Potential for inappropriate regulatory reporting including overstating of risk-weighted capital ratios given that a loan to the originator would be assigned a higher risk weighting than residential mortgage loans.
  - — Potential violation of legal lending limits depending on the magnitude of the total amount advanced to the originator.

Subsequent Accounting for an Indemnification Asset Recognized at the Acquisition Date as a Result of a Government-Assisted Acquisition of a Financial Institution

.217 In October 2012, FASB issued ASU No. 2012-06, *Business Combinations (Topic 805): Subsequent Accounting for an Indemnification Asset*

Recognized at the Acquisition Date as a Result of a Government-Assisted Acquisition of a Financial Institution (a consensus of the FASB Emerging Issues Task Force). The amendments in this ASU address current diversity in practice about how to subsequently measure an indemnification asset for a government-assisted (FDIC or NCUA) acquisition of a financial institution that includes a loss-sharing agreement (indemnification agreement).

.218 Accounting for a business combination in accordance with FASB ASC 805-20-35-4 requires that at each subsequent reporting date, an acquirer measure an indemnification asset on the same basis as the indemnified liability or asset, subject to any contractual limitations on that amount and, for an indemnification asset that is not subsequently measured at its fair value, management's assessment of the collectability of the indemnification asset. The diversity exists primarily because there are differing interpretations on what is meant by the terms *on the same basis* and *contractual limitations*. In certain circumstances, some entities amortize the decrease in expected cash flows on an indemnification asset over the term of the indemnification agreement, and other entities amortize the decrease in expected cash flows over the remaining life of the assets subject to indemnification. Other entities reflect the decrease in expected cash flows immediately as a write down of the indemnification asset.

.219 With the issuance of ASU No. 2012-06, when a reporting entity recognizes an indemnification asset (in accordance with FASB ASC 805-20) as a result of a government-assisted acquisition of a financial institution and subsequently a change in the cash flows expected to be collected on the indemnification asset occurs (as a result of a change in cash flows expected to be collected on the assets subject to indemnification), the reporting entity should subsequently account for the change in the measurement of the indemnification asset on the same basis as the change in the assets subject to indemnification. Any amortization of changes in value should be limited to the contractual term of the indemnification agreement (that is, the lesser of the term of the indemnification agreement and the remaining term of the indemnified assets).

.220 For both public and nonpublic entities, the amendments in the ASU were effective for fiscal years, and interim periods within those years, beginning on or after December 15, 2012, with early adoption permitted. The amendments should be applied prospectively.

Fed Funds Effective Swap Rate

.221 As a result of the financial crisis in 2008, the exposure to and the demand for hedging the Fed Funds rate have increased significantly. That demand has been driven by an increased focus by banks on their sources of funding (including an increased focus on overnight interbank borrowings of surplus balances held at the Federal Reserve), the greater (and sometimes volatile) spread between the London Interbank Offered Rate (LIBOR) and the Overnight Index Swap Rate (OIS, also referred to as the Fed Funds Effective Swap Rate), and new regulatory measures to curb systemic risks (such as increased collateralization of derivatives).

.222 Considering the increased importance of OIS, in July 2013, FASB issued ASU No. 2013-10, *Derivatives and Hedging (Topic 815): Inclusion of the Fed Funds Effective Swap Rate (or Overnight Index Swap Rate) as a Benchmark Interest Rate for Hedge Accounting Purposes (a consensus of the FASB Emerging*

Issues Task Force). The amendments apply to all entities that elect to apply hedge accounting of the benchmark interest rate under FASB ASC 815.

.223 The amendments in this ASU permit the Fed Funds Effective Swap Rate (OIS) to be used as a U.S. benchmark interest rate for hedge accounting purposes under FASB ASC 815, in addition to Treasury obligations of the U.S. government (UST) and LIBOR. The amendments also remove the restriction on using different benchmark rates for similar hedges. Including the Fed Funds Effective Swap Rate (OIS) as an acceptable U.S. benchmark interest rate in addition to UST and LIBOR will provide risk managers with a more comprehensive spectrum of interest rate resets to utilize as the designated benchmark IRR component under the hedge accounting guidance in FASB ASC 815.

.224 The amendments are effective prospectively for qualifying new or redesignated hedging relationships entered into on or after July 17, 2013.

PCAOB Inspection Report on 2007–2010 Domestic Firms That Audit 100 or Fewer Public Companies

.225 In February 2013, the PCAOB released *Report on 2007–2010 Inspections of Domestic Firms that Audit 100 or Fewer Public Companies* to provide a summary of observations from its inspection program. This report covers domestic audit firms that audit the financial statements of issuers, and that regularly issue 100 or fewer audit reports each year. This report describes inspection findings from 578 firms and 1,801 individual audits that were inspected from 2007–2010. Although audit deficiencies can occur in many different areas of an audit, inspections staff have identified certain areas in which deficiencies occurred more frequently. Audit areas with frequent findings in the 2007–2010 period that are of importance to financial institutions are related to

- auditing accounting estimates, including the allowance for loan losses.
- auditing fair value measurements.
- auditing impairment of intangible and long-lived assets.
- auditing share-based payments and equity financing instruments.
- auditing convertible debt instruments.
- auditing related party transactions.
- use of analytical procedures as substantive tests.
- audit procedures to respond to the risk of material misstatement due to fraud.

Accounting Estimates

.226 In accordance with paragraph .04 of AU section 342, *Auditing Accounting Estimates* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards), the auditor is responsible for evaluating the reasonableness of accounting estimates made by management in the context of the financial statements taken as a whole. As estimates are based on subjective as well as objective factors, it may be difficult for management to establish controls over them. Accordingly, when planning and performing procedures to evaluate accounting estimates, the auditor should consider, with an attitude of professional skepticism, both the subjective and objective factors. Paragraph .07 of

AU section 342 states that the auditor's objective when evaluating accounting estimates is to obtain sufficient appropriate evidential matter to provide reasonable assurance that

- all accounting estimates that could be material to the financial statements have been developed.
- those accounting estimates are reasonable in the circumstances.
- the accounting estimates are presented in conformity with applicable accounting principles and are properly disclosed.

.227 In evaluating the reasonableness of an accounting estimate, paragraph .10 of AU section 342 states that the auditor should obtain an understanding of how management developed the estimate. Based on that understanding, the auditor should use one or a combination of the following approaches:

- Review and test the process used by management to develop the estimate.
- Develop an independent expectation of the estimate to corroborate the reasonableness of management's estimate.
- Review subsequent events or transactions occurring prior to the date of the auditor's report.

.228 In instances in which firms chose to evaluate accounting estimates by reviewing and testing management's process for developing the estimate, deficiencies identified by inspection staff include firms' failures to (*a*) sufficiently evaluate the reasonableness of management's significant assumptions, and (*b*) sufficiently test the data underlying management's calculation of the accounting estimate.

.229 A common estimate for which inspections staff observed instances in which firms' audit procedures were deficient included the allowance for loan losses. Examples of instances in which firms failed to obtain sufficient appropriate audit evidence related to the allowance for loan loss include the following:

- Sufficiently testing the completeness and accuracy of the loan watch list report that is used by management in the allowance estimation process. Specifically, the auditors did not subject loans determined by management to be unclassified to testing of the risk grade, one of management's criterion for inclusion on the watch list.
- Failing to test the completeness and accuracy of the system-generated loan delinquency report that is used by management in the preparation of various credit quality management reports.
- Failing to perform audit procedures to test the loan-loss factors used by management for either the qualitative or historical loss components of the allowance for loan losses beyond gaining an understanding of management's process for developing such factors.
- Failing to test the appropriateness of the related allowance percentages used for loan grades within management's allowance model.

Fair Value Measurements

.230 In accordance with paragraph .03 of AU section 328, *Auditing Fair Value Measurements and Disclosures* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards), the auditor should obtain sufficient appropriate audit evidence to provide reasonable assurance that fair value measurements and disclosures are in conformity with GAAP. In planning and performing procedures in response to the risk associated with fair value measurements, Paragraph .09 of AU section 328 states that the auditor should obtain an understanding of the entity's process for determining fair value measurements and disclosures and of the relevant controls sufficient to develop an effective audit approach. Paragraph .23 of AU section 328 states that substantive tests of 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.

.231 In some cases, an issuer's estimates of fair value may be based on fair values obtained from external pricing sources or other service providers such as custodians, record keepers, and trustees. When testing management's process for determining fair value measurements or estimates, the auditor should perform procedures commensurate with the related risk. If the auditor develops independent fair value estimates by obtaining fair values from external pricing sources, it is important for the auditor to determine that the sources they use are different from those used by management or managements' service providers. When there are no observable market prices and the auditor obtains fair values from pricing sources, it is important for the auditor to obtain an understanding of the methods and assumptions underlying the fair values obtained from the pricing sources. Inspections staff observed situations in which firms set out to test such estimates but failed to sufficiently perform certain necessary procedures.

.232 In some cases, particularly in circumstances involving instruments with higher risk of material misstatement, the firm's approach to auditing fair value estimates involved testing the issuer's process for estimating fair value. This involves evaluating the reasonableness of the issuer's significant assumptions and testing the valuation model and the underlying data. Inspections staff observed situations in which firms in these circumstances failed to sufficiently evaluate the appropriateness of the valuation methods or the reasonableness of the issuer's significant assumptions, or both.

.233 Inspection staff observed that a firm failed to perform sufficient audit procedures to test the reasonableness of the fair value estimates for available-for-sale debt securities. Specifically, the firm compared fair value estimates on management's detailed schedule of investment value to fair value estimates provided to management by securities pricing sources. PCAOB staff noted the firm should have performed additional audit procedures to test the fair value estimates, such as developing independent fair value estimates by obtaining fair values from an independent external source or evaluating the appropriateness of the methods and the reasonableness of the significant assumptions used by management's securities pricing sources on individual securities on at least a sample basis.

.234 In other cases, inspections staff observed that firms evaluated managements' estimates of fair value by developing an independent expectation of fair value for corroborative purposes. PCAOB staff reminds firms that when an auditor's approach to evaluating management's fair value estimate involves the auditor's development of an independent expectation as to that estimate, the auditor must have a reasonable basis, supported by audit evidence, for each of the significant assumptions it uses in developing its expectation.

Goodwill Impairment, Other Indefinite-Lived Intangible Assets, and Other Long-Lived Assets

.235 In accordance with FASB ASC 350-20-28 and 350-30-35-18, goodwill and other intangible assets that are not subject to amortization are required to be evaluated for impairment annually, or more frequently when events or changes in circumstances indicate that the asset might be impaired. FASB ASC 360-10-35-21 states that a long-lived asset should be tested for recoverability whenever events or changes in circumstances indicate that its carrying amount might not be recoverable. FASB ASC 360-20-35-17 states that the carrying amount of a long-lived asset is not recoverable if it exceeds the sum of the undiscounted cash flows expected to result from the use and eventual disposition of the asset. Management might make judgments regarding the application of GAAP and might use fair value measurements or other estimates, such as projections of future cash flows, when assessing or measuring impairment of goodwill, other indefinite-lived intangible assets, and other long-lived assets. An evaluation of impairment can be complex, and the auditor should obtain sufficient appropriate audit evidence to provide reasonable assurance that fair value measurements and disclosures are in conformity with GAAP. Refer to previous discussion on auditor requirements related to auditing fair value measurements used by management.

.236 Inspections staff have observed instances in which firms' procedures to test and conclude on the valuation of goodwill, other indefinite-lived intangible assets, and other long-lived assets were inadequate. Examples of instances in which firms failed to obtain sufficient appropriate audit evidence related to impairment of goodwill, other indefinite-lived intangible assets, or other long-lived assets include the following:

- Failing to sufficiently evaluate goodwill for possible impairment. The procedures related to evaluating goodwill for possible impairment were limited to discussing with management an internal prepared memorandum supporting management's determination that goodwill was not impaired, based on certain internal and external qualitative factors. However, procedures were not performed to evaluate whether other relevant information was inconsistent with management's determination and should have resulted in a determination that goodwill was impaired.

- Failing to test management's projections and underlying assumptions in management's determination that an intangible asset was not impaired. It was concluded that the intangible asset was not impaired, based on obtaining management's projections of the issuer's future financial performance, which indicated substantial increases in revenue, net income, and cash flows in the subsequent three years, and discussing those projections with the issuer. However, the auditors failed to evaluate whether other relevant information was inconsistent with management's determination and should have resulted in a determination that the intangible asset was impaired.

- Failing to perform sufficient procedures in connection with the auditor's own goodwill impairment analysis (as management did not prepare a goodwill impairment analysis). Specifically, failing to obtain information to support the assumptions regarding expected cash flows used in its goodwill impairment calculation and failing to address the apparent inconsistency between the assumptions used in the auditor's cash flow projection and the issuer's history of significant losses and negative cash flows.
- Failing to test the values assigned to long-lived assets that were deemed to be impaired by management, such as (*a*) testing the significant assumptions, underlying data, and methodology used by management, or (*b*) developing an independent fair value estimate to obtain corroboration of the reasonableness of management's fair value estimate. The auditor's procedures related to evaluating the impairment of the long-lived assets were limited to reading management-prepared documentation related to the impairment charge.

Share-based Payments and Equity Financing Transactions

.237 A common means of funding operations by newer or smaller companies facing difficulty raising capital is through issuance of share-based payments and equity financing instruments. Accounting for share-based payments and equity financing instruments may involve terms and conditions that would increase the auditor's risk of material misstatement. In addition, a significant amount of judgment and assumptions may be involved in the fair value measurement of such instruments. As such, the auditor may consider performing procedures including obtaining an understanding of key terms and conditions contained in the arrangements or contracts.

.238 Deficiencies identified during inspection relating to firms' testing of issuers' accounting for share-based payments and equity instruments or issuers' determinations of fair value, or both, include the firms' failure to

- perform procedures to obtain and understanding of the terms of the agreements relating to the issuance of the instruments in order to determine the appropriate accounting for those transactions.
- sufficiently test estimates of fair value for equity instruments, including the inputs, assumptions, and methodologies used in determining their fair value (see previous discussion on auditor requirements related to auditing fair value measurements used by management and for discussion on fair value related audit deficiencies).

Auditing Convertible Debt Instruments

.239 PCAOB inspectors identified deficiencies related to firms' testing of management's accounting for transactions involving debt instruments with warrants and conversion features. Such deficiencies include firms' failures to sufficiently evaluate

- management's determination of fair value of the instruments, or components thereof;
- the allocation of proceeds to the various components of the instruments; and
- the adequacy of the presentation and disclosure of the transactions in the financial statements.

Auditing Related Party Transactions

.240 In accordance with paragraphs .01 and .04 of AU section 334, *Related Parties* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards), auditors are responsible for performing procedures to identify related party relationships and material related party transactions. Audit procedures to address possible material related party transactions normally are performed even if the auditor does not suspect that related party transactions or control relationships exist.

.241 Once an auditor has identified related party transactions, paragraph .09 of AU section 334 states that the auditor should apply procedures to obtain satisfaction concerning the purpose, nature, and extent of transactions with the related parties and the effect of those transactions on the financial statements. The procedures should be directed toward obtaining and evaluating sufficient appropriate audit evidence and should extend beyond inquiry of management. Finally, in accordance with paragraph .11 of AU section 334, auditors should evaluate the adequacy of disclosures for each material related party transaction or common ownership or management control relationship.

.242 Inspections staff have observed deficiencies related to firms' failures to test for undisclosed related parties or transactions with undisclosed related parties. Some of those firms failed to identify and address the lack of disclosure of related party transactions in the financial statements. Inspections staff have also identified deficiencies relating to the firms' failure to obtain an understanding of the nature and business purpose of transactions with related parties and to evaluate whether the accounting for those transactions reflects their economic substance.

Use of Analytical Procedures as Substantive Tests

.243 Auditors often use analytical procedures in their audits as substantive tests of significant accounts or disclosures. As stated in paragraphs .02 and .05 of AU section 329, *Substantive Analytical Procedures* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards), analytical procedures are an important part of the audit process and involve comparisons of recorded amounts, or ratios developed from recorded amounts, to expectations developed by the auditor. The auditor develops such expectations by identifying and using plausible relationships that are reasonably expected to exist based on the auditor's understanding of the client and of the industry in which the client operates.

.244 In determining when to apply substantive analytical procedures, firms need to consider, among other things, that, where significant risks of material misstatement exist, it is unlikely that audit evidence obtained from substantive analytical procedures alone will be sufficient as stated in paragraph .09 of AU section 329. Before using the results of substantive analytical procedures, paragraph .16 of AU section 329 states that auditors should test the completeness and accuracy of the underlying information used in the procedures or test the design and operating effectiveness of controls over the completeness and accuracy of the underlying financial information. When analytical procedures are used as a substantive test of a relevant financial statement assertion, paragraphs .17–.21 of AU section 329 state that the auditor should (*a*) develop an expectation at a sufficient level of precision to provide the desired level of assurance, (*b*) consider the amount of difference from the expectation that can be accepted without further investigation, and (*c*) evaluate significant unexpected differences. Auditors should ordinarily perform procedures to obtain corroboration for management's explanations of significant unexpected differences with other audit evidence.

.245 Inspections staff have identified deficiencies relating to firms' use of analytical procedures that include the firms' failures to (*a*) develop appropriate expectations, including appropriately disaggregating data in order to obtain the necessary level of precision for the expectation; (*b*) investigate significant unexpected differences; (*c*) obtain evidence to corroborate management's explanations regarding significant unexpected differences; and (*d*) test the underlying data used in the analytical procedures.

Fraud

.246 Inspections staff have identified deficiencies relating to firms' consideration of fraud in a financial statement audit that include firms' failures to (*a*) sufficiently test journal entries and other adjustments for evidence of possible material misstatement due to fraud, including assessing the completeness of the listing of journal entries and other adjustments that is used for testing purposes; (*b*) consider the risk of material misstatement due to fraud relating to revenue recognition or indicate why revenue recognition would not be considered a fraud risk; (*c*) make inquiries of the audit committee, management, and others as to their views about the risk of fraud; (*d*) conduct a brainstorming session by members of the engagement team to discuss fraud risks, (*e*) obtain an understanding of management's controls over journal entries and other adjustments, and (*f*) assess the risk of management override of controls.

.247 Firms should design and perform audit procedures that address the fraud risks, including reassessing risk and adjusting procedures as appropriate during the audit. Paragraph .13 of AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards), states that the auditor should exercise professional skepticism, and conduct the audit engagement with a mindset that recognizes the possibility that a material misstatement due to fraud could be present. In addition, in designing and performing its fraud-related audit procedures, PCAOB Staff Audit Practice Alert Nos. 3, *Audit Considerations in the Current Economic Environment*, and 8, *Audit Risks in Certain Emerging Markets* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400 par. .03 and .08), states that firms should take into consideration that (*a*) the current economic environment may trigger certain risk factors that may affect the risk of misstatement due to fraudulent financial reporting, and (*b*) recent disclosures of possible improprieties in financial reporting by companies based in certain large emerging markets in Asia and observations from the PCAOB's oversight activities highlight the need for heightened awareness of risks of misstatement due to fraud when performing audits of companies with operations in emerging markets.

PCAOB Auditing Standards for Broker-Dealers

.248 The Dodd-Frank Act gave the PCAOB full oversight authority over audits of broker-dealers. This includes a provision that audits of broker-dealers be performed under PCAOB auditing standards. To date the SEC has directed auditors to perform audits of broker-dealers under GAAS. However, in late July 2013 the SEC approved revisions to SEC Rule 17a-5 to require audits of broker-dealers to be performed under PCAOB auditing standards. This new requirement will be effective for fiscal years ending on or after June 1, 2014.

.249 In order to accommodate audits of broker-dealers being performed under PCAOB auditing standards, changes to those standards are necessary. Because many PCAOB auditing standards refer to audits of issuers, certain standards need to be revised to include audits of nonissuer broker-dealers. Furthermore, additional auditing standards need to be revised or established to address particular areas applicable to an audit of a broker-dealer.

.250 In July 2011 the PCAOB proposed two standards for attestation engagements that would be applicable to an examination of compliance reports and a review of exemption reports in response to the then proposed revisions to SEC Rule 17a-5. The July 2011 proposals also include a new standard on auditing supplemental information to accommodate the required reporting by regulators.

.251 In February 2012 the PCAOB proposed amendments to its rules and forms to apply them to auditors of broker-dealers registered with the SEC.

.252 In October 2013 the PCAOB issued Release No. 2013-007, in which it adopted two new attestation standards, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers* and *Engagements Regarding Exemption Reports of Brokers and Dealers*, as well as related amendments to certain PCAOB standards. The attestation standards and related amendments will be applicable to all registered firms conducting attestation engagements related to broker and dealer compliance or exemption reports required by the SEC.

Attestation Standard No. 1, Examination Engagements Regarding Compliance Reports of Brokers and Dealers

.253 According to PCAOB Release No. 2013-007, the examination standard (presented in appendix 1 of the release) establishes requirements for the auditor with respect to the auditor's examination regarding a broker's or dealer's compliance report. Consistent with SEC Rule 17a-5, the examination standard requires auditors to obtain sufficient appropriate evidence to opine on a broker's or dealer's statements in its compliance report as to whether

- the internal control over compliance of the broker or dealer was effective during the most recent fiscal year;
- the internal control over compliance of the broker or dealer was effective as of the end of the most recent fiscal year;
- the broker or dealer was in compliance with SEC Rule 15c3-1 (the "net capital rule") and SEC Rule 15c3-3(e) (the "reserve requirements rule") as of the end of the most recent fiscal year; and
- the information the broker or dealer used to state whether it was in compliance with the net capital rule and reserve requirements

rule was derived from the books and records of the broker or dealer.

.254 The examination standard provides requirements for auditors that

- focus the auditor on the matters that are most important to the auditor's conclusions regarding the broker's or dealer's assertions;
- incorporate consideration of fraud risks, including the risk of misappropriation of customer assets;
- are designed to be scalable based on the broker's or dealer's size and complexity;
- coordinate the examination engagement with the audit of the financial statements and the audit procedures performed on supplemental information; and
- describe how to report on an examination engagement, in connection with the requirements of SEC Rule 17a-5.

.255 PCAOB Release No. 2013-007 additionally states that the examination standard retains the requirement that the auditor obtain reasonable assurance to support the auditor's opinion. In particular, the examination standard requires the auditor to obtain reasonable assurance in order to opine on whether the broker's or dealer's assertions are fairly stated, in all material respects. This replaces the requirement to obtain reasonable assurance in prior SEC Rule 17a-5, which stated that "[t]he scope of the audit and review of the accounting system, the internal control and procedures for safeguarding securities shall be sufficient to provide reasonable assurance that any material inadequacies existing at the date of the examination in (*a*) the accounting system; (*b*) the internal accounting controls; (*c*) procedures for safeguarding securities; and (*d*) the practices and procedures whose review is specified [in SEC Rule 17a-5] would be disclosed."

.256 Significant revisions from the proposed standard include the following:

- The auditor's reporting requirements were revised to align with the statements of the broker or dealer pursuant to SEC Rule 17a-5;
- The requirements for auditor testing of controls over compliance were revised to cover internal controls over compliance both as of the end of the fiscal year and during the fiscal year, as provided by SEC Rule 17a-5; and
- The requirements for auditors to test for compliance were revised in view of the changes to SEC Rule 17a-5 to focus specifically on testing compliance with the net capital rule and reserve requirements rule.

Appendix 4 to PCAOB Release No. 2013-007 further discusses the revisions reflected in the examination standard.

Attestation Standard No. 2, Review Engagements Regarding Exemption Reports of Brokers and Dealers

.257 According to PCAOB Release No. 2013-007, the review standard (presented in appendix 2 of the release) establishes requirements for the auditor with respect to the auditor's review regarding the broker's or dealer's exemption report. Consistent with SEC Rule 17a-5, the review standard establishes requirements that apply when an auditor is engaged to perform a review of the broker's or dealer's statements in an exemption report.

.258 The review standard establishes requirements that are designed specifically for the review required by SEC Rule 17a-5. The review standard establishes requirements for making inquiries and performing other procedures that are commensurate with the auditor's responsibility to obtain moderate assurance regarding whether one or more conditions exist that would cause one or more of the broker's or dealer's assertions not to be fairly stated, in all material respects. The broker's or dealer's exemption report includes the following assertions:

- A statement that identifies the provisions in paragraph (k) of SEC Rule 15c3-3 (the "exemption provisions") under which the broker or dealer claimed an exemption from SEC Rule 15c3-3 (the "identified exemption provisions");
- A statement that the broker or dealer (*a*) met the identified exemption provisions throughout the most recent fiscal year without exception or (*b*) met the identified exemption provisions throughout the most recent fiscal year except as described in the exemption report; and
- If applicable, a statement that identifies each exception during the most recent fiscal year in meeting the identified exemption provisions (an "exception") and that briefly describes the nature of each exception and the approximate date(s) on which the exceptions existed.

.259 PCAOB Release No. 2013-007 additionally states that the auditor's review report regarding a broker's or dealer's exemption report replaces the statement provided by auditors under the prior SEC rules. Before the amendments, SEC Rule 17a-5 provided that the auditor engaged by the broker or dealer must "ascertain that the conditions of the exemption were being complied with as of the examination date and that no facts came to the independent public accountant's attention to indicate that the exemption had not been complied with during the period since the independent public accountant's last examination."

.260 The procedures required by the review standard include evaluating relevant evidence obtained from the audit of the financial statements and the audit procedures performed on supplemental information and are designed to enable the auditor to scale the review engagement based on the broker's or dealer's size and complexity. The review standard also establishes requirements for the content of the review report.

.261 Significant revisions from the proposed standard include the following:

- The requirements of the standard were revised to include consideration of disclosure of exceptions to the exemption provisions, as provided by SEC Rule 17a-5; and
- The auditor's reporting requirements were revised to align with the statements of the broker or dealer pursuant to SEC Rule 17a-5.

See PCAOB Release No. 2013-007 for additional information.

Auditing Standard No. 17, Auditing Supplemental Information Accompanying Audited Financial Statements

.262 In October 2013 the PCAOB issued Release No. 2013-008, in which it adopted Auditing Standard No. 17, *Auditing Supplemental Information Accompanying Audited Financial Statements*, substantially as proposed. The following provides a high-level overview of the standard. See appendix 3 of Auditing Standard No. 17 for a more detailed discussion of the standard, significant comments received, and changes made.

.263 According to PCAOB Release No. 2013-008, Auditing Standard No. 17 applies when the auditor of the company's financial statements is engaged to perform audit procedures and report on supplemental information that accompanies financial statements audited pursuant to PCAOB standards. Such supplemental information includes

- supporting schedules that brokers and dealers are required to file pursuant to SEC Rule 17a-5;
- supplemental information (*a*) required to be presented pursuant to the rules and regulations of a regulatory authority and (*b*) covered by an independent public accountant's report on that information in relation to financial statements that are audited in accordance with PCAOB standards; or
- information that is (*a*) ancillary to the audited financial statements, (*b*) derived from the company's accounting books and records, and (*c*) covered by an independent public accountant's report on that information in relation to the financial statements that are audited in accordance with PCAOB standards.

.264 PCAOB Release No. 2013-008 states that the standard covers supplemental information required by regulatory authorities and supplemental information that is voluntarily provided, when the auditor is engaged to report on that information in relation to the financial statements as a whole and the financial statements are audited in accordance with PCAOB standards.

.265 *"In relation to" opinion.* Historically, when auditors reported on supplemental information, they often expressed their opinions on the supplemental information "in relation to" the basic financial statements taken as a whole. Audit procedures regarding that supplemental information generally have been performed in conjunction with the audit of the financial statements. The standard retains the existing "in relation to" language in the auditor's report; however, it also updates the report to describe the auditor's responsibilities for the supplemental information.

.266 *Performance and reporting requirements.* The standard establishes procedural and reporting responsibilities for the auditor regarding supplemental information accompanying financial statements. The standard establishes

- requirements that the auditor perform audit procedures to test the supplemental information;
- requirements that the auditor evaluate the supplemental information, which include evaluating (*a*) whether the supplemental information, including its form and content, is fairly stated, in all material respects, in relation to the financial statements as

a whole, and (*b*) whether the supplemental information is presented in conformity, in all material respects, with the relevant regulatory requirements or other applicable criteria;

- requirements that promote enhanced coordination between the work performed on the supplemental information with work performed on the financial statement audit and, if applicable, other engagements, such as a compliance attestation engagement for brokers and dealers; and
- reporting requirements that clearly articulate the auditor's responsibilities when reporting on supplemental information.

The standard will not apply to schedules prepared pursuant to Regulation S-X because those schedules are deemed by SEC rule to be part of the financial statements.

.267 See PCAOB Release No. 2013-008 for additional information.

PCAOB Interim Inspection Program Report Issued

.268 On August 19, 2013 the PCAOB released its second inspection report on the interim inspection program for broker-dealers. The report, "Second Report on the Progress of the Interim Inspection Program Related to Audits of Brokers and Dealers," is based on inspections of 60 broker-dealer audits performed by 43 firms. Of the 43 firms, 19 were already subject to PCAOB inspection because they audited public companies.

.269 To give some context to the numbers, note that approximately 4,200 broker-dealers filed audited financial statements with the SEC for fiscal periods ended during 2012. Approximately 800 registered public accounting firms audited broker-dealer filings for these periods. Of those it is estimated that approximately 300 of the firms auditing broker-dealers also audit issuers, therefore, approximately 500 firms performing audits of broker-dealers are registered with the PCAOB only because they audit nonissuer broker-dealers.

.270 The report notes that deficiencies were identified in 57 of the 60 audits selected for inspection, or 95 percent. In response to the report findings PCAOB Deputy Director of the Division of Registration and Inspections and Program Leader of the Broker-Dealer Inspections Program, Robert Maday stated "The nature and extent of audit deficiencies and independence findings included in this report are troubling." Maday went on to say "We encourage registered public accounting firms to take action and conduct audits with due professional care, including professional skepticism." The deficiencies were observed in a number of areas, including auditing compliance with the applicable regulatory requirements and in other audit areas not specific to an audit of a broker-dealer. A summary of the deficiencies follows—see PCAOB Release No. 2013-006 for detailed report findings.

.271 Findings related to failures to satisfy independence requirements were as follows:

- *Failure to satisfy independence requirements.* The PCAOB identified independence findings in 22 of the 60 audits selected for inspection. SEC rules provide, among other things, that an accountant is not independent if the accountant provides bookkeeping or other services related to the accounting records or financial statements of the audit client unless it is reasonable to conclude that the results of these services will not be subject to audit procedures performed by the accountant during an audit of the client's financial statements.

In 22 of the audits, by 22 firms, the firms performed bookkeeping or other services related to the accounting records or financial statements of the brokers or dealers. All 22 of these firms prepared, or assisted in the preparation of, the financial statements or supporting schedules required by SEC Rule 17a-5. In addition, some of the firms also prepared trial balances or source data underlying the financial statements of the broker or dealer.

.272 Audit deficiencies were found related to the customer protection and net capital rules, as follows:

- ***Accountant's Supplemental Report on Material Inadequacies (Internal Control Report)***

  — In 41 of the 60 audits, firms failed to perform sufficient audit procedures to obtain reasonable assurance that any material inadequacies existing at the date of the examination would be disclosed in the accountant's supplemental report. It was noted that firms performed a risk assessment and made inquiries of management regarding internal controls as part of the financial statement audit; however, those firms did not sufficiently test controls related to the accounting system, internal accounting controls, or procedures for safeguarding securities of the broker or dealer.

  — For 33 of the 47 audits of broker-dealers that claimed an exemption from the requirement to maintain a Special Reserve Account, firms limited their procedures to inquiry alone and did not perform sufficient other inquiries or other procedures related to the exemption claimed by the broker or dealer under the Customer Protection Rule.

  — In 2 audits, firms failed to evaluate whether a material inadequacy existed when the broker or dealer reported a net capital deficiency in its financial statements.

  — In 1 audit, the firm was aware of an error in the computation required under the Net Capital Rule, but failed to assess whether this error indicated the existence of a material inadequacy.

  — In 1 audit, the firm did not notify the SEC or FINRA of a material inadequacy, related to the customer reserve computation, within the required time frame after the broker or dealer failed to provide notification.

- ***Compliance With the Customer Protection Rule***

  — In 2 of the 5 audits, the firms failed to sufficiently test completeness and accuracy of customer credits or customer debits included in the customer reserve computation.

- — In the other 3 of 5 audits, the firms failed to verify the existence of a Special Reserve Bank Account or failed to evaluate that the account agreements contained the required restrictive provisions of SEC Rule 15c3-3(f).

- ***Compliance With the Net Capital Rule***

  - — In 10 audits, firms failed to assess the nature of the broker's or dealer's operations in relation to the required minimum net capital amounts in accordance with SEC Rule 15c3-1.
  - — In 17 audits, firms did not perform sufficient procedures to test the broker's or dealer's classification of allowable and nonallowable assets when computing net capital. In 3 of those 17 audits, firms failed to perform sufficient procedures to verify that the conditions necessary for the right of offset of certain receivables by related payables were met in accordance with the applicable sections of SEC Rule 15c3-1. Additionally, in 3 of the 17 audits, firms failed to test whether the assets held by a clearing broker, under this arrangement, met the requirements of an allowable asset under SEC Rule 15c3-1.
  - — In 9 audits, firms did not perform sufficient procedures over haircuts on securities. In five of those 9 audits, firms failed to perform sufficient audit procedures on supporting records obtained from the broker or dealer, or external parties, related to haircuts on securities. In these instances, firms did not test the completeness and accuracy of supporting records received from the broker or dealer, or external parties. Further, in three other audits, firms failed to perform procedures to evaluate whether the appropriate haircut percentages were applied by the broker or dealer, including tests of the relevant characteristics of the securities positions.
  - — In 3 audits, firms failed to perform sufficient procedures to test the completeness and accuracy of operational charges deducted from the broker's or dealer's net capital.

Deficiencies found related to the financial statement audit were as follows:

- ***Consideration of Risks of Material Misstatement Due to Fraud***

  - — In 11 of the 60 audits, firms failed to perform audit procedures to respond to the identified risk of fraud for revenue recognition. Further, in 4 other audits, firms did not identify a fraud risk related to revenue recognition or overcome the presumption that such risk existed.
  - — In 35 audits that the firms failed to perform sufficient journal entry testing in response to the risk of management override.

- ***Related Party Transactions***

  — In 3 audits, firms did not perform any procedures to test for related parties or related party transactions.

  — In 10 audits, firms failed to perform sufficient procedures to determine the existence of related parties and material related party transactions. Firms identified certain related parties or material related party transactions, yet failed to test for the existence of undisclosed related parties and related party transactions.

  — In 18 audits, firms identified material related parties or related party transactions pertaining to service agreements, fee agreements, and intercompany balances, yet the firms did not perform procedures necessary to obtain sufficient appropriate audit evidence or did not sufficiently evaluate audit evidence concerning the purpose, nature, or extent of such transactions and their effect on the financial statements. In 9 of these audits, the firms failed to perform procedures to evaluate whether the allocation of revenue and expense amounts for related party transactions was reasonable.

  — In 1 audit, the firm failed to identify that the broker or dealer did not appear to account for a related party transaction appropriately.

- ***Revenue Recognition***

  — In 18 audits, the extent of testing was insufficient for material classes of revenue transactions, including trading gains and losses, commission revenue, and principal transaction revenue. Also, there were instances where the firms did not support a reduced extent of substantive tests of material classes of revenue transactions. Finally, a number of firms failed to select a sample of revenue transactions for testing that was representative of the underlying population or adequate to support a conclusion about the reported revenues, given the basis of the sampling approach applied.

  — In 9 audits, firms performed substantive analytical procedures that did not provide the intended level of assurance.

  — In 27 audits, firms failed to perform sufficient procedures to test the occurrence, accuracy, completeness, or cutoff of revenue.

- ***Establishing a Basis for Reliance on Records and Reports***

  — In 23 audits, firms did not perform sufficient procedures on reports prepared by service organizations and used in audit procedures. In 11 of those 23 audits, firms used reports from a service organization, such as a clearing broker, for purposes of testing commission revenue and the related commission receivable, but either did not obtain and evaluate a service auditor's report or failed to perform procedures regarding the accuracy and completeness of information obtained from the service organization. In 13 of those 23 audits, firms obtained a service auditor's report, but the firm did not sufficiently evaluate the service auditor's report or failed to consider whether the service auditor's report provided evidence about the design and operating effectiveness of the controls being relied upon. Additionally, in 5 of those 23 audits, the firms failed to perform additional procedures when the service auditor did not test controls over relevant financial statement assertions.

— In 8 audits, firms failed to perform procedures to obtain evidence about the accuracy and completeness of records and reports produced by the brokers and dealers that were used in the performance of tests of controls or substantive tests.

- ***Fair Value Measurements***

  — In 5 of 19 audits, firms did not perform sufficient procedures to test the valuation of securities.

- ***Evaluation of Control Deficiencies***

  — In 3 of the 60 audits, firms identified one or more internal control deficiencies while performing procedures to obtain an understanding of internal control. Although the firms identified these deficiencies, the evaluations by the firms did not include a sufficient assessment of the severity of the control deficiency to determine whether the deficiency, individually or in combination, represented a significant deficiency or material weakness. In addition, the firms failed to consider whether there would be any effect on the financial statement audit.

  — In 3 of the 60 audits, firms identified errors during the performance of substantive tests. However, the firms failed to evaluate the severity and nature of the errors, both individually and in the aggregate, and the circumstances of their occurrences, including whether the errors were evidence of one or more control deficiencies. In addition, the firms failed to consider whether there would be any effect on the financial statement audit.

- ***Financial Statement Disclosures***

  — In 8 of the 60 audits, firms failed to identify and address the omission of disclosures pertaining to areas such as related parties and related party transactions, fair value of securities, or revenue recognition policies, despite the fact that these matters were applicable and exceeded materiality thresholds set by the firms.

  — In 19 of the 60 audits, firms failed to identify incomplete disclosures or respond to evidence that was inconsistent with disclosures included in the financial statements. In addition, in 4 audits, firms failed to sufficiently test the disclosure of securities within the hierarchy required by FASB ASC 820, *Fair Value Measurement*.

- ***Understanding the Entity and Its Environment***
  - — In 4 audits, firms did not obtain an understanding of the entity and its environment, including its internal control, in order to design the nature, timing, and extent of audit procedures.
- ***Auditor's Report***
  - — In 14 audits, the auditor's reports on the supporting schedules failed to include one or more of the elements required by AU section 551, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards), such as a statement that the supplementary information is the responsibility of management and was derived from, and relates directly to, the underlying accounting and other records used to prepare the financial statements.
  - — In seven audits, there were errors in the accountant's supplemental report on material inadequacies.

.273 During 2013, the PCAOB plans to inspect approximately 60 firms and portions of approximately 90 audits. The PCAOB currently expects that by the end of 2013, the interim inspection program will include inspections of portions of more than 170 audits of brokers and dealers conducted by approximately 100 registered public accounting firms. The program is designed to cover a cross-section of audits of SEC-registered broker-dealers. The inspection program will continue until new rules for a permanent program are adopted and become effective.

.274 In accordance with the temporary rule regarding the interim inspection program, a report containing results of the inspections performed must be issued yearly. As directed by the rule the report does not name audit firms inspected, unlike the individual inspection reports of public company auditors. However, during an inspection, the deficiencies were discussed with the firm being inspected. Any deficiencies that were considered to be significant were communicated to the firm in writing.

.275 The second interim inspection report states that the PCAOB currently anticipates presenting a rule proposal for a permanent inspection program in 2014 or later. Until a permanent inspection program is in place, audits of issuer and nonissuer broker dealers will remain subject to inspection under the PCAOB Interim Inspection Program. Additionally, audits of nonissuer broker dealers will remain subject to peer review under the AICPA Peer Review Standards until such time that the AICPA Peer Review Board votes to exclude them from the scope of the standards.

On the Horizon

.276 Auditors should keep abreast of 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 financial institutions industry. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing existing standards.

.277 Information on, and copies of, outstanding exposure drafts may be obtained from the various standard-setters' websites. These websites 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 Audit Risk Alert *General Accounting and Auditing Developments—2013/14* (product nos. ARAGEN13P, ARAGEN13E, or WGE-XX), for further information.

Dodd-Frank Regulatory Reform

Volcker Rule

.278 The Volcker Rule prohibits banking entities and affiliated companies from proprietary trading; acquiring or retaining any equity, partnership, or other ownership interest in a hedge fund or private equity fund; and sponsoring a hedge fund or private equity fund. Proprietary trading consists of transactions made by an entity that affect the entity's own account but not the accounts of its clients. Banks are allowed to make de minimis investments in hedge funds and private equity funds using no more than three percent of their tier 1 capital in all such funds combined. Also, a bank's investment in a private fund may not exceed three percent of the fund's total ownership interest. Nonbank financial institutions supervised by the Federal Reserve also have restrictions on proprietary trading, hedge fund investments, and private equity investments.

.279 In February 2011, the Federal Reserve adopted a final rule, Conformance Period for Entities Engaged in Prohibited Proprietary Trading or Private Equity Fund or Hedge Fund Activities. This rule was adopted to implement the conformance period during which banking entities and nonbank financial companies supervised by the Federal Reserve must bring their activities and investments into compliance with the prohibitions and restrictions on proprietary trading and relationships with hedge funds and private equity funds imposed by the Volcker Rule. This rule became effective on April 1, 2011. The final rule has been incorporated into Regulation Y (Title 12 U.S. *Code of Federal Regulations* Part 225).

.280 Under the new ruling, in general, a banking entity should bring its activities and investments into compliance with the requirements of Section 13 of the Bank Holding Company Act no later than 2 years after the earlier of July 21, 2012, or 12 months after the date on which final rules adopted under Section 13(b)(2) of the Bank Holding Company Act are published in the Federal Register. A nonbank financial company supervised by the Federal Reserve should become compliant with all applicable requirements of Section 13 of the Bank Holding Company Act, including any capital requirements or quantitative limitations adopted, no later than 2 years after the date that the company becomes a nonbank financial company supervised by the Federal Reserve. The rule also addresses conformance periods for new banking entities established subsequent to July 21, 2010, and conformance period extensions for both banking entities and nonbank financial entities.

.281 *In April 2012, the Federal Reserve approved the* Statement of Policy Regarding the Conformance Period for Entities Engaged in Prohibited Proprietary Trading or Private Equity Fund or Hedge Fund Activities*, which confirms that an entity covered by the Volcker Rule has two years from July 21, 2012, to conform all of its activities and investments unless the Federal Reserve extends the conformance period. The policy statement can be accessed from the U.S. Government Printing Office website at www.gpo.gov.*

.282 In October 2011, the OCC, the Federal Reserve, the FDIC, and the SEC released a proposed ruling to implement the Volcker Rule. The proposed regulation clarifies the scope of the Volcker Rule's prohibitions and provides certain exemptions. In addition, the proposed regulation would require banking entities engaging in exempt activities to establish an internal compliance program designed to monitor compliance with the regulation. The proposal also imposes certain regulatory reporting requirements on entities with significant trading operations. The proposed regulation can be accessed at any of the respective agencies' websites.

Appraisals for Higher-Priced Mortgage Loans Exemption

.283 In July 2013, the Federal Reserve, the CFPB, the FDIC, the FHFA, the NCUA, and the OCC are proposing to amend their final rule Appraisals for Higher-Priced Mortgage Loans, which establishes new appraisal requirements for higher-priced mortgage loans. See further discussion on the final rule in the "Legislative and Regulatory Developments" section of this alert. Specifically, the proposed guidance exempts from the appraisal rules transactions secured by existing manufactured homes and not land, certain "streamlined" refinancings, and transactions of $25,000 or less. The proposed guidance, Appraisals for Higher-Priced Mortgage Loans—Supplemental Proposal, can be accessed from the U.S. Government Printing Office website at www.gpo.gov.

Stress Test Guidance for Medium-Sized Firms

.284 In August 2013, the Federal Reserve, FDIC, and OCC issued proposed guidance outlining high-level principles for implementation of section 165(i)(2) of the Dodd-Frank Act stress tests. The guidance would be applicable to all bank and savings-and-loan holding companies, national banks, state-member banks, state nonmember banks, Federal savings associations, and state chartered savings associations with more than $10 billion but less than $50 billion in total consolidated assets (collectively, referred to as medium-sized firms). The proposed guidance addresses supervisory expectations for Dodd-Frank Act stress test practices and offers additional details about methodologies that should be employed by these medium-sized firms. It also underscores the importance of stress testing as an ongoing risk management practice that supports a company's forward–looking assessment of its risks and better equips the company to address a range of macroeconomic and financial outcomes. The Proposed Supervisory Guidance on Implementing Dodd-Frank Act Company-Run Stress Tests for Banking Organizations With Total Consolidated Assets of More Than $10 Billion But Less Than $50 Billion can be accessed from the U.S. Government Printing Office website at www.gpo.gov.

Supplementary Leverage Ratio Standards

.285 *In July 2013, the OCC, the Federal Reserve, and the FDIC adopted the Notice of Proposed Rulemaking (NPR)* Regulatory Capital Rules: Regulatory Capital, Enhanced Supplementary Leverage Ratio Standards for Certain

Bank Holding Companies and Their Subsidiary Insured Depository Institutions, *which would strengthen the agencies' leverage ratio standards for large, interconnected U.S. banking organizations. The NPR would apply to any U.S. top-tier bank holding company (BHC) with at least $700 billion in total consolidated assets or at least $10 trillion in assets under custody (covered BHC) and any IDI subsidiary of these BHCs.*

.286 In the revised capital approaches adopted by the agencies in July 2013 (2013 revised capital approaches), the agencies established a minimum supplementary leverage ratio of 3 percent (supplementary leverage ratio), consistent with the minimum leverage ratio adopted by the BCBS, for banking organizations subject to the advanced approaches risk-based capital rules. In this NPR, the agencies are proposing to establish a "well capitalized" threshold of 6 percent for the supplementary leverage ratio for any IDI that is a subsidiary of a covered BHC, under the agencies' PCA framework.

.287 The Federal Reserve also proposes to establish a new leverage buffer for covered BHCs above the minimum supplementary leverage ratio requirement of 3 percent (leverage buffer). The leverage buffer would function like the capital conservation buffer for the risk-based capital ratios in the 2013 revised capital approaches. A covered BHC that maintains a leverage buffer of tier 1 capital in an amount greater than 2 percent of its total leverage exposure would not be subject to limitations on distributions and discretionary bonus payments. The proposal would take effect beginning on January 1, 2018, and can be accessed from the U.S. Government Printing Office website at www.gpo.gov.

Broker-Dealer Considerations

.288 The regulatory requirements for broker-dealers are in a state of change. Many key regulatory developments were previously discussed in the "Legislative and Regulatory Developments" section of this alert. In addition to those items previously discussed, the following releases have been issued.

.289 The SEC issued Release No. 34-69490, *Cross-Border Security-Based Swap Activities; Re-Proposal of Regulation SBSR and Certain Rules and Forms Relating to the Registration of Security-Based Swap Dealers and Major Security-Based Swap Participant*s, which proposes rules and interpretive guidance to address the application of the provisions of the Securities Exchange Act of 1934, as amended.

.290 The proposed rules and interpretive guidance address the application of Subtitle B of Title VII of the Dodd-Frank Act with respect to each of the major registration categories covered by Title VII relating to market intermediaries, participants, and infrastructures for security-based swaps, and certain transaction-related requirements under Title VII in connection with reporting and dissemination, clearing, and trade execution for security-based swaps. In connection with these proposals, Regulation SBSR and certain rules and forms relating to the registration of security-based SDs and major security-based swap participants were also re-proposed.

.291 Additionally, this release contains proposed rules that

- provide an exception from the aggregation requirement, in the context of the security-based SD definition, for affiliated groups with a registered security-based SD.

- address the sharing of information and preservation of confidentiality with respect to data collected and maintained by SDRs.
- address the policy and procedural framework under which the SEC would consider permitting compliance with comparable regulatory requirements in a foreign jurisdiction to substitute for compliance with requirements of the 1934 Act, and the rules and regulations thereunder, relating to security-based swaps ("substituted compliance").

.292 In 2013, the SEC issued Release No. 34-69606, *Regulation Systems Compliance and Integrity*, and Release No. 34-69491, *Reopening of Comment Periods for Certain Rulemaking Releases and Policy Statement Applicable to Security-Based Swaps Proposed Pursuant to the Securities Exchange Act of 1934 and the Dodd-Frank Wall Street Reform and Consumer Protection Act*, both of which reopened the comment periods for previously proposed rules. The following table outlines the proposed rules and the timeframes for the original comment periods and the updated comment periods, which have all expired as of the time this publication was produced. It is important that auditors be alert for further developments.

SEC File Number	***Title***	***Original Proposal Date***	***Original Comment Period Close Date***	***Updated Comment Period Close Date***
S7-27-10	Ownership Limitations and Governance Requirements for Security-Based Swap Clearing Agencies, Security-Based Swap Execution Facilities, and National Securities Exchanges with Respect to Security-Based Swaps under Regulation MC	October 14, 2010	November 26, 2010	July 22, 2013
S7-32-10	Prohibition Against Fraud, Manipulation, and Deception in Connection with Security-Based Swaps	November 3, 2010	December 23, 2010	July 22, 2013
S7-34-10	Regulation SBSR-Reporting and Dissemination of Security-Based Swap Information	November 19, 2010	January 18, 2011	July 22, 2013

(continued)

SEC File Number	*Title*	*Original Proposal Date*	*Original Comment Period Close Date*	*Updated Comment Period Close Date*
S7-35-10	Security-Based Swap Data Repository Registration, Duties, and Core Principles	November 19, 2010	January 24, 2011	July 22, 2013
S7-43-10	End-User Exception to Mandatory Clearing of Security-Based Swaps	December 15, 2010	February 4, 2011	July 22, 2013
S7-03-11	Trade Acknowledgment and Verification of Security-Based Swap Transactions	January 14, 2011	February 22, 2011	July 22, 2013
S7-06-11	Registration and Regulation of Security-Based Swap Execution Facilities (Proposed Interpretation)	February 2, 2011	April 4, 2011	July 22, 2013
S7-08-11	Clearing Agency Standards for Operation and Governance	March 3, 2011	August 29, 2011	July 22, 2013
S7-25-11	Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants	July 29, 2011	August 29, 2011	July 22, 2013
S7-40-11	Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants	October 12, 2011	December 19, 2011	July 22, 2013
S7-05-12	Statement of General Policy on the Sequencing of the Compliance Dates for Final Rules Applicable to Security-Based Swaps Adopted Pursuant to the Securities Exchange Act of 1934 and the Dodd-Frank Wall Street Reform and Consumer Protection Act	June 11, 2012	August 13, 2012	July 22, 2013

SEC File Number	*Title*	*Original Proposal Date*	*Original Comment Period Close Date*	*Updated Comment Period Close Date*
S7-08-12	Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers	October 18, 2012	January 22, 2013	July 22, 2013
S7-01-13	Regulation Systems Compliance and Integrity	March 8, 2013	May 24, 2013	July 8, 2013

Commodities Regulations

.293 Rulemaking continues in a number of areas affecting FCMs and SDs. Although many of the regulations being developed were mandated by the Dodd-Frank Act, also being revised are the basic regulations under which FCMs operate. The proposed rulemaking will have a significant impact on FCMs. Readers should be alert for new developments.

.294 On October 23, 2012, the CFTC approved for public comment proposed new regulations, and amendments to existing regulations (RIN 3038-AD88), to enhance protections for customers and to strengthen the safeguards surrounding the holding of money, securities and other property deposited by customers with FCMs and DCOs. The proposals are the result of the CFTC's efforts to coordinate and consult with the futures industry on enhancing customer protections, including two public roundtables that were hosted by CFTC staff. The proposals also expand upon previous CFTC actions to enhance customer protections, including rolling back certain exemptions from investment standards for customer funds under Regulation 1.25 and the adoption of the legal segregation with operational commingling (LSOC model) for cleared swap transactions.

.295 The proposal would enhance the protection of customers and customer funds in the following ways:

- Amending Part 30 of the regulations to require FCMs to hold sufficient funds in secured accounts to meet their total obligations to both U.S.-domiciled and foreign-domiciled customers trading on foreign contract markets, computed under the net liquidating equity method
- Prohibiting FCMs from holding any positions in a Part 30 secured account other than customers' foreign futures and option positions and associated margin collateral
- Requiring FCMs to hold sufficient proprietary funds in segregated accounts, Part 30 secured accounts, and cleared swaps customer accounts to reasonably ensure that the firms are properly

segregated at all times, and to cover margin deficiencies in customers' trading accounts

- Requiring FCMs to establish a target residual interest, maintain written policies and procedures governing the maintenance of excess funds in customer segregated, Part 30 secured accounts, and cleared swaps customer accounts, and requiring FCMs to obtain the pre-approval of management prior to the withdrawal of 25 percent or more of the excess funds held in segregated, secured, or cleared swaps customer accounts if the withdrawals were not for the benefit of the FCMs' customers
- Requiring FCMs to provide the CFTC and their respective DSROs with daily reporting of the segregation, Part 30 secured amount computations, and cleared swaps customer computation and semimonthly reporting of the location of customer funds and how such funds are invested under Regulation 1.25
- Requiring FCMs and DCOs to provide the CFTC and DSROs, as applicable, with read-only direct electronic access to bank and custodial accounts holding customer funds
- Requiring FCMs to adopt policies and procedures on supervision and risk management
- Requiring FCMs to provide potential customers with additional disclosures addressing firm specific risks
- Enhancing the standards for the self-regulatory organizations' examinations of member FCMs

The proposals were open for public comment until February 15, 2013. Some of these proposals are already required by NFA Financial Requirement Rules Section 16. See further information within the "Legislative and Regulatory Developments" section of this alert.

.296 The following paragraphs provide limited details of the preceding proposals. Readers are encouraged to review the entire proposal from the CFTC website at www.cftc.gov.

FCM Certified Annual Report Deadline

.297 The CFTC proposed to amend Regulation 1.10(b)(1)(ii) to require that an FCM submit its certified annual report to the Commission and to its DSRO within 60 days of its year-end date. Regulation 1.10(b)(1) currently requires that the certified annual report be filed within 90 days of the FCM's fiscal year end, except if the FCM is also a registered securities broker or dealer, in which case the annual report must be filed within 60 days of the firm's year end.

Leverage Ratio Calculation

.298 The CFTC proposed to add a new requirement in Regulation 1.10(b)(5) to require each FCM to file with the CFTC on a monthly basis its balance sheet leverage ratio.

New Cleared Swaps Segregation Schedules

.299 The CFTC proposed to amend Regulation 1.10(d) to revise the unaudited monthly Form 1-FR-FCM and the annual audited Form 1-FR-FCM to include a Statement of Cleared Swaps Customer Segregation Requirements and Funds in Cleared Swaps Customer Accounts Under Section 4d(f) of the Commodity Exchange Act.

Where and How to File Monthly and Annual Audited Forms 1-FR-FCM

.300 The CFTC proposed to amend Regulation 1.10(c)(2)(i) to require an FCM to file its certified financial statement in electronic format. An FCM will use the WinJammer system to file its certified financial report as a PDF document.

Proposed Risk Management Program—Regulation 1.11

.301 The CFTC proposed a new Regulation 1.11 that would require each FCM that carries customer accounts to establish a risk management program (RMP) designed to monitor and manage the risks associated with the FCM's activities as an FCM. Proposed Regulation 1.11 further provides that

- such RMP consist of written policies and procedures:
  - — Shall take into account market, credit, liquidity, foreign currency, legal, operational, settlement, segregation, technological, capital and other applicable risks together with a description of the risk tolerance limits
  - — Shall take into account risks proposed by affiliates, all lines of business of the FCM and all other trading activity engaged in by the FCM
  - — Proposed regulation 1.11(e)(3)(i) requires risk management policies and procedures related to risks associated with safekeeping and segregation of customer funds and must include
    - evaluation and monitoring of depositories.
    - account opening procedures that ensure the FCM obtains the acknowledgement required by regulation 1.20 from the depository.
    - establishing and maintaining an adequate targeted amount of excess funds in customer accounts to ensure the FCM is at all times in compliance with the segregation requirements for customer funds.
    - controls ensuring that the withdrawal of cash, securities, or other property from accounts holding customer funds not for the benefit of customers are in compliance with the Commodity Exchange Act and CFTC regulations.
  - — Shall include policies and procedures for detecting breaches of risk tolerance limits set by the FCM and alerting supervisors within the risk management unit and Senior Management
- such policies and procedures be approved by the governing body of the FCM and be furnished to the CFTC and DSRO. The risk management unit shall provide to Senior Management and to its Governing Body quarterly written reports setting forth all applicable risk exposures of the FCM and

- a risk management unit that is independent from the business unit be established to administer the RMP:
  - The RMP shall be reviewed and tested on at least an annual basis, or upon any material change in the business of the FCM that is likely to alter the risk profile.
  - The review and testing shall be performed by qualified internal audit staff that are independent of the business unit or by a qualified third party audit service.

Additional Notices From FCMs—an amendment to Regulation 1.12

.302 The CFTC proposed to expand Regulation 1.12 to require each FCM to immediately notify the CFTC if the FCM

- does not hold a sufficient amount of funds in segregated, secured amount accounts, or cleared swaps customer accounts to meet the targeted residual interest pursuant to the FCM's policies and procedures required under Regulation 1.11, or whenever the amount of residual interest in any such accounts is less than the sum of all margin deficits for such accounts;
- or the FCM's parent or material affiliate, experiences a material adverse impact to its creditworthiness or ability to fund its obligations;
- experiences a material change in its operations or risk profile, including a change in the senior management of the FCM, establishment or termination of a line of business, material adverse change in the FCM's clearing arrangements, or a material adverse change to the FCM's credit arrangements, including a change that could adversely impact the firm's liquidity resources;
- receives a notice, examination report, or any other correspondence from a DSRO, the SEC or a securities industry self-regulatory organization.

Regulation 1.16—Audits

.303 The CFTC proposed to amend Regulation 1.16 to

- require the public accountant to be registered with the PCAOB and the annual audits be conducted in accordance with PCAOB audit standards.
- require PCAOB registered CPAs to be subject to an examination by the PCAOB, and to have remediated any findings identified.
- require the governing body of each FCM to perform due diligence to ensure the CPA engaged is duly qualified to perform an audit of an FCM. Evaluation of the qualifications should include, among other things
  - CPA's experience in auditing FCMs
  - the depth of the CPA's staff
  - CPA's knowledge of the Commodity Exchange Act and regulations

— size and geographic location of the FCM

— independence of the CPA

Minimum Net Capital—Regulation 1.17—Reduction From Three Days to One Day of Time to Cover Outstanding Margin Calls

.304 The CFTC proposed to amend Regulations 1.17(c)(5)(viii) and (ix) to require an FCM to take capital charges for customer, noncustomer, and omnibus accounts that are undermargined for more than one business day after a margin call is issued.

.305 Currently, an FCM is required to take a capital charge if a margin call is outstanding three business days or more from the call date. For example, if a customer's account is undermargined at the close of business on Monday, the FCM is expected to issue the margin call on Tuesday, and to take a capital charge at the close of business on Friday if the customer has not met the margin call. The proposal would amend Regulation 1.17 by requiring the FCM in the preceding example to take a capital charge as of the close of business on Wednesday.

Reporting of Segregated Account Computation and Details Regarding the Holding of Futures Customer Funds—Regulation 1.32 (Regulation 22.2(g) for Cleared Swaps Customers and Regulation 30.7(l) for Foreign Futures and Foreign Options Customers)

.306 Regulation 1.32 requires each FCM to prepare a daily segregation calculation each business day showing account balances as of the close of business on the previous business day. The FCM is not currently required to file such computation with the CFTC but is required to file the computations with the NFA.

.307 The CFTC proposed to amend Regulation 1.32 to require each FCM to file its daily segregation computation with the CFTC and with the firms' DSRO. The CFTC also proposed to amend Regulation 1.32 to require each FCM to file with the CFTC and with the firm's DSRO twice each month a detailed listing of depositories holding customer funds in the form of cash or Regulation 1.25 permitted investments, and to disclose if any of the depositories holding customer funds is affiliated with the FCM.

.308 Regulation 1.32 also provides that an FCM may offset any deficit in a customer's account balance by readily marketable securities deposited as margin by the customer. The value of the securities, however, must be reduced to reflect potential changes in the market value of the securities. The CFTC proposed to amend Regulation 1.32 to provide that an FCM may use its own internal credit risk assessment to determine the appropriate haircut in lieu of imposing a standard 15 percent deduction for commercial paper, convertible debt instruments, and nonconvertible debt instruments deposited by customers as margin.

.309 The CFTC proposed similar requirements for FCMs carrying cleared swaps accounts and foreign futures accounts.

Public Availability of Information

.310 The CFTC proposed to amend Regulation 1.10 to require each FCM to disclose in its Segregation Schedule and Secured Amount Schedule a target amount of "residual interest" that the FCM is required to maintain pursuant to its policies and procedures. Additionally, the FCM will be required to report on these schedules the sum of outstanding margin deficits of the relevant customers for each computation, to ensure that the residual interest is at all times in excess of such sum. The CFTC also proposed to revise Form 1-FR-FCM to adopt a new "Statement of Cleared Swap Customer Segregation Requirements and Funds in Cleared Swap Customer Accounts Under Section 4d(f) of the Act." This Cleared Swaps Segregation Schedule is proposed to be a public document in the same manner as the Segregation Schedule and Secured Amount Schedule and is available by requesting copies from the Commission.

.311 Proposed Regulation 1.55(o)(1) would require each FCM to make available on its website certain financial information, including (*a*) the daily Statement of Segregation Requirements and Funds in Segregation for Customers Trading on U.S. exchanges for the most current 12-month period; (*b*) the daily Statement of Secured Amounts and Funds Held in Separate Accounts for 30.7 Customers Pursuant to Commission Rule 30.7 for the most current 12-month period; (*c*) the daily Statement of Cleared Swaps Customer Accounts under Section 4d(f) of the Commodity Exchange Act for the most recent 12-month period; and (*d*) a summary schedule of the FCM's adjusted net capital, net capital, and excess net capital, all computed in accordance with Regulation 1.17 and reflecting balances as of the month-end for the 12 most recent months.

Foreign Futures—Part 30—Limitation of Funds Held in Non-US Depositories

.312 The CFTC proposed to amend Regulation 30.7(c) to provide that an FCM may not deposit or hold the foreign futures or foreign options secured amount with any depository located outside the U.S. except to meet margin requirements, including prefunding margin requirements established by rule, regulation or order of a foreign board of trade or clearing organization, or to meet margin calls issued by foreign brokers carrying the customers' positions. The proposal provides further that an FCM may hold in depositories located outside the U.S. an additional amount of up to 10 percent of the total amount of funds necessary to meet the margin and prefunding margin requirements.

Mortgage Servicing Compensation Reform

.313 Under the typical current servicer compensation structure, the loan servicer is paid a servicing fee that is normally expressed as a percentage of the principal balance of the outstanding loan, which is collected over the life of the loan as payments are received.

.314 The servicer is ultimately responsible for performing its duties, regardless of whether the loan is performing or nonperforming. Servicing a performing loan is generally significantly less complex and expensive then servicing a nonperforming loan because servicing for performing loans can be performed almost entirely from centralized processing operations that have been automated. In contrast, the servicing of nonperforming loans tends to be more labor intensive because it requires the servicer to directly interact with borrowers.

.315 As a result of the housing crisis and rise in mortgage delinquencies, the current servicing compensation structure has become the subject of much debate. Enhanced automation of loan servicing increased the spread between servicing fees and the costs of servicing for performing loans. Some believe that servicers were too focused on increasing the spread for performing loans, resulting in the servicers failing to invest appropriately in the technology, systems, and infrastructure needed for managing nonperforming loans when the volume of loan delinquencies and foreclosures increased.

.316 In January 2011, the FHFA requested Fannie Mae and Freddie Mac to work on a joint initiative with the FHFA and HUD to consider alternatives for future mortgage servicing structures and servicing compensation for their single family mortgage loans. The joint initiative was developed with the goals of improving service for borrowers, reducing financial risk to servicers, and providing flexibility to guarantors to better manage nonperforming loans.

.317 In September 2011, the FHFA released for public comment the discussion paper Alternative Mortgage Servicing Compensation Discussion Paper, which can be accessed from the FHFA website at www.fhfa.gov. The discussion paper proposes two alternatives to the current servicing compensation structure. The first proposal provides for a reduced minimum servicing fee, along with a reserve account that would offset unexpectedly high servicing costs resulting from extraordinary deteriorations in industry conditions. The second proposal introduces the concept of a fee-for-service structure, which would allow for a base servicing fee for performing loans.

.318 Although responses to the proposal to date are largely in favor of no change on the reserve account structure, servicing compensation reform remains a key FHFA initiative and is planned to be further analyzed.

FASB Project Roster and Status

.319 The following table lists current FASB projects that may affect your financial institutions, including a brief description of the project objectives. Further information on each of these projects and the most up-to-date technical plan, including a summary of decisions reached to date, can be accessed from the FASB Project Roster and Status page at www.fasb.org.

FASB Current Technical Plan	
Revenue Recognition *Revenue Recognition (Topic 605): Revenue from Contracts with Customers (including proposed amendments to the FASB* Accounting Standards Codification®*)*	The objective of this joint FASB and IASB project is to clarify the principles for recognizing revenue and to develop a common revenue standard for GAAP and IFRSs that would (1) remove inconsistencies and weaknesses in existing revenue requirements, (2) provide a more robust framework for addressing revenue issues, (3) improve comparability of revenue recognition practices across entities, industries, jurisdictions, and capital markets, (4) provide more useful information to users of financial statements through improved disclosure requirements, and (5) simplify the preparation of financial statements by reducing the number of requirements to which an entity must refer. A final ASU is anticipated for release in the fourth quarter 2013.

(continued)

FASB Current Technical Plan	
Leases *Leases (Topic 842): a revision of the 2010 proposed FASB Accounting Standards Update, Leases (Topic 840)*	The objective of the revised exposure draft is to increase transparency and comparability among organizations by recognizing lease assets and liabilities on the balance sheet and disclosing key information. The board plans to consider all feedback on the revised exposure draft and begin redeliberations on all significant issues in the fourth quarter 2013.
Insurance Contracts *Insurance Contracts (Topic 834)*	The objective of this joint FASB and IASB project is to develop common, high-quality guidance that will address recognition, measurement, presentation, and disclosure requirements for insurance contracts (including reinsurance), even if the contracts are not issued by an insurance entity. Specifically, the project is intended to improve, simplify, and converge the financial reporting requirements for insurance contracts and to provide investors with decision-useful information. The board plans to consider all feedback on the exposure draft and begin redeliberations on all significant issues in the fourth quarter 2013.
Accounting For Financial Instruments *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities* *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities—Proposed Amendments to the FASB* Accounting Standards Codification® *Financial Instruments—Credit Losses (Subtopic 825-15)* *Selected Issues about Hedge Accounting*	The objective of this joint FASB and IASB project is to significantly improve the decision usefulness of financial instrument reporting for users of financial statements. The project will replace FASB's and the IASB's respective financial instruments standards with a common standard. The overall project was split into the following three topical areas: *Classification and Measurement* A final ASU is anticipated for release in the fourth quarter 2013. *Credit Impairment* No anticipated timing has been released for issuance of a final ASU. *Hedge Accounting* FASB is considering feedback received through comment letters on FASB's discussion paper and outreach activities to determine the best path forward for redeliberations on hedge accounting.

FASB Current Technical Plan	
Going Concern *Presentation of Financial Statements (Topic 205): Disclosure of Uncertainties about an Entity's Going Concern Presumption*	The objective of this FASB project is to provide preparers with guidance in GAAP on management's responsibilities for evaluating and disclosing going concern uncertainties and, thereby, reduce existing diversity in footnote disclosures. In doing so, the board believes that the proposal also would improve the timeliness and the quality of footnote disclosures about going concern uncertainties. The board plans to consider all feedback on the exposure draft and begin redeliberations on all significant issues in the fourth quarter 2013.
Consolidation: Policy and Procedures *Consolidation (Topic 810): Principal versus Agent Analysis*	The objective of this FASB project is to consider comprehensive guidance for consolidation of all entities, including entities controlled by voting or similar interests. This includes an evaluation of guidance for determining the capacity of a decision maker. A final ASU is anticipated for release in the fourth quarter 2013.
Transfers and Servicing: Repurchase Agreements and Similar Transactions *Transfers and Servicing (Topic 860): Effective Control for Transfers with Forward Agreements to Repurchase Assets and Accounting for Repurchase Financings*	The objective of this FASB project is to improve the existing accounting and disclosure guidance on repurchase agreements (and other transactions involving a transfer and a forward agreement to repurchase the transferred assets at a fixed price from the transferee) to address application issues and changes in the marketplace and to ensure that investors obtain useful information about these transactions. A final ASU is anticipated for release in the fourth quarter 2013.
EITF Issue No. 12-G, Measuring the Financial Liabilities of a Consolidated Collateralized Financing Entity *Consolidation (Topic 810): Measuring the Financial Liabilities of a Consolidated Collateralized Financing Entity* (a consensus of the FASB Emerging Issues Task Force)	The objective of this EITF project is to determine how a reporting entity should initially and subsequently account for the excess in the fair value of assets over liabilities of a consolidated collateralized financing entity (CFE). This issue applies to all entities that subsequent to the effective date of ASU No. 2009-17, *Consolidations (Topic 810): Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities*, are required to consolidate a CFE as a result of (*a*) a reassessment of the consolidation conclusion, (*b*) a business combination, or (*c*) the acquisition of a management contract that results in the consolidation of a CFE.

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FASB Current Technical Plan	
EITF Issue No. 13-E, Reclassification of Collateralized Mortgage Loans upon a Troubled Debt Restructuring *Receivables—Troubled Debt Restructurings by Creditors (Subtopic 310-40): Reclassification of Collateralized Mortgage Loans upon a Troubled Debt Restructuring* (a consensus of the FASB Emerging Issues Task Force)	The objective of this EITF project is to clarify when an in substance repossession or foreclosure occurs, that is, when a creditor should be considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, such that all or a portion of the loan should be derecognized and the real estate property recognized.

Resource Central

.320 The following are various resources that practitioners engaged in the financial institutions industry may find beneficial.

Publications

.321 Practitioners may find the following publications useful. Choose the format best for you—print, ebook, or online.

- Audit and Accounting Guide *Depository and Lending Institutions: Banks and Savings Institutions, Credit Unions, Finance Companies, and Mortgage Companies* (2013) (product nos. AAGDEP13P [paperback], AAGDEP13E [ebook], or WDL-XX [online with the associated Audit Risk Alert])
- Audit and Accounting Guide *Brokers and Dealers in Securities* (2013) (product nos. AAGBRD13P [paperback], AAGBRD13E [ebook], or WBR-XX [online with the associated Audit Risk Alert and Practice Aid *Audits of Futures Commission Merchants, Introducing Brokers, and Commodity Pools*])
- Audit and Accounting Practice Aid *Audits of Futures Commission Merchants, Introducing Brokers, and Commodity Pools* (product nos. 06639 [paperback] or WFM-XX [online])

Continuing Professional Education

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

- *Audits of Banks, Savings Institutions, Credit Unions and Other Financial Institutions* (product no. 733445 [text]). This course features practical worksheets and insights such as the applicable metrics that create value for financial institutions.

Visit www.cpa2biz.com for a complete list of CPE courses.

Member Service Center

.323 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

.324 Do you have a complex technical question about GAAP, other comprehensive bases of accounting, or other technical matters? If so, use the AICPA's Accounting and Auditing Technical Hotline. AICPA staff will research your question and call you back with the answer. The hotline is available from 9 a.m. to 8 p.m. ET on weekdays. You can reach the Technical Hotline at 877.242.7212 or online at www.aicpa.org/Research/TechnicalHotline/Pages/TechnicalHotline.aspx. Members can also e-mail questions to aahotline@aicpa.org. Additionally, members can submit questions by completing a Technical Inquiry form found on the same website.

Ethics Hotline

.325 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.

AICPA Online Professional Library: Accounting and Auditing Literature

.326 The AICPA has created your core accounting and auditing library online. The AICPA Online Professional Library is now customizable to suit your preferences or your firm's needs. You can also 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.

Codified Clarity Standards

.327 The best way to obtain the codified clarity standards is with a subscription to AICPA *Professional Standards* in the AICPA Online Professional Library. Although the individual SASs are available in paperback, this online codified resource is what you need to update your firm audit methodology and begin understanding how clarity standards change certain ways you perform your audits. Visit www.cpa2biz.com/AST/AICPA_CPA2BIZ_Specials/MostPopularProductGroups/AICPAResourceOnline/PRD~PC-005102/PC-005102.jsp for online access to AICPA *Professional Standards*.

.328 You can also get the clarified standards in paperback format. *Codification of Statements on Auditing Standards* is published each spring and includes the clarified auditing standards and the attestation standards. *Professional Standards*, which has the full complement of AICPA standards, is published each summer.

.329 The codification of clarified standards includes various resources:

- A preface, "Principles Underlying the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards"
- A glossary of terms defined in the standards
- An appendix describing the differences between GAAS and the ISAs
- A table mapping the pre-clarity AU sections to the clarified AU sections

Financial Reporting Center of AICPA.org

.330 CPAs face unprecedented changes in financial reporting. As such, the AICPA has created the Financial Reporting Center to support you in the execution of high-quality financial reporting. This center provides exclusive member-only resources for the entire financial reporting process and can be accessed at www.aicpa.org/FRC.

.331 The Financial Reporting Center provides timely and relevant news, guidance, and examples supporting the financial reporting process. You will find resources for accounting, preparing financial statements, and performing various types of engagements, including compilation and review, audit and attest, and assurance and advisory.

.332 For example, the Financial Reporting Center offers a dedicated section to the Clarity Project. For the latest resources available to help you implement the clarified standards, visit the "Improving the Clarity of Auditing Standards" page at www.aicpa.org/SASClarity.

Industry Conference

.333 The AICPA offers an annual National Conference on Banks and Savings Institutions in the fall. The banks and savings institutions conference is a three-day conference designed to update attendees on recent developments related to the banking industry. The conference brings together leading experts, regulators, and your peers for in-depth coverage on all aspects of auditing, accounting and tax issues within the banking industry. The conference features specialized tracks for all banks, as well as specialized sessions for community banks and large banks. For further information about the conference, call 888.777.7077, or visit www.cpa2biz.com.

.334 The AICPA offers an annual Conference on Credit Unions in the fall. The credit union conference is a three-day conference designed to update attendees on recent related to the credit union industry. The conference aims to provide attendees with new ideas and practical solutions to help them successfully handle today's key challenges in their organization. This conference brings together a wide array of industry experts and offers in-depth discussions on the latest regulatory, accounting, auditing, technological and practical issue prevalent in the credit union industry today. For further information about the conference, call 888.777.7077, or visit www.cpa2biz.com.

.335 The AICPA/SIFMA FMS Conference on the Securities Industry is co-sponsored by the AICPA and the Financial Management Society of the Securities Industry and Financial Markets Associations and is offered annually in the fall. The conference is a two-day conference geared toward accounting, regulatory and financial professionals, as well as public practitioners involved with the securities industry. This intensive program gives attendees first-hand access to regulators and exposure to the latest developments, in-depth analysis and thought provoking question and answer sessions with industy insiders. For further information about the conference, call 888.777.7077, or visit www.cpa2biz.com.

AICPA Industry Expert Panel—Financial Institutions

.336 For information about the activities of the AICPA Depository and Lending Institutions Industry Expert Panel, visit the panel's webpage at www.aicpa.org/InterestAreas/FRC/IndustryInsights/Pages/Expert_Panel_Depository_and_Lending_Institutions.aspx.

.337 For information about the activities of the AICPA Stockbrokerage and Investment Banking Expert Panel, visit the panel's webpage at www.aicpa.org/InterestAreas/FRC/IndustryInsights/Pages/Expert_Panel_Stockbrokerage_and_Investment_Banking.aspx.

Industry Websites

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

Organization	***Website***
American Bankers Association	www.aba.com
Board of Governors of the Federal Reserve System	www.federalreserve.gov/
Commodity Futures Trading Commission	www.cftc.gov
Consumer Financial Protection Bureau	www.consumerfinance.gov
Federal Deposit Insurance Corporation	www.fdic.gov
Federal Financial Institutions Examination Council	www.ffiec.gov
Federal Housing Finance Agency	www.fhfa.gov
Financial Industry Regulatory Authority	www.finra.org
Futures Industry Association	www.futuresindustry.org
Mortgage Bankers Association	www.mbaa.org
National Credit Union Administration	www.ncua.gov
National Futures Association	www.nfa.futures.org
Office of the Comptroller of the Currency	www.occ.gov

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Organization	*Website*
Securities Industry and Financial Markets Association	www.sifma.org
U.S. Department of Housing and Urban Development	www.hud.gov
U.S. Securities and Exchange Commission	www.sec.gov

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