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Including Depository and Lending Institutions and Brokers and Dealers in Securities

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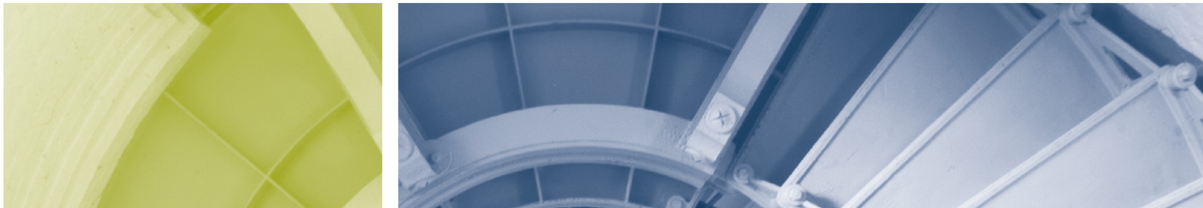

AUDIT RISK ALERT

2014/15

Financial Institutions Industry Developments

Including Depository and Lending Institutions and Brokers and Dealers in Securities

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AUDIT RISK ALERT

2014/15

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—2013/14*.

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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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 in securities (broker-dealers), 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 risks that may result in the material misstatement of financial statements, including significant risks requiring special audit consideration. 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 AICPA Audit Risk Alert *General Accounting and Auditing Developments—2014/15*, 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. See "Resource Central" in this alert for information on ordering this and other related publications.

.03 It is essential that you 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 You 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 you with this aspect of the risk assessment procedures and further expands your understanding of other important considerations relevant to the audit.

Economic and Industry Developments

Debt Crisis—U.S. Municipal and European Sovereign

.05 There continues to be an elevated level of (*a*) risk that certain issuers of state and municipal bonds and certain 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 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 2014 as austerity measures and bailout administration continued to progress. These efforts have generally tempered some concerns over the short-term collapse of certain 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 June 2014 euro area jobless rate remained at 11.5 percent compared to 12 percent as of June 2013.

.08 Due to the interrelated lending relationships and the significant debt exposures among 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.

.09 Paragraphs 20–21 of 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

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- 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 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) for the quarter-ended June 30, 2014, has increased more than five percent year-over-year. In FDIC Chairman Martin J. Gruenberg's August 28, 2014, remarks on the second quarter 2014 *FDIC Quarterly Banking Profile*, he noted continued improvement in the condition of the banking industry as evidenced by increasing net income, loan growth, and continued asset quality improvement. Gruenberg further noted that although allowance releases have been a primary driver of earnings growth in the industry in recent years, diminishing benefits are resulting from these lower loan loss provisions. Therefore, future earnings will be increasingly dependent on other sources. This may prove challenging due to narrow interest margins as well as reductions in mortgage-related income.

.13 The year-over-year trend in bank failures has continued to improve. In addition, the number of insured institutions on the FDIC Problem Bank List declined for a thirteenth consecutive quarter.

OCC Semiannual Risk Perspective

.14 The Office 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 its *Semiannual Risk Perspective* to address key risks facing the

banking industry. Specifically, the most recent spring 2014 report highlighted the following risks:

- Strategic risk remains high for many banks as they determine ways to generate returns.
- Bank risk management continues to be complicated by competitive pressures, revenue growth needs, an environment of low interest rates, and compliance challenges
- Operational risk remains high for many banks due to the changes occurring in business models and operations as well as ongoing cyber-threats

.15 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 topping over $1.1 trillion, net worth exceeding $118.8 billion, and membership exceeding 98 million as of June 30, 2014, according to June 2014 Call Report data submitted to and compiled by the National Credit Union Administration (NCUA).

.17 Despite the many encouraging trends, supervisory concerns remain in interest rate risk (IRR) and cybersecurity threats. In addition, emerging concerns have been raised over investments in less established or complex products (for example, private student loans).

.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 During 2013 and the first portion of 2014, the impact of many borrowers having already locked in lower rates in the preceding years caused refinancing to drop at a fairly rapid pace. According to the Mortgage Bankers Association's (MBA's) "MBA Mortgage Finance Forecast" from July 2014, at the beginning of 2013, the percentage of originations due to refinance was 74 percent. However, this percentage has decreased throughout 2013 and 2014 and now resides in the 40-percent to 50-percent range. The MBA expects stability in overall mortgage originations for the remainder of 2014, as purchase originations are expected to offset the reductions in refinance originations during the period. The Mortgage Credit Availability Index, the MBA's measure of credit availability, indicates that the supply of mortgage credit has continued to increase overall during 2014.

Mortgage Loan Delinquencies and Foreclosures

.20 According to the MBA, as of the end of the second quarter of 2014, the delinquency rate for mortgage loans on residential properties of 1-4 units was

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at a seasonally adjusted rate of 6.04 percent of all loans outstanding.[1] This rate represented a decrease of 92 basis points from 1 year ago and a decrease of 7 basis points over the prior quarter.

.21 The percentage of mortgages that entered the foreclosure process decreased to 0.4 percent during the second quarter of 2014 compared to 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 2.49 percent, representing a 16-basis-point drop from the first quarter and 84 basis points from the second quarter of 2013.

Broker-Dealers in Securities

.22 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. 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 at an increasing pace, including those necessary for meeting the requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the Dodd-Frank Act).

.23 As of June 2014, FINRA oversaw approximately 4,100 brokerage firms, which is consistent with the number of firms in 2013 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 in addition to firms that have left the business. Some expect the consolidation trend to continue for the next 3–5 years as the larger firms acquire the smaller or mid-sized independent broker-dealers in response to the pressure on margins. As of mid-2014, FINRA was supervising approximately 635,000 registered representatives, which is consistent with 2013 but below 2008 levels according to the FINRA website.

.24 Compliance with the Dodd-Frank Act, FINRA regulations, and other new regulatory requirements, including the recent amendments to SEC Rule 17a-5, may entail considerable investments in technology or third-party services, which will continue to add pressure to the bottom line for broker-dealers. Without 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.

Legislative and Regulatory Developments

Dodd-Frank Act Regulations

.25 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

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[1] According to the Mortgage Bankers Association's press release, "Delinquency and Foreclosure Rates Decrease in Second Quarter," dated August 7, 2014, the delinquency rate includes loans that are at least one payment past due but does not include loans in the process of foreclosure.

big to fail," protecting American taxpayers by ending bailouts, and protecting consumers from abusive financial services practices.

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

.27 You 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. You 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 your determination of the reliance that you may place on the institution's internal audit department, especially with respect to audits of internal control over financial reporting.

Volcker Rule

.28 On December 10, 2013, the OCC, the Board of Governors of the Federal Reserve System (Federal Reserve), the FDIC, and the SEC released their rule "Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds," otherwise known as the Volcker Rule.

.29 The final rules prohibit IDIs and companies affiliated with IDIs (banking entities) from engaging in, with certain exemptions, short-term proprietary trading of certain securities, derivatives, commodity futures, and options on these instruments, for their own account, as well as impose, with certain exclusions, limits on banking entities' investments in, and other relationships with, hedge funds or private equity funds and numerous other types of privately offered funds and pooled investment vehicles, referred to as *covered funds*.

.30 The regulations became effective April 1, 2014, and bank entities must bring their activities and investments into conformance with the regulations by July 21, 2015. On April 7, 2014, the Federal Reserve issued a news release announcing its intent to exercise its authority to give banking entities two additional one-year extensions to conform their ownership interests in, and sponsorship of, certain collateralized loan obligations to meet the requirements of the Volcker Rule. These extensions move the conformance date to July 21, 2017. Only collateralized loan obligations owned as of December 31, 2013, that do not qualify for the exclusion in the final rule for loan securitizations are eligible for the extensions. The Federal Reserve intends to act on these extensions in August of this year and the next year. The other banking regulatory agencies plan to administer their oversight of banking entities under their respective jurisdictions in accordance with the Federal Reserve's conformance rule, including any extension of the conformance period applicable to collateralized loan obligations. The conformance dates and scope of interests covered

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by the Volcker Rule are subject to further deliberation and rule making by the regulatory agencies.

.31 The final rules include compliance requirements that vary based on the size of the banking entity and the amount of activities conducted, reducing the burden on smaller, less complex entities. The final rules generally require banking entities to establish an internal compliance program reasonably designed to ensure and monitor compliance with the final rules. Larger banking entities would have to establish a more detailed compliance program, including a required CEO attestation; smaller entities engaged in modest activities would be subject to a simplified compliance regime. Banking entities that do not engage in any activity subject to the final rules, other than trading in exempt government and municipal obligations, are not required to establish a compliance program.

.32 Banking entities with significant trading operations are required to report certain quantitative measurements designed to monitor certain trading activities. The reporting requirements would be phased in based on the type and size of the firm's trading activities. Beginning June 30, 2014, banking entities with $50 billion or more in consolidated trading assets and liabilities will be required to report quantitative measurements. Banking entities with at least $25 billion, but less than $50 billion, in consolidated trading assets and liabilities will become subject to this requirement on April 30, 2016. Those with at least $10 billion, but less than $25 billion, in consolidated trading assets and liabilities will become subject to the requirement on December 31, 2016. The agencies will review the data collected prior to September 30, 2015, and revise the collection requirement as appropriate.

.33 Banking entities will need to carefully review their hedging and investment portfolios to identify those investments and operations that will be affected by the Volcker Rule and develop a credible plan to divest these assets and comply with the reporting and record-keeping requirements. Community banks with less than $10 billion in total consolidated assets are exempt from trading restrictions and compliance requirements with respect to trading in U.S. Treasury bonds, government-sponsored enterprise agencies, municipals, and certain other obligations.

.34 You should consider the potential impact of the requirements of the Volcker Rule in the performance of your audits, including the following internal control and substantive audit considerations:

- An evaluation of internal control established by management to evaluate and monitor the implementation of the Volcker Rule, including the establishment of policies and procedures and internal control over the identification of non-permissible activities and covered funds requiring divestiture, and the evaluation (accounting and valuation considerations) and monitoring of covered funds (including the *de minimis* and other requirements).
- An evaluation of internal control established by management to apply the provisions of the Volcker Rule on an ongoing basis, including internal control established to ensure that new investments or relationships are appropriately reviewed and approved and consistent with the requirements of the Volcker Rule.
- An evaluation of internal control established by management to evaluate the implications of the Volcker Rule in the determination

of regulatory capital, ongoing compliance reporting, and financial statement disclosures.

- The appropriateness of the classification of covered funds as available-for-sale and held-to-maturity. Certain securities may not be able to be classified as held-to-maturity and may need to be reclassified to available-for-sale because the banking entity will no longer have the ability to hold the security to maturity.
- An evaluation of unrealized losses for "other than temporary impairment," as required by U.S. generally accepted accounting principles (GAAP). Unless an entity has the intent and ability to hold the investment until recovery, an impairment charge is recorded. With the impending divestitures resulting from the Volcker Rule, it would seem unlikely that such an assertion could be made and, therefore, any related impairment on affected investments may need to be recognized earlier than previous guidance would dictate.
- An evaluation of liquidity and other market conditions and considerations that may affect the underlying valuation assumptions and judgments used in determining the fair value of covered funds and their classification in the valuation hierarchy (for example, level II versus level III).
- The impact of the Volcker Rule on a banking entities determination of regulatory capital.
- Non-adherence to the requirements of the Volcker Rule, which may affect an entity's compliance with laws and regulations (for example, in accordance with reporting requirements of Section 112 of the FDIC Improvement Act).
- Implications of the Volcker Rule on an entity's liquidity and its ability to continue as a going concern.

Basel III

.35 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 micro-prudential, regulation, which will help raise individual banking institutions' resilience to periods of stress; (*b*) system-wide, or macro-prudential, risks that can build up across the banking sector; and (*c*) the pro-cyclical 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*,

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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.

.36 Basel III regulations include (*a*) a tighter definition of *tier1 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.

.37 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.

.38 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.

.39 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.

.40 The proposal on the application of credit risk adjustments to derivatives suggests that debit valuation adjustments for over-the-counter (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.[2] 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. You can find the final rule at www.bis.org/press/p120725b.htm.

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

U.S. Implementation of Basel III

.42 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.[3] For advanced approaches banking organizations, the revised definition of *capital* and revised advanced approaches for measuring risk-weighted assets became 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.

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

.43 *Revisions to the minimum capital requirements and adjustments to prompt corrective action thresholds*. The new rule implements higher minimum

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[2] 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.

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

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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 counter-cyclical buffer, which acts as an extension of the capital conservation buffer, which would be activated by the banking agencies under certain economic conditions.

.44 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.

.45 The capital thresholds for the different prompt corrective action (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.

.46 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.

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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.

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.47 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 the gradual removal of non-qualifying 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 non-qualifying capital instruments.

.48 *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.[4] 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.

.49 *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.

.50 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.

[4] 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%	No payout limitation applies
Less than or equal to 2.5% and greater than 1.875%	60%
Less than or equal to 1.875% and greater than 1.25%	40%
Less than or equal to 1.25% and greater than 0.625%	20%
Less than or equal to 0.625%	0%

.51 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.

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

.53 *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.

.54 *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 have 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).

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.55 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 is 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 non-significant 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, non-deducted investments in trust preferred security collateralized debt obligations are treated as securitization exposures.

.56 *Accumulated other comprehensive income.* Under the final rule, the requirement to include unrealized gains and losses recognized in accumulated other comprehensive income (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.

.57 *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

.58 The OCC, Federal Reserve, and FDIC have revised the advanced approaches rule to incorporate certain aspects of Basel III as well as requirements introduced by the Basel Committee on Banking Supervision (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, credit valuation adjustment (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.

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

- modify the definition of *financial collateral* such that resecuritizations, conforming residential mortgages, and noninvestment-grade debt securities no longer qualify as financial collateral.
- revise the standard supervisory haircuts for securitization exposures in the exposure-at-default adjustment approach to eliminate references to credit ratings.
- adjust the holding period in the collateral haircut and simple Value-at-Risk 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 supervisor that the stress period coincides with increased CDs or other credit spreads of the banking organization's counterparties and 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 identify, 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.

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- 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.

.60 *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 when 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.

.61 *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 remove 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 credit-enhancing interest-only strip (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 in which 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.

.62 The revised advanced approaches amendments also

- include specific treatment for credit protection purchased and 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 mitigator 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.

.63 *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 with the exception of deductions from total capital of insurance underwriting.

.64 *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:

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- 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 that 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 pre-sold construction loans and multifamily residential loans

NCUA Derivatives Regulations

.65 On January 31, 2014, the NCUA published in the Federal Register a final rule amending the derivatives authority set forth in Subpart B of Title 12, *Banks and Banking*, of U.S. *Code of Federal Regulations* (CFR). The effective date of the new rule is March, 3, 2014. The new rule is applicable to all federal credit unions with limited applicability to federally insured state chartered credit unions (FISCUs), although FISCUs are required to notify the NCUA at least 30 days prior to engaging in derivatives activities. As of June 30, 2014, the NCUA Call Report added schedule D dedicated to the disclosure of derivatives.

.66 The new rule permits federal credit unions to engage in interest rate swaps, caps, floors, basis swaps, and Treasury futures for purposes of mitigating IRR subject to certain limits based on notional amount and maximum fair value loss. The new rule does not apply to derivatives transactions, which are permitted under 12 CFR703.14 and include European call options, interest rate lock commitments, certain embedded options, and certain options associated with the sale of loans in the secondary market.

.67 Under the new rule, prior to engaging in derivatives activity, federal credit unions must apply for derivatives authority through a two-step process that includes providing documentation of required resources, systems, and controls. However, a federal credit union with outstanding derivatives positions under the NCUA's derivatives pilot program as of January 1, 2013, does not need to comply with the requirements of the new rule until March 3, 2015, and may continue to operate its derivatives program under the terms and conditions of its pilot program until that time. The rule includes a requirement for an annual financial statement audit as defined in 12 CFR 715.2(d). The rule also requires an internal controls review by an independent external or internal auditor for the first two years following commencement of the derivatives program.

.68 A federal credit union that no longer meets the requirements set forth in the new rule must immediately stop entering into new derivatives transactions and notify and submit a written action plan for correcting the regulatory

violation to the appropriate NCUA field director within 3 and 15 days, respectively. The NCUA may revoke a federal credit union's derivatives authority at any time if the credit union fails to comply with the requirements of the new rule. Should derivatives authority be revoked, the federal credit union would be prohibited from entering into any new derivatives transactions and, under certain circumstances, may be required to terminate existing transactions if deemed by the applicable field director that doing so would not pose a safety and soundness concern.

Additional Regulations Issued

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

Regulators	Title	Summary	Effective Date
OCC, Federal Reserve, FDIC, NCUA, FHFA, CFPB	Appraisals for Higher-Priced Mortgage Loans (supplemental rule)	Provides an exemption to loans of $25,000 or less and certain streamlined refinancings from the Dodd-Frank Act appraisal requirements. In addition, the supplemental rule provides an 18-month exemption for manufactured home loans from the Dodd-Frank Act's appraisal requirements that went into effect on January 18, 2014.	1/18/2014
OCC, Federal Reserve, FDIC, SEC, CFTC	Treatment of Certain Collateralized Debt Obligations Backed Primarily by Trust Preferred Securities With Regard to Prohibitions and Restrictions on Certain Interests in, and Relationships With, Hedge Funds	Permits banking entities to retain investments in certain pooled investment vehicles that invested their offering proceeds primarily in certain securities issued by community banking organizations of the type grandfathered under Section 171 of the Dodd-Frank Act.	4/1/2014

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Regulators	Title	Summary	Effective Date
OCC, Federal Reserve, FDIC, NCUA, Conference of State Bank Supervisors	Interagency Guidance on Home Equity Lines of Credit Nearing Their End-of-Draw Periods	Describes core operating principles that should govern management's oversight of home equity lines of credit (HELOCs) nearing their end-of-draw periods. The guidance also describes components of a risk management approach that promotes an understanding of potential exposures and consistent, effective responses to HELOC borrowers who may be unable to meet contractual obligations. In addition, the guidance highlights concepts related to financial reporting for HELOCs.	Issued 7/1/2014
OCC, Federal Reserve, FDIC	Interagency Supervisory Guidance Addressing Certain Issues Related to Troubled Debt Restructurings	Reiterates key aspects of previously issued regulatory guidance and discusses the definition of *collateral-dependent loans* and the circumstances under which a charge-off is required for troubled debt restructures (TDRs). The guidance applies to all national banks, federal savings associations, and federal branches and agencies of foreign banks.	Issued 10/24/2013

(continued)

Regulators	Title	Summary	Effective Date
OCC, Federal Reserve, FDIC	Uniform Agreement on the Classification and Appraisal of Securities Held by Depository Institutions	Guidance replaces the 2004 Agreement by applying the agencies' revised investment grade standards of creditworthiness in place of credit ratings as the basis for classifying securities. This guidance applies to all national banks and federal savings associations.	Issued 10/29/2013
OCC, Federal Reserve, FDIC	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	Discusses supervisory expectations for Dodd-Frank Act stress test practices and offers additional details about methodologies that should be employed by these companies. This guidance is applicable to institutions with more than $10 billion but less than $50 billion in total consolidated assets.	3/31/2014 (OCC and FDIC) 4/1/2014 (Federal Reserve)
OCC, Federal Reserve, FDIC	Regulatory Capital Rules: Advanced Approaches Risk-Based Capital Rule, Revisions to the Definition of Eligible Guarantee	Revises the definition of *eligible guarantee* in the agencies' advanced approaches risk-based capital rule by removing the requirement that an eligible guarantee be made by an eligible guarantor for purposes of calculating the risk-weighted assets of an exposure under the advanced approaches risk-based capital rule.	10/1/2014

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Regulators	Title	Summary	Effective Date
OCC, Federal Reserve, FDIC	Addendum to the Interagency Policy Statement on Income Tax Allocation in a Holding Company Structure	Instructs IDIs and their holding companies to review and revise their tax allocation agreements to ensure that the agreements expressly acknowledge that the holding company receives a tax refund from a taxing authority as agent for the IDI and are consistent with certain of the requirements of Sections 23A and 23B of the Federal Reserve Act.	Implement no later than 10/31/2014.
OCC, Federal Reserve, FDIC	Regulatory Capital Rules: Regulatory Capital, Revisions to the Supplementary Leverage Ratio	Revises *total leverage exposure* as defined in the 2013 revised capital rule to include the effective notional principal amount of credit derivatives and other similar instruments through which a banking organization provides credit protection (sold credit protection); modifies the calculation of total leverage exposure for derivative and repo-style transactions; and revises the credit conversion factors applied to certain off-balance sheet exposures. The final rule also changes the frequency with which certain components of the supplementary leverage ratio are calculated and establishes the public disclosure requirements of certain items associated with the supplementary leverage ratio.	1/1/2015

(continued)

Regulators	Title	Summary	Effective Date
OCC, Federal Reserve, FDIC	Liquidity Coverage Ratio: Liquidity Risk Measurement Standards	Implements a quantitative liquidity requirement consistent with the liquidity coverage ratio standard established by the BCBS. The final rule applies to large and internationally active banking organizations, generally, bank holding companies, certain savings and loan holding companies, and depository institutions with $250 billion or more in total assets or $10 billion or more in on-balance sheet foreign exposure and to their consolidated subsidiaries that are depository institutions with $10 billion or more in total consolidated assets.	1/1/2015
OCC, Federal Reserve, FDIC	Regulatory Capital Rules: Regulatory Capital, Enhanced Supplementary Leverage Ratio Standards for Certain Bank Holding Companies and Their Subsidiary Insured Depository Institutions	Establishes enhanced supplementary leverage ratio standards for covered bank holding companies and their subsidiary IDIs. The final rule applies to any U.S. top-tier bank holding company with more than $700 billion in total consolidated assets or more than $10 trillion in assets under custody and any IDIs subsidiary of these bank holding companies.	1/1/2018

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Regulators	Title	Summary	Effective Date
OCC	Integration of National Bank and Savings Association Regulations: Interagency Rules	Combines certain rules originally issued jointly with the other federal banking agencies by the OCC with respect to national banks and by the former Office of Thrift Supervision with respect to savings associations.	6/16/2014
OCC	OCC Guidelines Establishing Heightened Standards for Certain Large Insured National Banks, Insured Federal Savings Associations, and Insured Federal Branches; Integration of Regulations	Guidelines establishing minimum standards for the design and implementation of a risk governance framework for large insured national banks, insured federal savings associations, and insured federal branches of foreign banks with average total consolidated assets of $50 billion or more and minimum standards for a board of directors when overseeing the framework's design and implementation.	11/10/2014
Federal Reserve	Risk-Based Capital Guidelines; Market Risk	Revises its market risk capital rule to address recent changes to the Country Risk Classifications published by the Organization for Economic Cooperation and Development; clarifies the treatment of certain traded securitization positions; makes a technical amendment to the definition of *covered position*; and clarifies the timing of the required market risk disclosures.	4/1/2014

(continued)

Regulators	Title	Summary	Effective Date
NCUA	Liquidity and Contingency Funding Plans	Requires FICUs with less than $50 million in assets to maintain a basic written policy that provides a credit union boar-approved framework for managing liquidity and a list of contingent liquidity sources that can be employed under adverse circumstances. The rule requires FICUs with assets of $50 million or more to have a contingency funding plan that clearly sets out strategies for addressing liquidity shortfalls in emergency situations. Finally, the rule requires FICUs with assets of $250 million or more to have access to a back-up federal liquidity source for emergency situations.	3/31/2014
NCUA	Capital Planning and Stress Testing	Requires FICUs with assets of $10 billion or more to develop and maintain capital plans. The rule also provides for annual stress tests of those credit unions.	5/30/2014
NCUA	Credit Union Service Organizations	Expands the requirements of the credit union service organization (CUSO) regulation that apply to federally insured state-chartered credit unions (FISCUs) to address accounting, financial statements, and audits. The final rule also includes limits on the ability of "less than adequately capitalized" FISCUs to recapitalize their CUSOs and adds several new requirements that apply to both FCUs and FISCUs.	6/30/2014

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Broker-Dealers

.70 The regulatory environment under which broker-dealers operate has been in the midst of significant change for a number of years. The Dodd-Frank Act initiated some of this change. Furthermore, a principle rule under which broker-dealers operate, SEC Rule 17a-5, Broker-Dealer Reports, was recently revised. This alert does not cover all 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

.71 In July 2013, the SEC issued Release No. 34-70073, *Broker-Dealer Reports*, which amended its broker-dealer annual reporting, audit, and notification requirements. The amendments include a requirement that broker-dealer audits be conducted in accordance with PCAOB standards. 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 allow the accountant to discuss the findings related to the reports of the accountant with those representatives, when requested in connection with a regulatory examination of the broker-dealer. Broker-dealers must also file a compliance or exemption report, as discussed in the following section. Finally, the amendments require a broker-dealer to file a new form, Form Custody,[5] with its DEA that elicits information about the broker-dealer's practices with respect to the custody of securities and funds of customers and non-customers.

Reporting and Audit Requirements[6]

.72 Under the amendments to the reporting and audit requirements, broker-dealers must, among other things, file with the SEC annually either a compliance report (prepared and filed by those broker-dealers that have custody of customer assets) or an exemption report (prepared and filed by those broker-dealers that do not have custody of customer assets), as well as the report 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 or operations, a statement of cash flows, a statement of changes in ownership equity [stockholders' or members' equity or partners' or sole proprietor's capital], and a statement of changes in liabilities subordinated to claims of general creditors and required disclosures). In addition, the financial report

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[5] As noted in the FAQ released by the SEC on April 4, 2014, beginning December 31, 2013, all broker-dealers must file a Form Custody with their designated examining authority (DEA) (for example, the Financial Industry Regulatory Authority) within 17 business days after the end of each calendar quarter, with the first filing due in January 2014. A broker-dealer that files its Financial and Operational Combined Uniform Single Reports annually must file Form Custody each calendar quarter and as of the end of the fiscal year of the broker-dealer when that date does not fall at the end of a calendar quarter. Readers should refer to the SEC website for additional responses to frequently asked questions regarding Form Custody at www.sec.gov/divisions/marketreg/amendments-to-broker-dealer-reporting-rule-faq.htm.

[6] For further information, see the "PCAOB Standards for Broker-Dealers" section, beginning at paragraph .154, and the "Independence" section, beginning at paragraph .169.

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(e), which now includes both the Customer Reserve Computation and the Proprietary Accounts of Broker-Dealers computation, or a statement of exemption thereto, and information relating to the possession or control requirements under SEC Rule 15c3-3).

.73 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.

.74 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 audit 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 their self-regulatory organization (SRO), their DEA, and the SEC, along with the financial report and the compliance report or exemption report prepared by the broker-dealer.

.75 The broker-dealer's annual reports also must be filed with the Securities Investor Protection Corporation (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 includes an agreed-upon procedures report prepared by the independent public accountant that covers the SIPC annual general assessment reconciliation. The agreed-upon procedures must be conducted in accordance with PCAOB standards.

.76 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. 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.

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.77 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 may be used by the broker-dealer to satisfy the internal control report requirement under SEC Rule 206(4)-2.

.78 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.

.79 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 working papers of the independent public accountant and allow the accountant to discuss his or her findings with the examiners.

Effective Dates

.80 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 the SIPC, which is effective for fiscal years ending on or after December 31, 2013.

.81 As noted in the FAQ[7] released by the SEC on April 4, 2014, for broker-dealers whose 2014 or 2015 fiscal year begins prior to June 1, 2014, the SEC staff will not object if the broker-dealer submits statements in its compliance report or exemption report that do not cover the period of the fiscal year that is prior to June 1, 2014 and, instead, cover only the period beginning after that date through the end of the broker-dealer's fiscal year. However, in such cases, a broker-dealer may still elect to have its statements cover the entire fiscal year.

Financial Responsibility Rules for Broker-Dealers

.82 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.

Net Capital Rule (SEC Rule 15c3-1)[8]

.83 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.

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[7] Readers should refer to the SEC website for additional responses to frequently asked questions regarding the amendments to SEC Rule 17a-5 at www.sec.gov/divisions/marketreg/amendments-to-broker-dealer-reporting-rule-faq.htm.

[8] Readers should refer to the SEC website for full responses to frequently asked questions regarding the amendments to SEC Rules 15c3-1, 15c3-3, and 17a-11 at www.sec.gov/divisions/marketreg/amendments-to-broker-dealer-financial-responsibility-rule-faq.htm.

- 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 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.

Customer Protection Rule (SEC Rule 15c3-3)[9]

.84 The key amendments to the Customer Protection Rule are intended to

- 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 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 prohibit the use of 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 in which customer cash in a securities account is "swept" to a money market or bank deposit product.

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

.85 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)

.86 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

[9] See footnote 7.

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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, on a monthly basis. As noted in the FAQ[10] released by the SEC on March 6, 2014, paragraph (c)(5) of SEC Rule 17a-11 covers only cash (that is, cash-for-collateral) transactions. It does not include noncash (that is, collateral-to-collateral) transactions.

Futures Commission Merchants

FCM Certified Annual Report Deadline

.87 To align Futures Commission Merchant (FCM) reporting requirements with those of dually registered broker-dealer/FCMs, the CFTC amended its Regulation 1.10(b)(1)(ii) to require the certified annual reports for all FCMs be submitted within 60 calendar days of their fiscal year-end date. This amendment is effective for fiscal years ending on or after June 1, 2014.

Risk Management Program

.88 For FCMs that accept customer money, securities, or property, an appropriate risk management program is essential. Amendments to CFTC Regulation 1.11 require that all FCMs have a risk management program. It is important for FCMs to mitigate inherent risks associated with their business activities. At a minimum, the risk management program should define an FCM's risk tolerance limits and consider market, credit, liquidity, operational, capital, and segregation risks, among other risks. The risk management policies and procedures should be developed to monitor and manage these risks and should discuss the appropriate actions to be taken in the event of breaches in limits and escalation processes.

.89 The risk management program and the written risk management policies and procedures, and any material changes thereto, should be approved in writing by the governing body of the FCM. In addition, each FCM must furnish a copy of its written risk management policies and procedures to the CFTC and its designated SRO upon application for registration and thereafter upon request.

.90 Risk exposure reports are required to be prepared on at least a quarterly basis and furnished to senior management and the CFTC. These reports must discuss all applicable risk exposures of the FCM, any recommended or completed changes to the risk management program, the recommended time frame for implementing changes, and the status of any incomplete implementation. The effective date for the risk management program was July 12, 2014.

Qualifications and Reports of Accountants

.91 Amendments to CFTC Regulation 1.16 require a public accountant to meet certain qualification standards in order to conduct audits of FCMs. CFTC Regulation 1.16(b) requires that the public accountant

- be registered with the PCAOB;
- have undergone a PCAOB inspection; and
- may not be subject to a temporary or permanent bar to engage in the audit of public issuers or broker-dealers as a result of a PCAOB disciplinary action.

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[10] See footnote 7.

.92 Further, the amendments to CFTC Regulation 1.16(c) require that audits of FCMs be conducted using the auditing standards set by the PCAOB.[11] The public accountant's audit report should state the auditing standards used to conduct the audit. All public accountants conducting audits of FCMs should have been registered with the PCAOB by June 1, 2014.

.93 The effective date of this amendment was June 1, 2014. The effective date is in alignment with the SEC's requirement that audits be conducted in accordance with PCAOB standards. This amendment provides relief for those public accountants of dually registered broker-dealers/FCMs who would have been required to issue two different audit reports (one audit report to the SEC for an examination conducted under PCAOB standards and a second audit report for the CFTC for an examination conducted under GAAS).

.94 The requirement in CFTC Regulation 1.16 that a public accountant must have undergone an inspection by the PCAOB in order to qualify to conduct an FCM audit will be effective on December 31, 2015. The extension of the compliance date to December 31, 2015, is intended to provide additional time for the PCAOB to conduct inspections of public accountants that are registered with, but have not been inspected by, the PCAOB.

.95 Lastly, the amendment to CFTC Regulation 1.16(b)(1) that provides that a public accountant may not be subject to a temporary or permanent bar to engaging in the audit of public issuers or broker-dealers as a result of a PCAOB disciplinary action was effective as of the date of the amendment. According to the CFTC, if a public accountant is registered with the PCAOB and is subject to a PCAOB disciplinary action that temporarily or permanently bars the public accountant from auditing public issuers, the public accountant is not qualified to conduct audits of FCMs.

Audit and Accounting Developments

ALLL

.96 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 recent years, the OCC's National Risk Committee 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.

.97 In light of current market conditions, financial institutions should ensure they are exercising prudent judgment when considering releases of the

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[11] As discussed in the Member Alert, *Updates to SEC and CFTC Regulations and Related Audit and Attestation Reports of Brokers and Dealers and Futures Commission Merchants, including those that are Dual-Registered*, as jointly issued by the Center for Audit Quality and the AICPA, amendments to CFTC Regulation 1.10 did not change the auditing standards for introducing brokers that are solely registered with the CFTC. Audits of entities solely registered with CFTC as introducing brokers should continue to be performed under AICPA standards, including AICPA independence standards.

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allowance and in the determination of incurred loss estimates of the ALLL. When 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).

.98 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 because 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.

Troubled Debt Restructures

.99 Although improvements in the housing market and overall levels of nonperforming loans and delinquencies have reduced the levels of new loan restructurings, the potential for troubled debt restructures (TDRs) remains elevated. 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 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.

.100 Due to the continued high level of debt modifications, auditing TDRs continues to be a significant audit risk for many financial institutions. Based on your assessment of the risk of material misstatement, you 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 as well as to identify when an in substance repossession or foreclosure occurs, as clarified by recently issued FASB Accounting Standards Update (ASU) No. 2014-04, *Receivable—Troubled Debt Restructurings by Creditors (Subtopic 310-40): Reclassification of Residential Real Estate*

Collateralized Consumer Mortgage Loans upon Foreclosure (a consensus of the FASB Emerging Issues Task Force).

.101 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 its conclusions regarding TDR status and appropriately accounted for renewals of this nature. When the practical expedient for collateral-dependent loans is not elected, you 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.

.102 Additionally, the seasoning of TDRs that were initiated during the peak years of the credit crisis may present elevated exposure to re-default as an increased number of previously restructured loans roll out of their restructure periods to full market rates or full debt service levels. Auditors may consider the risk that institutions have not appropriately considered this exposure in the determination of the adequacy of the ALLL.

.103 In August 2014, FASB issued ASU No. 2014-14, *Receivables—Troubled Debt Restructurings by Creditors (Subtopic 310-40): Classification of Certain Government-Guaranteed Mortgage Loans upon Foreclosure (a consensus of the FASB Emerging Issues Task Force)*, in order to reduce the diversity in practice by providing guidance for the classification of certain foreclosed mortgage loans held by creditors that are guaranteed (fully or partially) under government programs. Readers should refer to Audit Risk Alert *General Accounting and Auditing Developments—2014/15* for further information.

Other Real Estate Owned

.104 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

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.105 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.

.106 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.

.107 The sale of foreclosed property may be financed by a loan at less than current market interest rates. In those circumstances, you 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.

.108 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 collectability of the receivable
- The length of the financing period, the interest rate, and other terms of the financing arrangement

.109 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.

.110 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*

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- 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 or hold
  - — 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

.111 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.

.112 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.

.113 If the preparation of the financial statements involves the use of expertise in a field other than accounting, paragraph .A7 of AU-C section 620, *Using the Work of an Auditor's Specialist* (AICPA, *Professional Standards*),

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explains that the auditor, who is skilled in accounting and auditing, may not possess the necessary expertise to audit those financial statements. The engagement partner is required by AU-C section 220, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards* (AICPA, *Professional Standards*), to be satisfied that the engagement team and any external auditor's specialists who are not part of the engagement team, collectively, have the appropriate competence and capabilities to perform the audit engagement. Further, the auditor is required by AU-C section 300, *Planning an Audit* (AICPA, *Professional Standards*), to ascertain the nature, timing, and extent of resources necessary to perform the engagement. The auditor's determination of whether to use the work of an auditor's specialist, and, if so, when and to what extent, assists the auditor in meeting these requirements. As the audit progresses or as circumstances change, the auditor may need to revise earlier decisions about using the work of an auditor's specialist.

.114 The auditor should also consider the risk that the specialist does not provide access to his or her work product. In such instances, the auditor is required to perform procedures to evaluate the consequence of an inability to obtain sufficient appropriate audit evidence due to a management-imposed limitation. Further discussion on those requirements can be found in paragraphs .11–.14 of AU-C section 705, *Modifications to the Opinion in the Independent Auditor's Report* (AICPA, *Professional Standards*).

.115 You should also consider whether management's internal controls related to the process to review appraisals and asking prices are appropriate because the estimate is ultimately management's responsibility and, therefore, should be subject to their system of internal control.

.116 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

.117 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.

.118 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.

.119 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 the discussion of OREO audit risks within this section of the alert.

Accounting for Mortgage Purchase Programs

.120 Under some mortgage purchase programs, 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 take-out 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.

.121 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.

.122 When 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 (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.

.123 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

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the transferor (the originator, in this case) has surrendered control over the transferred loan and, therefore, met the requirements for sales treatment. FASB ASU No. 2014-11, *Transfers and Servicing (Topic 860): Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures*, was issued in June 2014. FASB ASU No. 2014-11 revises the conditions of FASB ASC 860-10-40-5. Additional information regarding FASB ASU No. 2014-11, including its effective date, is provided in the Audit Risk Alert *General Accounting and Auditing Developments—2014/15*.

.124 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 2014 Call Report located on the FDIC website at www.fdic.gov for further information on purchased loans originated by others.

.125 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 and purchase transaction, depending on whether the preceding criteria for sale treatment are met. Inappropriately accounting for these mortgage purchase transactions as sales and purchases can have numerous ramifications to both parties including, but not limited to, the following:

- Originator (transferor or 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 or 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.

Revenue Recognition

.126 In May 2014, the International Accounting Standards Board (IASB) and FASB issued a joint accounting standard on revenue recognition to address a number of concerns regarding the complexity and lack of consistency surrounding the accounting for revenue transactions. Consistent with each board's policy, FASB issued ASU No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, and the IASB issued IFRS 15, *Revenue from Contracts with Customers*. FASB ASU No. 2014-09 will amend FASB ASC by creating a new topic 606, *Revenue from Contracts with Customers*, and a new subtopic 340-40, *Other Assets and Deferred Costs—Contracts with Customers*. The guidance in FASB ASU No. 2014-09 provides what FASB describes as a framework for revenue recognition and supersedes or amends several of the revenue recognition requirements in FASB ASC 605, *Revenue Recognition*, as well as guidance within the 900 series of industry-specific topics. Readers should refer to the Audit Risk Alert *General Accounting and Auditing Developments—2014/15* for further information.

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

.127 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 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 to 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

.128 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

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statements as a whole. Because 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.

.129 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

.130 In instances in which firms choose 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.

.131 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

.132 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.

.133 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.

.134 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.

.135 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

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used by management's securities pricing sources on individual securities on at least a sample basis.

.136 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 about 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

.137 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 the previous discussion on auditor requirements related to auditing fair value measurements used by management.

.138 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

.139 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 that include obtaining an understanding of key terms and conditions contained in the arrangements or contracts.

.140 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 an 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

.141 PCAOB inspectors identified deficiencies related to firms' testing of management's accounting for transactions involving debt instruments with

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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

.142 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.

.143 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 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.

.144 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

.145 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.

.146 In determining when to apply substantive analytical procedures, firms need to consider, among other things, that when 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.

.147 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

.148 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 are 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 about 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.

.149 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, when designing and performing its fraud-related audit procedures, PCAOB 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. 400.03 and 400.08), state 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

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due to fraud when performing audits of companies with operations in emerging markets.

Audits of Broker-Dealers Under PCAOB Standards

.150 The Dodd-Frank Act gave the PCAOB full oversight authority over audits of broker-dealers. Historically, the SEC had directed auditors to perform audits of broker-dealers under GAAS; however, as previously discussed, in July 2013 the SEC approved revisions to SEC Rule 17a-5 to require audits of broker-dealers to be conducted under PCAOB standards. This new requirement was effective for fiscal years ending on or after June 1, 2014.

.151 On June 26, 2014, the PCAOB released Staff Guidance for Auditors of SEC-Registered Brokers and Dealers (AICPA, *PCAOB Standards and Related Rules*, PCAOB Other Staff Guidance, sec. 300.02), to assist auditors of broker-dealers registered with the SEC to plan and perform audits in accordance with standards issued by the PCAOB. The guidance in the release is geared towards auditors of smaller broker-dealers that have less complex operations. The guidance in chapter 1, "Getting Started," of this release is for auditors of broker-dealers that have not performed audits under PCAOB standards. Additionally, the release discusses, among other things, the following topics:

- Understanding the broker-dealer and its environment
- Consideration of fraud, materiality, and the broker-dealer's use of third parties and service organizations
- Audit procedures regarding related party transactions
- Coordinating the audit of the financial statements with the audit procedures on the supporting schedules and the attestation engagements
- Performing audit procedures on the supporting schedules
- Communication requirements
- Reporting on an audit of a broker-dealer

.152 The release also contains the following illustrative example reports:

- Auditor's Report with Unqualified Opinions on the Financial Statements and Supporting Schedules
- Examination Report with an Unqualified Opinion
- Modified Examination Report—Material Weakness Existed During the Most Recent Fiscal Year
- Standard Review Report
- Modified Review Report—Unreported Exception

.153 Appendix B, "Auditing Considerations for Particular Accounts and Records of Brokers and Dealers," of the release discusses auditing considerations for certain accounts and records that are particular to broker-dealers. You are encouraged to consult the full text of this release, which is available at www.pcaobus.org/Standards/Documents/06262014_Staff_Guidance.pdf.

PCAOB Standards for Broker-Dealers

.154 To accommodate audits of broker-dealers being performed under PCAOB standards, changes to those standards were necessary. Because many PCAOB standards refer to audits of issuers, certain standards were revised

to include audits of non-issuer broker-dealers. Furthermore, additional auditing standards need to be revised or established to address particular areas applicable to an audit of a broker-dealer.

.155 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. At that time, the PCAOB also issued Release No. 2013-008, in which it adopted Auditing Standard (AS) No. 17, *Auditing Supplemental Information Accompanying Audited Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards). These standards and related amendments are applicable to all registered firms conducting audits and attestation engagements related to broker-dealer compliance or exemption reports required by the SEC.

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

.156 According to 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-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-dealer's statements in its compliance report about whether

- the internal control over compliance of the broker-dealer was effective during the most recent fiscal year;
- the internal control over compliance of the broker-dealer was effective as of the end of the most recent fiscal year;
- the broker-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-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-dealer.

.157 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-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-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.

.158 Release No. 2013-007 additionally states that the examination standard retains the requirement that the auditor obtain reasonable assurance

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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-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.

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

.159 According to 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-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-dealer's statements in an exemption report.

.160 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-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-dealer claimed an exemption from SEC Rule 15c3-3 (the "identified exemption provisions")
- A statement that the broker-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
- If applicable, a statement that identifies each exception during the most recent fiscal year in meeting the identified exemption provisions (an "exception") and briefly describes the nature of each exception and the approximate date(s) on which the exceptions existed

.161 Release No. 2013-007 additionally states that the auditor's review report regarding a broker-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."

.162 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-dealer's size and complexity. The review standard also establishes requirements for the content of the review report.

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

.163 In October 2013, the PCAOB issued Release No. 2013-008, in which it adopted AS No. 17. The following provides a high-level overview of the standard.

.164 As discussed in Release No. 2013-008, AS 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 broker-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.

.165 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.

.166 *"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 as a whole. Audit procedures regarding that supplemental information generally have been performed in conjunction with the audit of the financial statements. AS No. 17 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.

.167 *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;

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- requirements that the auditor evaluate the supplemental information, which includes 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 broker-dealers; and
- reporting requirements that clearly articulate the auditor's responsibilities when reporting on supplemental information.

.168 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.

Independence

.169 SEC Rule 17a-5 requires auditors of broker-dealers to comply with SEC independence rules. These independence requirements predate the recent July 2013 amendments to SEC Rule 17a-5. SEC independence rules prohibit auditors from performing bookkeeping or other services related to the accounting records or financial statements of the broker-dealer, among other things. Prohibited services include

- maintaining or preparing the audit client's accounting records;
- preparing financial statements that are filed with the SEC or the information that forms the basis of financial statements filed with the SEC; and
- preparing or originating source data underlying the broker-dealers financial statements.

.170 Auditors of non-issuer broker-dealers are not subject to the SEC rules related to

- partner rotation requirements,
- certain partner compensation agreements,
- audit committee administration requirements, and
- "cooling-off" period requirements.

.171 In addition to these SEC independence requirements, auditors of broker-dealers must also comply with PCAOB independence requirements. The PCAOB adopted amendments as well as certain updates and clarifications that specifically identify and tailor those rules that will be applicable to engagements of non-issuer broker-dealers. In those amendments, the PCAOB identified certain rules and standards that were effective on June 1, 2014, for audit and attestation engagements of non-issuer broker-dealers covering fiscal years ending on or after June 1, 2014. These rules, as found in the AICPA *PCAOB Standards and Related Rules*, are as follows:

- Rule 3501, *Definitions of Terms Employed in Section 3, Part 5 of the Rules*

- Rule 3502, *Responsibility Not to Knowingly or Recklessly Contribute to Violations*
- Rule 3520, *Auditor Independence*
- Rule 3521, *Contingent Fees*
- Rule 3522, *Tax Transactions*
- Rule 3526, *Communication with Audit Committees Concerning Independence*
- Interim Independence Standards

.172 The PCAOB also identified three rules that would not be applicable to engagements of non-issuer broker-dealers. These rules, as found in the AICPA *PCAOB Standards and Related Rules*, are as follows:

- Rule 3523, *Tax Services for Persons in Financial Reporting Oversight Roles*
- Rule 3524, *Audit Committee Pre-approval of Certain Tax Services*
- Rule 3525, *Audit Committee Pre-approval of Non-audit Services Related to Internal Control Over Financial Reporting*

.173 The PCAOB's Interim Independence Standards do not supersede the SEC's auditor independence rules to the extent that a provision of the SEC's rule is more (or less) restrictive than the PCAOB's Interim Independence Standards, a registered public accounting firm must comply with the more restrictive rule.

Further Information

.174 On May 12, 2014, the Center for Audit Quality and the AICPA jointly issued a Member Alert, *Updates to SEC and CFTC Regulations and Related Audit and Attestation Reports of Brokers and Dealers and Futures Commission Merchants, including Those That Are Dual-Registered*, which is intended to remind audit firms of certain auditing considerations in response to regulatory changes set forth by the SEC and the CFTC, as well as related guidance and standards issued by the PCAOB.

PCAOB Interim Inspection Program Related to Audits of Brokers and Dealers Report Issued

.175 On August 18, 2014, the PCAOB released its third inspection report on the interim inspection program for broker-dealers. The report, "Third Report on the Progress of the Interim Inspection Program Related to Audits of Brokers and Dealers," is based on inspections of 90 broker-dealer audits performed by 60 firms. At the time of inspection, 25 of the 60 firms were already subject to PCAOB inspection because they audited public companies.

.176 To give some context to the numbers, note that approximately 4,300 broker-dealers filed audited financial statements with the SEC for fiscal periods ended between July 1, 2012 and June 30, 2013. 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 non-issuer broker-dealers.

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.177 The report notes that deficiencies or independence findings were identified in 71 of the 90 audits selected for inspection, or 78 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, "Many of the observations noted during 2013 have not changed from prior inspections and relate to fundamental auditing principles." He further added, "We again urge firms that audit broker-dealers to re-examine their audit approaches and we remind firms that independence rules applicable to broker-dealer audits prohibit bookkeeping or financial statement preparation by the auditor." 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. 2014-003 for detailed report findings.

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

- *Failure to Satisfy Independence Requirements*
  - — The PCAOB identified independence findings in 21 of the 90 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 21 of the audits, by 20 firms, the firms performed bookkeeping or other services related to the accounting records or financial statements of the broker-dealers. All 20 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 journal entries or source data underlying the financial statements of the broker-dealer.

.179 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)*
  - — For 31 of the 69 audits of broker-dealers that claimed an exemption from the requirement to maintain a special reserve account, firms failed to comply with this requirement. Instances were found in which firms failed to perform any procedures to ascertain that the broker-dealer complied with conditions of the exemption and firms limited procedures to inquiry alone and did not perform sufficient other inquiries or other procedures related to the exemption claimed by the broker-dealer under the Customer Protection Rule.

— In 11 of the 20 audits, firms failed to perform sufficient audit procedures with respect to the accountant's supplemental report on material inadequacies. There were instances in which firms did not perform sufficient procedures to obtain reasonable assurance that any material inadequacies existing at the date of the examination would be disclosed, including not sufficiently testing controls related to the broker-dealer's practices and procedures in making the periodic computations of aggregate indebtedness, net capital, or the customer reserve. Additionally, there were instances in which firms identified errors or deficiencies during other audit procedures but did not sufficiently assess whether those errors or deficiencies indicated the existence of a material inadequacy.

- *Compliance With the Customer Protection Rule*

  — In 3 of the 21 audits, the firms failed to sufficiently test completeness and accuracy of customer credits or customer debits included in the customer reserve computation.

  — In 2 of 21 audits, the firms failed to verify the existence of a special reserve bank account or failed to determine whether the account agreements contained the required restrictive provisions of SEC Rule 15c3-3(f).

  — In 3 of the 21 audits, the firms failed to perform sufficient procedures to test compliance with the possession or control requirements.

- *Compliance With the Net Capital Rule*

  — In 9 of the 10 audits, firms failed to assess the nature of the broker-dealer's operations in relation to the required minimum net capital amounts in accordance with SEC Rule 15c3-1. In 3 of the same 10 audits, firms failed to sufficiently test whether aggregated indebtedness was calculated in accordance with SEC Rule 15c3-1(c)(1)(i) and, therefore, failed to evaluate whether the calculated minimum net capital was in accordance with SEC Rule 15c3-1(a).

  — In 1 audit, the firm failed to test whether the amount of the liability for employee bonuses that was added to net worth in the determination of net capital was payable solely at the discretion of the broker-dealer, in accordance with SEC Rule 15c3-1.

  — In 19 audits, firms did not perform sufficient procedures to test the broker-dealer's classification of allowable and non-allowable assets when computing net capital. In 5 of those 19 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. In 6 of the 19 audits, firms failed to

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test whether the assets held by a clearing broker met the requirements of an allowable asset under SEC Rule 15c3-1(c)(2)(iv)(E). Additionally, in 6 of the 19 audits, firms failed to perform sufficient procedures to test the aging of commissions receivable to determine whether the amount reported as an allowable asset met the requirements of SEC Rule 15c3-1(c)(2)(iv)(C).

— In all 6 audits, firms did not perform sufficient procedures over haircuts on securities. In all 6 of those audits, firms failed to perform procedures to evaluate whether the appropriate haircut percentages were applied by the broker-dealer, including tests of the relevant characteristics of the securities positions.

— In 2 audits, firms failed to perform sufficient procedures to test the completeness and accuracy of operational charges deducted from the broker-dealer's net capital.

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

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

  — In 10 of the 90 audits, firms did not identify a fraud risk related to revenue recognition or document their conclusion that no such risk existed. Further, in 1 other audit, the firm identified a fraud risk related to revenue recognition but failed to obtain an understanding of the broker-dealer's control activities related to revenue in order to evaluate whether such controls were designed and implemented to mitigate the identified fraud risk.

  — In 32 audits, firms failed to perform sufficient procedures to address risks related to management override of controls, including sufficiently testing the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements. In 9 of these 32 audits, firms did not test the completeness of the population of journal entries from which they selected a sample for journal entry testing.

  — In 6 audits, firms failed to design or perform audit procedures whose nature, timing, and extent were responsive to the assessed risks of material misstatement due to fraud related to revenue recognition.

- *Related Party Transactions*

  — In 7 audits, firms failed to perform sufficient procedures to determine the existence of related parties and material related party transactions. In 5 of the 7 audits, firms limited their procedures to inquiries of management and did not inspect records and documents for the purpose of identifying significant related party relationships or material transactions that had not been previously identified or disclosed.

- In 13 audits, firms identified related parties or material related party transactions, including service agreements, fee agreements, or intercompany balances; yet, the firms did not perform procedures necessary to obtain sufficient appropriate audit evidence to respond to the assessed risks of material misstatement associated with related party relationships and transactions.

- *Revenue Recognition*
  - In 29 audits, the extent of testing was insufficient for material classes of revenue transactions, including trading gains and losses, commission revenue, and advisory fees.
  - In 24 audits, firms performed substantive analytical procedures that did not provide the intended level of assurance.
  - In 36 audits, firms failed to perform sufficient procedures to test the relevant assertions for revenue.

- *Establishing a Basis for Reliance on Records and Reports*
  - In 31 audits, firms did not perform sufficient procedures on information produced by service organizations that were used to perform substantive audit procedures or tests of controls. In 30 of those 31 audits, firms used information produced by a service organization, such as records or reports from a clearing broker, but failed to obtain sufficient appropriate audit evidence on such information. In 7 audits, firms obtained a service auditor's report but failed to sufficiently evaluate it or consider whether it provided evidence about the design and operating effectiveness of the controls being relied upon.
  - In 15 audits, firms failed to perform procedures to obtain evidence about the accuracy and completeness of records and reports produced by the broker-dealers that were used in the performance of tests of controls or substantive tests.

- *Financial Statement Presentation and Disclosures*
  - In 9 audits, firms failed to identify and evaluate the omission of required disclosures pertaining to areas such as related parties and related party transactions or revenue recognition policies.
  - In 16 audits, firms failed to identify incomplete disclosures or respond to evidence that was inconsistent with disclosures included in the financial statements.
  - In 4 audits, firms failed to evaluate the broker-dealer's classification of fair value measurements of securities owned within the hierarchy required by FASB ASC 820.
  - In 4 audits, firms failed to evaluate whether the financial statements presented and disclosed the underlying transactions in a manner that complied with GAAP.

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- *Fair Value Accounting Estimates*
  - In 6 of the 32 audits, firms did not perform sufficient procedures to test the valuation of securities.
  - In 2 of the 32 audits, firms failed to identify that the broker-dealers had applied FASB ASC 320, *Investments—Debt and Equity Securities*, and, therefore, had inappropriately accounted for investments as securities that were held to maturity or available for sale.
- *Evaluation of Internal Control Deficiencies*
  - In 2 audits, firms identified 1 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 5 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 combination, and the circumstances of their occurrences, including whether the errors were evidence of 1 or more control deficiencies.
- *Auditor's Report*
  - In 5 of the 90 audits, deficiencies were identified related to the auditor's report. Inspections staff found that in 4 of these audits, the auditor's report on the supporting schedules failed to include 1 or more of the elements required by AU-C section 725, *Supplementary Information in Relation to the Financial Statements as a Whole* (AICPA, *Professional 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.

.181 During 2014, the PCAOB plans to inspect approximately 60 firms and portions of approximately 100 audits. 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.

.182 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.

.183 The third interim inspection report states that the PCAOB is currently working to develop a rule proposal for a permanent inspection program. Until a permanent inspection program is in place, audits of issuer and non-issuer broker-dealers will remain subject to inspection under the PCAOB Interim Inspection Program. Additionally, audits of non-issuer 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

.184 You 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 non-authoritative and cannot be used as a basis for changing existing standards.

.185 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—2014/15* (product nos. ARAGEN14P, ARAGEN14E, or WGE-XX), for further information.

NCUA Proposed Regulations: Prompt Corrective Action

.186 In February 2014, the NCUA board proposed to amend its regulations concerning PCA for the purpose of restructuring and making various revisions. Among others, these revisions would replace the current risk-based net worth requirements with new risk-based capital requirements for certain (federally insured "natural person") credit unions. The proposed requirements are intended to be more consistent with NCUA's risk-based capital measure for corporate credit unions as well as those used by the FDIC, Federal Reserve, and OCC. The proposed revisions also would revise risk weights for certain of NCUA's asset classifications and revise minimum levels of capital for federally-insured natural person credit unions with certain concentrations.

NCUA Proposed Regulations: Federal Credit Union Ownership of Fixed Assets

.187 The NCUA proposed a rule to provide federal credit unions with regulatory relief and greater flexibility managing fixed assets by removing the waiver requirement for credit unions to exceed the 5-percent aggregate limit on fixed-asset investments. The proposed rule would eliminate the current requirement that a federal credit union with assets of $1 million or more that wants to make investments in fixed assets exceeding 5 percent of shares and retained earnings must obtain an agency waiver. The fixed-assets proposed rule would

- allow federal credit unions to exceed the 5-percent limit without prior NCUA approval, provided they do so safely and soundly by establishing and following fixed-asset management policies and programs.

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- simplify the partial occupancy requirement for premises acquired for future expansion.
- eliminate or streamline certain aspects of the fixed-asset waiver requirements.

FASB Project Roster and Status

.188 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 "Technical Agenda" page at www.fasb.org.

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 second exposure draft comment period has ended, and the second exposure draft redeliberations are in progress.
Insurance Contracts *Insurance Contracts (Topic 834)*	The initial objective of this joint FASB and IASB project was to develop common, high-quality guidance that would address recognition, measurement, presentation, and disclosure requirements for insurance contracts. In light of the feedback received on the 2013 proposed ASU, FASB decided to limit the scope to insurance entities as described in existing U.S. GAAP. FASB also decided that the project should focus on making targeted improvements to existing U.S. GAAP. For short-duration contracts, the board decided to limit the targeted improvements to enhancing disclosures. As a result, the overall project was divided into the following topical areas: *Targeted Improvements to the Accounting for Long-Duration Contracts* Exposure draft redeliberations are in progress. *Disclosures About Short-Duration Contracts* A final ASU is anticipated to be released during the first quarter of 2015.

(continued)

FASB Current Technical Plan	
Accounting For Financial Instruments	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:
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®*	*Classification and Measurement* This project reconsiders the classification and measurement of financial instruments. Second exposure draft redeliberations are in progress. No anticipated timing has been released for issuance of a final ASU.
Financial Instruments—Credit Losses (Subtopic 825-15)	*Credit Impairment* The goal of this project is to develop a single credit loss model for financial assets that enables more timely recognition of credit losses. Redeliberations on the Current Expected Credit Losses model are in progress. No anticipated timing has been released for issuance of a final ASU.
Selected Issues about Hedge Accounting	*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.

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FASB Current Technical Plan	
Consolidation: Principal Versus Agent Analysis *Consolidation (Topic 810): Principal versus Agent Analysis*	The objective of this FASB project is to (1) provide criteria for a reporting entity to evaluate whether a decision maker is using its power as a principle or agent, (2) eliminate inconsistencies in evaluating kick-out and participating rights, and (3) amend the requirements for evaluating whether a general partner controls a limited partnership. Drafting of a final standard is in progress and anticipated to be released during the fourth quarter of 2014.
Emerging Issues Task Force (EITF) Issue No. 12-F, *Recognition of New Accounting Basis (Pushdown) in Certain Circumstances* *Business Combinations (Topic 805): Pushdown Accounting (a consensus of the FASB Emerging Issues Task Force)*	The objective of this EITF project is to provide guidance on when and how an acquired entity that is a business or nonprofit activity can apply pushdown accounting in its separate financial statements. Drafting of a final standard is in progress and anticipated to be released during the fourth quarter of 2014.

Resource Central

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

Publications

.190 Choose the format best for you—print, e-book, or online:

- Audit and Accounting Guide *Depository and Lending Institutions: Banks and Savings Institutions, Credit Unions, Finance Companies, and Mortgage Companies* (2014) (product nos. AAGDEP14P [paperback], AAGDEP14E [e-book], or WDL-XX [online with the associated Audit Risk Alert])

- Audit and Accounting Guide *Brokers and Dealers in Securities* (2014) (product nos. AAGBRD14P [paperback], AAGBRD14E [e-book], or WBR-XX [online with the associated Audit Risk Alert])

Continuing Professional Education

.191 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 financial institutions industry:

- *Audits of Banks and Other Financial Institutions* (product no. 733446 [text]). This course features practical worksheets and

insights, such as the applicable metrics that create value for financial institutions.

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

Online CPE

.193 AICPA CPExpress, offered exclusively through CPA.com, is the AICPA's flagship online learning product. Divided into 1-credit and 2-credit courses that are available 24 hours a day, 7 days a week, CPExpress offers hundreds of hours of learning in a wide variety of topics. Subscriptions are available at www.cpa2biz.com/AST/AICPA_CPA2BIZ_Pages/C2BOnlineSubscriptions Page/Section2/PRDOVR~PC-BYF-XX/PC-BYF-XX.jsp (product no. BYF-XX).

.194 To register for individual courses or to learn more, visit www.cpa2biz .com.

Webcasts

.195 Stay plugged in to what is happening and earn CPE credit right from your desktop. AICPA webcasts are high-quality CPE programs that bring you the latest topics from the profession's leading experts. Broadcast live, they allow you to interact with the presenters and join in the discussion. If you cannot make the live event, each webcast is archived and available for viewing. For additional details on available webcasts, please visit www.cpa2biz.com/ AST/AICPA_CPA2BIZ_Browse/Store/Webcasts.jsp.

Member Service Center

.196 To order AICPA products, receive information about AICPA activities, and get help with your membership questions, call the AICPA Service Center Operations at 888.777.7077.

Hotlines

Accounting and Auditing Technical Hotline

.197 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/TechnicalHot line.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

.198 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.

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AICPA Online Professional Library: Accounting and Auditing Literature

.199 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 sign up for access to the entire library. Get access—anytime, anywhere—to the FASB ASC; the AICPA's latest *Professional Standards*, *Technical Practice Aids*, Audit and Accounting Guides, Audit Risk Alerts, *Best Practices in Presentation and Disclosure*; and more. To subscribe to this essential online service for accounting professionals, visit www.cpa2biz.com.

Codified Clarity Standards

.200 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 Statements on Auditing Standards 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*.

.201 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.

.202 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

Financial Reporting Center of AICPA.org

.203 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.

.204 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.

.205 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.

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Industry Conference

.206 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.

.207 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 issues 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 issues prevalent in the credit union industry today. For further information about the conference, call 888.777.7077, or visit www.cpa2biz.com.

.208 The AICPA/SIFMA FMS Conference on the Securities Industry is cosponsored by the AICPA and the Financial Management Society of the Securities Industry and Financial Markets Association and is offered annually in the fall. This two-day conference is 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 industry insiders. For further information about the conference, call 888.777.7077, or visit www.cpa2biz.com.

AICPA Industry Expert Panel—Financial Institutions

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

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

Industry Websites

.211 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.

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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
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

.212 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 you.