Copyright 2010 Thomson Reuters/PPC  
All Rights Reserved

This material, or parts thereof, may not be reproduced in another document or manuscript  
in any form without the permission of the publisher.

This publication is designed to provide accurate and authoritative information in regard to the subject  
matter covered. It is sold with the understanding that the publisher is not engaged in rendering legal,  
accounting, or other professional service. If legal advice or other expert assistance is required, the  
services of a competent professional person should be sought.—From a Declaration of Principles  
jointly adopted by a Committee of the American Bar Association and a Committee of Publishers and  
Associations.

The following are registered trademarks filed with the United States Patent and Trademark Office:

Checkpoint® Tools
PPC’s Practice Aids™
PPC’s Workpapers™
PPC’s Engagement Letter Generator™
PPC’s Interactive Disclosure Libraries™
PPC’s SMART Practice Aids™

Practitioners Publishing Company is registered with the National Association of State Boards of Accountancy (NASBA) as a sponsor of  
continuing professional education on the National Registry of CPE Sponsors. State boards of accountancy have final authority on the  
acceptance of individual courses for CPE credit. Complaints regarding registered sponsors may be addressed to the National Registry of CPE  

Practitioners Publishing Company is registered with the National Association of State Boards of Accountancy (NASBA) as a Quality  
Assurance Service (QAS) sponsor of continuing professional education. State boards of accountancy have final authority on  
acceptance of individual courses for CPE credit. Complaints regarding QAS program sponsors may be addressed to NASBA, 150 Fourth  

Registration Numbers
Texas 001615
New York 001076
NASBA Registry 103166
NASBA QAS 006
### Interactive Self-study CPE

**Companion to PPC’s Guide to Audits of Financial Institutions**

**TABLE OF CONTENTS**

<table>
<thead>
<tr>
<th>COURSE 1: LOANS RECEIVABLE AND THE LOAN LOSS ALLOWANCE</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overview</td>
<td>1</td>
</tr>
<tr>
<td>Lesson 1: Loans Receivable and Lending Activities</td>
<td>3</td>
</tr>
<tr>
<td>Lesson 2: Loan Loss Allowance</td>
<td>41</td>
</tr>
<tr>
<td>Lesson 3: ADC Loans, Audit Procedures, and a Case Study</td>
<td>105</td>
</tr>
<tr>
<td>Glossary</td>
<td>139</td>
</tr>
<tr>
<td>Index</td>
<td>141</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>COURSE 2: AN INTRODUCTION TO AUDITS OF FINANCIAL INSTITUTIONS AND RELATED PRE-ENGAGEMENT ACTIVITIES</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overview</td>
<td>143</td>
</tr>
<tr>
<td>Lesson 1: An Introduction to Auditing Financial Institutions and an Industry Overview</td>
<td>145</td>
</tr>
<tr>
<td>Lesson 2: Pre-engagement Activities for Audits of Financial Institutions</td>
<td>197</td>
</tr>
<tr>
<td>Glossary</td>
<td>271</td>
</tr>
<tr>
<td>Index</td>
<td>275</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>COURSE 3: FORECLOSED ASSETS, REAL ESTATE INVESTMENTS, CASH, OTHER ASSETS, AND LIABILITIES</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overview</td>
<td>279</td>
</tr>
<tr>
<td>Lesson 1: Foreclosed Assets and Real Estate Investments</td>
<td>281</td>
</tr>
<tr>
<td>Lesson 2: Cash, Other Assets, and Liabilities</td>
<td>343</td>
</tr>
<tr>
<td>Glossary</td>
<td>399</td>
</tr>
<tr>
<td>Index</td>
<td>401</td>
</tr>
</tbody>
</table>
To enhance your learning experience, the examination questions are located throughout the course reading materials. Please look for the exam questions following each lesson.

EXAMINATION INSTRUCTIONS, ANSWER SHEETS, AND EVALUATIONS

Course 1: Testing Instructions for Examination for CPE Credit .................................................. 405
Course 1: Examination for CPE Credit Answer Sheet .......................................................... 407
Course 1: Self-study Course Evaluation .................................................................................. 408
Course 2: Testing Instructions for Examination for CPE Credit .............................................. 409
Course 2: Examination for CPE Credit Answer Sheet .......................................................... 411
Course 2: Self-study Course Evaluation .................................................................................. 412
Course 3: Testing Instructions for Examination for CPE Credit .............................................. 413
Course 3: Examination for CPE Credit Answer Sheet .......................................................... 415
Course 3: Self-study Course Evaluation .................................................................................. 416
INTRODUCTION

Companion to PPC’s Guide to Audits of Financial Institutions consists of three interactive self-study CPE courses. These are companion courses to PPC’s Guide to Audits of Financial Institutions designed by our editors to enhance your understanding of the latest issues in the field. To obtain credit, you must complete the learning process by logging on to our Online Grading System at OnlineGrading.Thomson.com or by mailing or faxing your completed Examination for CPE Credit Answer Sheet for print grading by June 30, 2011. Complete instructions are included below and in the Test Instructions preceding the Examination for CPE Credit Answer Sheet.

Taking the Courses

Each course is divided into lessons. Each lesson addresses an aspect of financial institution audits. You are asked to read the material and, during the course, to test your comprehension of each of the learning objectives by answering self-study quiz questions. After completing each quiz, you can evaluate your progress by comparing your answers to both the correct and incorrect answers and the reason for each. References are also cited so you can go back to the text where the topic is discussed in detail. Once you are satisfied that you understand the material, answer the examination questions which follow each lesson. You may either record your answer choices on the printed Examination for CPE Credit Answer Sheet or by logging on to our Online Grading System.

Qualifying Credit Hours—QAS or Registry

PPC is registered with the National Association of State Boards of Accountancy as a sponsor of continuing professional education on the National Registry of CPE Sponsors (Registry) and as a Quality Assurance Service (QAS) sponsor. Part of the requirements for both Registry and QAS membership include conforming to the Statement on Standards of Continuing Professional Education (CPE) Programs (the standards). The standards were developed jointly by NASBA and the AICPA. As of this date, not all boards of public accountancy have adopted the standards. Each course is designed to comply with the standards. For states adopting the standards, recognizing QAS hours or Registry hours, credit hours are measured in 50-minute contact hours. Some states, however, require 100-minute contact hours for self-study. Your state licensing board has final authority on accepting Registry hours, QAS hours, or hours under the standards. Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program or have adopted the standards and allow QAS CPE credit hours. Alternatively, you may visit the NASBA website at www.nasba.org for a listing of states that accept QAS hours or have adopted the standards. Credit hours for CPE courses vary in length. Credit hours for each course are listed on the “Overview” page before each course.

CPE requirements are established by each state. You should check with your state board of accountancy to determine the acceptability of this course. We have been informed by the North Carolina State Board of Certified Public Accountant Examiners and the Mississippi State Board of Public Accountancy that they will not allow credit for courses included in books or periodicals.

Obtaining CPE Credit

Online Grading. Log onto our Online Grading Center at OnlineGrading.Thomson.com to receive instant CPE credit. Click the purchase link and a list of exams will appear. You may search for the exam using wildcards. Payment for the exam is accepted over a secure site using your credit card. For further instructions regarding the Online Grading Center, please refer to the Test Instructions preceding the Examination for CPE Credit Answer Sheet. A certificate documenting the CPE credits will be issued for each examination score of 70% or higher.

Print Grading. You can receive CPE credit by mailing or faxing your completed Examination for CPE Credit Answer Sheet to the Tax & Accounting business of Thomson Reuters for grading. Answer sheets are located at the end of all course materials. Answer sheets may be printed from electronic products. The answer sheet is identified with the course acronym. Please ensure you use the correct answer sheet for each course. Payment of $79 (by check or credit card) must accompany each answer sheet submitted. We cannot process answer sheets that do not include payment. Please take a few minutes to complete the Course Evaluation so that we can provide you with the best possible CPE.
You may fax your completed Examination for CPE Credit Answer Sheet to the Tax & Accounting business of Thomson Reuters at (817) 252-4021, along with your credit card information.

If more than one person wants to complete this self-study course, each person should complete a separate Examination for CPE Credit Answer Sheet. Payment of $79 must accompany each answer sheet submitted. We would also appreciate a separate Course Evaluation from each person who completes an examination.

Express Grading. An express grading service is available for an additional $24.95 per examination. Course results will be faxed to you by 5 p.m. CST of the business day following receipt of your Examination for CPE Credit Answer Sheet. Expedited grading requests will be accepted by fax only if accompanied with credit card information. Please fax express grading to the Tax & Accounting business of Thomson Reuters at (817) 252-4021.

Retaining CPE Records

For all scores of 70% or higher, you will receive a Certificate of Completion. You should retain it and a copy of these materials for at least five years.

PPC In-House Training

A number of in-house training classes are available that provide up to eight hours of CPE credit. Please call our Sales Department at (800) 431-9025 for more information.
COMPANION TO PPC’S GUIDE TO AUDITS OF FINANCIAL INSTITUTIONS

COURSE 1

LOANS RECEIVABLE AND THE LOAN LOSS ALLOWANCE (AFITG101)

OVERVIEW

COURSE DESCRIPTION: This interactive self-study course covers topics related to the loans receivable and loan loss allowance elements of an audit of a financial institution. Lesson 1 provides a discussion of the relevant authoritative guidance, an overview of audit procedures used to obtain audit evidence related to loans receivable, the types of loans receivable, key considerations necessary to obtain an understanding of a loan portfolio, and lending activities and the related risks. Lesson 2 discusses the accounting principles and common industry accounting practices related to the allowance for loan losses, loan reviews, allowances related to specific loans, and the components of the allowance for loan losses other than specific allowances. Lesson 3 provides information on acquisition, development, and construction (ADC) loans, the audit procedures commonly performed in audit areas related to loans receivable, and a case study on auditing the allowance for loan losses.

PUBLICATION/REVISION DATE: June 2010

RECOMMENDED FOR: Users of PPC’s Guide to Audits of Financial Institutions

PREREQUISITE/ADVANCE PREPARATION: Basic knowledge of auditing.

CPE CREDIT: 8 QAS Hours, 8 Registry Hours

Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at www.nasba.org for a listing of states that accept QAS hours.

FIELD OF STUDY: Auditing

EXPIRATION DATE: Postmark by June 30, 2011

KNOWLEDGE LEVEL: Basic

Learning Objectives:

Lesson 1—Loans Receivable and Lending Activities

Completion of this lesson will enable you to:
- Identify the authoritative literature and audit procedures related to loans receivable and the loan loss allowance.
- Compare and contrast the different types of loans used by financial institutions, and summarize how an auditor gains an understanding of a financial institution’s loan portfolio.
- Summarize how an auditor gains an understanding of a financial institution’s lending activities.

Lesson 2—Loan Loss Allowance

Completion of this lesson will enable you to:
- Identify accounting principles and practices used in relation to the loan loss allowance for a financial institution.
- Summarize how an auditor performs loan reviews and estimates specific allowances for loans in a financial institution audit.
- Assess issues related to the allowance for loan losses other than specific allowances in a financial institution audit.
Lesson 3—ADC Loans, Common Audit Procedures, and a Case Study

Completion of this lesson will enable you to:
- Define ADC loans, and summarize related accounting methods used by financial institutions.
- Identify audit procedures for areas related to loans receivable in a financial institution audit.

TO COMPLETE THIS LEARNING PROCESS:

Send your completed Examination for CPE Credit Answer Sheet, Course Evaluation, and payment to:

Thomson Reuters
Tax & Accounting—R&G
AFITG101 Self-study CPE
36786 Treasury Center
Chicago, IL 60694-6700

See the test instructions included with the course materials for more information.

ADMINISTRATIVE POLICIES:

For information regarding refunds and complaint resolutions, dial (800) 431-9025 for Customer Service and your questions or concerns will be promptly addressed.
Lesson 1: Loans Receivable and Lending Activities

INTRODUCTION

Loans receivable is perhaps the most critical and most difficult area in a financial institution audit. An institution's financial condition and profitability often depends on the quality and performance of its loan portfolio. Accordingly, a substantial portion of the auditor's attention is devoted to auditing loans receivable. Auditing the allowance for loan losses usually requires extensive partner involvement (at least in planning and supervision), and the most senior audit personnel on the engagement are usually assigned to that area.

However, that does not mean that all of the financial statement assertions relating to loans receivable receive the same degree of attention. The auditor's objectives for some assertions, such as completeness, can usually be met rather easily. Accordingly, it is important for the auditor to design the audit plan to focus on the critical areas and avoid overauditing less critical areas. This course discusses matters auditors should consider in planning and performing audit procedures relating to loans receivable.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify the authoritative literature and audit procedures related to loans receivable and the loan loss allowance.
- Compare and contrast the different types of loans used by financial institutions, and summarize how an auditor gains an understanding of a financial institution’s loan portfolio.
- Summarize how an auditor gains an understanding of a financial institution’s lending activities.

ACCOUNTING AND AUDITING LITERATURE

The accounting and auditing literature relating to loans receivable is extensive. Some of the literature applies specifically to loans held by financial institutions. For example, FASB ASC 942 contains accounting guidance specifically related to depository and lending institutions. Other literature [such as FASB ASC 450-10 (formerly SFAS No.5) and FASB ASC 310 (formerly SFAS No. 114)] provides general guidance. The following paragraphs discuss significant accounting and auditing literature relating to loans receivable.

Accounting Literature

The following summarizes the accounting literature applicable to loans receivable:

- FASB ASC 310, Receivables, provides general guidance relating to accounting for loans and the allowance for loan losses. In addition, the following subsections contain specific guidance related to more narrow topics:
  
  - FASB ASC 310-10-35 (formerly SFAS No. 114, Accounting by Creditors for Impairment of a Loan and SFAS No. 118, Accounting by Creditors for Impairment of a Loan-Income Recognition and Disclosures) provides subsequent measurement guidance for loans receivable, including guidance on loan impairment, the allowance for loan losses, and recognition of interest income on impaired loans.
  
  - FASB ASC 310-20 (formerly SFAS No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases) provides guidance on the accounting for nonrefundable loan fees and origination costs.
  
  - FASB ASC 310-10-25-14 through 25-30 (formerly AcSEC Practice Bulletin No. 1, Purpose and Scope of AcSEC Practice Bulletins and Procedures for Their Issuance) provides guidance relating to accounting for acquisition, development and construction (ADC) loans.
  
  - FASB ASC 310-40 (formerly SFAS No. 15, Accounting by Creditors and Debtors for Troubled Debt Restructurings) provides guidance on troubled debt restructurings.
FASB ASC 450-10 (formerly SFAS No. 5, Accounting for Contingencies) covers the basic accounting principles relating to recognizing loan losses.

FASB ASC 860 (formerly SFAS No 140, Accounting for Transfers of Financial Assets and Extinguishment of Liabilities, as amended by SFAS No. 156, Accounting for Servicing of Financial Assets—an amendment of FASB Statement No. 140 and SFAS No. 166, Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140) provides the accounting guidance for transfers and servicing of financial assets, including loan participations sold, both prior to and after the effective date of ASU 2009-16 (which codified SFAS No. 166).

FASB ASC 942 [formerly AICPA Audit and Accounting Guide, Depository and Lending Institutions: Banks and Savings Institutions, Credit Unions, Finance Companies and Mortgage Companies (DEP)] provides specific accounting guidance for loans in a financial institution.

In addition to the preceding literature, there is additional guidance that is more narrowly defined or that indirectly affects loans receivable, including:

FASB ASC 948 (formerly SFAS No. 65, Accounting for Certain Mortgage Banking Activities).

FASB ASC 825-10 and 942-470-50-1 (formerly SFAS No. 107, Disclosures about Fair Value of Financial Instruments).

FASB ASC 815 (formerly SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities, as amended).

FASB ASC 820-10 (formerly SFAS No. 157, Fair Value Measurements).


Presentation of Assets and Liabilities. Although financial information normally is presented based on costs incurred, there are a number of situations in which other, more current information is either required or useful to the users of the presentation. Recent accounting literature indicates a move to providing more fair value information, and some nonpublic entities find that fair value information is useful to the primary readers of their financial statements. Under generally accepted accounting principles, fair values can be used for only specific items in the financial statements or, in some cases, as a comprehensive basis for all items in the financial statements. In addition, GAAP requires fair value disclosures in several areas, principally for financial instruments. This course includes discussion on fair value accounting, when appropriate under GAAP, for loans receivable.

Fair Value Measurements. FASB ASC 820-10 (formerly SFAS No. 157, Fair Value Measurements) provides a common definition of fair value, establishes a framework to measure fair value within GAAP, and expands the disclosures about fair value measurements. The SFAS applies under existing accounting pronouncements that require or permit fair value measurements, such as measuring fair value of investments, but it does not expand the use of fair value in any new circumstances.

FASB ASC 820-10-35-55 [formerly FASB Staff Position (FSP) No. FAS 157-3, Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active] clarifies the application of fair value measurements in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. FASB ASC 820-10-35-51A through 35-55H (formerly FSP FAS 157-4, Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly) provides additional details on determining fair value when there has been a significant decrease in the volume or level of activity for an asset or liability.

The Fair Value Option. FASB ASC 825-10 (formerly SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities) permits entities to choose to measure prescribed financial instruments at fair value. Such elections (a) are made on an instrument-by-instrument basis, (b) are irrevocable, and (c) require changes in fair
value to be recognized in earnings. This option was to provide entities the chance to reduce earnings volatility caused by measuring related assets and liabilities differently, such as measuring the liability at fair value but measuring the asset at historical cost. Generally, the Statement permits the fair value option for all financial assets and financial liabilities except the following, which are specifically excluded:

a. An investment in a subsidiary that is required to be consolidated by the entity.

b. A variable interest in a variable interest entity that is required to be consolidated by the entity.

c. Obligations for pension and other postretirement and postemployment benefits, share-based payments, compensated absences, and costs associated with exit or disposal activities.

d. Amounts recognized under FASB ASC 840 (formerly SFAS No. 13, Accounting for Leases).

e. Deposit and similar liabilities of financial institutions.

f. Financial instruments classified by the issuer as a component of equity.

Generally, a financial asset is defined as a financial instrument that conveys a right to the entity, and a financial liability is defined as a contract that imposes an obligation on the entity. For example, an entity could elect the fair value option for an investment that would otherwise be accounted for using the cost or equity method. Similarly, an entity could elect the fair value option for a fixed-rate long-term note.

The disclosure requirements only apply if an entity has elected the fair value option. Those requirements generally look at how the election affects the measurement of those assets and liabilities. For example, disclosure is required of the reason for electing the fair value option and information about differences between the fair values and contractual cash flows. In addition, the measurement and disclosure requirements of FASB ASC 820-10 (formerly SFAS No. 157) apply to those assets and liabilities.

Auditing Literature

The following literature addresses significant auditing issues regarding loans receivable:

- SAS No. 73 (AU 336), Using the Work of a Specialist, covers the basic principles for using appraisers and other valuation specialists.

- SAS No. 57 (AU 342), Auditing Accounting Estimates, covers the basic principles used in auditing the allowance for loan losses.

- AICPA Audit and Accounting guide for depository and lending institutions (DEP) provides specific guidance for auditing loans receivable (and the allowance for loan losses).

Regulatory Literature

Financial institutions are subject to many detailed laws, regulations, and supervisory bulletins relating to loan policies and procedures. The following are some of the specific issues covered by regulatory literature:

a. Legal Lending Limits. These regulatory restrictions limit the amount of credit that may be extended to any one borrower.

b. Loan to Value Ratio Limits. These are restrictions on the collateral margins that are required on secured loans. The current regulations apply primarily to real estate loans.

c. Insider Loan Restrictions. These are limits on the amount of loans to executive officers, directors, principal shareholders, and their affiliates. NCUA regulations prohibit federal credit unions from making business loans to compensated directors, the chief executive officer, any assistant chief executive officer (such as a vice president), the chief financial officer (or controller), or any associated member or immediate family
member. (NCUA regulations define an associated member as any member with a shared ownership, investment, or other monetary interest in a business or commercial venture with the borrower.)

**AUDIT PROCEDURES USED TO OBTAIN AUDIT EVIDENCE RELATED TO LOANS RECEIVABLE**

The third standard of fieldwork states:

> The auditor must obtain sufficient appropriate audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit. (AU 150.02)

SAS No. 106 (AU 326), *Audit Evidence*, states that those audit procedures consist of the following:

- Risk assessment procedures.
- Tests of controls.
- Substantive procedures.

Risk assessment procedures and tests of controls contribute to the formation of the auditor’s opinion, but do not, by themselves, provide sufficient appropriate audit evidence. SAS No. 110 (AU 318), *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, states that regardless of the assessed risk of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure. Substantive procedures consist of (a) tests of details of transactions, account balances, and disclosures, and (b) substantive analytical procedures.

**Relevant Assertions for Loans Receivable and Related Accounts**

Relevant assertions for a particular audit area are assertions that have a meaningful bearing on whether the related account balances, transaction classes, or disclosures are fairly stated. The relevant assertions for loans receivable and related accounts generally are as follows:

- **Existence or Occurrence (E/O)**—Loans receivable reported in the balance sheet exist and represent loans in the normal course of business. Interest and other related income reported in the statement of income represents valid transactions that occurred during the period and pertain to the institution.
- **Completeness (C)**—Loans receivable include all amounts owed to the institution at the balance sheet date. All interest and other related income that should be included in the statement of income is recorded. Related disclosures are complete.
- **Rights or Obligations (R/O)**—Loans receivable are authentic rights held by the institution.
- **Valuation or Allocation (V)**—Loans receivable is recorded net of an allowance for loan losses, and the allowance is adequate to cover estimated losses inherent in the loan portfolio but not excessive.
- **Cutoff (C/O)**—Loans receivable and related accounts are recorded in the proper accounting period.
- **Accuracy or Classification (A/C)**—Loans receivable and related accounts have been properly recorded as to account and amount. Loans receivable are properly classified in the balance sheet and all significant categories of loans receivable are presented separately in the balance sheet or disclosed (e.g., total loans, major categories of loans, unearned income on installment loans, unamortized premiums and discounts on purchased loans, and net unamortized deferred loan fees and origination costs). Information about loans receivable and related accounts required by GAAP is fairly disclosed at appropriate amounts.
The auditor uses relevant assertions in assessing the risks of material misstatement by considering the different types of potential misstatements that may occur (that is, what could go wrong in the financial statements), and then designing audit procedures that are responsive to the assessed risks. For each relevant assertion within an account balance, class of transactions, or disclosure, the auditor assesses the risks of material misstatement and, based on that assessment, determines the nature, timing, and extent of the substantive procedures necessary to obtain sufficient appropriate audit evidence.

**PPC’s Guide to Audits of Financial Institutions** discusses the auditor’s considerations when responding to assessed risks of material misstatement at the relevant assertion level and considerations when choosing substantive procedures, including substantive analytical procedures and tests of details. Auditors should be familiar with those concepts when designing the nature, timing, and extent of substantive audit procedures for loans receivable and the loan loss allowance.

**Major Categories of Audit Procedures**

There are a number of audit procedures that could be performed in order to provide sufficient appropriate audit evidence for the relevant assertions listed in the preceding paragraph. This course provides an audit approach for loans receivable that can effectively and efficiently provide such evidence. SAS No. 106 (AU 326), *Audit Evidence*, states that audit procedures for obtaining audit evidence consist of risk assessment procedures, tests of controls, and substantive procedures. More information about risk assessment procedures and tests of controls can be found in **PPC’s Guide to Audits of Financial Institutions**. Tests of controls are commonly performed on loans receivable. Substantive procedures are discussed in the remainder of this course. The specific procedures that should be performed have been organized into major categories listed in Exhibit 1-1. With the exception of the confirmation process, which is discussed in **PPC’s Guide to Audits of Financial Institutions**, all of the categories of audit procedures listed in Exhibit 1-1 are discussed in this course. Basic, extended, and other substantive audit procedures can be considered in auditing a loan portfolio. The auditor should choose procedures that will be adequate to obtain sufficient audit evidence for the relevant assertions.

**Exhibit 1-1**

**Major Categories of Audit Procedures Relating to Loans Receivable**

1. *Loan Portfolio*. Obtain an understanding of the client’s loan portfolio.
2. *Lending Activities*. Obtain an understanding of the client’s lending activities.
4. *Participations*. Confirm participations purchased and sold with other institutions.
7. *Related Areas*. Perform procedures on loan-related accounts including the following:
   a. Assess the liability for estimated credit losses of off-balance-sheet instruments.
   b. Analytical procedures for accrued interest.
   c. Yield analysis for interest income on loans.
   d. Tests of amortization of installment loans.
   e. Review of the accounting for initial capitalization and subsequent amortization of loan fees and costs in accordance with FASB ASC 320-10 (formerly SFAS No. 91).
   f. Tests of undisbursed portion of loans in process on construction loans.
   g. Tests of escrow accounts (advance payments by borrowers for taxes and insurance).

* * *
SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. Joe, an auditor, is engaged to perform the audit of Timber Hills Bank. What piece of authoritative literature should he consult to refresh himself on accounting principles related to loan loss recognition?
   
   a. FASB ASC 310-40.
   
   b. FASB ASC 450-10.
   
   c. FASB ASC 860.
   
   d. FASB ASC 942.

2. Joe would like to consult an appraiser during his audit of Timber Hills. What piece of authoritative literature should he consult to find out the basic auditing principles related to use of an appraiser?
   
   a. SAS No. 57.
   
   b. SAS No. 73.
   
   c. The DEP.
   
   d. Regulations that affect financial institutions.

3. During his audit, Joe uses the relevant assertion that Timber Hills recorded loans receivable net of an allowance for loan losses, and that allowance should adequately cover any estimated losses inherent in the loan portfolio but not excessive losses. Which relevant assertion for loans receivable and related accounts is this?
   
   a. Existence or occurrence.
   
   b. Rights or obligations.
   
   c. Cutoff.
   
   d. Valuation or allocation.
SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. (References are in parentheses.)

1. Joe, an auditor, is engaged to perform the audit of Timber Hills Bank. What piece of authoritative literature should he consult to refresh himself on accounting principles related to loan loss recognition? (Page 3)

   a. FASB ASC 310-40. [This answer is incorrect. FASB ASC 310-40 (formerly SFAS No. 15, Accounting for Creditors and Debtors for Troubled Debt Restructurings) provides guidance on troubled debt restructurings.]

   b. FASB ASC 450-10. [This answer is correct. FASB ASC 450-10 (formerly SFAS No. 5, Accounting for Contingencies) covers the basic accounting principles related to recognizing loan losses. For this element of his financial institution audit, Joe should consult this piece of authoritative guidance.]

   c. FASB ASC 860. [This answer is incorrect. FASB ASC 860 (formerly SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, as amended by SFAS No. 156, Accounting for Servicing of Financial Assets—an amendment of FASB Statement No. 140, and SFAS No. 166, Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140) provides the accounting guidance for transfers and servicing of financial assets, including loan participations sold, both prior to and after the effective date of ASU 2009-16 (which codified SFAS No. 166).]

   d. FASB ASC 942. [This answer is incorrect. FASB ASC 942 (formerly AICPA Audit and Accounting Guide, Depository and Lending Institutions: Banks and Savings Institutions, Credit Unions, Finance Companies and Mortgage Companies (DEP)) provides specific accounting guidance for loans in a financial institution, but not the specific guidance Joe needs in this scenario.]

2. Joe would like to consult an appraiser during his audit of Timber Hills. What piece of authoritative literature should he consult to find out the basic auditing principles related to use of an appraiser? (Page 5)

   a. SAS No. 57. [This answer is incorrect. SAS No. 57, Auditing Accounting Estimates, covers the basic principles used in auditing the allowance for loan losses.]

   b. SAS No. 73. [This answer is correct. SAS No. 73, Using the Work of a Specialist, covers the basic principles for using appraisers and other valuation specialists. Therefore, this is the authoritative guidance that Joe should consult in this scenario.]

   c. The DEP. [This answer is incorrect. The DEP provides specific guidance for auditing loans receivable (and the allowance for loan losses).]

   d. Regulations that affect financial institutions. [This answer is incorrect. Financial institutions are subject to many detailed laws, regulations, and supervisory bulletins related to loan policies and procedures. Some of the specific issues covered by regulatory literature are legal lending limits, loan to value ratio limits, and insider loan restrictions.]

3. During his audit, Joe uses the relevant assertion that Timber Hills recorded loans receivable net of an allowance for loan losses, and that allowance should adequately cover any estimated losses inherent in the loan portfolio but not excessive losses. Which relevant assertion for loans receivable and related accounts is this? (Page 6)

   a. Existence or occurrence. [This answer is incorrect. The relevant assertion for existence or occurrence is as follows: Loans receivable reported in the balance sheet exist and represent loans in the normal course of business. Interest and other related income reported in the statement of income represents valid transactions that occurred during the period and pertain to the institution.]

   b. Rights or obligations. [This answer is incorrect. The relevant assertion for rights or obligations is as follows: Loans receivable are authentic rights held by the institution.]
c. Cutoff. [This answer is incorrect. The relevant assertion for cutoff is as follows: Loans receivable and related accounts are recorded in the proper accounting period.]

d. Valuation or allocation. [This answer is correct. Relevant assertions for a particular audit area are assertions that have a meaningful bearing on whether the related account balances, transaction classes, or disclosures are fairly stated. The relevant assertion related to loans receivable and related accounts described in the scenario above is related to valuation or allocation.]
OBTAINING AN UNDERSTANDING OF THE LOAN PORTFOLIO FOR LOAN AUDITS

To audit loans efficiently and effectively, the auditor must obtain an understanding of the client’s loan portfolio. This understanding is obtained during planning when performing risk assessment procedures and should be documented. That understanding will normally include the following:

- The types of loans comprising the loan portfolio and the relative size of each type.
- The degree of risk associated with the loan portfolio.

Each of those factors is discussed in the following paragraphs.

Types of Loans

Financial institutions provide a number of different types of loans to their customers. Loan terms vary depending on the type of financial institution, type of borrower or collateral, loan purpose, and other factors. The following are examples of some of the primary loan categories:

- Commercial business loans.
- Real estate loans.
- Installment loans.
- Other consumer loans (such as student loans).
- Other commercial loans (such as SBA loans).

Loans may also differ in their terms of repayment (such as term, demand, time, installment, or line of credit).

The auditor should obtain an understanding of the types of loans comprising the client’s loan portfolio and their relative size. Loan portfolios composed primarily of homogeneous loan pools (such as consumer loans) have different risk characteristics and require different audit procedures from diverse loan pools (such as commercial loans). The composition of a client’s loan portfolio is an important factor to consider when assessing inherent risk related to loans. For example, the client’s risks associated with real estate lending are different from those associated with installment lending.

Commercial Business Loans. Commercial business loans (which may also be referred to as commercial loans; business loans; commercial, industrial, and agricultural loans; or C and I loans) are made for a variety of business purposes (such as working capital or equipment acquisition), and the characteristics of those loans vary widely. The loans may be secured or unsecured and they may have a variety of maturities and repayment terms. Those loans often carry an interest rate that floats with prime, although some loans may have fixed interest rates. The following are examples of common types of commercial business loans:

- **Working Capital or Seasonal Loans.** Working capital loans are typically short-term loans that are used to provide temporary financing to meet seasonal or other short-term needs. The loans may be unsecured, but they are more often secured by accounts receivable and inventory. In many cases, the loan is made for a specified period, such as three to six months. At maturity, the loan is either repaid or renewed in a transaction known as a rollover. The loans may have floating rates, or they may have fixed rates that change on renewal.

- **Equipment Financing.** Equipment purchases are generally financed over a term of one to five years, although large acquisitions may be financed over a longer term. Payment terms on equipment loans usually call for some type of periodic payment, either a monthly payment similar to an installment loan or a quarterly payment of principal plus interest based on a floating rate.
• **Agricultural Loans.** In a sense, agricultural loans may refer to any loan to a farmer or rancher. However, in this course, agricultural loans are those that are secured by land, crops, livestock, or warehouse receipts. In some banks, agricultural loans comprise a significant portion of the loan portfolio. Repayment terms on agricultural loans are typically structured based on the expected realization of earnings from the collateral. Because of the length of the production process, the maturities of agricultural loans may be two to three years or longer.

Banks make most of the commercial business loans. Savings institutions and credit unions have only limited powers for originating commercial loans. For federally chartered savings institutions, federal law (12 USC 1464, as amended) generally restricts the size of commercial business loan portfolios to 10% of total assets. However, if portfolio amounts in excess of 10% of total assets are used for small businesses, the commercial loan portfolio may comprise up to 20% of total assets. To be considered a small business loan, a loan must meet the Small Business Administration criteria or have an originating balance of $1 million or less. Federal credit unions are restricted by NCUA Regulations 701 and 723 in the types and amount of commercial loans they can make.

**Real Estate Loans.** Real estate loans are merely loans that are secured by a lien on real estate. The term encompasses a number of different types of loans and different types of property, and the characteristics of each loan can vary widely. However, most real estate loans can be classified into one of the following categories:

a. **Single-family Residential Loans.** Those loans are permanent mortgage loans secured by liens on single-family homes. The loans may have fixed interest rates that do not change over their lives, or they may have adjustable rates that are tied to a benchmark rate such as rates on U.S. Treasury Bills. The loans are typically repaid in monthly installments over original terms of 15 or 30 years. However, variations on repayment terms include longer or shorter maturities and such features as balloon payments or negative amortization. For example, subprime mortgage loans generally have elements of adjustable rates, variations on repayment terms (such as interest-only payments for a short time period and balloon payments), and 100% financing. While subprime loans are typically pooled and sold as securitized mortgage products, the institution may still have some of these loans in their loan portfolio. Subprime lending is discussed later in this lesson. In addition to being secured by real estate liens, many single-family residential loans are insured or guaranteed by public or private agencies, which helps reduce the institution’s credit risk on the loans. The following are examples of insured or guaranteed loans:

(1) **FHA-insured or VA-guaranteed Loans.** The Federal Housing Administration (FHA) insures and the Department of Veterans’ Affairs (VA) partially guarantees loans that meet certain qualifications. FHA generally applies to qualifying first-time homebuyers, and VA generally applies to veterans of military service. Under the FHA program, borrowers pay an insurance premium to the agency. If the borrower defaults, the lender can convey the property to FHA in exchange for cash or debentures. Under the VA program, if the buyer defaults, the VA either purchases the property from the lender or pays a specified guarantee amount representing a portion of the loan balance and costs incurred. The Department of Housing and Urban Development (HUD) administers the FHA and VA loan programs.

(2) **Privately Insured Loans.** For conventional loans (that is, loans other than FHA or VA loans), the lender may choose not to have any mortgage insurance. However, if the loan amount exceeds 80% to 90% of the value of the house at origination, the lender may require the borrower to purchase private mortgage insurance (commonly referred to as PMI). PMI typically reimburses the lender for all or a portion of any loss incurred by the lender if the borrower defaults.

The effect of mortgage insurance on the allowance for losses relating to these loans is discussed in Lesson 2.

b. **Commercial Real Estate Loans.** Commercial real estate loans are loans secured by liens on properties such as multifamily residential, retail, commercial office, industrial, and land development projects. The characteristics of commercial real estate loans vary based on the type of property, purpose of the loan, and other factors. Generally, the loans involve larger loan amounts and greater risk to the lender than
single-family residential loans. Commercial real estate loans can generally be classified into two categories—

1. **Loans on Owner-occupied Properties.** These are loans on buildings in which the borrower is the sole or primary tenant. The loans are typically repaid in periodic installments over the economic life of the buildings. The interest rate charged on a loan secured by owner-occupied property may be either fixed or floating. Repayment of the loan typically depends on the profitability of the borrower’s business.

2. **Loans on Investment Properties.** These loans often comprise a large portion of a lender’s commercial real estate loan portfolio. These loans usually have floating interest rates and repayment terms that require small periodic payments of principal and interest, interest only, or no payments until maturity. Maturities on such loans generally vary from one to seven years. The primary source of repayment on a loan secured by investment property is usually the proceeds from the sale or operation of the real estate project. Some loans are made without recourse to the borrower.

Federal laws and regulations restrict the commercial real estate lending practices of many savings institutions. For federally chartered savings institutions, federal law (12 USC 1464) restricts the size of their commercial nonresidential real estate loan portfolios to 400% of regulatory capital, unless specifically approved by the Office of Thrift Supervision (OTS). Although credit unions are permitted to make business loans, there are regulations limiting the total investment they can have in such loans.

c. **Development and Construction Loans.** Development loans provide financing to develop raw land into lots for sale. Construction loans provide financing to construct buildings or other improvements. Construction projects range from individual single-family homes to large commercial projects. Development and construction loans are typically structured to disburse funds to borrowers as construction or development progresses. Those loans may also include an initial amount for acquisition of the project site. Repayment terms typically do not require the borrower to make any payments during the construction phase. Instead, the loan is typically paid off through the sale of the project, or it is refinanced with the construction lender or another financial institution after the project has been completed. Construction loans typically involve more risk than permanent loans because repayment depends upon successful completion of the project, and the collateral value will not be fully realized until completion. Construction loans may be made by banks or savings institutions. Credit unions may grant construction loans on single-family homes, but generally they are granted only after the borrower has obtained a permanent loan commitment.

In the 1980s, many savings institutions obtained profit participations (commonly known as equity kickers) in their commercial real estate loans, whereby the institution received a portion of the profits from the sale or operation of the project collateralizing the loan. Those types of loans are referred to as acquisition, development, and construction (ADC) loans. Since 1990, ADC loans have become far less common. Those arrangements are discussed in more detail in Lesson 3.

**Subprime Mortgage Lending.** Starting in 2007, the mortgage industry sustained significant losses resulting from the subprime mortgage lending activities of the previous decade. The subprime mortgage lending market frequently financed mortgage loans for higher risk borrowers and provided 100%-plus financing, adjustable rates that allowed a borrower to qualify at a lower starting interest rate, and interest-only payments for three- to five-year periods with balloon payments at the end of the period. Because of the initial low payments and low cash requirements, more borrowers entered the home ownership market. The lenders generally expected the borrower to refinance the loan or sell the property when rates increased or a balloon payment was due. The lenders also assumed that if the borrower defaulted and foreclosure occurred, the property could be sold at a higher value than when the loan was originated. This plan worked in some real estate markets. However, in many markets, real estate values decreased due to the recent economic downturn. Borrowers could no longer afford the higher payments and were in houses with much lower values than when originally financed, so they could not be sold to cover the outstanding loan balance or be refinanced at the same loan balance. If foreclosures occurred, the property had to be sold at a loss.

Most subprime loans are packaged into securitized mortgage loan products, sold to investors, and removed from the lender’s books under FASB ASC 860 (formerly SFAS No. 140, as amended). The institution may still service the subprime loans. Prior to the implementation of programs under the American Recovery and Reinvestment Act of
2009 (Recovery Act), institutions that are only servicing the loans can generally collect payments and work with a borrower only after actual default. However, the Recovery Act was passed in 2009 and includes over $75 billion allocated to help struggling homeowners in programs under the Homeowner Affordability and Stability Plan. One of those programs is the Home Affordable Modification Program, and it allows institutions that service certain mortgages to work with borrowers prior to the actual default.

Effective as of the beginning of the first annual reporting period that begins after November 15, 2009, for interim periods within that year, and for interim and annual periods thereafter, FASB ASC 860 (formerly SFAS No. 166, Accounting for Transfers of Financial Assets) requires entities to provide more information about sales of securities, financial assets, and similar transactions (particularly if the seller retains some risk related to the assets) and eliminates the concept of a qualifying special-purpose entity. Also for those periods, FASB ASC 810-10 [formerly SFAS No. 167, Amendments to FASB Interpretation No. 46(R)] expands the consolidation application to qualified special-purpose entities. When applicable, many of the securitized mortgage loan products that were qualified special-purpose entities should be evaluated for consolidation by financial institutions. The guidance also eliminates some special provisions and requires guaranteed mortgage securitizations to be treated the same as any other transfer of financial assets within the scope of FASB ASC 860. Transfers of securitized mortgage loans that do not meet the requirements for sale accounting should continue to be classified as loans in the transferor’s statement of financial position.

**Installment Loans.** Installment loans are made to consumers to finance the acquisition of consumer goods, such as automobiles, boats, appliances, furniture, or other consumer goods. The loans typically have fixed interest rates and are repaid through fixed monthly payments over a specified term. For accounting purposes, installment loans are often recorded at the total payments to be received, and an unearned discount is recorded for the interest portion of the loan balance. The unearned discount reduces the carrying amount of the loan to its outstanding principal balance. The unearned discount should be accreted into income each month. Although there is a trend toward the use of simple interest, many financial institutions use the rule of 78s method (which is also called the sum of the month’s digits method) to recognize income on installment loans. Although the rule of 78s method is not an acceptable method under GAAP, it may approximate the interest method under certain conditions. Audit considerations relating to the use of the rule of 78s method are discussed in Lesson 3.

Installment loans may be originated by the institution through a process known as **direct lending.** They may also be originated by other parties and sold to the institution, which is known as **indirect lending.** Indirect loans are usually made under an agreement between the financial institution and a retail dealer (such as an auto dealer, mobile home dealer, or retail store), and they typically arise from a sale of the dealer’s merchandise. A typical dealer agreement establishes the conditions under which loans will be purchased. That agreement normally covers the types of merchandise the lender will finance, credit requirements for borrowers, lending limits, payment terms, discount rates, and recourse provisions. There are three common types of recourse provisions—

- **Full Recourse.** The institution has the right to compel the dealer to repurchase the loan.

- **Limited Recourse.** The institution can compel the dealer to repurchase the loan only under specified conditions (such as if the default occurs within the first year).

- **No Recourse.** The institution cannot compel the dealer to repurchase the loan.

In many instances, the financial institution will require the dealer to maintain reserves with the institution to offset potential recourse losses. The two primary types of reserves are:

- **Dealer Reserve.** Dealer reserves arise when the dealer charges the borrower an interest rate that is higher than the financial institution requires. For example, if the market rate for a specific loan is 8% but the borrower pays interest at an 8.5% rate, the institution might receive the first 8%, with the additional one-half percent going to the dealer. If the loan was sold with recourse, the institution will generally retain some or all of the dealer’s additional interest payments in a deposit account (known as a dealer’s reserve account), which will be used to offset losses. The dealer’s agreement generally specifies the maximum size of the reserve account and the conditions under which the dealer may receive refunds from that account.

- **Holdback Reserve.** Holdback reserves are portions of the proceeds from the loan sales that are retained by the financial institution to offset potential losses. They are generally used for sales of loans that carry
higher credit risk. Like dealer reserves, the holdback reserves are maintained in accordance with the terms of the dealer agreement.

Even full recourse agreements and reserve accounts do not fully protect the financial institution from credit losses on indirect loans. A sufficiently high default rate on the indirect loans bought from a dealer can exhaust the reserve funds and expose the institution to credit losses if the dealer is unable to repurchase the loans. Thus, indirect lending relationships require an assessment of the creditworthiness of the dealer as well as the individual borrowers. If indirect lending is a significant program in an institution, the auditor, in connection with the assessment of audit risk and the adequacy of internal controls in the lending area, should consider whether adequate controls exist at the institution to appropriately minimize the risk in the indirect lending program. The following common control weaknesses associated with indirect lending programs could potentially result in material losses and other problems:

- Poor monitoring procedures.
- Deficient program quality controls.
- Lack of segregation of duties.
- Lack of standardization between dealers.
- Lack of dealer monitoring and controls.
- Approval and pricing factors that are subject to dealer manipulation without adequate procedures to substantiate or otherwise test the validity of these factors.
- Lack of established program limits.
- Inadequate planning, pricing analysis, and credit scoring or other approval analysis.
- Lack of legal counsel review.
- Deficient operational policy statements and procedures.
- Noncompliance with regulatory issues such as UCC, Reg. Z, and state laws and regulations.

Lesson 2 discusses the effects of recourse provisions on the allowance for losses relating to installment loans.

**Automobile Lease Financing.** As leasing becomes a more popular alternative to purchasing a car, many financial institutions continue to increase their involvement in automobile leasing. For closed-end leases, if the residual value is higher than the market price of the vehicle, most customers return the leased cars rather than buying them. The financial institution then has to adjust the residual values and sell the cars at losses. Therefore, management of the institution should make sure that residual values of leased cars are appropriately valued. FASB ASC 840-30-35-21 and 35-23 (formerly Paragraph 17(d) of SFAS No. 13, *Accounting for Leases*) provides guidance on accounting for estimated residual values. The auditor of a financial institution that engages in lease financing should look to that pronouncement as well as SAS No. 57 (AU 342), *Auditing Accounting Estimates*, to determine whether an adjustment to residual value is necessary.

Credit unions are required to purchase residual value insurance on vehicles the credit union leases to its members. In some cases, the residual value insurer has been unable to honor its obligation because of its poor financial condition. Therefore, the auditor of a credit union that engages in automobile lease financing should consider whether the credit union has (a) performed adequate due diligence related to the residual value insurer and (b) determined that the insurer has the financial capacity to meet its insurance obligation to the credit union.

**Other Consumer Loans.** In addition to the installment loans previously discussed, there are a number of other consumer loans that financial institutions make. Those loans have a variety of purposes, payment terms, and other characteristics. The following are examples of other consumer loans:

- **Home Improvement Loans.** Home improvement loans are made to finance the expansion, remodeling, or improvement of existing homes, and they are generally secured by second liens on the property. The loans
generally require monthly payments just like single-family residential loans, but they usually have shorter maturities. (These arrangements may also be classified as real estate loans. However, in many cases, they are accounted for more like consumer loans than real estate loans.)

- **Home Equity Lines of Credit.** Home equity lines of credit allow borrowers to obtain loans in varying amounts as needed up to a specified credit limit. The repayment terms are generally flexible and interest rates are typically lower than those for installment loans. The loans are secured by liens on the equity a borrower has in his or her residence. These loans have become popular since the Tax Reform Act of 1986 because the interest paid on them is generally tax-deductible, while most consumer interest is no longer deductible. (These arrangements may also be classified as real estate loans. However, in many cases, they are accounted for more like consumer loans than real estate loans.)

- **Loans Secured by Deposit Accounts.** As the name suggests, this is a loan made to a depositor that is secured by a designated deposit account. At credit unions and mutual savings institutions, these loans may be referred to as share loans.

- **Student Loans.** Prior to July 1, 2010, education or student loans were generally made by financial institutions pursuant to specific student loan programs, such as the Federal Stafford Loan Program, Federal Supplemental Loans for Students (Federal SLS) Program, Federal Parent Loans for Undergraduate Students (Federal PLUS) Program, and the Federal Consolidation Loan Program. In many student programs, the university or vocational school handled much of the application processing and eligibility determination, and the financial institution merely provided the funding. The loans are generally guaranteed by a federal or state governmental agency. In many instances, the borrower is not required to pay principal or interest on the loan before leaving school. Until then, interest is received from state or federal agencies. If the borrower defaults, the federal or state agency reimburses the lender for losses in accordance with its insurance rules. However, losses may be incurred if the loans are not fully guaranteed or if the financial institution fails to fully comply with the government agency’s rules. In March 2010, the Health Care & Education Affordability Reconciliation Act was signed into law. The new law includes the Student Aid and Fiscal Responsibility Act (SAFRA), which makes sweeping changes to federal student loan programs. Among other things, the new legislation replaces the Federal Family Education Loan Program (FFEL) with 100% direct lending from the government effective July 1, 2010. Beginning on that date, the federal government will directly issue student loans through the Direct Loan Program, not the FFEL.

- **Credit Card Loans.** A credit card loan is any loan made to an individual by means of a credit card that is not a commercial loan.

- **Payday Loans.** Payday loans are small-dollar, short-term unsecured loans often exchanged for a check post-dated to the borrower's next payday. The FDIC has issued examination guidance for banks and thrifts that make payday loans. The FDIC felt this guidance was necessary given that payday loans are being offered by an increasing number of insured depository institutions. The FDIC warns that the combination of the borrower's limited financial capacity, the unsecured nature of the credit, and the limited underwriting analysis of the borrower’s ability to repay the loan poses substantial credit risk for insured depository institutions. Payday lenders are subject to special examination procedures to verify and monitor their performance. Failure to meet the standards will result in enforcement actions, which could include instructions to exit the business. The FDIC also cautions that a bank’s board of directors and management will be held responsible for ensuring that the entire payday lending operation—including those portions handled by a third party—are conducted in a safe and sound manner and in compliance with all applicable consumer protection laws, regulations, and policies. The FDIC’s guidance to examiners on payday lending can be found on the agency’s website at [www.fdic.gov/news/news/financial/2005/fil1405a.html](http://www.fdic.gov/news/news/financial/2005/fil1405a.html).

**Other Commercial Loans.** Financial institutions offer a variety of other types of financing for businesses besides the traditional commercial business loans and commercial real estate loans. The following are examples of those other types of financing:

a. **SBA Loans.** SBA loans are commercial business loans made to small businesses under programs sponsored by the Small Business Administration. Under the program, SBA guarantees 50%–90% of the loan balance for loans that meet certain requirements. The loans are made to provide working capital,
finance equipment purchases, acquire plant facilities, or for other purposes. Loan maturities range from 5 to 25 years. Interest rates are set by the financial institution but may not exceed SBA maximums, which are tied to government borrowing rates and are adjusted periodically.

b. Letters of Credit. Letters of credit are a form of financing used by commercial businesses. Letters of credit are used for a variety of reasons, and thus their terms differ. Generally, letters of credit can be classified into two categories—

(1) Commercial Letters of Credit. Commercial letters of credit are typically used to finance the purchase of goods in international trade. Under these arrangements, the financial institution promises to pay a specific amount to the beneficiary (the seller of the goods) when evidence is presented that the goods have been shipped or delivered to the buyer. Payment terms on these letters of credit vary but generally range from payment on presentation (for a sight draft) to 180 days (for a time draft). When the institution accepts the letter of credit from the beneficiary, the buyer becomes obligated to repay the institution in the same way as a direct loan. In fact, some financial institutions establish lines of credit with buyers to facilitate the issuance of commercial letters of credit. In those situations, letters of credit are treated as draws against the buyer’s line of credit.

(2) Standby Letters of Credit. Standby letters of credit are typically used as a financial guarantee by a financial institution of a customer’s third-party debt. Under these arrangements, the financial institution promises to pay the beneficiary a specific sum if the customer defaults on an obligation to the beneficiary. Unlike commercial letters of credit, standby letters of credit do not depend on shipment or receipt of goods, and the financial institution does not necessarily expect to actually fund the standby letter. The financial institution generally receives a fee for issuing standby letters of credit.

Participations

Financial institutions sometimes receive loan requests that exceed their lending limits or amounts they are willing to lend. Participations (or shared lending arrangements) allow financial institutions to handle those requests without violating lending regulations or policies. Loan participation arrangements involve the sale of a portion of a loan by one institution (the lead lender) to one or more participating institutions (the participants). The lead lender normally disburses the loan funds, performs the primary origination functions (including perfecting the lien on the collateral), and services the loan. The participants reimburse the lead lender for their proportionate shares of the loan funds disbursed, and they receive proportionate shares of the loan fees and payments received from the borrower. Each participant normally receives a participation certificate and copies of the participation agreement and other pertinent loan documents. The borrower deals only with the lead lender, and is often unaware of the participation arrangement. The relevant assertions for participations purchased are the same as for directly originated loans, but the audit procedures must be modified to address the unique aspects of those arrangements. For example, a participation purchased is normally confirmed with the lead lender instead of the borrower.

FASB ASC 860-10-55-61 through 55-64 (formerly Paragraphs 104–106 of SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, as amended by SFAS No. 166, Accounting for Transfers of Financial Assets—an amendment of Statement No. 140) provide guidance on accounting for loan participations sold. Sale treatment is allowed when the lead lender surrenders control over the participating interest in accordance with certain conditions. However, sale treatment is jeopardized when the participation agreement contains a clause preventing the buyer of the loan from selling the interest to a third party. If the participation agreement constrains the buyer from pledging or exchanging the participating interest, the transaction should be accounted for as a secured borrowing.

Lending Risks

In many ways, lending is the process of incurring and monitoring risk to maximize income and minimize losses. Almost any lending transaction involves some degree of risk, so it is almost impossible for a financial institution to completely eliminate risk from its lending operations. Rather, the financial institution’s board of directors and management seek to determine the conditions under which the institution will assume lending risks as well as the controls necessary to properly manage those risks. In performing risk assessment procedures, the auditor gains knowledge of the client’s lending risks and considers them in designing an effective audit plan for loans receivable.
Financial institutions face several different types of lending risk in varying degrees. The following are examples of lending risks to which small to mid-sized financial institutions may be exposed:

a. **Credit Risk.** Credit risk is the risk that the borrower will not repay the loan and the lender will not recover the amount of the loan. It is the most significant, and perhaps the most obvious, type of lending risk. The other types of risk in this list affect the degree of credit risk in a loan portfolio.

b. **Collateral Risk.** Collateral risk is the risk that a loss will be incurred on secured loans because of circumstances such as the following:

   (1) The lender's lien on the collateral is not perfected.

   (2) The value of the collateral has declined significantly.

   (3) The collateral is lost or impaired, especially if it is not under the institution's control.

   (4) Environmental contingencies impair the value of the collateral or subject the institution to liability for cleanup costs.

Collateral risk can be considered an aspect of credit risk because it can directly affect the risk of credit loss relating to a loan. It is especially important for collateral-dependent loans, that is, loans that are expected to be repaid through the operation or sale of the collateral. For example, an institution with a large portfolio of real estate loans secured by investment properties may have a significant exposure to collateral risk.

c. **Concentration Risk.** Concentration risk is the risk that the institution will suffer significant credit losses because of inadequate diversification in its loan portfolio. Credit concentrations may exist with respect to individual borrowers, groups of borrowers, industries, geographic regions, or other characteristics. Regulatory restrictions (such as legal lending limit or loans to one borrower regulations) can reduce concentrations with individuals. Likewise, institutions can voluntarily limit their lending to affiliated groups (such as companies under common control). However, many small to mid-sized financial institutions have other types of credit concentrations because they are limited in their ability to significantly diversify their portfolios. The recent economic condition may impact financial institutions that have significant concentrations in residential or commercial real estate. Residential real estate has been susceptible to declining home values and increasing unemployment. Commercial real estate loans and construction and development loans may also be more likely to experience corporate defaults and difficulties and an extended recovery. Examples of common credit concentrations that may indicate increased concentration risk include the following:

   (1) **Geographic Concentrations.** Small to mid-sized financial institutions rarely have widely dispersed lending operations. Most loans are made to individuals and businesses in and around the community in which the financial institution is located. Consequently, those institutions often have geographic concentrations.

   (2) **Industry Concentrations.** Small to mid-sized institutions also may develop industry concentrations because of their location. For example, a small bank in a rural farming community is likely to have a concentration of agricultural loans. Industry concentrations may also develop because of strategic niches that the institution has developed. For example, the institution may have established strong relationships with area mobile home dealers and consequently originated a large number of mobile home loans.

   (3) **Group Concentrations.** Small to mid-sized institutions may have concentrations with other groups, such as employees of a common employer or businesses that are economically dependent on the same customer or supplier. When group concentrations exist, the risk of loan losses often depends on the financial condition and practices of the common employer, customer, or supplier. Credit unions can be especially vulnerable to group concentrations because their membership is typically composed of employees of a particular sponsoring organization (such as a specific commercial business or government agency).
d. Management or Operations Risk. Management risk is the risk that the institution will suffer loan losses because of a lack of competence, integrity, or judgment in originating, disbursing, supervising, collecting, or reviewing loans. This risk includes the risk that management will engage in a significant amount of lending in new areas where the institution has little or no experience. Operations risk results from failure to establish or follow sound controls over lending (such as disbursing loan funds without proper authorization, collateral, or loan documentation). While obtaining an understanding of the client’s lending activities (as discussed later in this lesson), the auditor may become aware of deficiencies in the institution’s controls over lending. The auditor should consider those deficiencies in planning the loans receivable audit procedures.

e. Fraud or Insider Risk. Fraud risk relates to the risk of loss resulting from loans that are not bona fide transactions. Insider risk relates to losses on loans to insiders (such as senior officers, directors, principal shareholders, or their affiliates) that are not made according to the institution’s controls over lending. Examples of such loans are—

(1) Loans to insiders who have little credit history.

(2) Loans to affiliated companies that are newly formed or highly leveraged and have inadequate collateral or insufficient financial information.

(3) Loans to insiders with no significant source of repayment.

Federal laws and regulations generally require that loans to insiders be made on the same terms as loans to independent third parties. Loans to insiders and affiliates pose special risks because they are not arm’s length transactions. A significant number of those loans in the portfolio generally suggests the potential for higher risk in the portfolio. Also, additional procedures may be needed for insider and affiliate loans to determine whether those loans were subject to the same underwriting standards as third-party loans.

A financial institution may also be exposed to country risk or foreign exchange risk if it makes international loans. It also may have a significant exposure to interest rate risk if it makes a substantial number of long-term, fixed-rate loans. However, these generally do not significantly affect the loans receivable audit objectives for small to mid-sized financial institutions.

The following techniques are commonly used to evaluate the degree of credit risk in a loan portfolio:

a. Statistical Trends. Statistical trends can highlight conditions indicating the degree of credit risk in the loan portfolio. Examples of such data include—

(1) Loan Growth Patterns. Loan growth patterns obviously affect the size of the loan portfolio, but they can also affect the degree of credit risk. Excessive growth may be the result of more liberal lending standards. Also, a high volume of lending transactions can place additional burdens on the loan officers and staff, which can increase the risk of unintentional deviations from established lending policies (such as failure to adequately investigate the borrower’s credit history or to perfect the institution’s lien position regarding loan collateral).

(2) Delinquency Statistics. One of the most obvious signs of deteriorating quality of a loan portfolio may be a negative trend in delinquent loans. The auditor should review delinquency statistics for the entire portfolio and each loan type. The auditor may also consider obtaining delinquency statistics by loan officer.

(3) Loan Charge-offs and Recoveries. Loan charge-offs and recoveries are good indicators of losses actually being incurred by the institution. Accordingly, the auditor should analyze the activity in the allowance for loan losses, especially charge-offs and recoveries. In fact, DEP states that auditors should test the propriety of loan charge-offs and recoveries. The auditor should also consider the timeliness of charge-offs.

b. Number and Amount of Problem Loans. The number and amount of problem loans (as defined in Lesson 2) is a significant indicator of the condition of the loan portfolio.
The following ratios can be used to help the auditor obtain an understanding of an institution’s credit risks and assess the reasonableness of the recorded allowance for loan losses:

- **Loans by Type Divided by Total Loans.** Measures the composition of the loan portfolio. These ratios also provide an indication of lending strategy and portfolio risk.

- **Classified Loans Divided by Total Loans.** Provides an indication of asset quality.

- **Allowance for Loan Losses Divided by Total Loans.** Indicates the percentage of the loan portfolio covered by the allowance. The percentage should increase when the quality of the portfolio declines.

- **Allowance for Loan Loss Divided by Nonperforming Loans.** Indicates the percentage of nonperforming loans covered by the allowance. Significant declines in this percentage could indicate that the institution’s allowance is inadequate.

- **Provision for Loan Loss Divided by Net Charge-offs.** A measure of the adequacy of the provision.

The auditor may wish to consider comparing statistical trends of the client to its industry peers. The auditor should analyze the trend in ratios from the previous year(s) to the current year end. If interim procedures are performed, the computations should also be made at interim and compared to year end.

Other types of lending risks relate to—

- **Interest Rate Risk.** This type of risk is the exposure to interest rate movements that occur when a financial institution borrows funds on a short-term basis and lends those funds at a fixed rate for a longer period of time. If interest rates rise, the institution must increase the rate of interest it pays on borrowings without being able to invest at a higher rate until existing fixed rate loans mature. Besides reducing the spread in interest earnings, increasing interest rates reduce the market value of fixed rate mortgage loans.

- **Regulatory or Legal Violations.** Certain violations of laws or regulations, such as interest rates in excess of stated limits or discriminatory lending practices, can lead to regulatory fines or even litigation claims. If those practices come to the auditor’s attention, he or she should consider the effect of any resulting contingent liabilities on the financial statements. The auditor may also have a responsibility for communicating those findings to senior management or those charged with governance.

The preceding risks are often discussed in regulatory examination reports.

**Documenting the Understanding of the Loan Portfolio**

Most of the information about the loan portfolio is obtained as part of performing risk assessment procedures. The following are examples of how that information should be documented:

- The loan statistics discussed previously are normally documented with other analytical procedures performed during audit planning.

- Information about loan concentrations and loans to insiders and affiliates should also be documented. One method that can be used is the “Understanding the Entity and Identifying Risks” form in *PPC’s Guide to Audits of Financial Institutions*.

- Information about the types of loans in a client’s portfolio is normally reflected in the list of general ledger accounts or on a recap of the loan trial balance.

Other relevant information can be documented in a memo. Some auditors find it useful to prepare a simple memo that summarizes the understanding of the loan portfolio.
SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

4. Northwest Bank's loan portfolio includes loans that are guaranteed by the Department of Veterans' Affairs (VA). What type of loans are these?
   b. Real estate loans.
   c. Installment loans.
   d. Other consumer loans.

5. Mercer Bank's loan portfolio is made up primarily of mortgage loans that provide 100%-plus financing, adjustable rates allowing higher risk borrowers to qualify for loans at a lower starting interest rate. The loans have interest-only payments for several years followed by a balloon payment. What is the term for this type of loan?
   a. Subprime loan.
   b. Privately insured loan.
   c. Owner-occupied property loans.
   d. Home equity lines of credit.

6. The following financial institutions all have installment loans in their loan portfolio that came from indirect lending. Which has a dealer reserve?
   a. Bank One's loans include a provision allowing the bank the right to compel the dealer to repurchase the loans.
   b. Bank Two's loans include a provision allowing the bank the right to compel the dealer to repurchase the loans if default occurs in the first year.
   c. Bank Three's loans allow the dealer to charge the borrower an 8.5% interest rate though the bank only requires an 8% rate.
   d. Bank Four retains portions of the loan sale proceeds to offset potential losses.

7. Second National Bank (SNB) specializes in other commercial loans. Which of the following loan types would SNB be likely to offer?
   a. Automobile leases.
   b. Letters of credit.
   c. Student loans.
   d. Home improvement loans.
8. The Allen Credit Union is a small financial institution. Most of its loans are made to businesses and individuals in the town that the credit union is located. What type of lending risk is this?
   
   a. Credit risk.
   
   b. Collateral risk.
   
   c. Concentration risk.
   
   d. Operations risk.

9. Caroline, an auditor, is engaged to audit a financial institution. As part of her audit, she must evaluate the degree of credit risk affecting the institution’s loan portfolio. Which of the following would allow Caroline to measure the composition of the institution’s loan portfolio?
   
   a. Using a ratio that takes loans by type and divides them by total loans.
   
   b. Using a ratio that takes the allowance for loan losses and divides it by total loans.
   
   c. Examining the institution’s loan growth patterns.
   
   d. Examining the institution’s loan charge-offs and recoveries.

10. Oakmont Savings and Loan borrows funds on a short-term basis. It then lends those funds for a longer period of time at a fixed rate. This is an example of what type of lending risk?

   a. Interest rate risk.
   
   b. Regulatory or legal violations.
   
   c. Industry concentrations.
   
   d. Insider risk.
SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. (References are in parentheses.)

4. Northwest Bank’s loan portfolio includes loans that are guaranteed by the Department of Veterans’ Affairs (VA). What type of loans are these? (Page 13)

   a. Commercial business loans. [This answer is incorrect. Commercial business loans are made for a variety of business purposes (such as working capital or equipment acquisition). VA loans do not fall into this type of loan classification.]

   b. Real estate loans. [This answer is correct. Real estate loans are merely loans that are secured by liens on real estate. VA-guaranteed loans are a type of single-family residence loans. The VA partially guarantees loans that meet certain qualifications, and these types of loans generally apply to veterans of military service.]

   c. Installment loans. [This answer is incorrect. Installment loans are made to consumers to finance the acquisition of consumer goods, such as automobiles, boats, appliances, furniture, or other consumer goods. VA loans are not part of this loan type.]

   d. Other consumer loans. [This answer is incorrect. Examples of other consumer loans are home improvement loans, home equity lines of credit, loans secured by deposit accounts, and student loans. VA loans are not classified as other consumer loans.]

5. Mercer Bank’s loan portfolio is made up primarily of mortgage loans that provide 100%-plus financing, adjustable rates allowing higher risk borrowers to qualify for loans at a lower starting interest rate. The loans have interest-only payments for several years followed by a balloon payment. What is the term for this type of loan? (Page 14)

   a. Subprime loan. [This answer is correct. The scenario above is an example of subprime mortgage lending. Most subprime loans are packaged into securitized mortgage loan products, sold to investors, and removed from the lender’s books under FASB ASC 860. The institution may still service the subprime loans. Prior to the implementation of programs under the American Recovery and Reinvestment Act of 2009 (Recovery Act), Institutions that are only servicing the loans can generally collect payments and work with a borrower only after actual default. However, after the Recovery Act, institutions that service certain mortgages can work with borrowers prior to default.]

   b. Privately insured loan. [This answer is incorrect. A privately insured loan is a type of single-family residence loans. If the loan amount exceeds 80% to 90% of the value of the house at origination, the lender may require the borrower to purchase private mortgage insurance (commonly referred to as PMI).]

   c. Owner-occupied property loans. [This answer is incorrect. This type of commercial real estate loan is described as loans on buildings in which the borrower is the sole or primary tenant.]

   d. Home equity lines of credit. [This answer is incorrect. This type of loan is classified under other consumer loans. Home equity lines of credit allow borrowers to obtain loans in varying amounts as needed up to a specified credit limit. These loans have become popular since the Tax Reform Act of 1986.]
6. The following financial institutions all have installment loans in their loan portfolio that came from indirect lending. Which has a dealer reserve? (Page 15)

   a. Bank One’s loans include a provision allowing the bank the right to compel the dealer to repurchase the loans. [This answer is incorrect. This is an example of a full recourse provision.]

   b. Bank Two’s loans include a provision allowing the bank the right to compel the dealer to repurchase the loans if default occurs in the first year. [This answer is incorrect. This is an example of a limited recourse provision.]

   c. Bank Three’s loans allow the dealer to charge the borrower an 8.5% interest rate though the bank only requires an 8% rate. [This answer is correct. Dealer reserves arise when the dealer charges the borrower an interest rate that is higher than the financial institution requires. If the loan was sold with recourse, the institution will generally retain some or all of the dealer’s additional interest payments in a deposit account (known as a dealer’s reserve account), which will be used to offset losses.]

   d. Bank Four retains portions of the loan sale proceeds to offset potential losses. [This answer is incorrect. This is an example of a holdback reserve.]

7. Second National Bank (SNB) specializes in other commercial loans. Which of the following loan types would SNB be likely to offer? (Page 17)

   a. Automobile leases. [This answer is incorrect. This is an other consumer loan. Automobile leasing is a different type of lending activity with its own accounting concerns. FASB ASC 840-30-35-21 and 35-23 provide guidance on accounting for estimated residual values, which is a factor when dealing with automobile leases.]

   b. Letters of credit. [This answer is correct. Financial institutions offer a variety of other types of financing for businesses besides the traditional commercial business loans. Letters of credit are a form of financing used by commercial businesses. Generally, letters of credit are classified into two categories: (1) commercial letters of credit and (2) standby letters of credit.]

   c. Student loans. [This answer is incorrect. Student loans would be considered an other consumer loan. Prior to July 1, 2010, they were generally made by financial institutions pursuant to specific student loan programs. The federal student loans programs were changed by the Healthcare & Affordability Reconciliation Act.]

   d. Home improvement loans. [This answer is incorrect. Home improvement loans would be considered an other consumer loan. They are made to finance the expansion, remodeling, or improvement of existing homes, and they are generally secured by second liens on the property.]

8. The Allen Credit Union is a small financial institution. Most of its loans are made to businesses and individuals in the town that the credit union is located. What type of lending risk is this? (Page 19)

   a. Credit risk. [This answer is incorrect. This is the risk that the borrower will not repay the loan and the lender will not recover the amount of the loan.]

   b. Collateral risk. [This answer is incorrect. This is the risk that a loss will be incurred on secured loans because of circumstances such as the value of the collateral has declined significantly.]

   c. Concentration risk. [This answer is correct. This is the risk that the institution will suffer significant credit losses because of inadequate diversification in its loan portfolio. The credit union in this scenario is suffering from a geographic concentration. Other examples of concentration risk include industry concentrations and group concentrations.]

   d. Operations risk. [This answer is incorrect. This type of risk results from failure to establish or follow sound controls over lending (such as disbursing loan funds without proper authorization, collateral, or loan documentation).]
9. Caroline, an auditor, is engaged to audit a financial institution. As part of her audit, she must evaluate the degree of credit risk affecting the institution’s loan portfolio. Which of the following would allow Caroline to measure the composition of the institution’s loan portfolio? (Page 20)

   a. Using a ratio that takes loans by type and divides them by total loans. [This answer is correct. The number and amount of problem loans is a significant indicator of the condition of the loan portfolio. Certain ratios can be used to help the auditor obtain an understanding of an institution’s credit risks and assess the reasonableness of the recorded allowance for loan loss. If Caroline divides loans by type by total loans, she is using a ratio that will measure the composition of the loan portfolio. These ratios also provide an indication of lending strategy and portfolio risk.]

   b. Using a ratio that takes the allowance for loan losses and divides it by total loans. [This answer is incorrect. This would allow Caroline to determine the percentage of the loan portfolio covered by the allowance for loan losses. The percentage should increase when the quality of the portfolio declines.]

   c. Examining the institution’s loan growth patterns. [This answer is incorrect. Loan growth patterns obviously affect the size of the loan portfolio, but they can also affect the degree of credit risk. This type of statistical information would not, however, allow Caroline to measure the portfolio’s composition.]

   d. Examining the institution’s loan charge-offs and recoveries. [This answer is incorrect. Loan charge-offs and recoveries are good indicators of losses actually being incurred by the institution. However, this type of statistical information, while highlighting conditions that indicate the degree of credit risk in a loan portfolio, will not allow Caroline to measure the portfolio’s composition.]

10. Oakmont Savings and Loan borrows funds on a short-term basis. It then lends those funds for a longer period of time at a fixed rate. This is an example of what type of lending risk? (Page 21)

   a. Interest rate risk. [This answer is correct. By engaging in the type of lending described in this scenario, Oakmont Savings and Loan has interest rate risk. If interest rates rise, the institution must increase the rate of interest it pays on borrowings without being able to invest at a higher rate until existing fixed rate loans mature. Besides reducing the spread in interest earnings, increasing interest rates reduce the market value of fixed rate mortgage loans.]

   b. Regulatory or legal violations. [This answer is incorrect. Certain violations of laws or regulations, such as interest rates in excess of stated limits or discriminatory lending practices, can lead to regulatory fines or even litigation claims. If those practices come to the auditor’s attention, he or she should consider the effect of any resulting contingent liabilities on the financial statements. However, this is not the type of lending risk illustrated in the scenario above.]

   c. Industry concentrations. [This answer is incorrect. This is a type of concentration risk. Small to mid-sized financial institutions may develop industry concentrations because of their location. Industry concentrations may also develop because of strategic niches that the institution has developed. The scenario above does not illustrate this type of lending risk.]

   d. Insider risk. [This answer is incorrect. Insider risk relates to losses on loans to insiders that are not made according to the institution’s controls over lending, such as loans to insiders who have little credit history. The scenario above does not illustrate this type of lending risk.]
OBTAINING AN UNDERSTANDING OF A FINANCIAL INSTITUTION’S LENDING ACTIVITIES

Financial institutions design their lending activities to control and manage the lending risks that were discussed in the preceding paragraphs. Those activities can generally be classified into the following categories:

- Origination and disbursement.
- Servicing and accounting.
- Credit monitoring and collection.
- Internal loan review.
- Loan evaluation.

In performing risk assessment procedures, the auditor should obtain an understanding of those activities. The extent of additional information, if any, that is needed to plan the audit of the allowance for loan losses depends on the size and complexity of the client’s lending activities. For example, in a small institution where most of the lending decisions are made by the president, the understanding may be relatively brief and not extend much beyond the auditor’s basic audit planning documentation. For a larger institution with more complex lending operations and transactions, the auditor may have to obtain more specific information about lending policies and practices. In either case, while obtaining that knowledge, the auditor will obtain information about the effectiveness of the client’s procedures in controlling credit and other lending risks. The auditor should consider that information in determining the nature, timing, and extent of audit procedures. The auditor should also consider the experience and competence of the loan officers because that can affect the soundness of lending practices and the quality of the loan portfolio. The following paragraphs discuss lending activities and certain related controls.

Origination and Disbursement Activities

Origination and disbursement activities cover all of the activities from the original loan application to the disbursement of the loan funds. Those activities typically include the following policies and procedures:

- **Credit initiation**, which includes obtaining:
  1. A completed loan application.
  2. Borrower financial information.
  3. Guarantor financial information, if applicable.
- **Credit investigation**, which includes the following:
  1. Obtaining credit reports.
  2. Reviewing customer credit information, including expected sources of repayment.
  3. Reviewing information relating to guarantors.
  4. Verifying employment, which is especially important for credit unions.
- **Loan approval** (for both new loans and renewals), including:
  1. Preparation and assembly of loan documents (and independent inspection of loan documentation for proper form, completeness and accuracy, if the documents were prepared by the loan officer).
(2) Determination of the loan-to-value ratio for the loan. (Limits on loan-to-value ratios are generally prescribed by regulators or institution policies.)

(3) Verification of collateral ownership and control, including the institution’s lien position.

(4) Verification of compliance with lending regulations and institution lending policies.

(5) Approval by the originating loan officer. (Normally, individual credit limits are imposed on each officer based on the officer’s expertise and level of authority.)

(6) Approval by an appropriate committee (or the board of directors) for loans exceeding prescribed limits.

(7) Separation of duties between the loan approval function and the loan disbursement and collection functions.

d. Filing of appropriate liens to protect the institution’s security interest in the collateral.

e. Disbursement of the loan proceeds.

The AICPA Audit Risk Alert titled Banks, Credit Unions, and Other Lenders and Depository Institutions Industry Developments—2002/03, contains a discussion on the development of new consumer loan delivery channels and systems and the related risks and internal control factors that auditors of financial institutions need to address. Subsequent updates of the AICPA Audit Risk Alert continue to address these areas of lending risk. The following paragraphs summarize the discussion in the Audit Risk Alert.

**Credit Scoring.** Credit scoring is a popular trend in the banking industry for smaller loans (usually those under $100,000 but sometimes up to $250,000). Credit scoring uses specialized computer software to analyze risk similar to the traditional, formula-based process used to evaluate consumer and mortgage loans. These credit-scored approvals are based on behavioral factors such as personal and business loan repayment patterns, number of personal credit cards used by the business owners, etc. Credit scoring is usually based primarily on the business owner’s personal credit record, rather than the financial statement analysis normally performed for larger commercial loans. Credit scoring has automated small loan decision-making and is now common for many financial institutions active in small business lending. Credit scoring is often used in a high-volume lending environment. Thus, loan performance should be monitored carefully by the institution and the credit scoring parameters should be adjusted as circumstances warrant. Also, reliability of these risk factors should be assessed (based on loan performance and other factors) in evaluating the allowance for loan losses.

In addition, the auditor should gain assurance that the scoring system (whether externally or internally developed) used by the financial institution is reliable and has been validated properly. Management must have the capability to properly estimate the expected performance of each category of credit scores. Additionally, system controls should be in place to capture and report relevant credit scoring information, including the ability to monitor performance by credit scores. Credit scoring can be improperly calculated if old credit-scoring models are used or other customer variables are ignored.

**Risk-based Lending.** Another lending tool or system that has grown significantly in recent years is the use of risk-based lending (RBL) or pricing programs. RBL programs involve pricing different categories of loans according to the risk or probability of default. Instead of all borrowers being viewed equally, loans are made and priced according to the borrower’s credit. Usually, an applicant’s creditworthiness is rated using a credit scoring system. The financial institution’s goal for using such a system is to increase loan volume, as well as overall portfolio returns, by (a) pricing loans more appropriately based on risk, (b) expanding the institution’s customer and loan base, and (c) reaching more underserved customers who may otherwise be declined credit. Risk-based lending can serve as a valuable program and resource, and it can also help the financial institution meet expanding competitive pricing constraints. However, like credit scoring, RBL programs also present substantial risk of loss and compliance concerns.
Common Credit Scoring and Risk-based Lending Control Weaknesses. Some common control weaknesses associated with credit scoring and risk-based lending or pricing programs that could potentially result in material losses and other problems include the following:

- Originating significantly more high-risk loans than intended.
- Insufficient reporting mechanisms to alert management and the board of directors to potential problems.
- Inadequate training and understanding by personnel and management related to credit scoring and risk-based lending.
- Using old or outdated scoring models and a lack of validation and revalidation, resulting in improper loan approval and pricing decisions.
- Inadequate risk management procedures and inadequate risk management staffing.
- Inadequate operational risk controls and monitoring resulting in significantly greater risk to the institution than was expected given a particular score.
- Lack of sufficient policies and procedures related to both RBL and credit scoring.
- Inefficient use of databases, purging of data, and lack of controls over data entry.
- Inconsistent decisions and excessive overrides of scores.
- Errors in calculations of scores and rates caused by incorrect system parameters established without appropriate knowledge and control.
- Improper pricing of risk tiers.
- Lack of knowledge and information on the profitability of the individual risk tiers.
- Incomplete monitoring of scoring and risk-based lending.

The auditor should determine that the financial institution has established an adequate control environment for its risk-based lending and that it has properly addressed any applicable regulatory advisories and requirements. The auditor also should gain a sufficient understanding of the potential effect of higher risk loan categories on loan losses and the allowance for loan losses.

Online Lending. Financial institutions often provide loan applications on their websites. This process has expanded into true online lending, whereby the customer can not only apply for a loan online, but also have the loan automatically approved and sometimes even have the funds disbursed over the Internet. It is likely that this online approval process will continue to grow in the future. The auditor of financial institutions should be aware that this delivery channel presents security and other risks. Some of these risks include the following:

- The risk that the financial institution does not have adequate controls to validate the identity of the individual customer who is applying for a loan online.
- The risk that the institution does not have adequate security over all loan application information (loan applications contain critical financial and personal information about the applicant).
- The risk that approval decisions reached for online loans are not consistent with decisions made on loans approved through other delivery channels.

Another important consideration in online lending is regulatory compliance. Critical loan regulations could potentially be overlooked for loans applied for and processed via the Internet. Compliance with regulations may not be complete because these online systems are often still in development. For example, the required lending disclosures may not be posted on the institution’s website.
Servicing and Accounting Activities

Servicing and accounting activities cover the functions relating to initially recording the loan, collecting and recording payments, and reporting loan transactions and balances (including past due loan reports). Unlike the other activities in this section, servicing and accounting activities are more directly related to aspects of lending other than credit losses. However, some aspects of accounting and servicing activities, such as the financial reporting system’s ability to produce accurate past due loan reports, indirectly contribute to controlling credit risk. Also, poorly designed or ineffective servicing and accounting activities can contribute to increased risk in areas besides credit risk, such as fraud, insider, operations, or management risk.

Credit Monitoring and Collection Activities

Credit monitoring and collection activities include functions relating to identifying problem loans and seeking to maximize the return of amounts due on those loans. Examples of those functions include the following:

a. **Monitoring Activities.** Monitoring activities vary with the type of loan. For example, monitoring a commercial business loan may include—
   
   (1) Analyzing the borrower’s periodic financial statements.
   
   (2) Reassessing collateral values.
   
   (3) Making periodic visits to the project or commercial business site.
   
   (4) Reviewing trends and developments in the borrower’s industry.
   
   (5) Evaluating the borrower’s ability to make its required payments.

On the other hand, single-family residential loans and consumer loans are not usually monitored extensively unless they become delinquent. In either case, loans that are identified as problems should be brought to management’s attention.

b. **Collection Activities.** Collection activities also vary with the type of loan and other circumstances. Those activities may include any or all of the following:

   (1) Negotiating with borrowers to obtain repayment of loans.
   
   (2) Restructuring loans (such as modifying loan terms or obtaining additional collateral).
   
   (3) Seeking legal judgment regarding defaulted loans.
   
   (4) Seeking foreclosure proceedings to obtain collateral.

Loan officers are often primarily responsible for monitoring and collecting loans. However, it would be a best practice for senior management to, at a minimum, review delinquent loan reports, observe collection efforts on problem loans, and approve modifications or renewals of significant problem loans.

Internal Loan Review Activities

Some small and many mid-sized financial institutions have internal loan review functions. DEP (paragraph 8.13) indicates that internal loan review functions are essential for assessing the quality of the loan portfolio and lending process. Furthermore, the lack of an internal loan review function may constitute an internal control deficiency under SAS No. 115 (AU 325). However, judgments about internal control deficiencies can be made on a case-by-case basis. For example, a separate internal loan review function may be too costly for a small financial institution, and the same objectives may be met through extensive involvement by senior management and the board of directors.
To be fully effective, the internal loan review function should be independent of origination, disbursement, servicing, accounting, monitoring, and collection functions. The loan review function may be performed by internal auditors, a committee of the board of directors, or employees in another department. In either case, the reviewers should report directly to the board of directors. The objectives of internal loan reviews are as follows:

a. Monitor compliance with established lending policies.

b. Assess whether the payments due on the loan are likely to be received in accordance with the loan terms.

c. Identify weaknesses in the lending process or the lending officers’ skills in originating, monitoring, and collecting loans.

The nature and extent of internal loan review procedures normally varies by loan type. For example, both performing and nonperforming commercial loans will normally be selected for review, while single-family residential and consumer loans may be limited only to delinquent loans, unless those loans are significant to the total loan portfolio. The actual loan review procedures performed typically include the following:

a. Review of loan file documentation to determine whether—
   
   (1) Credit reports, appraisals, and other required documentation existed before the loan was made.
   
   (2) The quality of the loan documentation supported the decision to make the loan.

b. Review of borrower’s financial statements and loan history to determine whether sufficient information has been obtained to assess the borrower’s financial condition and ability to make the required loan payments.

c. Determination of whether the collateral on the loan, if any, is appropriately controlled by the institution, and whether the institution’s lien has been perfected.

d. Assessment of the current value of the collateral and the institution’s loan-to-value position.

e. Determination of whether guarantees have been properly executed.

f. Assessment of the propriety of the current loan classification, including whether the loan is impaired.

The findings and conclusions of loan reviews are typically summarized in written reports.

**Loan Evaluation Activities**

Loan evaluation is the process used to determine the allowance for loan losses. The specific tasks involved vary by institution and are influenced by factors such as the institution’s size, organizational structure, management style, portfolio characteristics, administrative procedures, and information systems. (The accounting practices of banks, savings institutions, and credit unions are summarized in Lesson 2.) However, to be effective, a client’s loan evaluation activities should generally include the following elements:

- Regular and detailed analysis of the loan portfolio and off-balance-sheet financial instruments.
- Procedures for timely identification of problem loans.
- Consistent application of loan evaluation methods.
- Consideration of all relevant factors that affect loan collectibility.
- Consideration of all loans on an individual or pool basis.
- Consideration of the risks inherent in each type of lending.
- Consideration of current collateral values, when applicable.
- Analysis of loans by competent, well-trained personnel.
- Analysis of loans based on current and reliable data.
- Complete documentation with clear explanations of supporting analysis and rationale.

The auditor should also consider other information about the effectiveness of the client’s evaluation activities, such as results of regulatory examinations and prior audits.

**Documenting the Understanding of Lending Practices**

Relevant information regarding the client’s lending activities can be documented using various forms and checklists, such as those provided in *PPC’s Guide to Audits of Financial Institutions*. Information can also be documented in a memo, if necessary.
SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

11. Collinwood Bank uses credit scoring when deciding whether to accept loans under $100,000. The institution deals with a low volume of small loans. Which of the following statements applies?
   a. Credit scoring is based primarily on the financial statements of the business.
   b. Credit scoring would be a valuable tool for this institution because of the amount of small loans it processes.
   c. Credit scoring allows the institution to price different categories of loans according to risk.
   d. Use of credit scoring could result in improper loan approval.

12. Which of the following activities would effectively help Collinwood Bank determine its proper allowance for loan losses?
   a. Having procedures in place to identify problem loans in a timely fashion.
   b. Making visits to the borrower’s commercial business site periodically.
   c. Identifying any weaknesses in the institution’s lending process.
   d. Obtaining additional collateral for a loan.
SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. *(References are in parentheses.)*

11. Collinwood Bank uses credit scoring when deciding whether to accept loans under $100,000. The institution deals with a low volume of small loans. Which of the following statements applies? *(Page 30)*

   a. Credit scoring is based primarily on the financial statements of the business. [This answer is incorrect. Credit scoring is usually based primarily on the business owner’s personal credit record, rather than the financial statement analysis normally performed for larger commercial loans.]

   b. Credit scoring would be a valuable tool for this institution because of the amount of small loans it processes. [This answer is incorrect. Credit scoring has automated small loan decision-making and is now common for many financial institutions active in small business lending. Credit scoring is often used in a high-volume lending environment. Though Collinwood Bank can use credit scoring, the value comes more from the effect on decision-making than the number of loans the bank processes.]

   c. Credit scoring allows the institution to price different categories of loans according to risk. [This answer is incorrect. This is a description of risk-based lending or pricing programs, not credit scoring. Instead of all borrowers being viewed equally, risk-based lending allows loans to be made and priced according to the borrower’s credit.]

   d. Use of credit scoring could result in improper loan approval. [This answer is correct. This is a common control weakness associated with credit scoring or risk-based lending. Using old or outdated scoring models and a lack of validation and revalidation could result in improper loan approval and pricing decisions.]

12. Which of the following activities would effectively help Collinwood Bank determine its proper allowance for loan losses? *(Page 32)*

   a. Having procedures in place to identify problem loans in a timely fashion. [This answer is correct. Loan evaluation is the process used to determine the allowance for loan losses. The specific tasks involved vary by institution and are influenced by factors such as the institution’s size, organizational structure, management style, portfolio characteristics, administrative procedures, and information systems. Examples of activities that should generally be included are analysis of loans by competent, well-trained personnel; consistent application of loan evaluation methods; consideration of all loans on an individual or pool basis; and procedures for timely identification of problem loans.]

   b. Making visits to the borrower’s commercial business site periodically. [This answer is incorrect. This is an example of a monitoring activity that could be performed for a commercial business loan. To make the determination in this scenario, Collinwood Bank needs to perform loan evaluation activities.]

   c. Identifying any weaknesses in the institution’s lending process. [This answer is incorrect. This would be part of an internal loan review function. While this type of function could be useful for Collinwood Bank, in this scenario, the institution needs to perform loan evaluation activities, not internal loan review activities.]

   d. Obtaining additional collateral for a loan. [This answer is incorrect. Restructuring loans (such as modifying loan terms or obtaining additional collateral) is considered a collection activity. In this scenario, Collinwood Bank needs to perform loan evaluation activities.]
EXAMINATION FOR CPE CREDIT
Lesson 1 (AFITG101)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. Jane, an auditor, is engaged to audit the Lakeview Credit Union. Which of the following pieces of accounting literature would she consult for general guidance on issues related to accounting for loans and the allowance for loan losses?
   a. FASB ASC 310.
   b. FASB ASC 815.
   c. FASB ASC 820-10.
   d. FASB ASC 948.

2. Citywide Bank has made elections for certain financial instruments under FASB ASC 825-10. What did the financial institution elect?
   a. The costs incurred option.
   b. The fair value option.
   c. The loans impairment option.
   d. The loans to executive officers limitation.

3. Penny, an auditor, is engaged to audit the Second National Bank of Sheldon, Texas (SNBS). As part of her audit, she must select and perform audit procedures that will provide sufficient appropriate audit evidence to support her relevant assertions related to loans receivable and related accounts. Performance of which of the following audit procedures would further Penny’s goal?
   a. Confirming loans with SNBS.
   b. Confirming participations purchased and sold with SNBS.
   c. Reviewing a summary of all loans provided by SNBS.
   d. Assessing SNBS’s allowance for loan losses.

4. List all of the following that would be considered commercial business loans.
   i. Working capital loans
   ii. SBA loans
   iii. Student loans
   iv. Agricultural loans
   v. Equipment financing
   vi. Commercial real estate loans
   a. i., iv., and v.
   b. ii., iii., and vi.
   c. i., iv., v., and vi.
   d. iv., v., and vi.
5. Southeast Bank provides a loan to a group that transforms raw land into lots for sale. The loan is structured so that funds are disbursed to the group as the job progresses. What type of real estate loan is this?
   b. Commercial real estate loan.
   c. Development and construction loan.
   d. Investment property loan.

6. Southeast Bank has an agreement with a retail store under which the retail store makes loans to its customers and sells them to the financial institution. What is this an example of?
   a. Direct lending.
   b. Indirect lending.
   c. Do not select this answer choice.
   d. Do not select this answer choice.

7. Carbide Mutual, a financial institution, has a significant indirect lending program. During the institution’s audit, the auditor must assess the related audit risk and the institution’s adequacy of internal controls in this area. All of the following are control weaknesses, except:
   a. Lack of a holdback reserve.
   b. Poor monitoring procedures.
   c. Lack of controls for and monitoring of dealers.
   d. Inadequate pricing analysis, credit scoring, and planning.

8. Carbide Mutual receives a loan request that exceeds its lending limit. The financial institution sells a portion of the loan to another participating institution. Then it can approve the loan without violating its policies. What is the correct term for this kind of lending arrangement?
   a. A share loan.
   b. A participation.
   c. A C and I loan.
   d. A letter of credit.

9. Lenard, an auditor, is engaged to audit Third National Bank. When examining the institution’s lending risk, which of the following would be considered the most significant type of lending risk?
   a. Fraud risk.
   b. Management risk.
   c. Collateral risk.
   d. Credit risk.
10. Lenard must document information he gathered while performing risk assessment procedures on Third National Bank’s loan portfolio. What type of information would Lenard document with other analytical procedures that he performed during the audit planning phase?

   a. Loan statistics.
   
   b. Information about loan concentrations.
   
   c. Information about loans to affiliates and insiders.
   
   d. Information about the types of loans Third National Bank has in its portfolio.

11. Which of the following financial institutions is performing lending activities that would be classified as origination and disbursement activities?

   a. Bank A analyzes the periodic financial statements of its borrower.
   
   b. Bank B files liens to protect its security interest in a borrower’s collateral.
   
   c. Bank C makes the initial recording of a new loan.
   
   d. Bank D monitors its own compliance with its established lending policies.

12. Lenders Mutual has an online banking venture that includes online loan applications with automatic approval. When engaged to audit this financial institution, which of the following risks should an auditor be aware of specifically concerning online lending?

   a. The risk that approval decisions are inconsistent with the institution’s regular policies.
   
   b. The risk that client’s information is too securely controlled, which will hinder the approval process.
   
   c. The risk that more high-risk loans will be originated than the institution intended.
   
   d. The risk that databases and data purges will be used inefficiently.
Lesson 2: Loan Loss Allowance

INTRODUCTION

This lesson takes a look at the loan loss allowance and how it will affect the audit of a financial institution. It discusses relevant accounting practices and principles, an auditor’s loan reviews, estimates of specific allowances for loans, and the allowance for loan loss other than specific allowances.

Learning Objectives:

Completion of this lesson will enable you to:
- Identify accounting principles and practices used in relation to the loan loss allowance for a financial institution.
- Summarize how an auditor performs loan reviews and estimates specific allowances for loans in a financial institution audit.
- Assess issues related to the allowance for loan losses other than specific allowances in a financial institution audit.

ACCOUNTING PRACTICES AND PRINCIPLES RELATED TO THE ALLOWANCE FOR LOAN LOSSES

This lesson discusses the accounting standards and industry practices relating to the allowance for loan losses. FASB ASC 450-10 (formerly SFAS No. 5, Accounting for Contingencies) and FASB ASC 310-10-35 (formerly SFAS No. 114, Accounting by Creditors for Impairment of a Loan) are the primary sources of guidance on accounting for the allowance for loan losses. FASB ASC 310 (formerly SFAS No. 114) addresses the accounting by creditors for impaired loans, but it does not address how an institution should assess the overall adequacy of the allowance for credit losses.

In addition to the accounting literature, the SEC and federal financial institution regulators have issued guidance on the allowance for loan losses. FASB ASC 310-10-S99-4 [formerly SEC’s Staff Accounting Bulletin (SAB) No. 102, Selected Loan Loss Allowance Methodology and Documentation Issues] provides guidance on the documentation the staff normally would expect registrants to prepare and maintain in support of their allowances for loan losses.

In conjunction with the release of SAB No. 102, the Federal Financial Institutions Examination Council (FFIEC), issued in 2001 an Interagency Policy Statement titled Allowance for Loan and Lease Losses (ALLL) Methodologies and Documentation for Banks and Savings Institutions. (The 2001 policy statement was intended to supplement, not replace, the guidance the banking agencies provided in their Interagency Policy Statement on the Allowance for Loan and Lease Losses, which was issued in December 1993.) Subsequently, the National Credit Union Administration issued Interpretive Ruling and Policy Statement (IRPS) No. 02-3 titled Allowance for Loan and Lease Losses (ALLL) Methodologies and Documentation for Federally-Insured Credit Unions. These statements provide guidance on the design and implementation of ALLL methodologies and supporting documentation practices. Specifically, the policy statements:

- Clarify that the board of directors of each institution is responsible for ensuring that controls are in place to consistently determine the appropriate level of the ALLL.
- Indicate that the ALLL process must be appropriate, systematic, and consistently applied and must incorporate management’s current judgments about the credit quality of the loan portfolio.
- Emphasize the agencies’ position that financial institutions should maintain and support the ALLL with documentation that is consistent with their stated policies and procedures, GAAP, management’s best judgment, and applicable supervisory guidance.
- Provide guidance on maintaining and documenting policies and procedures that are appropriately tailored to the size and complexity of the institution and its loan portfolio.
In December 2006, the federal financial institution regulatory agencies issued a revised Interagency Policy Statement on the Allowance for Loan and Lease Losses (ALLL). The policy statement revises and replaces the banking agencies’ 1993 policy statement on the ALLL to ensure consistency with GAAP and more recent supervisory guidance. In addition, the agencies issued a supplemental Frequently Asked Questions (FAQs) document to assist institutions in complying with GAAP and ALLL supervisory guidance. This revised policy statement is also applicable to credit unions. Specifically, the revised policy statement:

- Requires an institution to maintain an ALLL at a level that is appropriate to cover estimated credit losses on individually evaluated loans determined to be impaired, as well as estimated credit losses inherent in the remainder of the loan and lease portfolio.

- Updates the previous guidance that describes the responsibilities of the boards of directors, management, and bank examiners regarding the ALLL; factors to be considered in the estimation of the ALLL; and the objectives and elements of an effective loan review system, including a sound credit grading system.

Because the revised policy statement reiterates key concepts and requirements included in GAAP and existing ALLL supervisory guidance, the agencies expect that any enhancements needed to bring an institution’s ALLL processes and documentation into full compliance with the guidance contained in the revised policy statement will be made as soon as possible.

The policy statements do not change existing accounting guidance in, or modify the documentation requirements of, GAAP or guidance provided in the relevant joint interagency statements. The policy statements recognize that estimating an appropriate allowance involves a great degree of management judgment and is inevitably imprecise. Therefore, a financial institution may determine that the amount of loss falls within a range. In accordance with GAAP, an institution should record its best estimate within the estimated range of loan losses.

The text of the policy statements can be found at the FDIC website at www.fdic.gov and the NCUA website at www.ncua.gov.

In addition to the policy statements, on March 1, 2004, the federal financial institution regulatory agencies jointly issued an update on accounting for loan and lease losses. Like the policy statements, this guidance does not change existing guidance but recognizes that an assessment of the appropriateness of the allowance for loan and lease losses is critical to the safety and soundness of a financial institution and serves to remind financial institutions of the following related to the ALLL:

- The financial institution is responsible for ensuring that controls are in place to consistently determine the ALLL in accordance with GAAP, the institution’s stated policies and procedures, and relevant supervisory guidance.

- To fulfill this responsibility, financial institutions should develop, maintain, and document a comprehensive, systematic, and consistently applied process to determine the amounts of the ALLL and provisions for loan and lease losses.

- Consistent with longstanding supervisory guidance, financial institutions must maintain an ALLL at a level that is sufficient to absorb estimated credit losses inherent in the loan and lease portfolio. Determining such an allowance involves a high degree of management judgment and results in a range of estimated losses. Accordingly, prudent, conservative, but not excessive, loan loss allowances that represent management’s best estimate from within an acceptable range of estimated losses are appropriate.

The accounting standards discussion in the following paragraphs covers the rules and related topics such as troubled debt restructurings and in-substance foreclosures. These paragraphs also discuss the unique accounting practices for banks, savings institutions, and credit unions. The remainder of this lesson discusses an approach to auditing the allowance for loan losses.
Basic Principles

FASB ASC 450-5 (formerly SFAS No. 5) covers the basic principles of accounting for loan losses. Loan losses should be recognized when both of the following conditions are met:

a. It is probable that the loan is impaired (that is, that the loan payments or other assets to be received in settlement of the loan are less than its recorded investment).

b. The loss can be reasonably estimated.

Generally, losses on loans that meet the preceding criteria should be recognized through a valuation allowance. Loan loss provisions in the allowance should be reflected in net income using a separate account such as Loan Loss Expense or Provision for Loan Losses.

More specific guidance is found in FASB ASC 310-10-35. FASB ASC 310-10-35-4 indicates that the allowance for loan losses should be adequate to cover all losses inherent in an institution’s year-end loan portfolio. Accordingly, the allowance should cover losses on both specifically identified loans and likely losses that cannot yet be associated with specific loans. To illustrate, suppose an institution identified specific impaired loans with estimated losses of $75,000 and that it had historically incurred losses on other loans amounting to 2% of the portfolio. Assuming that the historical percentage is indicative of losses inherent in the current portfolio, the allowance for losses should be at least $75,000 plus 2% of the remaining loan portfolio.

In addition to the allowance for loan losses, FASB ASC 310-10-35-43 requires the auditor to consider estimated credit losses for off-balance-sheet instruments. Estimated credit losses on loan commitments and other off-balance-sheet instruments should be reported as a liability.

As a practical matter, the evaluation of off-balance-sheet instruments should be considered at the same time as the evaluation of the loan portfolio. Estimated losses for off-balance-sheet instruments generally are determined based on consideration of individual items and are supplemented by a general allowance (liability) sufficient to cover inherent losses in off-balance-sheet instruments.

An institution’s total allowance for loan losses generally consists of several individual allowances or components, such as the following:

a. Specific allowances (or specific allocations of the allowance) for certain identified or impaired loans. (Commercial banks generally contend all of their allowances are general allowances and they have no specific allowances. In this course, the terms specific allocation and specific allowance are used interchangeably, but the term general allowance is used only for component d. rather than the entire allowance for loan losses.)

b. Allowance relating to classified loans.

c. Allowance relating to loans that are evaluated in pools (such as consumer loans and single-family residential loans).

d. General allowance for other loan losses inherent in the portfolio.

The amounts in components a. and b. are determined based on consideration of individual loans. The other amounts in the remaining categories are generally determined on an aggregate basis for groups of loans. The entire allowance is available to absorb credit losses incurred by the institution, and the allowances for each category may be reallocated as circumstances warrant. For example, if the estimated loss for a specific loan or group of loans decreases, the related allowance may be reallocated to a component with increased losses. However, the institution should maintain a sufficient total allowance for loan losses to cover losses inherent in the portfolio, and the component relating to impaired loans should be adequate to provide all losses. The institution should also maintain a liability to cover losses inherent in its off-balance-sheet financial instruments.

Proposed Guidance. The FASB has issued an exposure draft, Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses, which would require enhanced disclosures about the allowance.
for credit losses and the credit quality of financing receivables. Financing receivables are loans with a contractual right to receive money on demand or on fixed or determinable dates that is recognized as an asset, whether originated or acquired. The Board decided to provide a delayed effective date of the final Accounting Standards Update (ASU) for nonpublic entities. The final ASU (once it is issued) will be effective for nonpublic entities for annual reporting periods ending after December 15, 2011. For all other entities, the final ASU will be effective for interim and annual reporting periods ending after December 15, 2010. Disclosures for earlier periods presented for comparative purposes will not be required at initial adoption for any entities. Early application would be encouraged. The FASB expects to issue a final ASU in the second quarter of 2010. Readers should be alert for a possible ASU. Future editions of this course will provide updates on this proposed guidance.

Accounting Practices of Banks, Savings Institutions, and Credit Unions

Regulatory agencies generally require financial institutions to establish policies and procedures for determining the allowance for loan losses based on GAAP requirements. A variety of methods are used to determine the allowance. The following paragraphs discuss specific industry practices typically used by each type of financial institution in determining the allowance for loan losses. The accounting for loss allowances relating to specific impaired loans is discussed later in this lesson.

Accounting Practices of Banks. In banks, the entire allowance for loan losses has historically been considered to be a general allowance. Allowances relating to specific loans have been determined primarily through loan classifications, such as those shown in Exhibit 2-1. The classifications indicate the risk of loss associated with a particular loan. Using a classifications approach, specific problem loans are evaluated and classified. A loan may be classified entirely into one category or it may be allocated among different categories. To illustrate, assume that a $100,000 impaired loan is secured by inventory and equipment with a current fair value of $75,000. The $75,000 secured portion might be classified as substandard or unclassified with the remaining $25,000 unsecured portion classified as loss. After the loans have been classified, they are totaled by loan type and classification (such as all substandard commercial real estate loans, all doubtful commercial business loans, etc.). The bank normally provides a specific allocation of the allowance for amounts classified as loss. The portion of the allowance relating to amounts classified substandard or doubtful is normally determined by applying separate loss percentages to each loan type and classification. In either case, loss percentages for each category are generally based on historical losses and other factors, as discussed later in this lesson.

Because of the requirements of FASB ASC 310-10-35 (formerly SFAS No. 114), many banks are including impaired loans in their loan classification system. The amount of specific allowance on impaired loans should be classified as an impairment loss, and the remaining balance may be classified as substandard or unclassified.

To illustrate how the portion of a bank’s loss allowance that is determined using a classification system can be computed, assume that a bank has $200,000 in loans classified as substandard, $50,000 classified as doubtful, and $10,000 of impaired loans classified as loss. Also assume that appropriate loss percentages for substandard and doubtful loans are 15% and 55%, respectively. The portion of the bank’s allowance for loan losses that is determined using loan classifications can be computed as follows:

\[
\begin{align*}
\text{Substandard:} & \quad 200,000 \times 15\% = 30,000 \\
\text{Doubtful:} & \quad 50,000 \times 55\% = 27,500 \\
\text{Loss:} & \quad 10,000 \times 100\% = 10,000 \\
\end{align*}
\]

\[\text{Total} = 67,500\]
### Exhibit 2-1

**Examples of Loan Classifications**

<table>
<thead>
<tr>
<th>Classification</th>
<th>Description</th>
<th>Examples</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Unclassified</strong></td>
<td>Unclassified loans are not considered a greater-than-normal risk. (This rating may also be referred to as <em>pass</em> or <em>good.</em>.)</td>
<td>Performing loans for which the borrower appears to have the ability to repay its obligations and the collateral value exceeds the loan amount.</td>
</tr>
</tbody>
</table>
| **Substandard** | A substandard loan is one that is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. A loan classified substandard must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. The loan is characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected. | Loans with one of the following conditions:  
- The borrower is unable to generate enough cash flow to make debt payments but collateral value may be sufficient to cover amounts due.  
- The value of the collateral has declined significantly.  
- Flaws in documentation or inability to control collateral may impair the lender’s access to the collateral upon default.  
- A loss may not be readily apparent, but sufficient problems have arisen to cause the lender to go to abnormal lengths to protect its position.  
- The loan has been restructured in a troubled debt restructuring, and the value of the collateral approximates the loan balance. |
| **Doubtful** | A doubtful loan has the same weaknesses inherent in a substandard loan with the added characteristic that the weaknesses make collection or liquidation in full highly questionable and improbable based on currently existing facts, conditions, and circumstances. | Loans with one of the following conditions:  
- The borrower is having financial difficulties, and the collateral value does not cover the loan balance.  
- The loan is unsecured, and repayment is highly questionable.  
- The borrower is having financial difficulties, and the lender’s access or rights to the collateral are unclear, e.g., because the lender’s lien is subordinate to substantial other liens or there is a dispute over title to the collateral or the lender’s lien position. |
| **Loss** | Loans classified as loss are considered uncollectible and of such little value that continuance as bankable assets is not warranted. Classification as loss does not mean that a loan has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be effected in the future. | Loans with the following conditions:  
- Borrower has defaulted, foreclosure is imminent, and the collateral value does not cover the loan balance.  
- Repayment of the loan is unlikely, and the loan is unsecured. |
**Notes:**

a. Regulators also have a category of assets known as special mention or OAEM, which applies to assets with special weaknesses that deserve management’s attention. However, special mention assets are not considered classified assets and generally are not considered in determining the allowance for classified loans.

b. The federal credit union regulators have revised the NCUA rules and regulations to indicate that all charges for loan losses should be made in accordance with GAAP and the language pertaining to the classification system described in this Exhibit has been removed from their regulations. Credit unions are required to follow Letter to Credit Unions No. 02-CU-09, *Allowance for Loan and Lease Losses*, which is discussed later in this lesson and the Interpretive Ruling and Policy Statement (IRPS) No. 02-3 titled *Allowance for Loan and Lease Losses (ALLL) Methodologies and Documentation for Federally-Insured Credit Unions*, which was discussed earlier in this lesson.

c. The descriptions other than the description of unclassified loans were adapted from the *Interagency Policy Statement on Review and Classification of Real Estate Loans*, dated June 10, 1993.

d. A loan that meets the regulatory definition of doubtful or loss may qualify as an impaired loan under FASB ASC 310-10 (formerly SFAS No. 114). If a loan is considered impaired, the auditor should estimate the specific allowance for the loan as discussed later in this lesson. If the loan is not considered impaired, the auditor should classify the loan as substandard or unclassified using the definitions in this exhibit.

* * *
Besides estimating allowances using a classification system, banks also provide allowances for pools of homogeneous loans, such as consumer loans, credit card balances, and single-family residential loans. Like the allowances for classified loans discussed in the preceding paragraphs, the allowances for loan pools are generally computed by applying estimated loss percentages to the loan balances. Those percentages are based on historical loss percentages adjusted for additional risk factors. Historical losses are generally determined from average or weighted average charge-offs, net of recoveries, over a three to five year period. The calculation is generally expressed as a loss percentage (that is, average net charge-offs as a percentage of loans). The loss percentage is then adjusted for such risk factors as the following:

- Trends in volume and terms of loans.
- Levels of and trends in delinquencies, impaired loans, and loan losses.
- Current and expected economic conditions that may affect the borrower’s ability to pay.
- Levels of and trends in recoveries of prior charge-offs.
- Effects of any changes in lending policies and procedures.
- Ability and experience of lending management and other lending personnel.
- Collateral values.
- Credit concentrations or other factors affecting the portfolio.

In assessing its allowance for loan losses, a bank should consider both existing loans in the portfolio and related off-balance-sheet items such as loan commitments and loans sold with recourse. Credit exposures relating to off-balance-sheet instruments are usually evaluated on an individual item basis, and a liability is established for those items if necessary.

The portions of the allowance relating to classified loans and loan pools should generally be supplemented by a general allowance for inherent losses in the loan portfolio, such as losses on unclassified commercial loans and losses not considered in other calculations. In effect, this general reserve is used to assure that the allowance for loan losses covers all of the inherent losses in the loan portfolio. Accordingly, the assessment of the allowance should include consideration of the risk of material misstatement of the allowance. It should also include reconsideration of all of the major factors considered in establishing the other portions of the allowance, including:

- Nature and volume of the loan portfolio.
- Overall portfolio quality.
- Loan concentrations including loan type, geographic concentrations, and concentrations of loans to individuals, entities, and their related interests.
- Regulatory examination results.
- Nature and extent of loans to related parties.
- Policy and procedure changes in underwriting, collections, and other lending functions.
- Trends in the level of delinquent and classified loans.
- Circumstances and uncertainties with respect to specific problem loans.
- Current and anticipated economic conditions that may affect the borrower’s ability to pay.
- Collateral values.
The general portion of the allowance may be computed based on a percentage of the portfolio or it may be determined as a specific dollar amount.

**Accounting Practices of Savings Institutions.** OTS regulations require savings institutions to classify their loans using a system consistent with GAAP and the practices of the federal banking agencies (12 CFR 560.160) such as the one shown in Exhibit 2-1. In addition, the OTS requires savings institutions to classify loans consistent with the Thrift Activities Handbook. Some savings institutions use the term *specific valuation allowances* for allowances that relate to individually identified loans, whereas banks consider those amounts to be part of their general allowance. Savings institutions may also use the term *general valuation allowances* (GVAs) for unclassified loans. The difference seems to be primarily one of terminology rather than accounting principle because, in both cases, the allowance should be adequate to cover losses on specifically identified loans, plus other losses inherent in the loan portfolio.

**Accounting Practices of Credit Unions.** The NCUA has issued Letter to Credit Unions No. 02-CU-09, Allowance for Loan and Lease Losses, which clarifies the NCUA’s expectations regarding methodologies and documentation support for the ALLL. The NCUA believes that an essential part of a credit union’s ALLL methodology is a comprehensive, disciplined, timely, and consistently applied charge-off policy for uncollectible loans. Thus, the NCUA also issued Letter to Credit Unions No. 03-CU-01, Loan Charge-off Guidance, which provides guidance on the systematic charge off of uncollectible loans. Neither of these two Letters to Credit Unions change existing accounting guidance in or modify the documentation requirements of GAAP. The letters are intended to supplement, not replace, current guidance.

**Accounting for Losses Relating to Specific Loans.**

FASB ASC 310-10-35 (formerly SFAS No. 114) is the primary source of authoritative guidance for determining allowances relating to specific loans. The basic rules are as follows:

a. A loan is considered impaired if it is probable that the lender will be unable to collect all amounts due under the contractual terms of the loan agreement.

b. If the loan is impaired, one of the following methods should be used to determine the amount of loan loss:

   1. **Fair Value of the Collateral.** Under this method, the loan loss is the amount needed to reduce the recorded loan investment to the fair value of the collateral. This method must be used when foreclosure is probable. It may also be used for collateral-dependent loans, which are defined as loans for which the collateral is the sole source of repayment.

   2. **Expected Cash Flows.** Under this method, the loan loss is the amount needed to reduce the recorded loan investment to the expected cash flows to be received from the loan, discounted at the effective rate of the loan.

   3. **Aggregate Collection Experience.** Under this method, loans with similar risk characteristics are aggregated, and historical data is used to determine the loan loss for the group.

   4. **Market Value of the Loan.** Loan losses are allowed to be determined based on the market value of the loan, if there is an observable market value for the loan. This alternative will rarely be used because such market prices are rarely available.

The selection of methods is made on a loan-by-loan basis. However, after a method is selected for a loan, it should be applied consistently unless circumstances change. The first three methods are discussed in more detail later in this lesson.

A loan is considered impaired if it is probable that the lender will be unable to collect all amounts due under the contractual terms of the loan agreement. The definition of impairment is explained as follows:

a. *Probable* means likely to occur. It does not mean virtually certain.
b. **All amounts due under the contractual terms of the loan agreement** means all of the principal and interest payments will be received as scheduled in the loan agreement (excluding insignificant delays or shortfalls in payments). If the loan agreement contains either (1) a demand clause, (2) provision for maturity or renewal, such as every 90 or 180 days, or (3) periodic review of the loan status, the period to be used in determining the amounts due under the terms of the loan agreement can be one of the following:

(1) The time period the loan would remain outstanding based on the original understanding between the borrower and lender.

(2) The lender’s original estimate of the time period the loan would remain outstanding, if there was no such understanding between the borrower and lender.

For example, if a $200,000 loan is structured to be renewed every six months, but was expected to be paid down by $20,000 plus interest at each renewal, the amounts due under the contractual terms would be $20,000 plus interest twice a year for five years.

A discussion of how to determine whether a loan is impaired is provided later in this lesson.

The following are exceptions to the definition of impairment:

a. **Insignificant Delay or Deficiency.** An insignificant delay or shortfall in a loan payment does not mean the loan is impaired. An insignificant delay or insignificant shortfall is not defined, however, as a rule of thumb, a delay of less than 30 days and a shortfall of less than 5% of the required principal and interest payment could be considered insignificant.

b. **Interest Catch-up.** A loan is not considered impaired based on a delay in payment if the lender expects to collect all amounts due plus accrued interest at the contractual rate for the period of the delay.

**Accounting for Troubled Debt Restructurings**

**What Is a Troubled Debt Restructuring?** A troubled debt restructuring (TDR) occurs when the creditor for economic or legal reasons related to the debtor’s financial difficulties grants a concession to the debtor that it would not otherwise consider.

FASB ASC 470-60-15-9 (formerly SFAS No. 15) covers TDRs involving:

- Modifications of terms.
- Foreclosures.
- Transfers of assets or equity in full or partial settlement of debt.

Although FASB ASC 470-60-15-9 defines TDRs and related concepts, FASB ASC 310-40 (formerly SFAS No. 114) and FASB ASC 360-10-35 (formerly SFAS No. 144) are the primary sources of accounting for troubled debt restructurings and foreclosed assets.

However, not all restructurings are TDRs. For example, assume market interest rates decline from 10% to 8%, and a profitable company refinances its old 10% debt with new 8% debt on market terms. That would not be considered a TDR because (a) the borrower is not having financial difficulties and (b) the new debt has market terms and a market interest rate.

**Has a Troubled Debt Restructuring Occurred?** FASB ASC 470-60-55-4 (formerly EITF Issue No. 02-4, Determining Whether a Debtor’s Modification or Exchange of Debt Instruments Is within the Scope of FASB Statement No. 15, “Accounting by Debtors and Creditors for Troubled Debt Restructurings”) clarifies that no single factor or characteristic listed under FASB ASC 470-60-15 (formerly SFAS No. 15), considered independently, is reason enough to determine that a loan modification or exchange is a troubled debt restructuring within the scope of that guidance. Rather, judgment is required to make that determination. As indicated in FASB ASC 470-60-55-5, the following two
questions must be answered “yes” before determining that the modification or exchange of debt instruments is within the scope of that guidance:

   a. Is the debtor experiencing financial difficulty?
   b. Has the creditor granted a concession?

If the debtor is not experiencing financial difficulty or did not receive a concession from the creditor, the loan restructuring is not within the scope of FASB ASC 470-60-55. In that circumstance, the guidance provided by FASB ASC 470-50-40 (formerly EITF Issue No. 96-19, Debtor’s Accounting for a Modification or Exchange of Debt Instruments) is applicable.

Impact of Government Programs. Under the American Recovery and Reinvestment Act of 2009 (Recovery Act), the FDIC and other federal agencies implemented the Making Home Affordable (MHA) loan modification program that provides assistance to homeowners with the opportunity to refinance home mortgages and reduce monthly payments. The MHA includes an option for borrowers to modify mortgage loans. Auditors should consider whether modifications of mortgage loans under the MHA program constitute troubled debt restructurings.

Is the Debtor Experiencing Financial Difficulty? The following factors indicate that the debtor is experiencing financial difficulties:

   a. The debtor is currently in default on one or more of its debts.
   b. The debtor is in (or is in the process of declaring) bankruptcy.
   c. The debtor’s securities have been (or have been threatened to be) delisted.
   d. There are significant concerns about the debtor’s ability to continue as a going concern.
   e. The debtor’s projected cash flows are insufficient to service the debt according to the terms of the debt service agreement.
   f. The debtor is unable to borrow funds at market interest rates from other creditors.

Furthermore, if one or more of the factors listed in the previous paragraph existed for a particular debtor, the debtor would not be experiencing financial difficulties if all of the following conditions were met:

   a. The debtor is current on the existing loan payments.
   b. The debtor can obtain funds from a new creditor at existing market interest rates to repay the current loan.
   c. The creditor restructures the current loan exclusively due to:
      
      (1) A decrease in the existing market rates compared to the interest rates on the original debt, or
      (2) An increase in the creditworthiness of the debtor since the issuance of the original loan.

Has the Creditor Granted a Concession? A creditor grants a concession to the debtor if the debtor’s effective borrowing rate on the new debt is less than the effective borrowing rate on the old debt. However, the creditor may not have granted a concession if there is sufficient evidence to prove that the creditor granted a lower effective borrowing rate solely because of other factors, such as the debtor granting additional collateral or guarantees. In addition, if the debtor is restructuring the loan again after a recent restructuring, the effective borrowing rate of the new loan should be compared to the effective borrowing rate of the initial loan before any restructurings.

Modification of Loan Terms. In a TDR involving a modification of terms, the lender may grant concessions such as:

   • Extending the payment due dates.
• Lowering the contractual interest rate.
• Reducing accrued interest.
• Reducing the debt’s face or maturity amount.

Accounting for a Modification of Loan Terms. A loan that is modified in a troubled debt restructuring should be accounted for like an impaired loan, as discussed previously. If the expected cash flows method is used to determine the loss allowance, FASB ASC 310-40-35-12 indicates that the discount rate should be determined based on the original contractual rate rather than the rate on the modified loan. Accordingly, it would be a best practice to discount expected cash flows using the effective rate of the loan immediately before the restructuring.

The revised terms of the loan agreement may provide for additional principal or interest payments that are contingent based on certain future events or conditions (such as sales of certain assets). Best practices indicate that those contingent payments should be included in determining the present value of the revised cash flows only if it is probable that the institution will receive them and they can be reasonably estimated.

Foreclosures and Other Asset Transfers. Foreclosed assets are generally recorded at their fair value (less cost to sell if the assets will be sold) at the date of foreclosure. This accounting also applies to assets that are voluntarily transferred by the borrower in settlement of a loan (such as a deed in lieu of foreclosure).

Combination Restructurings. Sometimes, TDRs involve both a transfer of assets (or equity interest) to the lender as a partial settlement and a modification of terms on the remaining loan balance. Such combination restructurings should be accounted for as follows:

a. Any asset received in partial settlement should be recorded at its fair value (less cost to sell, if applicable), and the recorded investment in the loan should be reduced by that amount. (Accordingly, no gain or loss is recognized on the asset transfer.)

b. The modification of terms on the remaining loan balance should be accounted for as an impaired loan, as discussed previously.

Example of a Combination Restructuring. To illustrate, assume a lender has a 6% loan receivable with a principal balance of $500,000, deferred income of $50,000, and a loss allowance of $50,000. Accrued interest on the loan is $5,000. Also assume that the lender enters into a TDR with the following terms:

a. Lender receives real estate worth $150,000 (fair value of $160,000 less estimated selling costs of $10,000).

b. The principal balance of the loan is reduced to $180,000, and the accrued interest is forgiven.

c. Payment terms on the remaining loan balance are 10 annual payments of $18,000.

Exhibit 2-2 shows how the combination restructuring should be accounted for. After the journal entry in Exhibit 2-2 is recorded, the loan receivable balance is $132,000 [$180,000 principal less allowance of $48,000], which is the present value of the annual loan payments due under the revised loan terms.
Exhibit 2-2

Example of Accounting for a Combination Restructuring

Partial settlement

The loan investment is adjusted to be:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Principal balance of the loan</td>
<td>$500,000</td>
</tr>
<tr>
<td>Accrued interest</td>
<td>5,000</td>
</tr>
<tr>
<td>Deferred income</td>
<td>(50,000)</td>
</tr>
<tr>
<td>Loan investment before restructuring</td>
<td>455,000</td>
</tr>
<tr>
<td>Fair value of assets received, less cost to sell</td>
<td>(150,000)</td>
</tr>
<tr>
<td><strong>Adjusted loan investment</strong></td>
<td><strong>$305,000</strong></td>
</tr>
</tbody>
</table>

Modification of terms

A loss on restructuring should be recognized as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adjusted loan investment</td>
<td>$305,000</td>
</tr>
<tr>
<td>Minimum loan payments</td>
<td></td>
</tr>
<tr>
<td>[Present value of 10 payments of $18,000, discounted at 6%] (Rounded)</td>
<td>(132,000)</td>
</tr>
<tr>
<td>Loss on restructuring</td>
<td>173,000</td>
</tr>
<tr>
<td>Less amount of existing loss allowance</td>
<td>(50,000)</td>
</tr>
<tr>
<td><strong>ADDITIONAL LOSS RECOGNIZED</strong></td>
<td><strong>$123,000</strong></td>
</tr>
</tbody>
</table>

Lender’s journal entry to record the restructuring

<table>
<thead>
<tr>
<th>Description</th>
<th>DR</th>
<th>CR</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreclosed real estate</td>
<td>$150,000</td>
<td></td>
</tr>
<tr>
<td>Loss on restructuring</td>
<td>123,000</td>
<td></td>
</tr>
<tr>
<td>Deferred income</td>
<td>50,000</td>
<td></td>
</tr>
<tr>
<td>Allowance for loan losses</td>
<td>2,000</td>
<td>$320,000</td>
</tr>
<tr>
<td>Loans receivable</td>
<td></td>
<td>5,000</td>
</tr>
<tr>
<td>Accrued interest receivable</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Substitute Borrowers. Sometimes, a TDR involves adding new borrowers or replacing existing borrowers. This often occurs when old borrowers or partners surrender control to a new party in exchange for a capital infusion.

FASB ASC 310-40-25-2 (formerly SFAS No. 15, paragraph 42) states that those situations should be accounted for “according to their substance” and gives examples of certain types of TDRs involving additional borrowers. Generally, when new borrowers are added to or substituted for existing borrowers on a troubled loan, the restructuring should be accounted for as follows:

- **Unrelated Borrowers.** If a new borrower is unrelated to the original borrower after a restructuring, the TDR should be accounted for as an exchange of new debt for old debt and recorded at the fair value of the new debt. In such situations, the fair value of the collateral could be considered is a reasonable approximation of the fair value of the debt because a new borrower would rarely pay more than fair value for the property. A gain or loss should be recognized for the difference between the fair value of the new debt and the recorded investment in the old loan.

- **Related Borrowers.** If a new borrower controls (or is under common control with) the original borrower after a restructuring, the TDR should be accounted for as if the borrowers did not change. Thus, if no assets were
transferred, the TDR should be accounted for as a modification of terms as discussed previously. The same accounting applies if the new borrower and original borrower are related after the restructuring through an agency or trust arrangement in which the original borrower must set aside funds to pay the lender.

To illustrate the guidance above, assume the same facts as in the previous example, except that an unrelated investor is added as co-borrower on the loan, and the new borrower contributes the real estate to the lender. The fair value of the new loan is approximately equal to the fair value of the collateral, $120,000. Exhibit 2-3 shows the loss to be recognized on the exchange of old debt for new debt and other assets.

### Exhibit 2-3

**Example of Accounting for a Troubled Debt Restructuring Involving the Addition of an Unrelated Borrower**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loan investment before restructuring</td>
<td>$455,000</td>
</tr>
<tr>
<td>Fair value of new loan and real estate [$120,000 + $150,000]</td>
<td>($270,000)</td>
</tr>
<tr>
<td>Loss on asset exchange</td>
<td>185,000</td>
</tr>
<tr>
<td>Less amount of existing loss allowance</td>
<td>($50,000)</td>
</tr>
<tr>
<td><strong>ADDITIONAL LOSS RECOGNIZED</strong></td>
<td>$135,000</td>
</tr>
</tbody>
</table>

**Lender’s entry to record the restructuring**

<table>
<thead>
<tr>
<th>DR</th>
<th>CR</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loans receivable (new loan)</td>
<td>$120,000</td>
</tr>
<tr>
<td>Foreclosed real estate</td>
<td>150,000</td>
</tr>
<tr>
<td>Allowance for loan losses(\textsuperscript{a})</td>
<td>185,000</td>
</tr>
<tr>
<td>Deferred income</td>
<td>50,000</td>
</tr>
<tr>
<td>Loans receivable (old loan)</td>
<td>$500,000</td>
</tr>
<tr>
<td>Accrued interest receivable</td>
<td>5,000</td>
</tr>
</tbody>
</table>

**Note:**

\(\textsuperscript{a}\) The amount written off exceeds the amount of allowance for loan losses set up for this loan. This entry could therefore lead to an understatement of the allowance for loan losses.

\* \* \*

### Accounting for In-substance Foreclosures

In-substance foreclosures are defined as transactions in which the lender takes physical possession of the collateral without foreclosure proceedings (for example, in a deed in lieu of foreclosure).

An institution must obtain the collateral for the transaction to qualify as an in-substance foreclosure. If a transaction qualifies as an in-substance foreclosure, the assets received are accounted for as foreclosed assets.

### Accounting for Nonaccrual Loans

Regulatory agencies have traditionally established rules for discontinuing the accrual of interest on certain problem loans. For example, under the reporting standards of the banking agencies, banks are required to stop accruing interest on a loan in the following situations:

a. The bank places the loan on a cash basis because of the deterioration in the borrower’s financial condition.

b. Collection in full of the contractual principal or interest of the loan is not expected.
c. Principal or interest is past due for 90 days or more, unless the loan is both well secured and in the process of collection. (This situation does not apply to single-family residential loans or consumer loans.)

Savings institutions have similar regulations for nonaccrual loans. For credit unions, NCUA regulations require that all interest on loans greater than three months delinquent be reviewed for nonaccrual status. Since most smaller credit unions are not sophisticated in determining these calculations, many credit unions simply do not accrue any interest on loans greater than three or six months delinquent.

When a loan is placed on nonaccrual, there may be a general presumption the loan is impaired. However, it is possible to have nonaccrual loans that do not qualify as impaired, as well as impaired loans that are not on nonaccrual. If a nonaccrual loan is considered impaired, the auditor should estimate the specific allowance for the recorded investment in the loan (including accrued interest).

Interest payments received on an impaired loan may be accounted for as interest income (cash receipts method) or a reduction of the loan balance (cost recovery method). Under the cost recovery method, interest income is not recognized until the loan balance has been reduced to zero. Generally, the cash receipts method is used only when the likelihood of further loss on the loan is remote.
SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

13. Several pieces of authoritative literature exist related to the allowance for loan losses. Which one includes policy statements that, among other things, clarify that an institution’s board of directors must ensure controls are in place so that the appropriate level of the allowance for loan and lease losses is determined consistently and provide guidance for maintaining and documenting policies and procedures that are tailored for the size and complexity of the financial institution and its loan portfolio?

a. FASB ASC 310-10-S99-4.

b. FASB ASC 450-10 and FASB ASC 310-35.

c. The FFIEC’s Interagency Policy Statement, Allowance for Loan and Lease Losses (ALLL) Methodologies and Documentation for Banks and Savings Institutions.

d. The NCUA’s Interpretive Ruling and Policy Statement No. 02-3, Allowance for Loan and Lease Losses (ALLL) Methodologies and Documentation for Federally-Insured Credit Unions.

14. A financial institution determines its allowance for loan losses as a general allowance based on the classification of the loans in its portfolio. What type of financial institution is this?

a. A bank

b. A savings institution.

c. A credit union.

15. Which of the following financial institutions has correctly dealt with an issue related to impaired loans?

a. Institution A evaluates the odds of being unable to collect on a loan at 50%. It classifies this loan as impaired.

b. Institution B has a loan for which payment is delayed by a week. It classifies this loan as impaired.

c. Institution C has an impaired loan in its portfolio. It uses the fair value of the collateral to determine the amount of loan loss.

d. Institution D has several impaired loans in its portfolio. Each of the loans has different facts and circumstances. The institution uses the expected cash flows method to determine the amount of loan loss for all the loans.

16. MegaCo has a loan with Heartland National Bank (HNB). Market interest rates decline from 11% to 9%, so MegaCo refinances its old 11% debt with a new 9% debt on market terms. MegaCo is considered a profitable company, and HNB is willing to restructure this debt. Does this restructuring qualify as a troubled debt restructuring (TDR)?

a. Yes.

b. No.

17. Which of the following would be accounted for like an impaired loan?

a. A TDR.

b. Foreclosed assets.

c. Combination restructurings.
18. Grace Mutual enters into a TDR with one of its borrowers. Part of the restructuring includes replacing the existing borrower with a new borrower. The new borrower is unrelated to the original borrower. How should the financial institution account for this change?

   a. The TDR is accounted for as an exchange of new debt for old debt.

   b. The TDR is accounted for as if the borrowers did not change.
SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. (References are in parentheses.)

13. Several pieces of authoritative literature exist related to the allowance for loan losses. Which one includes policy statements that, among other things, clarify that an institution’s board of directors must ensure controls are in place so that the appropriate level of the allowance for loan and lease losses is determined consistently and provide guidance for maintaining and documenting policies and procedures that are tailored for the size and complexity of the financial institution and its loan portfolio? (Page 41)

a. FASB ASC 310-10-S99-4. [This answer is incorrect. In addition to the accounting literature, the SEC and federal financial institution regulators have issued guidance on the allowance for loan losses. FASB ASC 310-10-S99-4 (formerly the SEC’s Staff Accounting Bulletin No. 102, Selected Loan Loss Allowance Methodology and Documentation Issues) provides guidance on the documentation the staff normally would expect registrants to prepare and maintain in support of their allowances for loan losses. However, this guidance does not include the policy statements that are described above.]

b. FASB ASC 450-10 and FASB ASC 310-10-35. [This answer is incorrect. FASB ASC 450-10 (formerly SFAS No. 5, Accounting for Contingencies) and FASB ASC 310-10-35 (formerly SFAS No. 114, Accounting by Creditors for Impairment of a Loan) are the primary sources of guidance on accounting for the allowance for loan losses. However, these pieces of authoritative guidance do not include the policy statements described above.]

c. The FFIEC’s Interagency Policy Statement, Allowance for Loan and Lease Losses (ALLL) Methodologies and Documentation for Banks and Savings Institutions. [This answer is incorrect. In 2001, the Federal Financial Institutions Examination Council (FFIEC) issued this Interagency Policy Statement. It was intended to supplement, not replace, the guidance the banking agencies provided in their Interagency Policy Statement on the Allowance for Loan and Lease Losses, which was issued in December 1993. This piece of guidance does not include the policy statements described above.]

d. The NCUA’s Interpretive Ruling and Policy Statement No. 02-3, Allowance for Loan and Lease Losses (ALLL) Methodologies and Documentation for Federally-Insured Credit Unions. [This answer is correct. The National Credit Union Administration (NCUA) issued this Interpretive Ruling and Policy Statement to provide guidance on the design and implementation of ALLL methodologies and supporting documentation practices. The policy statements include those described above, and they also indicate that the ALLL process must be appropriate, systematic, and consistently applied and must incorporate management’s current judgments about the credit quality of the loan portfolio. The statements also emphasize the agencies’ position that financial institutions should maintain and support the ALLL with documentation that is consistent with their stated policies and procedures, GAAP, management’s best judgment, and applicable supervisory guidance.]

14. A financial institution determines its allowance for loan losses as a general allowance based on the classification of the loans in its portfolio. What type of financial institution is this? (Page 44)

a. A bank. [This answer is correct. In banks, the entire allowance for loan losses has historically been considered to be a general allowance. Allowances relating to specific loans have been determined primarily through loan classifications. The classifications indicate the risk of loss associated with a particular loan. Using a classifications approach, specific problem loans are evaluated and classified. A loan may be classified entirely into one category or it may be allocated among different categories.]

b. A savings institution. [This answer is incorrect. OTS regulations require savings institutions to classify their loans using a system consistent with GAAP and the practices of the federal banking agencies. In addition, the OTS requires savings institutions to classify loans consistent with the Thrift Activities Handbook.]
c. A credit union. [This answer is incorrect. The NCUA has issued a Letter to Credit Unions No. 02-CU-09, *Allowance for Loan and Lease Losses*, which clarifies the NCUA’s expectations regarding methodologies and documentation support for the ALLL. The NCUA believes that an essential part of a credit union’s ALLL methodology is a comprehensive, disciplined, timely and consistently applied charge-off policy for uncollectible loans. NCUA guidance supplements GAAP, but does not replace it.]

15. Which of the following financial institutions has correctly dealt with an issue related to impaired loans? (Page 48)

a. Institution A evaluates the odds of being unable to collect on a loan at 50%. It classifies this loan as impaired. [This answer is incorrect. According to FASB ASC 310-10-35, a loan is considered impaired if it is probable that the lender will be unable to collect all amounts due under the contractual terms of the loan agreement. Probable means likely to occur, not virtually certain. However, the loan in question is just as likely to be collected as it is likely to be impaired, so it would not meet the definition of an impaired loan.]

b. Institution B has a loan for which payment is delayed by a week. It classifies this loan as impaired. [This answer is incorrect. An insignificant delay or shortfall in loan payment does not mean the loan is impaired. An insignificant delay or insignificant shortfall is not defined in FASB ASC 301-10-35; however, as a rule of thumb, a delay of less than 30 days and a shortfall of less than 5% of the required principal and interest payment could be considered insignificant. Therefore, this loan would not need to be classified as impaired.]

c. Institution C has an impaired loan in its portfolio. It uses the fair value of the collateral to determine the amount of loan loss. [This answer is correct. According to FASB ASC 310-10-35, if a loan is impaired, one of the following methods should be used to determine the amount of loan loss: (1) fair value of the collateral, (2) expected cash flows, (3) aggregate collection experience, or (4) market value of the loan.]

d. Institution D has several impaired loans in its portfolio. Each of the loans has different facts and circumstances. The institution uses the expected cash flows method to determine the amount of loan loss for all the loans. [This answer is incorrect. According to FASB ASC 310-10-35, the selection of the method used to determine the amount of loan loss should be made on a loan-by-loan basis. However, after a method is selected for a loan, it should be applied consistently unless circumstances change.]

16. MegaCo has a loan with Heartland National Bank (HNB). Market interest rates decline from 11% to 9%, so MegaCo refinances its old 11% debt with a new 9% debt on market terms. MegaCo is considered a profitable company, and HNB is willing to restructure this debt. Does this restructuring qualify as a troubled debt restructuring (TDR)? (Page 49)

a. Yes. [This answer is incorrect. A TDR occurs when the creditor for economic or legal reasons related to the debtor’s financial difficulties grants a concession to the debtor that it would not otherwise consider. That is not the case in the above scenario, so MegaCo’s restructuring would not be considered a TDR. FASB ASC 470-60-55 provides authoritative guidance for TDRs.]

b. No. [This answer is correct. The restructuring in this scenario would not be considered a TDR because (1) the borrower is not having financial difficulties and (2) the new debt has market terms and a market interest rate. According to FASB ASC 470-60-55-5, the following two questions must be answered “yes” before determining that the modification or exchange of debt instruments is within the scope of that guidance: (1) is the debtor experiencing a financial difficulty? and (2) has the creditor granted a concession?]
17. Which of the following would be accounted for like an impaired loan? (Page 51)

a. A TDR. [This answer is correct. A loan that is modified in a TDR should be accounted for like an impaired loan. If the expected cash flows method is used to determine the loss allowance, FASB ASC 310-40-35-12 indicates that the discount rate should be determined based on the original contractual rate rather than the rate on the modified loan.]

b. Foreclosed assets. [This answer is incorrect. Foreclosed assets are generally recorded at their fair value (less cost to sell if assets will be sold) at the date of foreclosures.]

c. Combination restructurings. [This answer is incorrect. Combination restructurings are accounted for as follows: (1) any asset received in a partial settlement should be recorded at its fair value (less cost to sell, if applicable), and the recorded investment in the loan should be reduced by that amount, and (2) the modification of terms on the remaining loan balance should be accounted for as an impaired loan. So, though portions of this type of TDR would be accounted for as an impaired loan, there are certain differences.]

18. Grace Mutual enters into a TDR with one of its borrowers. Part of the restructuring includes replacing the existing borrower with a new borrower. The new borrower is unrelated to the original borrower. How should the financial institution account for this change? (Page 52)

a. The TDR is accounted for as an exchange of new debt for old debt. [This answer is correct. This accounting would be used in this situation, according to FASB ASC 310-40-25-2. The TDR is recorded at the fair value of the new debt.]

b. The TDR is accounted for as if the borrowers did not change. [This answer is incorrect. According to FASB ASC 310-40-25-2, these situations should be accounted for "according to their substance." This type of accounting would be used if the new borrower controls (or is under common control with) the original borrower. If no assets were transferred, the TDR should be accounted for as a modification of terms.]
LOAN REVIEWS AND SPECIFIC ALLOWANCES IN A FINANCIAL INSTITUTION AUDIT

Overview of Auditing the Allowance for Loan Losses

Auditing the allowance for loan losses is one of the most subjective parts of a financial institution audit and one of the most important. As discussed earlier in this lesson, financial institutions have various methods for determining their allowances for loan losses. The auditor’s objective is to determine whether the client’s allowance is appropriate under the accounting principles discussed previously. There are several ways to accomplish that. SAS No. 57 (AU 342.10) states that “the auditor should obtain an understanding of how management developed the estimate” and suggests applying one or a combination of the following basic approaches to auditing accounting estimates (including the allowance for loan losses):

- Reviewing and testing management’s process for developing the estimate.
- Developing an independent expectation of the estimate to assess the reasonableness of management’s estimate.
- Reviewing subsequent events or transactions occurring prior to the date of the auditor’s report.

The auditor’s approach to testing the allowance for loan losses usually includes aspects of all three approaches. However, the most effective and efficient approach for small to mid-size institutions may be to develop an independent estimate (or range of estimates) of the allowance for loan losses and compare it to the recorded allowance. DEP suggests testing management’s estimation process. However, DEP’s approach may be considered more appropriate for large financial institutions.

Exhibit 2-4 outlines the process for assessing a financial institution’s allowance for loan losses. The approach can be used for any financial institution, but it should be tailored to fit the circumstances of the engagement. For example, some auditors may wish to determine a desired percent of coverage for loan reviews and select a sufficient number of loans to achieve that coverage. Also, the length of time devoted to each step may vary depending on the auditor’s familiarity with the client, the risks associated with each portion of the loan portfolio, and other factors. The following paragraphs discuss loan reviews and specific allowances. The remaining steps in the approach are discussed later in this lesson.

Exhibit 2-4

Assessing the Allowance for Loan Losses

1. Review loans and estimate specific allowances.
   a. Select loans for detailed loan review.
   b. Assess the adequacy of the extent of loan review procedures.
   c. Review selected loans and estimate the specific allowances needed.

2. Estimate portions of the allowance that are needed for the following:
   a. Classified loans other than those with specific allowances.
   b. Loans evaluated on a pool basis (such as single-family residential loans, installment loans, and other consumer loans).
   c. Other loan losses inherent in the portfolio.

3. Assess the reasonableness of the recorded allowance for loan losses.
Note:

a These steps assume the auditor has already obtained an understanding of the client's loan portfolio and lending activities, as discussed in Lesson 1, including an understanding of the loan evaluation process used by management to estimate the allowance for loan losses.

Loan Reviews

Loan reviews are the most important and time-consuming part of a financial institution audit. Loan reviews serve a number of functions, including the following:

a. Their primary function is to enable the auditor to obtain information to assess the collectibility of significant loans. This information is then used in determining specific allowances and allowances relating to classified loans.

b. They provide evidence regarding the existence of loans receivable. Thus, they support loan confirmation procedures.

c. In some situations, they can be used as tests of controls relating to loan origination.

Generally, loan reviews cover commercial business and commercial real estate loans. They should also cover participations purchased in those loans. Single-family residential loans and consumer loans are generally assessed on a loan pool basis, as discussed later in this lesson.

Selecting Loans for Detailed Review

In selecting loans for detailed review, the auditor may base his or her selection either on individual loans or on lending relationships. Lending relationships cover all loans and extensions of credit to a given borrower, including irrevocable loan commitments, letters of credit, financial guarantees, and overdrafts. If individual loan selection is used, best practices indicate that the auditor should consider the effect of other loans to the borrower in evaluating each loan selected. The auditor should consider expanding the scope of loan reviews to include other loans if there are indications that the borrower may not repay its debts.

Loans are typically selected for detailed review based on the following criteria:

a. **Large Loans.** Loans or lending relationships that exceed a certain dollar amount are usually selected. The cutoff amount depends on the percentage of coverage desired. As a rule of thumb, the auditor may use tolerable misstatement as the initial cutoff for large loans and then select smaller loans if additional coverage is desired.

b. **Problem Loans.** The term problem loans refers to any loan with a significant risk of impairment. Examples of problem loans include:

   (1) Delinquent or nonaccrual loans.

   (2) Loans modified in troubled debt restructurings.

   (3) Loans classified by management or on internal watch lists.

   (4) Loans classified or criticized by examiners.

   (5) Loans identified in internal loan reviews as having documentation and other deficiencies.
(6) Loans to borrowers who are known to be having financial difficulties (such as operating losses, cash flow deficiencies, business interruptions, or bankruptcy).

(7) Loans in which the underlying collateral may have significantly declined in value or profitability.

(8) Loans to businesses in economically depressed industries or communities.

(9) Construction loans for which the project has experienced delays, cost overruns, or changes in the concept or plan (such as conversion of an apartment project into a condominium project).

(10) Other loans the auditor believes might be impaired.

The auditor may also wish to examine significant loans that were identified as problem loans in the prior audit but are no longer considered problem loans by the institution. Problem loans are typically selected using a lower dollar cutoff amount than the one used for large loans. The cutoff amount depends on the percent of coverage desired. As a rule of thumb, the auditor may consider using one-third of tolerable misstatement as the initial cutoff amount for problem loans.

In addition to large loans and problem loans, the auditor may also select certain loans with other characteristics such as the following:

a. New and Renewed Loans. A number of new and renewed loans may be selected to determine the quality of the institution’s documentation and lending practices. For renewals, the auditor should also consider whether the renewal appears to be made for valid business reasons and not merely to keep the loan current. Loan selection may be based on a dollar cutoff or a judgmentally selected number, such as 25 loans.

b. Other Loans. Auditors may also select other loans for detailed loan reviews, such as—

(1) Loans to affiliates, and loans to insiders such as directors and officers.

(2) Loans listed on documentation or compliance exception reports.

(3) Industry or other credit concentrations.

(4) Other loans selected randomly or haphazardly without any other specific criteria.

The first three categories are usually selected based on a dollar cutoff, such as one-third of tolerable misstatement. The last category may be a judgmentally selected number of items, such as 10 or 20.

Many auditors also try to ensure that they select some loans from each group of loans administered by a particular loan officer.

In selecting problem loans based on internally generated information, the auditor should consider the completeness and accuracy of that data. For example, the auditor may select all loans over 60 days past due as reported on delinquent loan reports. Those reports should be tested for completeness and accuracy. That is usually accomplished by tracing loans from the loan subsidiary records (noting paid-through dates) to the delinquent loan report and vice versa. Similar consideration should be given to the institution’s watch list and list of loans by borrower. If those reports are not complete and accurate, identification of problem loans is more difficult.

Assessing the Adequacy of the Extent of Detailed Loan Reviews

After making the initial selection of loans for detailed review, the auditor should assess the adequacy of the extent of loan reviews to be performed. This assessment is usually based on the percentage of coverage of the loan portfolio achieved from the loans initially selected for detailed review. The auditor’s assessment of that percentage is based on such factors as—

- Composition of the loan portfolio.
- Problem loans identified, including loans classified or criticized by examiners.
- Trends in loan volume, primarily categories experiencing rapid growth.
- Loss and recovery experience, including the timeliness of loan charge-offs.
- Loan concentrations including loan type, geographic concentrations, and concentrations of loans to individuals, entities, and their related interests.
- Size of individual credit exposures (installment based lender with few large loans versus commercial lender with numerous large loans).
- The amount of reliance placed on the client’s internal loan review and internal audit functions.
- Total amount of loans (loans to total assets), and the number of problem loans (including delinquent loans by loan officer).
- Effectiveness of policies and procedures over lending, charge-offs, collections, and loan recovery.
- Experience and competence of lending management and other lending personnel.
- Nature and amount of related party loans.
- Regulatory examination report comments or discussions with regulators concerning the client’s lending function.
- Effectiveness of the client’s procedures for determining the allowance for loan losses.
- Current economic conditions that affect the institution or its borrowers.

Depending on the preceding conditions, auditors generally determine the extent of detailed loan reviews using a specified number of loans or specified percentage of the dollar amount of each loan type tested through individual loan reviews (such as 30%-60% of commercial business and commercial real estate loans).

**Loan File Contents**

The documentation for a given loan file varies depending on the type of loan, the collateral, the borrower, and other factors. An example of the contents of a typical loan file is presented at Exhibit 2-5, which was obtained from DEP. Loan documentation may be contained in a single file or separate credit and documentation files. If multiple files are used, the auditor will generally need to review both files.

**Exhibit 2-5**

**Typical Loan File Contents**

**Credit Investigation/Application/Supervision Section**

- Loan application.
- Credit approval document that summarizes—
  - Borrower.
  - Amount of request/rate/payment terms/fees.
  - Purpose.
• Repayment sources (primary and secondary).
• Collateral description and valuation.
• Guarantors.
• Other conditions/requirements of approval.
• Evidence of loan committee or other required approval and date approval was granted.
• Financial statements of borrower, guarantor, or both.
• Spreadsheets and other analyses of the financial situation of the borrower.
• Borrower’s board resolutions concerning loan approval.
• Credit agency reports and other bank account information reports, as well as direct trade creditor references.
• Newspaper clippings about borrower.
• Various other pertinent data, including the borrower’s history and forecasts.
• Internal memoranda.
• Correspondence.
• Loan summary sheet, containing information such as—
  • Lending committee approval date.
  • Loan draw amounts and dates.
  • Interest rates and adjustment dates.
  • Amount of undrawn commitment.
  • Rate of commitment fee and due dates.
  • Date commitment fee received.
  • Repayment terms.
  • Name of country risk.
  • Name and country of any guarantor.
  • Amount of participation fee (if applicable).
  • Indication of overdue payments of interest, fees, or installments.
• Memorandum to the file, by the lending officer, with description of the credit and commentary on its quality and potential future developments.

**Loan Documents Section**

• Signed loan agreement.
- Legal opinion.
- Signed note.
- Signed mortgage or deed of trust, with evidence of recordation.
- Signed guarantee.
- Periodic report of collateral, including its location and value, and any related environmental studies.
- Participation certificates and participation agreements (if applicable).
- Evidence of insurance, including loss payable clauses that protect the bank’s interest.
- Approvals.
- Security agreements or other collateral pledge agreements, titles, or financing statements recorded in proper jurisdictions to perfect lien position (nonpossessory collateral), negotiable collateral (such as stocks and bonds) with proper endorsements/assignments, hypothecation agreement for third-party pledge of collateral.
- Collateral ledger used to record the instruments (including stocks and bonds, which are probably kept in a bank vault separate from loan files or with an independent custodian) that secure a borrower’s indebtedness.

[SOURCE: Adapted from the AICPA Audit and Accounting Guide, Depository and Lending Institutions: Banks and Savings Institutions, Credit Unions, Finance Companies and Mortgage Companies, AICPA, 2009.]

Document Review Procedures

Although the auditor typically looks through the entire loan file in performing a loan review, every document does not receive the same degree of attention. Typically, the auditor focuses on specific documents supporting the lender’s rights, the borrower’s obligations, and the sources of repayment. The remaining documentation is read merely to identify indications of potential impairment or other matters that require audit attention (such as participations). The following paragraphs discuss the documents that typically receive the most audit attention.

Legal Obligation. One of the auditor’s most important goals in performing a loan review is to determine whether the borrower has a legal obligation to repay the debt. This legal obligation can usually be supported by examining the original signed note and related loan agreement. If the borrower is a corporation, the loan file should also contain a corporate resolution authorizing the parties signing the note to incur the obligation on behalf of the corporation.

Loan Authorization. Loan files should normally contain evidence that the loans have been properly approved in accordance with the financial institution’s lending policies. That evidence may be documented in various forms depending on the size and type of loan and the institution’s policies. Examples of forms of loan authorization include the following:

- Memorandum signed by the loan officer.
- Initials of loan officer and president on a loan summary sheet.
- Copy of resolution by the board of directors or loan committee.

Lack of evidence of proper loan authorization might indicate a deficiency in lending practices regarding that loan. If that deficiency is noted often, the auditor should consider expanding the detailed loan review procedures.
Borrower Performance. In evaluating the collectibility of a loan, auditors normally assess two sources of repayment. The first, and most important, is the borrower’s cash flow. (The second source of repayment, which is the sale or operation of the collateral, is discussed later in this lesson.) The auditor should evaluate both the willingness and ability of the borrower to make the required debt service payments. Factors to consider in making that evaluation include the following:

a. Payment History. The most obvious indicator of the borrower’s willingness and ability to repay a loan is the payment history of the loan, that is, whether the borrower has historically made all of the required payments on time. The auditor will ordinarily give significant consideration to a loan’s payment history in assessing its collectibility if (1) the payment terms require periodic payments of principal and interest and (2) the loan has an appropriate maturity date. A good payment history may not be as significant if the loan requires little or no payments from the borrower before the maturity date (such as if it requires a large balloon payment at maturity). Furthermore, the fact that a loan is being kept current solely through continual renewal or funding of interest by loan proceeds might indicate that the borrower is unable to make debt service payments under normal terms.

b. Financial Statements. Analyzing borrower financial statements is a critical part of loan evaluation. For commercial loans, lenders should receive borrower financial statements on a regular basis. The need for current financial information varies with the borrower and type of loan. For a working capital loan in a highly cyclical business, the lender may receive monthly or quarterly financial statements. For a loan on the office facilities of a very stable and profitable business, annual financial statements may be sufficient. In analyzing borrower financial statements, the auditor should consider the basis of presentation of financial statements (such as GAAP, income tax, cash or fair market value basis). Financial statements prepared on a tax or other basis may not accurately reflect the borrower’s operations because of such items as accelerated tax deductions that are not expenses under GAAP. Other factors to consider in evaluating financial statements include—

1. Financial Condition. The borrower’s balance sheet provides information about its obligations and the resources and collateral available to settle those obligations. Some auditors tend to focus on only one aspect of the financial statements (such as net worth or the value of certain assets). However, the analysis of the balance sheet should cover other aspects as well, such as:

   a. Fair Market Value Adjustments. If the borrower’s balance sheet is presented on a fair market value basis, which is usually the case with personal financial statements, the auditor should consider how much of the borrower’s net worth results from asset appreciation and how the asset values were determined. A balance sheet that is based entirely on the borrower’s internal estimates of asset and liability values is usually not as reliable as one containing values supported by appraisals and other independent third-party estimates of value. An auditor should usually be somewhat conservative in adjusting a borrower’s net worth for such items as investments in closely-held businesses (especially if reliable financial statements of such businesses are not available), raw land, homesteads, and similar items that may be illiquid or difficult to value.

   b. Existing Liens on Assets. Regardless of the basis of presentation, the auditor should consider how much of the net worth relates to encumbered assets (including the assets securing the loan that is being reviewed). If the borrower has significant unencumbered assets, that may enhance the borrower’s ability to repay the loan. However, if substantially all of the borrower’s assets are pledged against outstanding debt, the assets might have to be liquidated to generate sufficient funds to repay the borrower’s obligations. In some cases, the assets may need to be sold at discounted prices, and the borrower’s equity in those assets will therefore be less than the reported amounts. Accordingly, the lender may have to rely more heavily on the collateral for repayment of a loan to a highly leveraged borrower.

   c. Liquidity. The extent of unencumbered liquid assets held by the borrower reflects the borrower’s ability to pay its debts in the normal course of business (that is, without selling productive assets). In a commercial business, the borrower’s liquidity may be reflected by its working capital levels.
Liquidity (or the level of working capital) is an important indicator of the extent to which the borrower can be relied on as the primary source of repayment.

(d) **Accessible Assets.** It may be difficult for a borrower to repay loans from its own funds if a substantial portion of its assets are inaccessible. Those assets might include assets located in trust funds, assets placed in escrow for third parties, or, in some states, personal residences. Such assets should usually be excluded in assessing the borrower’s financial condition.

(e) **Total Lending Relationship.** If the client has other loans to the borrower, the auditor should consider the lending relationship as a whole (that is, all of the loans, commitments, letters of credit, financial guarantees, and other extensions of credit to the borrower). The equity in assets that are financed by the client should be excluded in assessing the borrower’s financial condition.

(f) **Guarantees, Commitments, or Other Off-balance-sheet Obligations.** Guarantees, commitments, or other off-balance-sheet obligations can impair a borrower’s ability to repay its loans. Thus, the auditor should consider the effect of any off-balance-sheet obligations on the borrower’s financial condition.

(g) **Trends.** Trends can be an important indicator of the borrower’s financial health. Declining net worth or liquidity can indicate that the borrower is experiencing financial difficulties and may not be able to repay its loans or other obligations.

(2) **Operations.** The auditor should consider the borrower’s profitability and its level of operating cash flows in assessing its ability to meet its financial obligations. If the borrower is not producing enough cash flow to meet its obligations, the collateral may be the only source of repayment. The auditor should also consider trends in the borrower’s operations to evaluate the borrower’s ability to meet its future obligations. For example, a borrower that is experiencing declining operating profits and cash flow may be able to meet its obligations for a short period but not for the remaining loan term.

(3) **Adequacy of Financial Information.** If borrower financial information is inadequate, DEP states that the auditor should discuss the situation with an appropriate client official. If adequate financial information is not available for significant loans, DEP states the auditor should notify management that a scope limitation may result. When adequate financial information is not obtained, the auditor can consider qualifying or disclaiming an opinion on the client’s financial statements. PPC’s Guide to Auditor’s Reports provides guidance for reporting on scope limitations.

The extent of procedures and documentation involved in evaluating a borrower’s financial statements is a matter of professional judgment based on the circumstances. In many cases, the auditor may wish to obtain copies of the borrower’s financial statements or summarize them in the workpapers.

c. **Credit Reports.** Many loan files contain credit reports on the borrowers. Those reports show how the borrower has performed on other debt. Thus, they may be useful in assessing the borrower’s willingness and ability to repay the debts to the institution.

The preceding conditions primarily relate to the borrower’s ability to repay the loan. The auditor should also consider the borrower’s willingness to repay the loan. As noted in the preceding paragraph, payment history is an important indicator of the borrower’s willingness to repay the loan. Other factors to consider include the following:

a. **The Borrower’s Equity in the Collateral.** For asset-intensive loans such as those secured by real estate, the borrower’s equity in the project is an important consideration. Borrowers who have significant equity invested in the collateral generally will be committed to repaying their debts to preserve their investments. However, borrowers who have little or no equity in the property and no reasonable prospects to rebuild any equity in the foreseeable future may be inclined to abandon the property rather than continue contributing to a losing investment. (For this purpose, a borrower’s equity is the difference between the fair value of the property and the amount of the loan.)
b. **Personal Liability.** A borrower is more likely to be committed to repaying a loan if the lender has direct recourse against the borrower in the event of default. Borrowers have less commitment to repay nonrecourse loans, so they tend to be more difficult to collect.

**Personal Guarantees.** Personal guarantees are obtained in many situations involving loans to closely-held businesses. For loans that have been personally guaranteed, the loan files generally contain documentation of those guarantees and financial information of the guarantors. The purpose of those guarantees is to (a) ensure the commitment of the principal owners to repay the loans and (b) provide another potential source of repayment if the borrower defaults. Although personal guarantees may be a useful underwriting tool, they are generally of little value in collection of problem loans. However, in some situations, personal guarantees may be valuable, and thus they may warrant consideration in determining the allowance for losses for specific loans.

Best practices indicate that a personal guarantee generally should not be relied upon in determining the collectibility of a loan unless all of the following conditions are met:

a. **It Must Be Legally and Practically Enforceable.** The determination of legal enforceability requires a legal opinion, while the practicality of enforcement is a matter of judgment. However, the legality and practicality of enforcing a personal guarantee are often related. In some legal jurisdictions, guarantees are either not enforced or difficult to enforce. The following should be considered in assessing the enforceability of a guarantee:

   1. **Opinion of Legal Counsel.** The opinion of legal counsel is often considered important in determining the legal enforceability of a guarantee. Normally, a written opinion about enforceability is obtained from either the borrower’s or lender’s counsel before the loan is closed, and a copy of the opinion is placed in the loan file. If a written opinion is not available, the auditor should consider discussing the enforceability of significant guarantees with the client’s attorney.

   2. **Legal Requirements for Enforcement.** The enforcement requirements for personal guarantees vary by legal jurisdiction. For example, in some states, lenders must choose between foreclosing on the collateral or seeking judgments against the guarantors. In those situations, lenders generally find it more beneficial to foreclose, and, thus, enforcing a guarantee is usually impractical.

   3. **Time and Expense Requirements for Enforcement.** In some situations, it may be too expensive or time-consuming to enforce a personal guarantee. For example, a guarantor may seek bankruptcy protection to delay or eliminate any guarantee obligation. Alternatively, a guarantor may oppose an enforcement action or seek to have the guarantee voided in court.

   4. **Contingent Liabilities.** When a lender seeks to enforce a guarantee, the guarantor may file a lawsuit against the lender seeking damages for various alleged wrongdoings (such as breach of contract, violation of usury laws, breach of fiduciary duty, or violation of various state or federal lending laws). Such lender liability suits create contingent liabilities to the lender and thus may make a lender reluctant to enforce a guarantee.

   5. **Limitations on the Guarantee.** If the guarantee is limited to a small percentage of the loan, it may not be cost effective to enforce.

   6. **Normal Practice in the Legal Jurisdiction.** Lenders rarely try to enforce personal guarantees in some jurisdictions. If lenders generally do not try to enforce guarantees, that may suggest there are practical problems in doing so.

b. **The Lender Must Have the Intent to Enforce the Guarantee When Necessary.** If the lender does not intend to enforce a guarantee, then it should not be considered in estimating the amount of loss expected to be incurred on a guaranteed loan. On the other hand, if the lender intends to enforce the guarantee and has a history of enforcing them, guarantees might be considered.

c. **The Guarantee Must Be for a Substantial Portion of the Loan Balance.** Personal guarantees are sometimes limited to a specified amount or percentage of the loan balance. As a rule of thumb, the guarantee should usually cover at least 20% of the loan commitment for enforcement to be practical.
d. **The Guarantor Must Have the Financial Resources to Perform on the Guarantee.** In order for a personal guarantee to be effective, the guarantor must have the ability to perform. Thus, the assessment of the guarantee must include consideration of the financial condition of the guarantor. As a rule of thumb, a guarantor should have resources of the following amounts for the guarantee to be reliable:

1. **Net Worth.** The guarantor’s net worth should be equal to at least 30% of the loan commitment (the maximum amount of financing to be provided under the loan agreement). As previously noted, the net worth should exclude the amount of any inaccessible assets and the equity in projects that are financed by the lender.

2. **Liquid Assets.** The guarantor should have unencumbered liquid assets equal to at least 25% of the loan commitment.

If the guarantor has guaranteed two or more loans for the lender, the preceding rule of thumb should be applied to the total of all guaranteed loans. When the guarantor has significant guarantees outstanding with other financial institutions, the ability of a guarantor to perform under the guarantee should be considered in relationship to the guarantor’s net worth and liquid assets.

The considerations in item b. of the “Borrower Performance” paragraph for evaluating a borrower’s financial statements also apply to a guarantor’s financial statements.

**Collateral.** As discussed in the preceding paragraphs, the borrower is generally considered the primary source of repayment for a loan, and the collateral is the secondary source of repayment. The auditor has two considerations in assessing collateral—

- The lender’s rights to the collateral.
- The value of the collateral.

Both considerations are important. Valuable collateral is irrelevant if the lender cannot establish its rights to that collateral, and worthless collateral is irrelevant even if the lender has complete control of it. The following paragraphs discuss matters that affect the auditor’s assessment of collateral for a loan.

**Assessing the Lender’s Rights to Collateral.** The laws in each state establish the rights and procedures of lenders regarding loan collateral. However, many provisions of those laws are the same from one state to the next. For example, Article 9 of the Uniform Commercial Code governs the rights and procedures relating to collateral that is personal property (that is, property other than real estate). Generally, a lender must establish (or attach) its rights to collateral through a deed of trust (for real estate) or security agreement and financing statement such as a UCC-1 (for personal property) signed by the borrower at closing. Then, the lender files the deed of trust or financing statement to perfect those rights. When that is done, the lender generally has rights to the collateral that are superior to other parties except for the following:

- **Pre-existing Liens.** These are liens on the property that were perfected at an earlier date.

- **Tax Liens.** These are liens from federal, state, or local taxing authorities.

- **Certain Mechanics or Materialmen’s Liens.** These are liens of contractors or suppliers for improvements to property. The situations in which these liens receive priority vary from one state to the next.

- **Purchase Money Security Interests.** These are liens perfected by suppliers for goods sold on credit.

The preceding examples are general rules. The auditor should determine the specific rules under the applicable state’s laws.

Besides establishing the lender’s rights to the property, the lender may also need to apply additional procedures to monitor, protect, or control the collateral, such as:

- Retaining physical possession of negotiable securities.
• Retaining possession of the title to automobiles.
• Requiring hazard insurance on the collateral.
• Making periodic inspections of inventory or equipment.
• Requiring documentation that all property and other taxes have been paid.
• Requiring periodic reporting of inventory status or accounts receivable aging.
• For construction loans, requiring evidence of site inspections to determine project status before funding draw requests.

While reviewing loan files, the auditor should examine documentation of the client’s collateral position and determine whether the client has taken appropriate procedures to monitor, protect, or control the collateral. The auditor should also be alert for correspondence or other indications that the collateral or the lender’s rights have been impaired. Such documentation might include a notice of delinquent taxes, a notice of liens from mechanics or contractors, or internal documents referring to such situations. If it appears the client’s lien on a particular loan has been impaired, the auditor should consider that information in assessing the allowance for loan losses. For example, if there are pre-existing liens on property securing a loan, the collateral value should be reduced by the amount of those liens to determine the net collateral value available to the lender. Also, if there are superior liens, the auditor should determine the status of the related obligation. If the borrower is in default to the creditor who holds the superior lien, the other creditor may be able to foreclose on the property without giving any proceeds to the client. (The exact circumstances under which this can occur will vary based on the laws of the particular state and the nature of the lien.)

Assessing Collateral Value. The approach used to assess the value of a loan’s collateral varies depending on the assessed risk of default by the borrower and reliability of the appraisal. Exhibit 2-6 shows the relationship of those factors to the audit approach. The following is a summary of approaches that may be used depending on those factors:

a. Low Risk of Default and Reliable Appraisal. If there is a low risk of default by the borrower, the collateral value is a secondary consideration. In those situations, the audit procedures should, at a minimum, include briefly reading the appraisal to assess its reasonableness. If the appraisal appears to be reasonable and well-supported, no additional procedures are generally needed.

b. Low Risk of Default and Unreliable Appraisal. After reading the appraisal as discussed in item a, the auditor may decide that the appraisal is unreliable (for example, because it is too old, has inconsistencies in its calculations, or is not adequately supported). In that situation, although the risk of default may be low, the auditor should still assess the collateral margin for the loan. Factors to consider in making that assessment include:

   (1) Current Condition of the Collateral. If the physical condition of the collateral has declined, its value probably has also. For income-producing property (such as rental real estate), the auditor should also consider the cash flows produced by the property.

   (2) General Market Conditions. Declines in the overall market for similar assets (real estate, crops, livestock, etc.) probably mean that the collateral has declined in value.

   (3) Values of Similar Assets. Current appraisals or selling prices of similar assets may provide a general idea of the collateral’s value.

The auditor is not required to make a detailed estimate of the collateral’s value. The purpose of the additional procedures is to gain a general understanding of the approximate value of the collateral and thus the collateral margin for the loan. For example, if a $100,000 loan is secured by collateral with an original appraised value of $150,000, the auditor need only assess the probability that the value has declined by more than $50,000. If the collateral margin is still adequate, no further procedures are generally necessary.
However, if a collateral shortfall exists, the loan may need to be considered in estimating the allowance for loan losses.

c. **High Risk of Default and Reliable Appraisal.** If the loan has a high risk of default, repayment is likely to come from the collateral. Consequently, consideration of the appraisal is critical to assessing the potential for loss on the loan. In those situations, the auditor should review the appraisal in detail. In addition, the auditor should assess the probability that the property has declined in value since the appraisal date, considering such factors as the current cash flows produced by the property and current trends in market prices. If the appraisal is considered reliable and the collateral value does not appear to have declined, the auditor should use the appraised value in considering the potential loss on the property. Specific allowances are discussed in more detail later in this lesson.

d. **High Risk of Default and Unreliable Appraisal.** If the auditor determines that the appraisal is unreliable, the auditor should obtain sufficient information to estimate the current value of the collateral. Sometimes that may be accomplished by adjusting the appraisal to correct specific deficiencies. In other situations, it may involve obtaining more information about the current condition and operations of the collateral or about current market values of similar assets to estimate the collateral’s value. Appraisers can be consulted. The collateral value estimate is then used in considering the potential loss on the property.

### Exhibit 2-6

**Examples of Audit Approaches for Assessing the Value of Collateral**

<table>
<thead>
<tr>
<th></th>
<th>Reliable Appraisal</th>
<th>Unreliable Appraisal</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Low risk of default by the borrower</strong></td>
<td>Read appraisal to assess reasonableness of value estimate and adequacy of support.</td>
<td>Review appraisal or other documentation of value estimate. Assess the collateral margin for the loan based on the auditor’s knowledge of the collateral, general market conditions, and valuations of similar assets.</td>
</tr>
<tr>
<td><strong>High risk of default by the borrower</strong></td>
<td>Perform a detailed review of the appraisal. Assess whether circumstances occurring after the appraisal date may indicate a decline in collateral value.</td>
<td>Obtain sufficient information to estimate the current value of the collateral.</td>
</tr>
</tbody>
</table>

Some institutions make loans secured by collateral that is not appraised. For example, collateral such as marketable securities, inventories, and accounts receivable is generally not appraised. In many cases, the auditor may test the collateral value by independent confirmation (in the case of marketable securities), or by comparison to quoted market prices. The existence of collateral can be tested by physical observation, independent confirmation, or by reviewing client documentation verifying existence. In the absence of client documentation, DEP states that the auditor should perform collateral verification procedures, especially for significant loans or loans that have questionable collectibility.

**Discussions with Loan Officers**

For individual loan reviews, DEP states the auditor should discuss the status and background of the loan with the responsible loan officer and the loan review officer. These discussions can assist the auditor in obtaining an understanding of the loan, the related collateral, and the borrower’s financial status. Also, the loan officer can provide information about the institution’s reasons for making the loan. The auditor can also obtain an understanding of the loan officer’s attitude toward lending and his or her awareness of factors that influence loan collectibility.
Other Loan Documentation

Other loan documentation besides that discussed in the preceding paragraphs may also warrant audit attention. That documentation may indicate a higher or lower degree of credit risk depending on the nature of the evidence. Examples of other documentation that should be considered include:

- **Related Lender Guarantees or Commitments.** Since those items increase the lender’s credit exposure with respect to a given borrower or project, the auditor should consider any evidence indicating that the lender has made financial guarantees, issued standby letters of credit, or made commitments for additional funding.

- **Participation Agreements.** If the lender has sold participations in the loan to other institutions, the lender’s credit exposure generally is limited to the percentage of the loan it retained (unless the participations were sold with recourse or the lead lender’s interest is subordinated to the participants’ interests). Thus, the auditor should read any participation agreements and participation certificates to determine the extent of participations sold and the participants’ rights and obligations. Likewise, if the client bought a participation from another institution, the auditor should read the participation agreement and certificate to determine the client’s rights and obligations.

- **Letters of Credit or Take-out Commitments from Third Parties.** If the borrower obtains a letter of credit or a take-out commitment (an agreement between a lender and a borrower to refinance a loan at maturity) from a third party lender, the client may have little or no credit exposure on the loan. However, the auditor should determine that there are no conditions or contingencies relating to the letter of credit or commitment that might make their enforcement impractical. The same guidance applies to a surety bond with the same characteristics as a letter of credit.

- **Correspondence and Other Documentation.** The auditor should be alert for correspondence, internal memoranda, or other documentation of problems affecting the borrower or collateral. For example, a letter or memorandum noting that the borrower is involved in restructuring its debt with other financial institutions could indicate that the borrower is having financial difficulties. Similarly, documentation regarding quality problems with equipment or a real estate construction project could indicate an impairment of the collateral.

Documentation of Loan Reviews

There are a variety of forms that may be used to document loan reviews. Generally, that documentation consists of the following:

a. A summary memorandum or form that documents the extent of loans reviewed (such as dollar cutoffs for large and problem loans).

b. Documentation of individual loan reviews on separate forms, with supplemental documentation (such as copies of borrowers’ financial statements or other relevant data) where appropriate.

c. Summary listing of individual loans selected and specific allowances relating to those loans.

Limited Document Inspections on Recurring Engagements

The preceding paragraphs discuss general considerations for loan reviews. However, a comprehensive document inspection may not be needed for loans reviewed by the auditor in the prior year. For example, unless the loan has been renewed, modified, or refinanced during the current period, a detailed reading of the note and loan agreement is generally not necessary. In those situations, the documentation review may be limited to pertinent information that may change from year to year, such as the following:

a. Borrower or guarantor financial information.
b. Updated information regarding collateral value or monitoring of the collateral, such as—

(1) For real estate loans,
   (a) Documentation of renewal of the hazard insurance policy.
   (b) Evidence of payment of current year taxes.
   (c) Updated appraisals or evaluations, if any.
   (d) Inspection reports or operating statements relating to the current condition of the property.

(2) For loans collateralized by accounts receivable, recent copy of aged trial balance.

(3) For loans collateralized by inventory,
   (a) Current inventory listings or periodic inspection reports.
   (b) Evidence of insurance.

(4) For loans secured by equipment,
   (a) Periodic inspection reports.
   (b) Evidence of insurance.

c. Correspondence or other documentation that might indicate impairment of collateral values or the borrower’s ability to repay the loan.

Of course, if the loan is renewed or modified during the current period, the auditor should examine the new note, loan agreement, and other related documentation.

This type of limited loan review should also be documented.

**Special Considerations for Credit Union Audits**

Certain aspects of credit union audits can significantly affect the auditor’s approach to loan reviews and auditing the allowance for loan losses. The following are some special considerations that commonly apply to credit union audits:

a. **Loan Portfolio.** Credit union loan portfolios are generally composed of small consumer loans. There are generally few, if any, member business loans. Any loans that exceed tolerable misstatement are likely to be single-family residential loans. These characteristics can affect the audit approach in the following ways:

   (1) Most of the audit procedures for the allowance will be directed to the allowance for loan pools and the general allowance, which are discussed later in this lesson.

   (2) Loan file reviews will generally be limited to types of loans that have a history of high delinquency, charge-offs, or poor documentation. However, any large member business loans should also be reviewed.

b. **Loan File Documentation.** Since most credit union loans have many small consumer loans in addition to mortgage loans, the documentation in these loan files will generally be less extensive than that listed in Exhibit 2-5. Accordingly, the time needed to review a credit union loan file is generally less. Those loan files typically include, at a minimum, an application, note, credit report, collateral description, title or deed, and insurance information.
c. Monitoring and Collection Procedures. In many credit unions, there is little or no follow-up information on the loan after the initial loan is issued. The collection documentation concerning a loan will generally be a collection manager’s notes regarding discussions with the delinquent member. Thus, it may be difficult to assess the prospects for collection on an individual loan. Higher general reserves may be needed because of the uncertainties relating to specific reserves.

Performing Loan Reviews as Tests of Controls

Assessing control risk as low for loans receivable existence generally requires a review of loans originated during the year. In this review, the auditor tests controls over loan origination by inspecting specific loan documentation in the loan files. This test of controls review is separate from the collectibility review discussed in the preceding paragraphs and should be documented.

Sometimes the auditor may wish to assess the collectibility of the loans selected for the test of controls review. In those situations, the procedures discussed beginning in the “Loan Reviews” paragraph should be performed.

Estimating Specific Allowances

Specific allowances or allocations are typically determined in connection with individual loan reviews. That is, the auditor reviews loans as discussed beginning in the “Loan Reviews” paragraph and estimates portions of the allowance that should be specifically allocated to each loan. The auditor must make two key decisions to estimate the specific allowance for a loan—

a. Whether the loan is impaired.

b. How the impairment should be measured.

Determining Whether a Loan Is Impaired. As indicated previously, a loan is considered to be impaired if it is probable that the lender will be unable to collect all amounts due under the contractual terms of the loan agreement. The following factors can be considered in determining whether a loan is impaired:

- Payment history of the loan.
- Ability and intent of the borrower to repay the loan.
- Value of the collateral.

A detailed explanation about how to analyze those factors occurs earlier in this lesson.

As a practical matter, a number of other criteria can be used to help determine whether a loan is impaired. Examples of those criteria include the following:

a. Doubtful or Loss Classification. A loan that meets the regulatory definition of doubtful or loss (as shown in Exhibit 2-1) would generally be considered to qualify as an impaired loan.

b. Nonaccrual Loans. The criteria for placing a loan on nonaccrual, as discussed previously, are similar in many respects to the impairment definition. Accordingly, there is a general presumption that a loan placed on nonaccrual is also an impaired loan. However, it is possible to have nonaccrual loans that do not qualify as impaired, as well as impaired loans that are not on nonaccrual.

Although the preceding criteria are useful, they may not always provide sufficient evidence to determine whether a loan is impaired. The auditor should consider all of the relevant factors in making that determination.

If a loan is considered impaired, the auditor should estimate the specific allowance for the loan as discussed in the next paragraph. If the loan is not considered impaired, the auditor should merely classify the loan as substandard or unclassified using the definitions in Exhibit 2-1. Generally, if the auditor determines that the loan is likely to be repaid in accordance with its contractual terms, the loan may be considered unclassified. If there is some risk of loss on the loan, it should be classified as substandard.
**Estimating Losses on Impaired Loans.** After a loan is determined to be impaired, the auditor should estimate the loss on that loan using one of the following methods, if practical:

a. **Fair Value of the Collateral.** The fair value of the collateral should be used if foreclosure is likely. It can also be used if the collateral is expected to be the sole source of repayment.

b. **Expected Cash Flows from the Loan.** This method should be used if both of the following conditions are met:

   1. Foreclosure is not probable.
   2. Cash flows can be reasonably estimated.

If neither of the preceding methods is practical, the loan loss should be determined based on the institution’s aggregate collection experience. The following paragraphs explain how to apply each method. Loan losses can also be measured based on the observable market price of the loan, if available. However, this method is rarely used.

**Determining the Recorded Investment in the Loan.** Each of the methods for determining specific allowances discussed in the preceding paragraph requires a comparison to the recorded investment in the impaired loan. For example, if the expected cash flows method is used to determine loan losses, an allowance should be provided to reduce the recorded loan investment to the present value of the expected cash flows. Exhibit 2-7 shows how to calculate the recorded investment in the loan. The recorded investment does not contain any existing valuation allowance relating to the loan, but it does include any direct write-downs or remeasurement adjustments made to the loan.

**Exhibit 2-7**

**Calculating the Recorded Investment in the Loan**

\[
\text{Unpaid principal balance of the loan}^a \\
+ \text{Premiums} \\
+ \text{Deferred loan costs} \\
- \text{Discounts} \\
- \text{Deferred income}^b \\
+ \text{Accrued interest on the loan} \\
= \text{Recorded investment in the loan}
\]

**Notes:**

a. As noted previously, the recorded loan investment should be net of any previous write-downs.

b. Deferred income includes deferred loan fees. Best practices indicate that any gains on sales of real estate that are deferred under FASB ASC 360-20 (formerly SFAS No. 66) should also be included.

**Estimating Loan Losses Using the Fair Value of the Collateral.** Under this method, the specific allowance is the excess of the recorded loan investment over the fair value of the collateral. Obviously, when the fair value of collateral method is used, the lender should have an appraisal or other suitable documentation to support the fair value of the collateral.

Estimated costs to sell the collateral should be considered in determining the amount of future cash flows that are available to repay the loan. For example, if the loan will be repaid from the proceeds of selling the collateral, selling
costs should be considered in estimating expected cash flows. On the other hand, if loan payments are expected from the operation of the collateral rather than its sale, selling costs should not be considered.

**Estimating Losses Using the Expected Cash Flows Method.** Using the expected cash flows method, a specific allowance should be provided to reduce the recorded investment in the loan (as defined previously) to the present value of the expected cash flows of the loan, discounted at the effective rate of the loan. FASB ASC 310-10-35-26 (formerly SFAS No. 114, paragraph 15) states that—

. . . the estimates of expected future cash flows shall be the [lender’s] best estimate based on reasonable and supportable assumptions and projections. All available evidence, including estimated costs to sell if those costs are expected to reduce the cash flows available to repay or otherwise satisfy the loan, shall be considered in developing the estimate of expected future cash flows. The weight given to the evidence shall be commensurate with the extent to which the evidence can be verified objectively.

Estimating cash flows requires making subjective judgments about several uncertainties. For example, if the loan is past due (which is probably the case for most impaired loans), a judgment must be made about when the delinquent payments will be made. If the collateral is an income-producing asset such as rental real estate and the property is not producing sufficient cash flows to cover the loan payments, the borrower’s ability and intent to cover the deficiencies must be assessed. The auditor’s position is difficult because the client’s judgments in these situations often are not objectively verifiable. Consequently, the auditor must assess the reasonableness of the client’s judgments based on available information about the loan and other data. Factors to consider in assessing estimates of expected cash flows include the following:

- **Contractual Terms of the Loan Agreement.** Generally, the expected cash flows of an impaired loan should not include any large unscheduled balloon payments or other payments besides those required under the contractual terms of the loan agreement, unless there is evidence that the terms of the loan agreement are being revised. Also, the estimate should not consider payout of the loan over a greater period than that provided under the contractual terms of the loan agreement, as discussed previously, unless there is evidence that the loan agreement is being revised. For example, if the original understanding between the borrower and lender was that the loan would be repaid over three years, it would be unreasonable to assume expected cash flows over a 10-year period without evidence of a change in the agreement.

- **Existing Arrangements with Borrowers for Repayment.** Sometimes a borrower and a lender may be able to work out a revised payment plan allowing the borrower to catch up on past due payments and repay the loan in full. For example, the borrower may promise to increase quarterly payments by a specified amount until the delinquent payments are made. In those situations, the auditor should assess whether the borrower has the intent and ability to make loan payments under the revised terms. If the borrower has both the intent and ability, best practices indicate that the revised loan terms may be used as the basis for estimating expected cash flows.

- **Fair Value of the Collateral.** Although not explicitly stated in FASB ASC 310-10-35 (formerly SFAS No. 114), the current fair value of the collateral can be considered to offer a theoretical floor for the present value of the expected cash flows. If the expected cash flows are significantly less than the current fair value of the collateral to the lender, it will be more beneficial for the lender to foreclose, unless prior liens or other circumstances make foreclosure impractical. Thus, it is unlikely that any loss realized on the loan will exceed the difference between the recorded loan investment and the current fair value of the collateral.

- **Reasonableness of Underlying Assumptions.** As with any accounting estimate, the auditor should determine that the assumptions underlying the cash flow estimate are reasonable and well supported. For example, if loan payments are funded primarily by operating the collateral, the auditor should assess the reasonableness of the projected future operations of the collateral and likelihood that those operations will produce sufficient funds to cover the client’s estimate of expected cash flows.

If repayment of the loan is expected to come from sale of the collateral and selling costs will affect the proceeds available for repayment, the expected cash flows should be reduced by those selling costs.
Determining the discount rate to be used is much simpler than estimating cash flows. FASB ASC 310-10-35-22 (formerly SFAS No. 114) indicates that the expected cash flows should be discounted to present value using the effective rate of the loan. The effective rate of the loan is the contractual interest rate, adjusted for any premiums, discounts, or deferred loan fees or costs existing at the loan origination (or acquisition) date. If the loan has a floating interest rate, the effective rate should be computed initially using the rate in effect at the date the loan is first considered impaired. For example, if the interest rate on the loan is prime plus 1% and prime at the impairment date is 6%, the effective rate should be the contractual interest rate of 7%, adjusted for deferred loan fees and other factors previously noted. Spreadsheet software or a financial calculator can be used to determine the present value of the expected cash flows.

After a loan is determined to be impaired and a specific allowance or allocation is provided, the present value of future cash flows should be recalculated periodically (at least annually), and the specific allowance should be adjusted accordingly. If the loan has a floating interest rate, there are two options for recalculating the present value of expected cash flows—

- **Adjusted Rate.** Discounted cash flows can be computed using the current effective interest rate at each recalculation date. For example, if the effective interest rate increased from 7% at the beginning of the period to 8% at the end of the period, discounted cash flows can be computed using the 8% effective rate.

- **Constant Rate.** The rate in effect at the date the allowance was provided can be used to compute discounted cash flows at each subsequent date. For example, if the effective interest rate used to calculate the original valuation allowance was 7%, that same rate may be used in future periods to compute discounted cash flows even if rates increase to 8% or more.

The same option should be used for all floating rate loans.

**Example of the Expected Cash Flows Method.** To illustrate the preceding concepts, assume that a financial institution has a commercial loan receivable from a borrower. The loan has a recorded investment as follows:

<table>
<thead>
<tr>
<th>Principal balance</th>
<th>$ 150,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accrued interest receivable</td>
<td>10,000</td>
</tr>
<tr>
<td>Deferred loan fees, net of costs</td>
<td>(8,000)</td>
</tr>
<tr>
<td><strong>Recorded loan investment</strong></td>
<td><strong>$ 152,000</strong></td>
</tr>
</tbody>
</table>

The original payment terms on the loan require annual payments of $25,000, plus interest at 1% over prime. The loan has six years remaining until maturity. The prime rate is currently 9%, resulting in a contractual interest rate of 10%. Exhibit 2-8 shows the payments due under the contractual terms of the loan agreement. The institution collected net loan fees at origination, which increased the effective rate on the loan above 10%. Based on the cash flows shown in Exhibit 2-8, the effective rate on the loan is calculated as 12%, which is the internal rate of return needed to discount the contractual payments to the loan principal balance, net of deferred loan fees, of $142,000.

**Exhibit 2-8**

**Payments Due under Contractual Loan Terms**

<table>
<thead>
<tr>
<th>Year</th>
<th>Principal</th>
<th>Interest</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$ 25,000</td>
<td>$ 15,000</td>
<td>$ 40,000</td>
</tr>
<tr>
<td>2</td>
<td>25,000</td>
<td>12,500</td>
<td>37,500</td>
</tr>
<tr>
<td>3</td>
<td>25,000</td>
<td>10,000</td>
<td>35,000</td>
</tr>
<tr>
<td>4</td>
<td>25,000</td>
<td>7,500</td>
<td>32,500</td>
</tr>
<tr>
<td>5</td>
<td>25,000</td>
<td>5,000</td>
<td>30,000</td>
</tr>
<tr>
<td>6</td>
<td>25,000</td>
<td>2,500</td>
<td>27,500</td>
</tr>
</tbody>
</table>

* * *
The borrower is experiencing financial difficulties, and it is not likely that the borrower can make all of the required loan payments. Based on the borrower’s financial condition and other available information, the institution estimates the cash flows to be received on the loan. Exhibit 2-9 presents those expected cash flows, and the present value of those cash flows at the effective rate of the loan of 12%. Based on those calculations, an allowance of $62,100 is needed to reduce the recorded loan investment of $152,000 to the present value of the expected cash flows of $89,900. The journal entry to record the allowance for this loan is as follows:

\[
\begin{array}{cc}
\text{DR} & \text{CR} \\
\text{Provision for loan losses} & $62,100 \\
\text{Allowance for loan losses} & $62,100 \\
\end{array}
\]

**Exhibit 2-9**

**Expected Cash Flows Discounted at 12%**

<table>
<thead>
<tr>
<th>Year</th>
<th>Expected Cash Flows</th>
<th>Present Value Factor(^a)</th>
<th>Present Value of Cash Flows</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$15,000</td>
<td>.89286</td>
<td>$13,393</td>
</tr>
<tr>
<td>2</td>
<td>20,000</td>
<td>.79719</td>
<td>15,944</td>
</tr>
<tr>
<td>3</td>
<td>25,000</td>
<td>.71178</td>
<td>17,795</td>
</tr>
<tr>
<td>4</td>
<td>25,000</td>
<td>.63552</td>
<td>15,888</td>
</tr>
<tr>
<td>5</td>
<td>25,000</td>
<td>.56743</td>
<td>14,186</td>
</tr>
<tr>
<td>6</td>
<td>25,000</td>
<td>.50663</td>
<td>12,666</td>
</tr>
<tr>
<td>Total</td>
<td>(rounded)</td>
<td></td>
<td>$89,872</td>
</tr>
</tbody>
</table>

**Note:**

\(^a\) The present value factors are obtained from a spreadsheet software. It is assumed that each payment will be received at the end of the year.

\* \* \*

In addition to the entry shown in the previous paragraph, the accrued interest on the loan is reclassified to loans receivable as follows:

\[
\begin{array}{cc}
\text{DR} & \text{CR} \\
\text{Loans receivable} & $10,000 \\
\text{Accrued interest receivable} & $10,000 \\
\end{array}
\]

**Example of Applying the Expected Cash Flows Method in Subsequent Periods.** Assume the same facts as in the previous example. Assume also that the loan performed as expected in the following year, the interest rate remained the same, and there were no changes in expected cash flows from those shown in Exhibit 2-9. The present value of the expected loan payments at the end of the first year would be as follows:
### Present Value Calculation

<table>
<thead>
<tr>
<th>Year</th>
<th>Expected Cash Flows</th>
<th>Present Value Factor</th>
<th>Present Value of Cash Flows</th>
</tr>
</thead>
<tbody>
<tr>
<td>2</td>
<td>$20,000</td>
<td>.89286</td>
<td>$17,857</td>
</tr>
<tr>
<td>3</td>
<td>$25,000</td>
<td>.79719</td>
<td>19,930</td>
</tr>
<tr>
<td>4</td>
<td>$25,000</td>
<td>.71178</td>
<td>17,795</td>
</tr>
<tr>
<td>5</td>
<td>$25,000</td>
<td>.63552</td>
<td>15,888</td>
</tr>
<tr>
<td>6</td>
<td>$25,000</td>
<td>.56743</td>
<td>14,186</td>
</tr>
<tr>
<td></td>
<td><strong>Total</strong></td>
<td></td>
<td><strong>$85,656</strong></td>
</tr>
</tbody>
</table>

(rounded) $85,700

The present value could also be computed by amortizing the prior year’s present value balance as follows:

- Prior year’s present value of expected cash flows $89,900
- Less principal payment made during Year 1 $4,200
- \[15,000 - (89,900 \times 12\%\)]

\[= 4,200 \text{ (rounded)}\]

\[= 85,700\]

After the first year, the allowance should be adjusted to $51,300, which is the difference between the new recorded loan investment of $137,000 [($152,000 – $15,000)], and the new present value of loan payments, $85,700. The journal entry to record the receipt of the loan payment and adjust the allowance is as follows, assuming the total payment received is credited to the loan balance:

**DR** | **CR**
--- | ---
Cash | $15,000
Allowance for loan losses | 10,800
Loans receivable | $15,000
Provision for loan losses | 10,800

Alternatively, $10,800 of the loan payment could be credited to interest income. In that case, the journal entry to record the receipt of the loan payment is as follows:

**DR** | **CR**
--- | ---
Cash | $15,000
Interest income | $10,800
Loans receivable | 4,200

The allowance is not adjusted because the carrying amount of the loan [($152,000 – $4,200) – $62,100] is already equal to the present value of the expected loan payments, $85,700.

The preceding example assumes that there were no changes in expected cash flows or the interest rate used to discount those cash flows. If the cash flows had changed, the present value of expected cash flows should have been recomputed and the allowance adjusted accordingly. If the interest rate changed, the institution could have elected to either recompute the present value using the new rate or continue to use the same effective rate of 12% throughout the remaining life of the loan.

**Estimating Losses Using Aggregate Collection Experience.** For some loans, it may be difficult to determine expected cash flows or the fair value of the collateral. Examples of such situations include the following:

- The borrower is involved in bankruptcy proceedings and the lender is legally prevented from foreclosing to obtain the collateral.
- The loan is unsecured (or the collateral has little or no value to the lender) and the borrower is attempting to restructure other debt to obtain funds to repay the loan.
In situations such as the preceding, loan losses may be estimated using the aggregate experience method. Under this method, the estimated losses are determined using historical experience with similar loans. Best practices indicate that a variety of approaches may be used to compute losses based on aggregate collection experience, as long as they incorporate the following factors:

- Principal and interest cash flows
- Time value of money (that is, discounting)

One way to use aggregate collection experience is to review the cash flows received on similar loans that were charged off during the preceding three to five years. Those cash flows should be discounted to present value (using the average effective rate of the loans currently impaired) and compared to the recorded loan investment in those loans at the date they first became delinquent (or impaired, if more easily determinable). Then an estimated percentage should be calculated as follows:

\[
\frac{1 - \frac{\text{Present value of cash flows collected}}{\text{Recorded loan investment when the loans first became delinquent}}}{\text{Estimated loss percentage}}
\]

If necessary, the estimated loss percentage should be adjusted for changes in risk factors such as those listed in the accounting practices and principles discussion. The loss percentage can then be applied to the recorded investment of each currently impaired loan to estimate the loss on that loan.

To illustrate how a loss can be determined using aggregate collection experience, assume that an institution has impaired commercial business loans with a total recorded investment of $250,000 and an average effective interest rate of 8%. A review of commercial business loans that were charged off during the last five years reveals the following collection experience:

<table>
<thead>
<tr>
<th>Year</th>
<th>Principal</th>
<th>Interest</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$95,000</td>
<td>$71,000</td>
<td>$166,000</td>
</tr>
<tr>
<td>2</td>
<td>$67,000</td>
<td>$48,000</td>
<td>$115,000</td>
</tr>
<tr>
<td>3</td>
<td>$28,000</td>
<td>$13,000</td>
<td>$41,000</td>
</tr>
<tr>
<td>4</td>
<td>$16,000</td>
<td>$2,000</td>
<td>$18,000</td>
</tr>
<tr>
<td>Total</td>
<td>$340,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Recorded loan investment when the loans first became delinquent $830,000

The present value of the estimated cash flows at 8%, the average effective rate of the impaired loans, is as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Expected Cash Flows</th>
<th>Present Value Factor&lt;sup&gt;a&lt;/sup&gt;</th>
<th>Present Value of Cash Flows (Rounded)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$166,000</td>
<td>.92593</td>
<td>$153,700</td>
</tr>
<tr>
<td>2</td>
<td>115,000</td>
<td>.85734</td>
<td>98,600</td>
</tr>
<tr>
<td>3</td>
<td>41,000</td>
<td>.79383</td>
<td>32,500</td>
</tr>
<tr>
<td>4</td>
<td>18,000</td>
<td>.73503</td>
<td>13,200</td>
</tr>
<tr>
<td>Total</td>
<td>$340,000</td>
<td></td>
<td>$298,000</td>
</tr>
</tbody>
</table>
Note:

a These present value factors came from a spreadsheet software calculation. Theoretically, the present value factor should be an average factor for the period. However, end of period factors are used for simplicity and conservatism.

The estimated loss percentage is as follows:

\[ 1 - \frac{298,000}{830,000} = 64.1\% \]

The specific allowance for the impaired commercial business loans is computed as follows:

<table>
<thead>
<tr>
<th>Recorded investment in impaired loans</th>
<th>$ 250,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Estimated loss percentage</td>
<td>% 64.1%</td>
</tr>
<tr>
<td>Specific allowance (rounded)</td>
<td>$ 160,300</td>
</tr>
</tbody>
</table>

FASB ASC 310-10-35-21 (formerly SFAS No. 114) states that loans with similar risk characteristics can be aggregated. One possible method is to aggregate them by loan type. For example, commercial business loans can generally be aggregated, but they should be grouped separately from commercial real estate loans.

**Classifying Impaired Loans.** As discussed previously, an institution’s allowance for loan losses has several components, including specific allowances relating to impaired loans and allowances relating to classified loans. The auditor may wish to incorporate impaired loans into the classification system. When this is done, the amount of the specific allowance should be classified as an impairment loss, and the remaining balance may be classified as substandard or unclassified. The amounts classified substandard would then be considered in determining the allowance for substandard loans discussed later in this lesson.

**Specific Allowances for Loans Not Reviewed**

In many audits, the client will establish specific allowances on loans that are below the auditor’s scope, and thus are not reviewed. Generally, in those circumstances, the auditor can review the client’s calculations of those specific allowances and, if appropriate, include those allowances in the auditor’s calculation of the allowance for specific loans.
SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

19. Summer, an auditor, is engaged to audit Cent-worthy Bank. One of the most time-consuming parts of her audit will be performing loan reviews. Which of the following statements best describes this process?
   a. The primary function of loan reviews is to determine specific allowances for loans.
   b. Loan reviews support loan confirmation procedures.
   c. Loan reviews should cover single-family residential loans and consumer loans.
   d. Loan selection should be based on lending relationships.

20. When selecting loans for review, one category of loans Summer plans to focus on is problem loans. Which of the following loans should Summer select for detailed review as part of this category?
   a. A loan exceeding the tolerable misstatement amount.
   b. A loan that is part of an industry concentration.
   c. A loan that is either new or renewed.
   d. A loan to a business in an economically depressed community.

21. As part of her loan reviews, Summer examines documentation in the loan files related to payment history, financial statements, and credit reports. This documentation provides evidence for which of the following?
   a. Legal obligation.
   b. Loan authorization.
   d. Personal guarantees.

22. Highland Mutual has loans with closely held businesses in its loan portfolio. Some of those loans have personal guarantees attached. Tabitha, an auditor, is engaged to audit Highland Mutual. Assuming all other conditions are met, Tabitha can determine that it is appropriate for the financial institution to rely on a personal guarantee for which of the following loans?
   a. Loan A’s file includes a written opinion from the borrower’s legal counsel that says the guarantee is legally enforceable.
   b. Highland Mutual has a history of not enforcing guarantees similar to the one associated with Loan B.
   c. The personal guarantee for Loan C is limited to 5% of the loan balance.
   d. The guarantor for Loan D has liquid assets equal to 20% of the loan commitment.
23. While performing loan reviews as part of her audit of Highland Mutual, Tabitha discovers a loan for which the collateral’s physical condition has declined. She has already determined the risk that the borrower will default on the loan is low. What additional procedures, if any, should Tabitha perform?

a. Her initial reading of the appraisal should be sufficient; Tabitha does not need to perform additional procedures.

b. Tabitha should get an approximate value of the collateral and the collateral margin in case there is a collateral shortfall.

c. Tabitha should perform a detailed review of the appraisal and assess the probability that the collateral has declined in value.

d. Tabitha should obtain sufficient additional information to allow her to estimate the collateral’s value.

24. One of the loans Tabitha selects for review is a loan that she reviewed in detail during the previous year’s audit of Highland Mutual. Tabitha determines that, because the loan has not been renewed, modified, or refinanced during the current year, she does not need to perform a detailed reading of the note or the loan agreement. She will review information that may change from year to year. This loan is collateralized by inventory. What should Tabitha review with respect to this loan’s collateral?

a. The borrower’s financial information.

b. Evidence that the borrower paid its taxes for the current year.

c. A recent copy of the borrower’s aged trial balance.

d. Evidence that the borrower has insurance.

25. Paul, an auditor, is engaged to audit the Fairview Credit Union. Which of the following considerations, unique to credit unions, will affect his audit?

a. Credit union loan portfolios are generally made up of member business loans.

b. Reviewing credit union loans will take longer than reviewing loans from other types of financial institutions.

c. Credit unions may need higher general reserves than other types of financial institutions.

26. Arthur, an auditor, is engaged to audit Ocean City Bank. As part of the audit, Arthur reviews an impaired loan for which foreclosure is likely. What method should Arthur use to estimate the loss allowance for this loan?

a. Fair value of the collateral.

b. Expected cash flows from the loan.

c. Aggregate collection experience.

d. Market value of the loan.

27. Ocean City Bank has an impaired loan, and the expected cash flows method was used to determine its loss allowance. Arthur will review this loan as part of his audit of Ocean City Bank. Which of the following statements best describes this scenario?

a. Expected cash flows should have been determined as of the loan origination date.

b. The loan’s effective rate is the contractual interest rate, unadjusted.

c. Arthur’s assessment of this method’s reasonableness should include the contractual terms in the loan agreement.

d. If a floating interest rate is involved, the constant rate should have been used.
28. When using the aggregate collection experience to estimate the value of impaired loans, can a financial institution consider loans together as a group?

a. Yes.

b. No.
SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. (References are in parentheses.)

19. Summer, an auditor, is engaged to audit Centworthy Bank. One of the most time-consuming parts of her audit will be performing loan reviews. Which of the following statements best describes this process? (Page 61)

a. The primary function of loan reviews is to determine specific allowances for loans. [This answer is incorrect. Their primary function is to enable the auditor to obtain information to assess the collectability of significant loans. This information is then used in determining specific allowances and allowances relating to classified loans.]

b. Loan reviews support loan confirmation procedures. [This answer is correct. Loan reviews provide evidence regarding the existence of loans receivable. Thus, they support loan confirmation procedures.]

c. Loan reviews should cover single-family residential loans and consumer loans. [This answer is incorrect. Generally, loan reviews cover commercial business and commercial real estate loans. They should also cover participations purchased on these loans. Single-family residential loans and consumer loans are generally assessed on a loan pool basis.]

d. Loan selection should be based on lending relationships. [This answer is incorrect. In selecting loans for review, the auditor may base his or her selection either on individual loans or on lending relationships. Lending relationships cover all loans and extensions of credit to a given borrower.]

20. When selecting loans for review, one category of loans Summer plans to focus on is problem loans. Which of the following loans should Summer select for detailed review as part of this category? (Page 61)

a. A loan exceeding the tolerable misstatement amount. [This answer is incorrect. Large loans (loans or lending relationships that exceed a certain dollar amount) are usually selected for detailed review; however, they are not necessarily considered problem loans merely because they are large. The cutoff amount for a large loan depends on the percentage of coverage desired. As a rule of thumb, the auditor may use tolerable misstatement as the initial cutoff for large loans and then select smaller loans if additional coverage is desired.]

b. A loan that is part of an industry concentration. [This answer is incorrect. Auditors may select certain other types of loans for detailed loan review, such as loans to affiliates, loans listed on documentation or compliance exception reports, or loans that are part of an industry or other credit concentration. However, these other types of loans are not necessarily considered problem loans.]

c. A loan that is either new or renewed. [This answer is incorrect. A number of new and renewed loans may be selected to determine the quality of the institution's documentation and lending practices. However, a loan is not considered a problem loan merely because it is new or renewed.]

d. A loan to a business in an economically depressed community. [This answer is correct. The term problem loans refers to any loan with a significant risk of impairment. Examples of problem loans include (1) delinquent or nonaccrual loans, (2) loans classified by management or on internal watch lists, (3) loans in which the underlying collateral may have significantly declined in value or profitability, and (4) loans to businesses in economically depressed industries or communities.]
21. As part of her loan reviews, Summer examines documentation in the loan files related to payment history, financial statements, and credit reports. This documentation provides evidence for which of the following? (Page 66)

   a. Legal obligation. [This answer is incorrect. One of the auditor’s most important goals in performing a loan review is to determine whether the borrower has a legal obligation to repay the debt. This legal obligation can usually be supported by examining the original signed note and related loan agreement.]

   b. Loan authorization. [This answer is incorrect. Loan files should normally contain evidence that the loans have been properly approved in accordance with the financial institution’s lending policies. Examples of forms of loan authorization include memorandum signed by the loan officer, initials of loan officer and president on the loan summary sheet, or copy of resolution by the board of directors or loan committee.]

   c. Borrower performance. [This answer is correct. In evaluating the collectability of a loan, auditors normally assess two sources of repayment. The first, and most important, is the borrower’s cash flow. The auditor should evaluate both the willingness and the ability of the borrower to make the required debt service payments. Factors to consider in making that evaluation include (1) payment history, (2) financial statements, and (3) credit reports.]

   d. Personal guarantees. [This answer is incorrect. Personal guarantees are obtained in many situations involving loans to closely-held businesses. For loans that have been personally guaranteed, the loan files generally contain documentation of those guarantees and financial information of the guarantors.]

22. Highland Mutual has loans with closely held businesses in its loan portfolio. Some of those loans have personal guarantees attached. Tabitha, an auditor, is engaged to audit Highland Mutual. Assuming all other conditions are met, Tabitha can determine that it is appropriate for the financial institution to rely on a personal guarantee for which of the following loans? (Page 68)

   a. Loan A’s file includes a written opinion from the borrower’s legal counsel that says the guarantee is legally enforceable. [This answer is correct. The definition of legal enforceability requires a legal opinion, while the practicality of enforcement is a matter of judgment. The opinion of legal counsel is often considered in determining the legal enforceability of a guarantee. Normally, a written opinion about enforceability is obtained from either the borrower’s or lender’s counsel before the loan is closed, and a copy of the opinion is placed in the loan file.]

   b. Highland Mutual has a history of not enforcing guarantees similar to the one associated with Loan B. [This answer is incorrect. If the lender does not intend to enforce a guarantee, then it should not be considered in estimating the amount of loss expected to be incurred on a guaranteed loan. On the other hand, if the lender intends to enforce the guarantee and has a history of enforcing them, guarantees might be considered.]

   c. The personal guarantee for Loan C is limited to 5% of the loan balance. [This answer is incorrect. Personal guarantees are sometimes limited to a specified amount or percentage of the loan balance. As a rule of thumb, the guarantee should usually cover at least 20% of the loan commitment for enforcement to be practical.]

   d. The guarantor for Loan D has liquid assets equal to 20% of the loan commitment. [This answer is incorrect. In order for a personal guarantee to be effective, the guarantor must have the ability to perform. As a rule of thumb, a guarantor should have resources of the following amounts for the guarantee to be reliable: (1) the guarantor’s net worth should be equal to at least 30% of the loan commitment and (2) the guarantor should have unencumbered liquid assets equal to at least 25% of the loan commitment.]
23. While performing loan reviews as part of her audit of Highland Mutual, Tabitha discovers a loan for which the collateral’s physical condition has declined. She has already determined the risk that the borrower will default on the loan is low. What additional procedures, if any, should Tabitha perform? (Page 70)

   a. Her initial reading of the appraisal should be sufficient; Tabitha does not need to perform additional procedures. [This answer is incorrect. This would be the case if the loan had a low risk of default and the original appraisal on the collateral was reliable. Tabitha will need to perform additional procedures based on the facts in this scenario.]

   b. Tabitha should get an approximate value of the collateral and the collateral margin in case there is a collateral shortfall. [This answer is correct. If, after reading the appraisal, the auditor determines there is a low risk of default and the appraisal is unreliable (as is the case in this scenario), the collateral margin for the loan should be assessed. Because the physical condition of the collateral in this scenario has declined, its value probably has also. Tabitha does not have to make a detailed estimate of the collateral’s value. The purpose of the additional procedures is to gain a general understanding of the approximate value of the collateral and thus the collateral margin for the loan. If the collateral margin is still adequate, despite any decline in value, no further procedures are generally necessary. However, if a collateral shortfall exists, Tabitha may need to consider the loan when estimating the allowance for loan losses.]

   c. Tabitha should perform a detailed review of the appraisal and assess the probability that the collateral has declined in value. [This answer is incorrect. This would be the case if there was a high risk of default on the loan and the appraisal was reliable. Both of those conditions do not exist in this scenario.]

   d. Tabitha should obtain sufficient additional information to allow her to estimate the collateral’s value. [This answer is incorrect. This would be the case if there was a high risk of default on the loan and the appraisal was considered unreliable. Both of those conditions do not exist in this scenario.]

24. One of the loans Tabitha selects for review is a loan that she reviewed in detail during the previous year’s audit of Highland Mutual. Tabitha determines that, because the loan has not been renewed, modified, or refinanced during the current year, she does not need to perform a detailed reading of the note or the loan agreement. She will review information that may change from year to year. This loan is collateralized by inventory. What should Tabitha review with respect to this loan’s collateral? (Page 72)

   a. The borrower’s financial information. [This answer is incorrect. Borrower and guarantor financial information needs to be reviewed for all recurring engagements, as it might change from year to year. However, review of this information is not related to the loan’s collateral. Tabitha will need to review other documentation for this limited review, as well.]

   b. Evidence that the borrower paid its taxes for the current year. [This answer is incorrect. Tabitha would only need to review this documentation for a real estate loan.]

   c. A recent copy of the borrower’s aged trail balance. [This answer is incorrect. Tabitha would only need to review this documentation if the loan was collateralized by accounts receivable.]

   d. Evidence that the borrower has insurance. [This answer is correct. For loans collateralized by inventory, even when performing a limited document inspection on a recurring engagement, Tabitha should review current inventory listings or periodic inspection reports and evidence of insurance. Evidence of insurance should also be reviewed if the loan is secured by equipment.]

25. Paul, an auditor, is engaged to audit the Fairview Credit Union. Which of the following considerations, unique to credit unions, will affect his audit? (Page 73)

   a. Credit union loan portfolios are generally made up of member business loans. [This answer is incorrect. Credit union loan portfolios are generally composed of small consumer loans. There are generally few, if any, member business loans. Any loans that exceed tolerable misstatement are likely to be single-family residential loans. These characteristics will affect Paul’s audit approach.]
b. Reviewing credit union loans will take longer than reviewing loans from other types of financial institutions. [This answer is incorrect. Since most credit unions have many smaller consumer loans in addition to mortgage loans, the documentation in these loan files will generally be less extensive than that for other types of financial institutions. Accordingly, the time needed to review a credit union loan file is generally less. Those loan files typically include, at a minimum, an application, note, credit report, collateral description, title or deed, and insurance information.]

c. Credit unions may need higher general reserves than other types of financial institutions. [This answer is correct. In many credit unions, there is little or no follow-up information on the loan after the initial loan is issued. The collection documentation concerning a loan will generally be a collection of manager’s notes regarding discussions with the delinquent member. Thus, it may be difficult to assess the prospects for collection on an individual loan. Higher general reserves may be needed because of the uncertainties relating to specific reserves.]

26. Arthur, an auditor, is engaged to audit Ocean City Bank. As part of the audit, Arthur reviews an impaired loan for which foreclosure is likely. What method should Arthur use to estimate the loss allowance for this loan? (Page 75)

a. Fair value of the collateral. [This answer is correct. According to FASB ASC 310-10-35, the fair value of the collateral should be used if foreclosure is likely, as in this scenario. This method can also be used if the collateral is expected to be the sole source of repayment.]

b. Expected cash flows from the loan. [This answer is incorrect. According to FASB ASC 310-10-35, this method should be used if both of the following conditions are met: (1) foreclosure is not probable and (2) cash flows can be reasonably estimated. In this example, foreclosure is likely.]

c. Aggregate collection experience. [This answer is incorrect. Under FASB ASC 310-10-35, this method should be used if neither the fair value of the collateral nor the expected cash flows from the loan can be used. There is a better method that can be used based on the facts in this scenario.]

d. Market value of the loan. [This answer is incorrect. This method is rarely used, and there is a better method under FASB ASC 31-10-35 that can be used in this scenario.]

27. Ocean City Bank has an impaired loan, and the expected cash flows method was used to determine its loss allowance. Arthur will review this loan as part of his audit of Ocean City Bank. Which of the following statements best describes this scenario? (Page 76)

a. Expected cash flows should have been determined as of the loan origination date. [This answer is incorrect. FASB ASC 310-10-35-22 indicates that the expected cash flows should be discounted to present value using the effective rate of the loan.]

b. The loan’s effective rate is the contractual interest rate, unadjusted. [This answer is incorrect. Under FASB ASC 310-10-35, the effective rate of the loan is the contractual interest rate, adjusted for any premiums, discounts, or deferred loan fees or costs existing at the loan origination (or acquisition) date.]

c. Arthur’s assessment of this method’s reasonableness should include the contractual terms in the loan agreement. [This answer is correct. Estimating cash flows requires making subjective judgments about several uncertainties. The auditor’s position is difficult because the client’s judgments in these situations often are not objectively verifiable. Consequently, the auditor must assess the reasonableness of the client’s judgments based on available information about the loan and other data. Factors Arthur should consider include (1) the contractual terms of the loan agreement, (2) existing arrangements with borrowers for repayment, (3) fair value of the collateral, and (4) reasonableness of underlying assumptions.]

d. If a floating interest rate is involved, the constant rate should have been used. [This answer is incorrect. If the loan has a floating interest rate, there are two options for recalculating the present value of future cash flows—the adjusted rate and the constant rate. The same option should be used for all floating rate loans.]
28. When using the aggregate collection experience to estimate the value of impaired loans, can a financial institution consider loans together as a group? (Page 81)

a. Yes. [This answer is correct. FASB ASC 310-10-35-21 states that loans with similar risk characteristics can be aggregated.]

b. No. [This answer is incorrect. Under FASB ASC 310-10-21, aggregation is allowed under certain circumstances. One possible method is to aggregate them by loan type. For example, commercial business loans can generally be aggregated, but they should be grouped separately from commercial real estate loans.]
THE ALLOWANCE FOR LOAN LOSSES OTHER THAN SPECIFIC ALLOWANCES

After estimating allowances on specific loans (and related liability for losses on off-balance-sheet credit instruments), the auditor should determine the amounts needed for other loans and credit risk exposures that were not specifically reviewed, including:

- Classified loans other than those with specific allocations.
- Loans evaluated on a pool basis (such as single-family residential loans, installment loans, and other consumer loans).
- Other loan losses inherent in the portfolio.

The following paragraphs explain how to assess each of those allowances.

Estimating Losses on Classified Loans

The classification system that is typically used by financial institutions to determine their allowances for loan losses was discussed earlier in this lesson. Under this system, loans are classified as loss, doubtful, substandard, or unclassified. These terms are defined in Exhibit 21. Under the system provided by this course, impaired loans (as defined previously) are identified based on the results of detailed loan reviews. During these reviews, specific allowances are determined for each impaired loan as described earlier in this lesson. The suggested classification of impaired loans was also discussed earlier in this lesson.

The next step in the approach involves classifying the following amounts as either substandard or unclassified:

a. The remaining balance of each impaired loan that was not specifically reserved.

b. Each reviewed loan that was not considered to be impaired.

Proposed Guidance. The FASB has issued an exposure draft, Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses, which would require enhanced disclosures about the allowance for credit losses and the credit quality of financing receivables. Financing receivables are loans with a contractual right to receive money on demand or on fixed or determinable dates that are recognized as an asset, whether originated or acquired. The Board decided to provide a delayed effective date of the final Accounting Standards Update (ASU) for nonpublic entities. The final ASU (once it is issued) will be effective for nonpublic entities for annual reporting periods ending after December 15, 2011. For all other entities, the final ASU will be effective for interim and annual reporting periods ending after December 15, 2010. Disclosures for earlier periods presented for comparative purposes will not be required at initial adoption for any entities. Early application would be encouraged. The FASB expects to issue a final ASU in the second quarter of 2010. Readers should be alert for a possible ASU. Future editions of this course will provide updates on this proposed guidance.

Determining the Loss Percentage for Substandard Loans. As a practical matter, the only difference between an unclassified and a substandard loan is that a relatively small general allowance (as explained later in this lesson), will be applied to an unclassified loan, while a higher allowance percentage will be applied to a substandard loan. As discussed previously, current loss percentages for substandard loans should be based on historical loss percentages, with adjustments based on such factors as the following:

- Nature of loans in the category.
- Current and anticipated economic conditions that may affect the borrowers’ ability to pay.
- Trends in volume and terms of loans.
- Levels of and trends in recoveries of prior charge-offs.
- Effects of any changes in lending policies and procedures.
- Ability and experience of lending management and other lending personnel.
- Collateral values.
- Degree of uncertainty with respect to estimates of potential losses for loans in each classification (for example, because of lack of current financial information about the borrower or collateral values).
- Levels of and trends in delinquencies, impaired loans, and loan losses.
- Credit concentrations and other risk factors affecting the portfolio.

Loss percentages for substandard loans vary among different financial institutions and different auditors but, in many instances, they range from 10% to 25%.

During 2009, several regulatory agencies issued guidance emphasizing the need to consider the current economic conditions and how those conditions may impact the borrower’s ability to pay. During periods of increasing or decreasing losses, the use of historical loss rates should be supplemented with other methods that use more leading data. Qualitative factors should be applied to specific loan portfolio segments rather than application to the entire loan portfolio, which may distort the factor’s impact.

Auditors may use one of the following methods to estimate losses on substandard loans.

- **Independent Percentages.** Some auditors use standard percentages, for example 15%, for all financial institution clients. Others determine their own percentages based on the client’s historical loss percentages and the factors noted in the preceding paragraph.

- **Review Management’s Percentages.** The auditor may choose to use the client’s loss percentage instead of determining an independent percentage. This alternative can be used when the auditor’s experience with the client and other evidence indicates that management’s percentages are appropriate and generally reliable.

**A Word of Caution.** DEP, paragraph 9.21, cautions auditors to be alert to the risk that management may place inappropriate reliance on specified percentages to evaluate the allowance for certain loan losses. Instead of applying the judgment necessary to determine loan loss adequacy, management may use arbitrary percentages to determine the allowance for loan losses. For example, management may use industry average loss percentages applied to loan classifications. The use of these averages does not consider an institution’s underwriting and collection practices, portfolio composition, credit-rating policies and other significant differences between institutions. In such instances, DEP recommends the auditor ask management to justify that loan loss allowances have been established in conformity with GAAP.

**Using the Client’s Substandard Classification for Loans Not Reviewed.** In many audits, the client will classify loans as substandard that are below the auditor’s scope for detailed review. Depending on the auditor’s confidence in the client’s internal loan classification system, the auditor may apply the appropriate substandard loss percentage to loans classified by the client as well as those classified by the auditor. Factors to consider in assessing the reliability of the client’s classification system include the following:

- **Experience with the Client in Current and Prior Audits.** If the auditor’s classifications are the same as the client’s for the loans that were reviewed, the auditor can usually conclude that the remaining loans are classified properly.

- **Regulatory Examinations.** Examiners usually perform their own independent classifications of loans, and the results are included in their reports. They may also comment on the client’s internal classification procedures. Significant or numerous criticisms of loans or procedures may indicate that the client’s classification procedures are inadequate.
• Internal Loan Reviews. If the institution has effective internal loan review policies and procedures, the reviewer’s reports may be useful in assessing the reliability of management’s classification procedures.

Estimating Losses on Loan Pools

As discussed earlier in this lesson, the allowance for loan losses may include a component relating to loans that are evaluated in homogeneous pools. Examples of loans that may be evaluated in pools include—

• Single-family residential loans.
• Installment loans.
• Other consumer loans.

Each loan pool is evaluated in the aggregate rather than loan-by-loan. Because they usually do not have large commercial loans, estimating losses based on loan pools is the primary method used by credit unions.

Although the methods prescribed in FASB ASC 310-10-35 (formerly SFAS No. 114) can be used to estimate losses on loan pools, they are not required and can be difficult to apply. Normally, the allowance component for each loan type is determined based on historical loss percentages, adjusted for such factors as:

• Levels of and trends in delinquencies, impaired loans, and average losses per loan.
• Credit concentrations or other factors affecting the portfolio.
• Trends in volume and terms of loans.
• Levels of and trends in recoveries of prior charge-offs.
• Ability and experience of lending management and other lending personnel.
• Remaining lives of loans.
• Effects of any changes in lending policies and procedures.
• Current and expected economic conditions.
• Collateral values.

As discussed previously, regulatory agencies have emphasized the adjustment factor for current and expected economic conditions. In August 2009, the FDIC issued FDIC Financial Institutions Letter FIL43-2009, Allowance for Loan and Lease Losses: Residential Mortgages Secured by Junior Liens, to remind financial institutions that the appropriate historical loss rate for each group of junior lien loans with similar characteristics should be adjusted for current qualitative or environmental factors that are likely to cause the estimated credit losses on these loans as of the allowance evaluation date to differ from the group’s historical loss experience.

In auditing this component of the allowance, it may be more efficient to evaluate the client’s procedures and the reasonableness of the client’s estimates rather than to perform an independent calculation. However, the auditor should test any key assumptions or information used by the client in estimating this allowance.

Special Considerations for Insured or Guaranteed Loans. As noted in Lesson 1, some single-family residential loans are insured or guaranteed by the FHA, VA, or private mortgage insurers. Those loans typically have a lower risk of loss than uninsured loans. Accordingly, the auditor may decide to split single-family residential loans into insured and uninsured pools. Then separate loss percentages could be computed and applied to each pool. However, a simpler approach is to use a single pool for both insured and uninsured loans, and adjust the loss percentage based on the relative size of the insured portfolio. Using this approach, the loss percentage may be reduced in periods when the proportionate amount of insured loans is higher than normal.
Special Considerations for Installment Loans Purchased from Dealers. As discussed in Lesson 1, financial institutions sometimes purchase installment loans from dealers under indirect lending agreements. These agreements may provide full or limited recourse to the dealer if a borrower defaults. Recourse provisions normally are backed by reserve funds established by the dealer with the financial institution. When a significant amount of the installment loans are loans purchased with recourse from a specific dealer, the auditor may wish to evaluate the recourse loans as a separate pool. The loss percentage for the pool of recourse loans should generally be determined considering the following factors (in addition to those listed earlier in this discussion):

- Size of the current dealer reserve.
- The dealer’s willingness and ability to honor its recourse obligations if the dealer reserve is exhausted.

The recourse provisions should be ignored in determining the loss percentages if (a) the dealer reserve is relatively small and (b) the dealer does not appear to have the willingness or ability to honor its recourse obligations.

Estimating the General Component of the Allowance for Loan Losses

In most cases, the auditor should consider establishing a general component of the allowance for loan losses. (Some auditors refer to this component as the general reserve.) The general component allows for the imprecision inherent in estimating loan losses. It recognizes that there are usually additional unidentified losses in the loan portfolio, even after the auditor has completed the detailed loan reviews and other procedures previously discussed. The general component may be estimated as a specific amount or as a percentage of the loan portfolio. Regardless of the method used, the component should be based on consideration of the relevant factors such as—

- The risk of material misstatement of the other components of the allowance.
- Specific risk exposures in the loan portfolio, such as concentrations in specific industries.

The auditor may independently estimate the general component of the allowance. However, it may be more efficient to assess the appropriateness of management’s procedures and the reasonableness of its estimate.

Regulatory Guidance Related to the Unallocated Portion of an Allowance Account. As discussed at the beginning of this lesson, in December 2006, the federal financial institution regulatory agencies issued a revised Interagency Policy Statement on the Allowance for Loan and Lease Losses (ALLL). The policy statement revises and replaces the banking agencies’ 1993 policy statement on the ALLL to ensure consistency with GAAP and more recent supervisory guidance. In addition, the agencies issued a supplemental Frequently Asked Questions (FAQs) document to assist institutions in complying with GAAP and ALLL supervisory guidance. One of the questions in the FAQs specifically addresses the issue of unallocated reserves. The regulators’ answer refers to the guidance given in past financial institution letters and discusses specific items necessary to support the unallocated portion of the allowance. The guidance in the FAQs indicates a financial institution may have an amount labeled as “unallocated” as long as it reflects estimated credit losses determined in accordance with GAAP and is properly supported. The FAQs document specifically states the following:

... it is management’s objective evidence, analysis, and documentation that determine whether an “unallocated” amount is an acceptable part of the ALLL under GAAP. Appropriate support for any amount labeled “unallocated” within the ALLL should include an explanation for each component of the “unallocated” amount, including how the component has changed over time based upon changes in the environmental factor that gave rise to the component. In general, each component of any “unallocated” portion of the ALLL should fluctuate from period to period in a manner consistent with the factors giving rise to that component (i.e., directional consistency).

Overall Assessment of the Recorded Allowance

After assessing the separate components of the allowance for loan losses, the auditor should assess the reasonableness of the allowance as a whole. Typically, the overall assessment is made by comparing the auditor’s independent estimate of the total allowance to the recorded allowance. In addition, DEP requires the auditor to
perform analytical tests to determine the reasonableness of the recorded allowance. To avoid duplication of procedures, the auditor should coordinate these analytical procedures with similar analytical tests performed during the performance of risk assessment procedures. Lesson 1 discusses analytical techniques generally performed during the performance of risk assessment procedures.

If the auditor’s estimate differs from the recorded allowance, the auditor should consider the following:

a. **Make a Preliminary Assessment of the Significance of the Audit Difference.** In many financial institution audits, the largest audit difference is the difference relating to the allowance for loan losses. Thus, although not required by GAAS, it is normally more efficient to make a preliminary assessment of the significance of that audit difference instead of merely recording it for consideration at the end of the audit. The auditor should consider the potential effect of that audit difference on the financial statements taken as a whole and on items such as pre-tax income and regulatory capital.

b. **Reconsider the Precision of the Auditor’s Estimate.** If the audit difference relating to the allowance is minimal, the auditor can merely record it on the summary of audit differences, as discussed in item c. However, if the audit difference is significantly large (for example, if it exceeds one-third of tolerable misstatement), the auditor should reconsider the assumptions used to estimate the allowance before recording the audit difference or adjustment. For example, the auditor may decide to perform a more detailed analysis of one of the components of the allowance (such as the loss experience relating to classified loans). It may also be appropriate to discuss the auditor’s preliminary conclusions with the client to determine whether the client has additional information that might change some of the assumptions and estimates used. Based on that reconsideration, the auditor should revise the estimated allowance as needed. However, in many situations, the auditor will conclude that the estimated allowance is appropriate.

c. **Record an Immaterial Audit Difference on the Summary of Audit Differences.** If the audit difference is immaterial by itself, it should be recorded on the summary of audit differences to determine whether that difference, in addition to other audit differences, could result in material misstatement of the financial statements.

d. **Propose an Adjustment for a Material Audit Difference.** If the difference will result in the financial statements being materially misstated, the auditor should make an audit adjustment or qualify the auditor’s report.

The auditor’s conclusions regarding the recorded allowance for loan losses are normally documented in a memorandum. The case study in Lesson 3 illustrates the concepts discussed here.

Although not required, some auditors establish a range of reasonable amounts for the allowance rather than a single estimated amount. In those situations, the auditor determines whether the recorded allowance falls within the estimated range. If the recorded allowance is within that range, the auditor can conclude that the recorded amount is acceptable and no further procedures are necessary. If the recorded allowance is outside the reasonable range, the audit difference is the difference between the recorded allowance and the closest end of the auditor’s range. For example, if the estimated range is $200,000 – $250,000 and the recorded allowance is $175,000, the audit difference is $25,000 ($200,000 – $175,000). The audit difference should be evaluated as discussed in the preceding paragraph.

DEP states that the auditor should be skeptical if differences exist between the amount of loan loss allowance estimated by management for regulatory purposes and for GAAP. Any such differences must be justified based on the particular facts and circumstances.

**Special Considerations for Credit Union Audits**

Since most credit unions are relatively small, their procedures for evaluating the allowance for loan losses are typically less formal than in other financial institutions. Also, many credit unions lack the staff and computer resources necessary to keep detailed records of charge-offs by loan type. In these situations, the auditor may need to develop independent estimates of allowances for loan pools and general allowances instead of testing management’s procedures.
Considerations for Interim Audit Procedures

In many financial institution audits, the allowance for loan losses is audited at an interim date. The guidance provided earlier in this lesson generally applies regardless of whether the procedures are performed at year end or at an interim date. However, there are two primary factors to consider if the procedures are performed at an interim date:

1. No audit difference should be recorded and no audit adjustment should be made until the balance sheet date, and that difference should be determined based on the recorded allowance at the balance sheet date.
2. Additional procedures must be performed to extend the auditor’s conclusions regarding the allowance for loan losses to the balance sheet date, as discussed in the following paragraphs.

At year end, the auditor performs updating procedures to extend interim conclusions to year end. Exhibit 2-10 shows common updating procedures for the allowance for loan losses. The auditor should make another independent calculation of the allowance using information obtained from the both the interim and the updating procedures. The auditor’s primary focus in updating the interim audit of the allowance is to determine whether there have been any significant changes in the condition of the loan portfolio since the interim date.

**Exhibit 2-10**

**Examples of Updating Procedures Relating to the Allowance for Loan Losses**

1. Examine loan files for all loans reviewed at interim to determine whether there have been any significant changes in the credit risk of the loan. Revise specific allowances and classifications as necessary.
2. Review any additional loans not previously reviewed that now fall within the scopes established at interim. Classify the additional loans and determine specific allowances as necessary.
3. Reconsider the adequacy of the extent of detailed loan reviews using the factors discussed in the “Assessing the Adequacy of the Extent of Detailed Loan Reviews” paragraph.
4. Recompute the allowance for classified loans using the auditor’s revised classifications and the client’s classifications for loans that were not reviewed. If necessary, adjust the loss percentages used at interim for changes in economic conditions or other factors. Also, assess whether the client has appropriately classified loans that were not specifically reviewed by the auditor, as discussed in this lesson.
5. Recompute the allowance for loan pools. If necessary, adjust the loss percentages used at interim for changes in economic conditions or other factors.
6. Recompute the general component of the allowance for loan losses. If necessary, adjust the loss percentage used at interim for changes in economic conditions or other factors.
7. Reperform interim overall analytical procedures as of the balance sheet date.
8. Compare the auditor’s estimate of the total allowance for loan losses to the recorded allowance. Evaluate the recorded allowance as discussed earlier in this lesson.

*  *  *
SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

29. Collin, an auditor, is engaged to audit Fifth National Bank (FNB). Neither Collin nor his firm have prior experience with FNB. As part of his audit, he must determine the loss percentage for any substandard loans. Collin discovers that FNB’s management applies industry average loss percentages to loan classifications to determine its allowance for loan losses. Which method would be the most acceptable for Collin to use to estimate losses on FNB’s substandard loans?

   a. Independent percentages.
   b. Management’s percentages.

30. FNB’s allowance for loan losses includes a component related to loans evaluated in pools. These loans are evaluated in the aggregate. How Collin should proceed with this part of the audit?

   a. Collin should estimate the allowance for these loans using the methods provided in FASB ASC 310-10-35.
   b. Collin should estimate the allowance for all aggregated loans as a single amount based on historical percentages.
   c. Collin should apply a small general allowance to these types of loans.
   d. When estimating the allowance, Collin should take into account factors such as the remaining lives of the loans.

31. Collin plans to establish a general reserve as part of FNB’s allowance for loan losses. How should he proceed?

   a. Collin should base the general reserve on the tolerable misstatement.
   b. Collin should base the general reserve on specific risk exposures that affect the portfolio.
   c. Collin should base the general reserve on his detailed loan reviews.
   d. Collin should establish the general reserve based on his and FNB’s management’s judgment. It does not need specific support.

32. When assessing the reasonableness of FNB’s allowance for loan losses as a whole, Collin discovers that his estimate differs from the recorded allowance. However, he determines that the difference is immaterial. How should Collin address this finding in his audit?

   a. He should reconsider the precision of his estimate
   b. He should record it on the summary of audit differences.
   c. He should propose an adjustment.
SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. (References are in parentheses.)

29. Collin, an auditor, is engaged to audit Fifth National Bank (FNB). Neither Collin nor his firm have prior experience with FNB. As part of his audit, he must determine the loss percentage for any substandard loans. Collin discovers that FNB’s management applies industry average loss percentages to loan classifications to determine its allowance for loan losses. Which method would be the most acceptable for Collin to use to estimate losses on FNB’s substandard loans? (Page 92)

   a. Independent percentages. [This answer is correct. DEP cautions auditors to be alert to the risk that management may place inappropriate reliance on specified percentages to evaluate the allowance for certain loan losses. Instead of applying the judgment necessary to determine loan loss adequacy, management may use arbitrary percentages to determine the allowance for loan losses. An example of this would be management using industry average loss percentages applied to loan classifications, as FNB did in this scenario. The use of these averages does not consider an institution’s underwriting and collection practices, portfolio composition, credit-rating policies, and other significant differences between institutions. In such instances, DEP recommends the auditor ask management to justify that loan loss allowances have been established in conformity with GAAP. It would also be better for Collin to develop independent percentages to use when making his estimates, as FNB’s may not be reliable.]

   b. Management’s percentages. [This answer is incorrect. The auditor may choose to use the client’s loss percentage instead of determining an independent percentage. This alternative can be used when the auditor’s experience with the client and other evidence indicates that management’s percentages are appropriate and generally reliable. This is not the case for Collin, since the firm has no prior experience auditing FNB. The DEP provides information for auditors in this situation.]

30. FNB’s allowance for loan losses includes a component related to loans evaluated in pools. These loans are evaluated in the aggregate. How Collin should proceed with this part of the audit? (Page 93)

   a. Collin should estimate the allowance for these loans using the methods provided in FASB ASC 310-10-35. [This answer is incorrect. Although the methods prescribed in FASB ASC 310-10-35 can be used to estimate losses on loan pools, they are not required and can be difficult to apply. Generally, it would be better for Collin to use a different approach.]

   b. Collin should estimate the allowance for all aggregated loans as a single amount based on historical percentages. [This answer is incorrect. Normally, the allowance component for each loan type is determined based on historical loss percentages, adjusted for certain factors. Collin should not aggregate all loans included in pools together. There would be an amount estimated for installment loans aggregated into a pool, as well as an amount for other consumer loans aggregated into a pool.]

   c. Collin should apply a small general allowance to these types of loans. [This answer is incorrect. As a practical matter, the only difference between an unclassified and a substandard loan is that a relatively small general allowance will be applied to an unclassified loan, while a higher allowance percentage will be applied to a substandard loan. However, determining the loss percentage for substandard loans is a different part of the audit than estimating losses on loan pools, so this step is not applicable to Collin in this scenario.]

   d. When estimating the allowance, Collin should take into account factors such as the remaining lives of the loans. [This answer is correct. Factors that Collin should take into account include trends in volume and terms of loans, ability and experience of lending management and other lending personnel, remaining lives of loans, current and expected economic conditions, and collateral values.]
31. Collin plans to establish a general reserve as part of FNB’s allowance for loan losses. How should he proceed? (Page 94)

   a. Collin should base the general reserve on the tolerable misstatement. [This answer is incorrect. The component should be based on consideration of relevant factors, such as the risk of material misstatement of the other components of the allowance. Guidance provided by federal financial institution regulatory agencies can be consulted for information on this process.]

   b. **Collin should base the general reserve on specific risk exposures that affect the portfolio.** [This answer is correct. The general component may be estimated as a specific amount or as a percentage of the loan portfolio. Regardless of the method used, the component should be based on consideration of the relevant factors, such as specific risk exposures in the loan portfolio, such as concentrations in specific industries. The Interagency Policy Statement on the Allowance for Loan and Lease Losses (ALLL) issued by the federal financial institution regulatory agencies in December 2006 can be consulted for guidance related to the unallocated portion of the allowance account.]

   c. Collin should base the general reserve on his detailed loan reviews. [This answer is incorrect. The general component allows for the imprecision inherent in estimating loan losses. It recognizes that there are usually additional unidentified losses in the loan portfolio, even after the auditor has completed the detailed loan reviews and other procedures discussed in this course. The general component, therefore, would not be based on information from the detailed loan reviews. Guidance released by the federal financial institution regulatory agencies can be consulted related to the general reserve.]

   d. Collin should establish the general reserve based on his and FNB’s management’s judgment. It does not need specific support. [This answer is incorrect. According to guidance released by federal financial institution regulatory agencies, a financial institution may have an amount labeled as "unallocated" as long as it reflects estimated credit losses determined in accordance with GAAP and is properly supported.]

32. When assessing the reasonableness of FNB’s allowance for loan losses as a whole, Collin discovers that his estimate differs from the recorded allowance. However, he determines that the difference is immaterial. How should Collin address this finding in his audit? (Page 95)

   a. He should reconsider the precision of his estimate. [This answer is incorrect. If the audit difference is significantly large (for example, if it exceeds one-third of tolerable misstatement), Collin should reconsider the assumptions used to estimate the allowance before recording the audit difference or adjustment. Since the difference in this scenario is immaterial, Collin will not need to perform this step.]

   b. **He should record it on the summary of audit differences.** [This answer is correct. If the audit difference is immaterial by itself, Collin should record it on the summary of audit differences to determine whether that difference, in addition to other audit differences, could result in material misstatement of the financial statements. The DEP can be consulted for information related to determining the reasonableness of the overall allowance for loan losses.]

   c. He should propose an adjustment. [This answer is incorrect. If the difference will result in the financial statements being materially misstated, Collin should make an audit adjustment or qualify the auditor’s report. Since the difference in this scenario is immaterial, Collin will not have to take these steps.]
EXAMINATION FOR CPE CREDIT

Lesson 2 (AFITG101)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

13. Crandall’s Gap National Bank has a loan portfolio worth $1 million. In the current year, it identifies specific impaired loans with estimated losses of $100,000. Historically, it has incurred loan losses that amount to 2% of its portfolio. The historical percentage is deemed indicative of losses in the current portfolio. Based on the guidance in FASB ASC 310-10-35, calculate the minimum amount this bank should include in its loan loss allowance based on the facts in this scenario.

   a. $20,000.
   b. $100,000.
   c. $120,000.
   d. $180,000.

14. Harvest Bank has a borrower who is having financial difficulties. The value of the collateral for this loan has decreased over the past year, and now it does not cover the loan balance. Using the loan classification system, how should the bank classify this loan when determining its loan loss allowance?

   a. Unclassified.
   b. Substandard.
   c. Doubtful.
   d. Loss.

15. Harvest Bank’s loan loss allowance factors in amounts for classified loans and loan pools, as well as a general reserve to cover inherent losses in its loan portfolio. When assessing the allowance that includes the general reserve, all major factors that were originally considered when other portions of the allowance were established should be reconsidered. Which of the following is one of the factors for reconsideration?

   a. Risk of material misstatement.
   b. The overall quality of the loan portfolio.
   c. Trends related to loan terms and loan volume.
   d. The experience of lending personnel.

16. Harvest Bank has specific loans in its portfolio that are classified as impaired. The bank groups loans together that have similar risk characteristics and uses historical data to determine the loan loss for each group. Which of the methods provided in FASB ASC 310-10-35 has the bank used in this scenario?

   a. Fair value of the collateral.
   b. Expected cash flows.
   c. Aggregate collection experience.
   d. Market value of the loan.
17. SmallCo, the debtor, has a loan with Little Town Bank (LTB), a financial institution. SmallCo’s debt has recently been restructured by LTB. Existence of which of the following factors would indicate that this restructuring was a troubled debt restructuring (TDR)?

a. LTB restructured the loan exclusively based on a decrease in existing market rates.

b. SmallCo is currently in the process of declaring bankruptcy.

c. SmallCo is current on its existing loan payments to LTB.

d. SmallCo provided LTB with additional collateral as part of the restructuring.

18. According to the reporting standards provided by banking agencies, Fourth National Bank (FNB) should place a loan on nonaccrual under which of the following circumstances?

a. Principal or interest is past due for at least 30 days.

b. FNB expects collection in full, but collection will be significantly delayed.

c. FNB places the loan on a cash basis due to the borrower’s deteriorating financial condition.

d. FNB should not accrue interest on any loan that has been delinquent for more than six months.

19. Danny, an auditor, is engaged to audit a financial institution. Auditing which of the following would be considered both one of the most subjective and one of the most important parts of Danny’s audit?

a. Loan reviews.

b. Nonaccrual loans.

c. Loans receivable and related accounts.

d. The allowance for loan losses.

20. Danny is preparing to do loan reviews for his financial institution audit. He selects the loans for detailed review and obtains the loan files from his client. According to guidance provided in the DEP, what is an example of something Danny should expect to find in the loan documents section of the loan file?

a. The loan application.

b. A loan summary sheet.

c. A signed loan agreement.

d. A credit approval document.

21. One thing Danny hopes to determine from his examination of a loan’s documentation is the borrower’s willingness and ability to repay the loan. List all of the following types of information that will help Danny determine the borrower’s willingness to repay the loan.

i. The borrower’s payment history.

ii. The borrower’s operating cash flows and profitability, as indicated on the financial statements.

iii. Equity the borrower holds in the collateral.

iv. Credit reports on the borrower.

v. The borrower’s financial condition, as indicated on the balance sheet.

vi. The borrower’s personal liability for the loan.
22. A lender’s right to collateral can be affected by certain conditions, such as the existence of a lien perfected by suppliers for goods that are sold on credit. What is the term for this type of lien?
   a. Pre-existing lien.
   b. Tax lien.
   c. Mechanic or materialmen’s lien.
   d. Purchase money security interests.

23. Lois, an auditor, is engaged to audit a financial institution. When performing a loan review, she discovers loan documentation that increases the institution’s credit risk with that borrower. Which of the following did Lois discover?
   a. A related lender guarantee.
   b. A participation agreement.
   c. A letter of credit from a third party.
   d. A take-out commitment from a third party.

24. When documenting her loan review, where would Lois include supplemental documentation, such as copies of borrowers’ financial statements?
   a. With the summary memorandum or form that documents the extent of loans she reviewed.
   b. With the separate documentation of individual loan reviews.
   c. With the summary list of the individual loans and related specific allowances.
   d. Supplemental information would not be included in the loan review documentation.

25. Betty, an auditor, is engaged to audit a financial institution. She would like to assess control risk as low for loans receivable existence, so she performs loan reviews as a test of controls. Can the loan reviews done as part of the test of controls also be used in Betty’s assessment of the collectability of loans when determining the loan loss allowance?
   a. Yes.
   b. No.
   c. Do not select this answer choice.
   d. Do not select this answer choice.
26. During the course of her audit, Betty reviews a nonaccrual loan that would be considered impaired. What action should she take next?
   a. She should classify the loan as substandard.
   b. She should classify the loan as unclassified.
   c. She should estimate the specific allowance required for the loan.
   d. She should discuss the loan with the loan officer.

27. Calculate a bank’s recorded investment in a loan using the following information:

   Unpaid principle balance of the loan: $175,000
   Premiums: $5,000
   Deferred loan costs: $5,000
   Discounts: $0
   Deferred income: $1,000
   Accrued interest on the loan: $500

   a. $163,500.
   b. $165,500.
   c. $184,500.
   d. $186,500.

28. Township Bank has an impaired loan. The borrower is undergoing bankruptcy proceedings, so the bank legally cannot foreclose to obtain the collateral. What method should be used to estimate the loan losses?
   a. Fair value of the collateral.
   b. Expected cash flows.
   c. Aggregate experience method.
   d. Market value of the loan.

29. Aidan, an auditor, was engaged to audit Millsap National Bank. He estimated allowances for specific loans (including any related liability for losses on off-balance-sheet credit instruments). What is Aidan’s next step?
   a. To determine allowances for other loans and credit risk exposures that were not reviewed specifically.
   b. To establish specific allowances for loans that were not reviewed because they are below the scope.
   c. To classify the bank’s specific loans as unclassified, substandard, doubtful, or loss.
   d. To incorporate any impaired loans into the bank’s loan classification system.
30. Millsap National Bank’s (MNB) allowance for loan losses includes a component related to loans that are evaluated in pools. What is an example of the type of loan MNB might include in this type of homogeneous pool?
   a. Commercial real estate loans.
   b. Single-family residential loans.
   c. SBA loans.
   d. Commercial business loans.

31. MNB purchases installment loans from dealers. The loans’ recourse provisions are backed by a reserve fund established by the dealer; however, the reserve fund is very small. The dealer does not have the resources to honor its recourse obligations if the dealer reserve is exhausted. When Aidan evaluates these loans, should he consider the recourse provisions when estimating the loss percentage?
   a. Yes, any dealer reserve will positively affect the bank’s credit risk.
   b. No, if the reserve is small it should be ignored.
   c. Do not select this answer choice.
   d. Do not select this answer choice.

32. If Aidan performs his audit of MNB’s allowance for loan losses at an interim date, which of the following considerations would apply to his audit?
   a. He should record any audit difference as of the interim date.
   b. He should make any audit adjustments as of the interim date.
   c. He should perform additional procedures to extend his conclusion to the balance sheet date.
   d. He should reperform all estimates and procedures from the interim audit as of the balance sheet date.
Lesson 3: ADC Loans, Audit Procedures, and a Case Study

INTRODUCTION

This lesson examines a special type of loan that may affect financial institutions, the ADC loan, and related procedures. It then discusses procedures used in accounts that are closely related to loans receivable, including interest income on loans, accrued interest receivable, loan fees and costs, undisbursed portion of loans in progress, and advance payments by borrowers for taxes and insurance. The lesson concludes with a case study that will help testers better understand the concepts that have been explained in this course.

Learning Objectives:

Completion of this lesson will enable you to:

- Define ADC loans, and summarize related accounting methods used by financial institutions.
- Identify audit procedures for areas related to loans receivable in a financial institution audit.

A DISCUSSION OF ACQUISITION, DEVELOPMENT, AND CONSTRUCTION (ADC) LOANS

What Are ADC Loans?

The term *ADC loan* is commonly used to refer to arrangements in which the lender (usually a savings institution) participates in the expected residual profit from a real estate project. Although the initials stand for acquisition, development, and construction loans, the term is also applied to loans on operating real estate properties. The ADC label dates back to an AICPA Notice to Practitioners that was published in November 1983. A typical ADC arrangement has the following features:

a. The borrower has little or no equity in the real estate project.

b. The lender provides substantially all of the funds needed to acquire, develop, or build the project.

c. The lender funds substantially all of the interest and fees during the loan term by adding them to the loan balance.

d. The repayment terms on the loan are structured so that the borrower has little chance of defaulting before the loan matures. Generally, the borrower is not required to make any loan payments before the project is completed.

e. The lender’s primary security, perhaps its only security, is the project (that is, the lender has little or no access to other assets of the borrower). That situation can arise in various ways, such as:

   1. The loan is nonrecourse.

   2. The borrower is a limited partnership that has no assets other than the property, and the general partner has little or no unencumbered assets.

   3. State laws require the lender to either foreclose on the property or seek recourse against the borrowers/guarantors, but the lender cannot do both.

f. Repayment of the loan depends on one of the following:

   1. Sale of the property to independent third parties (with financing from sources other than the lender).
(2) Refinancing the loan with another lender.

(3) Cash flows from property operations upon completion assuming the project will generate sufficient cash flow to cover all scheduled debt payments.

In return for the preceding concessions, the lender receives a profit participation in the project. Generally the profit participation is in the form of a specified percentage of the operating profits and gain on sale (commonly referred to as an *equity kicker*). However, it can also be reflected in interest rates or fees that are higher than prevailing rates on similar loans.

The accounting rules for ADC loans can significantly affect the institution’s earnings. Under certain conditions, ADC arrangements may be accounted for as loans, real estate joint ventures, or direct investments in real estate. This accounting guidance regarding ADC arrangements is discussed in the following paragraphs.

**Authoritative Literature**

FASB ASC 310-10 includes guidance on ADC loans from the lender’s perspective. The guidance primarily applies to loans that finance the acquisition, development, or construction of real estate. However, FASB ASC 310-10-05-9 indicates that the guidance should also be applied to loans granted to acquire operating properties where the lender participates in the expected residual profit from the sale or refinancing of the property.

**Classifying ADC Arrangements**

ADC arrangements may be accounted for as loans, joint ventures, or direct real estate investments depending on the size of the lender’s profit participation and the degree of risk assumed by the lender. The characteristics of a typical ADC arrangement that are noted above are referred to in the guidance as characteristics implying direct investments or joint ventures. To determine how a given ADC arrangement should be accounted for, FASB ASC 310-10-25-19 through 25-29 provide specific criteria for each classification. Those criteria can be summarized as follows:

a. **Direct Investment in Real Estate.** The arrangement should be accounted for as a direct investment in real estate if the lender receives a majority of the project’s expected residual profit. Determining the lender’s profit participation involves more than merely identifying the equity kicker percentage in the loan agreement. The contractual interest rate and loan fees should also be considered. If the contractual interest rate or loan fees are higher than prevailing market rates for similar loans, then the excess interest and fees should be considered additional profit participation by the lender. (See Example 3-1.)

b. **Loan.** The arrangement should be classified as a loan if the lender participates in less than a majority of the expected residual profit and at least one of the following conditions are met:

   (1) The borrower has a *substantial* equity investment in the property that is not funded by the lender. The value of noncash equity is generally its current fair value, net of encumbrances. However, recently acquired property should not be valued higher than the borrower’s cost. Also, if the borrower contributes services to the project (commonly referred to as *sweat equity*), the value of those services should not be considered in assessing the borrower’s equity investment.

   (2) The lender has recourse to a substantial amount of other unencumbered assets that have a determinable sales value. The assets must be saleable and cannot include the ADC project or any other project financed by the lender.

   (3) The borrower has provided an irrevocable letter of credit from a creditworthy, independent third party to the lender for a substantial amount of the loan over the entire loan term. FASB ASC 360-20-40-11 (formerly EITF Issue No. 87-9) concluded that a surety bond with the same characteristics as an irrevocable letter of credit can be considered part of a buyer’s initial investment in accounting for sales of real estate. Best practices indicate that surety bonds with those characteristics can also be treated the same as letters of credit when evaluating ADC loans.
(4) A take-out commitment for the full amount of the loan is obtained from a creditworthy, independent financial institution. If the take-out commitment is conditional, the conditions should be reasonable and probable of being met.

(5) Noncancelable sales contracts or lease commitments from creditworthy, independent third parties are currently in effect that will provide sufficient cash flow upon completion of the project to cover normal principal and interest payments. If the contracts or lease commitments are conditional, it should be probable that the conditions will be met.

(6) The lender has obtained qualifying personal guarantees from the borrowers or principals.

In practice, an arrangement that has a profit participation of less than 20% is usually not classified as a joint venture or direct investment. Thus, loan accounting is generally used for those types of arrangements even if none of the preceding conditions is met.

c. Investment in a Real Estate Joint Venture. The arrangement should be accounted for as an investment in a real estate joint venture if the conditions are not met for applying direct investment or loan accounting (that is, if the lender participates in less than a majority of the expected residual profit and none of the conditions listed in item b. is met).

Defining a substantial equity investment [Condition b(1)], substantial assets of the borrower [Condition b(2)], or substantial letter of credit [Condition b(3)] is a matter of judgment. The initial investment requirements in FASB ASC 360-20 (formerly SFAS No. 66, Accounting for Sales of Real Estate) could provide useful guidance for determining substantial equity investments and assets. For example, if the minimum initial investment for a land development project is 20%, the borrower should have current equity in the property, letters of credit, or other assets equal to at least 20% of the total investment in the project throughout the life of the loan. That means the borrower should have $20 in equity, letters of credit, or unencumbered assets for each $100 invested in the project.

Example 3-1: Direct investment in real estate.

A lender enters into an ADC arrangement in which it provides all of the financing for the acquisition and development of a project. The total loan amount is $1,000,000 and the estimated fair value of the project at completion is $1,600,000. Interest on the loan is 10% and loan fees are 8% of the total loan amount. Market interest rates and loan fees are 8% and 4%, respectively. Contractual interest income during the loan term is $204,000. The lender will also receive 40% of the profits from the sale of the property. The expected residual profit is $600,000 [$1,600,000 $1,000,000]. The lender’s profit participation can be calculated as follows:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity kicker ($600,000 × 40%)</td>
<td>$240,000</td>
</tr>
<tr>
<td>Excess interest [$204,000 ÷ 10% × (10% − 8%)]</td>
<td>40,800</td>
</tr>
<tr>
<td>Excess loan fees [$1,000,000 × (8% − 4%)]</td>
<td>40,000</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>$320,800</strong></td>
</tr>
</tbody>
</table>

The total profit participation is 53.5% [$320,800 ÷ $600,000] of the expected residual profit, and thus the arrangement should be accounted for as a direct investment in real estate.

Evaluating Personal Guarantees

One of the conditions in item b. in the previous paragraph that may be used to support classification as a loan is the presence of a qualifying personal guarantee. In many ADC *, the borrower is a limited partnership or thinly capitalized corporation, and the loan is guaranteed by one or more of the principal investors in the borrower. The considerations for evaluating personal guarantees on ADC loans are the same as those for evaluating guarantees in auditing the allowance for loan losses (as discussed in Lesson 2). Best practices indicate that a personal guarantee generally should not be given any weight in determining the proper accounting for an ADC arrangement, unless the guarantee meets all of the conditions in Lesson 2.
Accounting for ADC Arrangements as Loans

ADC arrangements that are classified as loans are generally accounted for the same way as other loans. If the loan is collectible, interest income is recognized when it is earned and loan fees are deferred and recognized as a yield adjustment over the life of the loan. Income from profit participations is accounted for based on its nature. Operating profits are recognized as income when earned. Gains on property sales are accounted for in accordance with FASB ASC 360-20 (formerly SFAS No. 66). Accordingly, a gain is generally recognized at the date of sale if (a) the property is sold to a third party, (b) the lender does not provide financing, and (c) the lender has no continuing involvement with the property sold. Collectibility should be assessed the same way as other loans, and allowances for losses should be provided when needed. In assessing collectibility, the auditor should consider that ADC arrangements are often structured so that no amounts are due until the project is sold.

The financial institution may determine that a loan-funded interest reserve should be established upon the origination of an ADC loan. The decision to establish an interest reserve is based on the feasibility of the project, the creditworthiness of the borrower and guarantors, and the coverage provided by the real estate and other collateral. The interest reserve account allows for the periodic advance of loan funds to pay interest charges on the outstanding balance of the loan. While an interest reserve account may benefit both the lender and the borrower, the practice may also disguise problems with a borrower’s willingness and ability to repay the loan under the terms and conditions of the loan. The existence of problems with interest reserve accounts is more likely in periods of economic stress. Accounting concepts applicable to the recognition of income also apply to interest reserves. In general, interest that has been added to the balance of a loan through the use of an interest reserve should not be recognized as income if its collectibility is not reasonably assured.

General Considerations for ADC Arrangements Accounted for as Joint Ventures or Investments

Unfortunately, Practice Bulletin No. 1 provides little specific guidance regarding accounting for ADC arrangements that are classified as joint ventures or investments. Although practice varies, many accountants rely primarily on FASB ASC 970-323 (formerly SOP 78-9) for guidance in accounting for those arrangements. The following paragraphs discuss specific issues related to accounting for ADC arrangements that are classified as joint ventures or investments.

Accounting for ADC Arrangements as Joint Ventures

ADC arrangements that are classified as real estate joint ventures should be accounted for using the equity method of accounting as described in FASB ASC 970-323 (formerly SOP 78-9). The following paragraphs discuss issues involved in applying this guidance.

Arrangements that are classified as joint ventures should be reported separately from loans on the lender’s balance sheet, but they may be included with arrangements classified as direct investments. The lender’s share of profits and losses may be reported separately or included with other income from profit participations.

The lender should generally record its share of project earnings and losses based on its profit participation percentage. However, the lender should only record its share of profits to the extent that they will ultimately be received in cash. For example, if the profit participation agreement states that the lender will receive a percentage of profits earned beginning one year after the property is completed, then the lender should not record equity in earnings until that point is reached. Profit participations in sales of real estate should generally be recognized when the criteria in FASB ASC 360-20 (formerly SFAS No. 66) are met.

There is some diversity regarding the treatment of interest and fees on arrangements that are classified as joint ventures. Some accountants believe that the loan is an in-substance capital contribution, and thus all interest and fees should be accounted for as distributions of capital rather than interest income. However, the more common practice is to account for the loan as any other loan or advance to a joint venture. Thus, if the collectibility condition is met and the project is not incurring losses, the loan should be accounted for as a loan to an equity investee, and a portion of the interest income can be recognized if the following conditions are met:

- **Collectibility.** FASB ASC 970-835-35-1 (formerly SOP 78-9) states that all interest income on loans to a venture should be deferred if collectibility of the principal or interest is in doubt. Thus, principal and interest must be collectible to allow income recognition.
Profitability of the Project. FASB ASC 970-835-35-1 (formerly Paragraph 34 of SOP 78-9) states that all interest income on loans to a venture should be deferred if “there is a reasonable expectation that the other investors will not bear their shares” of the venture’s losses and there is uncertainty regarding the portion of those losses that the lender will bear. Since an ADC arrangement is generally accounted for as a joint venture because of the lack of borrower commitment or financial resources, the borrower is unlikely to be able to bear losses if the venture is unprofitable. Thus, a case can be made for deferring interest and fees should be deferred if the project is suffering recurring operating losses.

If the venture capitalizes interest and other development costs, only the lender’s share of fee and interest income in excess of its borrowing cost should be deferred.

Guidance on this topic does not specifically explain how to assess the recoverability of an ADC arrangement for loans that are classified as joint ventures. However, in practice, the assessment of recoverability (or collectibility) is normally made as if the arrangement were classified as a loan. Thus, the lender should follow the guidance for specific allowances for loan losses discussed in Lesson 2.

Accounting for an ADC Arrangement as a Direct Investment in Real Estate

FASB ASC 310-10-25-14 through 25-30 and 310-10-35-54 through 35-61 (formerly Practice Bulletin No. 1) present guidance on accounting for ADC arrangements. Arrangements where the lender is expected to receive more than 50% of the expected residual profit should be accounted for as a real estate investment. If the lender is expected to receive 50% or less of the expected residual profit, the entire arrangement should be accounted for as either a real estate joint venture or as a loan. FASB ASC 310-10-25-14 through 25-30 (formerly Practice Bulletin No. 1) specify the characteristics that distinguish which treatment the arrangements should be given and the related guidance that should be followed for each type of treatment. However, that guidance has been interpreted in different ways in practice. Using a strict interpretation of the Practice Bulletin, the lender would recognize all of the profits and losses relating to the project. Another approach is to account for those arrangements similar to a controlling interest in a joint venture (except that the project is not formally consolidated). The following are specific considerations in accounting for ADC arrangements that are classified as direct investments:

- **Financial Statement Presentation.** Arrangements that are classified as investments should be reported separately from loans on the lender’s balance sheet, but they may be included with arrangements classified as joint ventures. The lender’s share of profits and losses may be reported separately or included with other income from profit participations.

- **Recognizing Profits and Losses.** The lender should recognize its share of operating profits and losses based on its profit participation percentage. However, as in the case of joint venture arrangements, the lender should only record its share of profits to the extent that they will ultimately be received in cash.

- **Interest and Fee Income.** FASB ASC 970-835-35-1 (formerly SOP 78-9) requires deferral of all interest income on loans to controlled joint ventures. Thus, it is possible for all interest and fees to arrangements classified as direct investments to be deferred.

- **Recoverability.** Recoverability is normally assessed the same way as any other problem loan. For example, if the loan is impaired and the fair value of the property is less than the recorded investment in the loan, an allowance for loss should be provided.

Changes in Classification

FASB ASC 310-10-35-55 (formerly Practice Bulletin No. 1) states that the classification of ADC arrangements should be periodically reassessed, but it should not be changed unless there is a change in the facts that were relied upon in making the initial classification. Exhibit 3-1 shows examples that illustrate this guidance. According to FASB ASC 310-10-35-59 (formerly Practice Bulletin No. 1), AcSEC believes that a change in classification would be rare. If an ADC arrangement is reclassified, FASB ASC 310-10-35-59 (formerly Practice Bulletin No. 1) states that the effect of
the change should be accounted for prospectively. However, it does not explain specifically how to account for the change. Reclassifications can be accounted for as follows:

- **Changing from a Loan to a Joint Venture or Direct Investment.** The loan should be reclassified on the balance sheet, and income or losses on the arrangement in future periods should be accounted for as discussed earlier in this lesson, as appropriate. However, no adjustment should be made to reverse previously recognized income.

- **Changing from a Joint Venture or Direct Investment to a Loan.** Assuming the loan and accrued interest are collectible, interest income that was previously deferred should be recognized as of the date of reclassification. Deferred loan fees should be amortized as additional interest income over the remaining life of the loan. No adjustment should be made for previously recognized equity in profits or losses. The reclassification should not affect the accounting for gains on real estate sales relating to the project. Accordingly, if sales did not qualify for full accrual gain recognition before the reclassification, they should be accounted for the same way after reclassification.

### Exhibit 3-1

**Examples of Changes in Classification on Accounting for ADC Arrangements**

<table>
<thead>
<tr>
<th>Situation</th>
<th>Result</th>
</tr>
</thead>
<tbody>
<tr>
<td>The loan is renegotiated so that the lender will receive less than a majority of the expected residual profit and the borrower must begin making regular loan payments. The borrower pledges a substantial amount of unencumbered liquid assets as security for the loan, and the lender has less than a majority profit participation. The arrangement was originally classified as a loan because the lender had a net profits interest of less than 50% and the borrower pledged substantial additional assets. The loan is renegotiated so that the other assets are no longer pledged. The arrangement was originally classified as a joint venture, but appreciation in the value of the project has given the developer substantial appraised equity in the property. The arrangement was originally classified as a loan because of substantial cash equity in the project, but a decline in the value of the project has eroded substantially all of the borrower’s original investment.</td>
<td>The arrangement may be reclassified from a joint venture or investment to a loan because the lender’s risks and rewards have been reduced by changing the terms of the arrangement. The arrangement may be reclassified from a joint venture to a loan because the additional security reduces the lender’s risk. The loan should be reclassified to a joint venture because the renegotiation of terms significantly increased the lender’s risk. The arrangement should still be classified as a joint venture. Although the lender’s risk may be reduced, it occurred because of a change in economic conditions rather than a change in the terms of the arrangement. The loan should not be reclassified. The lender’s risk has increased because of the decline in economic conditions rather than changes in the terms of the arrangement. However, consideration should be given to the need for an allowance for loss on the loan.</td>
</tr>
<tr>
<td>Situation</td>
<td>Result</td>
</tr>
<tr>
<td>--------------------------------------------------------------------------</td>
<td>------------------------------------------------------------------------</td>
</tr>
<tr>
<td>The terms of the arrangement were renegotiated to reduce the lender’s profit participation from 55% to 10%.</td>
<td>The arrangement should still be classified as a direct investment. The lender’s reward was reduced, but the risks remain the same. The Practice Bulletin indicates that merely reducing the lender’s participation in the expected residual profits is not sufficient for reclassifying a joint venture or investment.</td>
</tr>
</tbody>
</table>

An arrangement is classified as a joint venture at the inception of the project, and after the project enters the permanent phase and generates positive cash flow, the borrower begins making loan payments.

FASB ASC 310-10-35-60 (formerly Practice Bulletin No. 1) states that this type of arrangement should continue to be accounted for as a joint venture. The rationale for that guidance appears to be that the permanent phase is merely an extension of the original arrangement, and the lender’s risk is reduced solely because of the operating performance of the project.

*          *         *

**Construction or Development Loans at Credit Unions**

The NCUA has specific definitions governing member business loans for construction or development. These loans are defined as any loan for the acquiring of property or rights to property with the intent to convert it to income-producing property. This classification only applies to loans that will convert the property to income-producing or convert it to a different use or an expansion of its current use. Financing for maintenance, repairs, or improvements to existing income-producing property without conversion does not qualify under this definition.
SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

33. Which of the following features would be found in an acquisition, development, and construction (ADC) loan?
   a. The lender will have little or no equity in the real estate project.
   b. The lender funds substantially all of the interest and fees that occur during the loan term.
   c. Repayment terms can lead to a high risk of the borrower defaulting before the loan matures.
   d. Additional collateral beyond the real estate project is required.

34. Barnsworth Savings has an ADC loan. Barnsworth will get approximately 40% of the expected residual profit; however, Barnsworth also has recourse to a substantial amount of other assets that are both unencumbered and have a determinable sales value. How should this loan be accounted for?
   a. As a direct investment in real estate.
   b. As a loan.
   c. As an investment in a real estate joint venture.

35. If a financial institution has an ADC arrangement that would be classified as an investment or a joint venture, what piece of guidance can an accountant consult for information on accounting for the arrangement?
   a. The 1983 AICPA Notice to Practitioners.
   b. FASB ASC 310-10.
   c. FASB ASC 970-323.

36. Cathedral Savings, a savings institution, has an ADC loan that should be accounted for as a direct investment in real estate. Which of the following should occur?
   a. The institution should include the arrangement with other loans on its balance sheet.
   b. The institution should recognize its share of the operating profits and losses.
   c. The institution should recognize all income from loans to controlled joint ventures.
   d. Recovery cannot be assessed on this type of arrangement.
SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. (References are in parentheses.)

33. Which of the following features would be found in an acquisition, development, and construction (ADC) loan? (Page 105)
   a. The lender will have little or no equity in the real estate project. [This answer is incorrect. In a typical ADC arrangement (as referred to in the 1983 ACIPA Notice to Practitioners), the borrower, not the lender, has little or no equity in the real estate project.]
   b. The lender funds substantially all of the interest and fees that occur during the loan term. [This answer is correct. The ADC label dates back to an AICPA Notice to Practitioners that was published in November 1983. In a typical ADC arrangement, the lender provides substantially all of the funds needed to acquire, develop, or build the project. The lender also funds substantially all of the interest and fees during the loan term by adding them to the loan balance.]
   c. Repayment terms can lead to a high risk of the borrower defaulting before the loan matures. [This answer is incorrect. Typically, in this type of arrangement (as defined in the 1983 AICPA Notice to Practitioners), the repayment terms on the loan are structured so that the borrower has little chance of defaulting before the loan matures.]
   d. Additional collateral beyond the real estate project is required. [This answer is incorrect. ADC loans are discussed in a 1983 AICPA Notice to Practitioners. The lender’s primary security in this type of loan, perhaps its only security, is the project.]

34. Barnsworth Savings has an ADC loan. Barnsworth will get approximately 40% of the expected residual profit; however, Barnsworth also has recourse to a substantial amount of other assets that are both unencumbered and have a determinable sales value. How should this loan be accounted for? (Page 106)
   a. As a direct investment in real estate. [This answer is incorrect. The arrangement should be accounted for as a direct investment in real estate if the lender receives a majority of the project’s expected residual profit. 40% would not be considered a majority; therefore, this is not the correct accounting method. AcSEC Practice Bulletin No. 1 can be consulted for information on ADC loans.]
   b. As a loan. [This answer is correct. According to AcSEC Practice Bulletin No. 1, ADC arrangements may be accounted for as loans, joint ventures, or direct real estate investments depending on the size of the lender’s profit participation and the degree of risk assumed by the lender. The arrangement should be classified as a loan if the lender participates in less than a majority of the expected residual profit and at least one of certain other conditions exist. One of those conditions is that the lender has recourse to a substantial amount of other unencumbered assets that have a determinable sales value. The assets must be saleable and cannot include the ADC project or any other project financed by the lender.]
   c. As an investment in a real estate joint venture. [This answer is incorrect. The arrangement should be accounted for as an investment in a real estate joint venture if the conditions are not met for applying direct investment or loan accounting. Because the loan described in the scenario above does meet the qualifications for one of the other categories, this one does not apply. AcSEC Practice Bulletin No. 1 provides guidance on ADC loans.]
35. If a financial institution has an ADC arrangement that would be classified as an investment or a joint venture, what piece of guidance can an accountant consult for information on accounting for the arrangement? (Page 108)

a. The 1983 AICPA Notice to Practitioners. [This answer is incorrect. The ADC label dates back to this piece of guidance; however, it is no longer the current guidance on ADC loans.]

b. FASB ASC 310-10. [This answer is incorrect. FASB ASC 310-10 includes guidance on ACD loans from the lender’s perspective. The guidance primarily applies to loans that finance the acquisition, development, or construction of real estate. However, FASB ASC 310-10-05-9 indicates that the guidance should also be applied to loans granted to acquire operating properties where the lender participates in the expected residual profit from the sale or refinancing of the property.]

c. FASB ASC 970-323. [This answer is correct. Although practice varies, many accountants rely primarily on FASB ASC 970-323 (formerly SOP 78-9) for guidance in accounting for these arrangements.]

36. Cathedral Savings, a savings institution, has an ADC loan that should be accounted for as a direct investment in real estate. Which of the following should occur? (Page 109)

a. The institution should include the arrangement with other loans on its balance sheet. [This answer is incorrect. Under Practice Bulletin No. 1, arrangements that are classified as investments should be reported separately from loans on the lender’s balance sheet, but they may be included with arrangements classified as joint ventures.]

b. The institution should recognize its share of the operating profits and losses. [This answer is correct. Under Practice Bulletin No. 1, the lender should recognize its share of operating profits and losses based on its profit participation percentage. However, the lender should only record its share of profits to the extent that they will ultimately be received in cash.]

c. The institution should recognize all income from loans to controlled joint ventures. [This answer is incorrect. FASB ASC 970-835-35-1 requires deferral of all interest income on loans to controlled joint ventures.]

d. Recovery cannot be assessed on this type of arrangement. [This answer is incorrect. Under Practice Bulletin No. 1, recoverability is normally assessed the same way as any other problem loan. For example, if the loan is impaired and the fair value of the property is less than the recorded investment in the loan, an allowance for loss should be provided.]
PROCEDURES USED FOR RELATED AUDIT AREAS

There are a number of other accounts that are closely related to loans receivable, including the following:

- Interest income on loans.
- Accrued interest receivable.
- Loan fees and costs.
- Undisbursed portion of loans in process.
- Advance payments by borrowers for taxes and insurance (also referred to as escrow accounts).

Audit procedures in these areas are often performed in connection with the audit of loans receivable. The following paragraphs discuss audit procedures commonly performed for these accounts.

Interest Income on Loans

Yield analysis is commonly performed to test interest income on loans. One method is to use a monthly yield analysis test, which calculates the yield by month. The calculation should be performed separately for each loan type. For loan types with floating rates (such as most commercial loans), the monthly yields may also be compared with changes in the prime rate or other appropriate benchmark rates. Significant fluctuations noted in the yield analysis should be investigated. In addition to monthly yield analysis, the auditor should consider whether it is necessary to perform other tests of interest income, such as recalculating interest income on a sample of loans. Factors to consider in determining whether additional tests of interest income are necessary include:

- Precision of Expected Yields. If the expected yields can be estimated precisely by loan type, yield tests alone may be sufficient.
- Evidence from Related Procedures. Detailed tests of accrued interest or other procedures may provide substantial evidence about the propriety of interest income. For example, if detailed recalculations of accrued interest receivable are performed for a sample of commercial loans, it is generally not necessary to perform a separate detailed recalculation of interest income on those loans.

Unearned Discounts on Installment Loans. If the client has a significant portfolio of installment loans, the audit of interest income should usually be combined with the audit of unearned discounts. As discussed in Lesson 1, installment loans are often recorded at a gross amount, and an unearned discount is recorded for the interest to be received on the loan. Unearned discounts should be accreted into income using the interest method, but, in practice, the discount may be accreted using the rule of 78s method instead. Rule of 78s accretion is based on the sum of months’ digits methods over the loan term. Under that method, the unearned discount is typically recalculated as each loan payment is received using the following formula:

\[
\text{Remaining unearned discount} = \frac{\text{Original unearned discount}}{N} \times \frac{r \times (r + 1)}{N \times (N + 1)}
\]

Where
\[r = \text{the remaining number of months in the loan term}\]
\[N = \text{the original number of months in the loan term}\]

The total amount of interest income recognized over the entire loan term is the same under both the rule of 78s and interest method, but the timing of interest income recognition is different. Generally, use of the rule of 78s results in more interest income being recognized in the early months of the loan term and less interest income in the later months. GAAP requires that the interest method be used for recognition of interest income. Accordingly, the rule of 78s method can be used only when it approximates the interest method. If the client uses the rule of 78s method, the auditor should assess whether the difference between that method and the interest method is material to the client’s financial statements. If it is material, an audit adjustment will be needed to reflect interest using the interest method.
In January 1999, the FDIC issued FIL999 to notify institutions that they can no longer use the rule of 78s accounting method to calculate interest income on short-term consumer loans for federal income tax purposes. The IRS requires financial institutions to use the constant yield method of accounting for interest earned on all short-term consumer loans made on or after January 1, 1999.

**Example of Rule of 78s versus Interest Method Amortization.** The following example shows how to convert rule of 78s amortization to interest method amortization. Assume that the client has a $10,000 installment loan with a 10% interest rate. The terms of the loan require 120 monthly payments of $132.15. The unearned discount on the loan is $5,858 \([132.15 \times 120] - 10,000\]. Using the rule of 78s method, the unearned discount after the first 12 payments is as follows:

\[
$5,858 \times \frac{108 \times 109}{120 \times 121} = 4,749
\]

Under the interest method, the unearned discount can be determined using spreadsheet software or a financial calculator. The present value factor for an annuity of 108 \(120 - 12\) monthly payments at 10% interest is 71.0294. Thus the unearned discount using the interest method is:

\[
\begin{align*}
\text{Total payments remaining} & \quad [132.15 \times 108] \\
\text{Present value of remaining payments} & \quad [132.15 \times 71.0294] \\
\text{Unearned discount—interest method} & \quad 4,885
\end{align*}
\]

Since the unearned discount under the interest method is greater than the discount computed using the rule of 78s, the adjustment needed to convert from rule of 78s amortization to interest method amortization is as follows:

\[
\begin{array}{c|c|c}
\text{DR} & \text{CR} \\
\hline
\text{Interest income} [4,885 - 4,749] & $136 \\
\text{Unearned discount} & $136
\end{array}
\]

Generally, the more significant the installment loan portfolio and the longer the term of the portfolio, the greater the chance of a material difference.

**Accrued Interest Receivable**

Auditing procedures commonly performed relating to accrued interest receivable are as follows:

- **Testing the Reconciliation of Subsidiary Records to the General Ledgers.** The total accrued interest receivable balance on the loans receivable trial balance (or accrued interest trial balance, if applicable) should be reconciled to the general ledger control account at the balance sheet date. Any significant reconciling items should be investigated.

- **Performing Analytical Procedures Relating to Ending Balances.** One common analytical procedure is to compute accrued interest receivable as a percentage of loans receivable for each loan type, and compare the results to the prior period’s percentages. Alternatively, the auditor may compute the number of days of accrued interest outstanding at the end of the current and prior year and compare the two amounts. Significant fluctuations should be investigated.

- **Assessing the Collectibility of the Ending Balances.** Accrued interest receivable is included in the recorded loan investment, and, thus, collectibility of accrued interest on specific loans is assessed as part of auditing the allowance for loan losses. For other types of loans that are not subject to detailed review, the auditor should consider the client’s policies for evaluating the collectibility of accrued interest, assess the reasonableness of those policies, and determine whether the client is following those policies. Because of their relative immateriality, it is usually not necessary for the auditor to perform detailed procedures on the accrued interest receivable relating to these other types of loans.
The auditor should also consider recomputing the accrued interest balance on a sample of individual loans. Detailed tests of accrued interest calculations may be necessary in the following situations:

a. The risk of material misstatement of accrued interest receivable is high.

b. Significant unexplained differences were noted in performing analytical procedures relating to accrued interest receivable or related interest income.

c. It is difficult to develop reliable expectations about what the accrued interest or interest income balances should be, such as when interest rates have fluctuated significantly during the period. (In those situations, the reliability of the analytical procedures is limited.)

d. Analytical procedures on accrued interest receivable or interest income do not provide sufficient appropriate audit evidence for relevant assertions related to these accounts.

However, if the institution uses a third-party service organization to compute accrued interest on loans, consider whether the service auditor’s report addresses the operating effectiveness of controls over interest accruals. If so, it may be possible to reduce the control risk assessment regarding interest accruals, and detail testing of accrual calculations may not be necessary.

Loan Fees and Costs

Lenders normally incur costs associated with originating and purchasing new loans. Those costs are incurred for such activities as application processing, credit evaluation, and loan term negotiation. To offset those costs, lenders usually charge commitment and origination fees (including application fees and points.) FASB ASC 310-20 (formerly SFAS No. 91) addresses the accounting for nonrefundable loan fees and origination costs. Key provisions of this guidance are as follows:

a. Origination Fees. Loan origination fees should be deferred and amortized into interest income over the life of the loan, generally using the interest method.

b. Origination Costs. The following origination costs should be deferred and amortized as a reduction of interest income over the life of the loan, generally using the interest method:

   (1) Incremental direct origination costs incurred in transactions with independent third parties. [Incremental direct origination costs are those that (a) result directly from and are essential to the lending transaction and (b) would not have been incurred by the lender if the loan had not been made.]

   (2) Certain costs directly related to specified activities that are an integral part of the loan origination process.

All other origination costs should be expensed as incurred, including any costs relating to unsuccessful loan originations. Exhibit 3-2 and Exhibit 3-3 show examples of costs that can and cannot be deferred.

c. Commitment Fees. Commitment fees should be deferred and amortized into interest income over the life of the loan, except in the following situations:

   (1) If the lender’s experience with similar commitments is that the likelihood of the commitment being used is remote, the fee should be deferred and amortized to service fee income over the commitment period using the straight-line method. However, if the commitment is exercised, the unamortized balance of the deferred fee should be recognized as interest income over the life of the loan using the interest method.

   (2) If the loan is a line of credit and the lender charges a fee based on the unused credit line during the previous year, the fee should be recognized as service fee income on the date it is determined, provided that both of the following conditions are met:

      (a) The fee percentage is insignificant compared to the stated rate of the loan.
(b) The loan carries a market interest rate at the origination date.

d. **Purchased Loans.** The difference between the initial investment in an acquired loan and its principal amount when purchased should be recognized as an adjustment of yield over the life of the loan. All other costs related to purchased loans should be charged to expense as incurred.

e. **Amortization Method.** Net deferred loan costs or fees should generally be amortized using the interest method over the life of the loan. However, the straight-line method may be used for fees on demand loans and lines of credit, as well as the commitment fees discussed in c(1) and c(2). The contractual life of the loan should generally be used in amortization calculations. Prepayments should not be assumed in calculations except for groups of loans for which prepayments are probable and can be reasonably estimated.

f. **Nonaccrual Loans.** FASB ASC 310-20-35-17 (formerly Paragraph 17 of SFAS No. 91) states that deferred fees or costs should not be amortized during periods in which interest income is not being recognized because of concerns about the realization of principal or interest.

g. **Floating Rate Loans.** If the loan’s interest rate varies based on changes in the prime rate or some other index, the effective yield used to amortize deferred fees and costs can be computed based on the index at the origination date, or it can be recomputed as the index changes.

h. **Refinancing and Renewal.** Refinancing or renewal of debt should be considered separate transactions (that is, retirement of old debt and issuance of new debt) if the new loan’s effective yield is at least equal to that for comparable loans made to new borrowers with similar collection risks. In those situations, any unamortized deferred costs or fees on the old loans should be charged or credited to interest income. However, if the loan’s effective yield is less than that for comparable loans, unamortized deferred costs or fees should be carried forward to the new loan and used to determine the effective rate of the new loan.

**Audit Considerations of Loan Costs and Fees.** Generally, accounting for loan fees and costs is materially affected only when loan fees are significant or there has been a significant number of new loans made during the year (regardless of whether or not fees were collected). Although deferral of qualifying loan origination costs is required regardless of whether loan fees were received, deferred costs are rarely material to the financial statements because of the extensive restrictions on cost deferral. Consequently, if loan fees are immaterial, the institution’s financial statements would normally not be materially affected, and the institution can simply recognize both fees and costs in net income for the period in which they arise. The auditor should consider whether loan fees and costs are material to the client’s financial statements. If they are material, the auditor should determine whether those costs and fees are properly deferred and amortized (or that the client’s accounting reasonably approximates the prescribed methods).

**Loan Costs and Fees for Credit Unions.** Credit unions normally do not charge loan fees for making loans to members. Consequently, many credit unions have loan origination costs, which are generally expensed, without any associated loan fees. Auditors should assess the significance of capitalizable loan origination costs in relation to the financial statements. The NCUA has taken the position that accounting for loan fees will not be material to most credit unions.
### Exhibit 3-2

**Examples of Origination Costs That Can Be Deferred**

<table>
<thead>
<tr>
<th>Incremental Direct Costs</th>
<th>Direct Costs of Specified Activities</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Commissions paid to independent loan brokers for loans purchased.</td>
<td>Salaries and payroll-related fringe benefits allocated to the following activities relating to successfully originated loans:</td>
</tr>
<tr>
<td>• Origination fees paid to independent lead lenders for loans or participations purchased.</td>
<td>• Counseling borrowers, such as discussing alternative financing arrangements and negotiating loan terms.</td>
</tr>
<tr>
<td>• Legal fees or escrow fees paid to third parties to close the loan.</td>
<td>• Processing loan applications.</td>
</tr>
<tr>
<td></td>
<td>• Evaluating the prospective borrower’s financial condition.</td>
</tr>
<tr>
<td></td>
<td>• Evaluating and recording guarantees, collateral, and other security arrangements.</td>
</tr>
<tr>
<td></td>
<td>• Preparing and processing loan documents.</td>
</tr>
<tr>
<td></td>
<td>• Performing a quality control review during the underwriting process.</td>
</tr>
<tr>
<td></td>
<td>• Formal approval of loan by senior management or loan committee.</td>
</tr>
<tr>
<td></td>
<td>• Closing the loan transaction.</td>
</tr>
</tbody>
</table>

Other direct origination costs that relate to the preceding activities, such as:

• Travel costs.
• Itemized long-distance charges.
• Supplies used to prepare the loan documents used.

* * *
Exhibit 3-3

Examples of Origination Costs That Must Be Expensed

- Costs relating to unsuccessful loan originations.
- Advertising costs.
- Costs relating to soliciting borrowers.
- Idle time of loan officers and underwriting staff.
- Loan servicing costs.
- Administrative costs.
- Equipment costs.
- Depreciation.
- Rent.
- Software costs.

Loans in Process

When some institutions make construction loans, they record them at the full commitment amount and provide a contra account called Loans in Process (LIP) to reduce the net loan balance to the amount of the funds disbursed. The LIP account starts out as a credit balance and is debited as additional funds are disbursed. Audit procedures relating to LIP normally include the following:

- **Testing the Reconciliation of Subsidiary Records to the General Ledger.** Total LIP on the loans receivable trial balance (or LIP trial balance, if applicable) should be reconciled to the general ledger control account at the balance sheet date. Any significant reconciling items should be investigated.

- **Performing Analytical Procedures Relating to Ending Balances.** The ending LIP balance may also be tested by comparing the current year’s LIP as a percentage of construction loans to the percentage in the prior year. Significant fluctuations should be investigated.

- **Scanning the Trial Balance for Unusual Items.** The loan trial balance (or LIP trial balance, if applicable) should be scanned for unusual items (such as debit balances) that may indicate problem loans.

Specific LIP amounts may also be tested in conjunction with detailed loan reviews of construction loans. If LIP is a significant amount (or is expected to be significant given the number and amount of construction loans), the auditor should usually include individual LIP amounts on construction loan confirmations.

Advance Payments by Borrowers for Taxes and Insurance (Escrows)

Many single-family residential loan agreements require the borrower to maintain certain funds (usually referred to as escrow accounts) to cover property taxes and insurance on the collateral. Audit procedures relating to escrow accounts normally include the following:

- **Testing the Reconciliation of Subsidiary Records to the General Ledgers.** Total escrow on the loans receivable trial balance (or other subsidiary ledger) should be reconciled to the general ledger control account at the balance sheet date. Any significant reconciling items should be investigated.
Performing Analytical Procedures Relating to Ending Balances. The ending escrow balance may also be tested by comparing the current year’s balance as a percentage of single-family residential loans to the percentage in the prior year. Significant fluctuations should be investigated.

Auditors sometimes confirm escrow balances along with single-family residential loan balances. However, that procedure may have limited effectiveness unless the borrowers have received analyses of their escrow balances. If confirmation is desired, it is generally preferable to provide details of transactions within the accounts instead of individual balances.

CASE STUDY: AUDITING THE ALLOWANCE FOR LOAN LOSSES

As discussed previously, the allowance for loan losses normally consists of the following components:

a. Specific allowances for certain identified or impaired loans.

b. Allowance relating to classified loans.

c. Allowance relating to loans that are evaluated in pools, such as consumer loans and single-family residential loans.

d. General allowance for other loan losses inherent in the portfolio.

The auditor typically makes an independent estimate of the allowance for loan losses and compares that estimate to the recorded allowance. The following case study illustrates the basic approach to auditing the allowance.

Assume Third National Bank had a loan portfolio of $51,200,000 consisting of the following:

- Commercial business $ 25,769,000
- Commercial real estate 7,504,000
- Single-family residential 9,315,000
- Installment and other consumer 8,612,000

$ 51,200,000

The bank had an allowance for loan losses of $868,000 consisting of the following components:

- Specific allowances (amounts classified as loss) $ 275,000
- Allowance for classified loans 357,000
- Allowances for loans evaluated by pools 138,000
- General allowance for other loan losses inherent in the portfolio 98,000

$ 868,000

The following paragraphs discuss an audit approach for each component of the allowance.

Specific Allowances

An auditor typically estimates specific allowances by reviewing and evaluating individual commercial business and commercial real estate loans. In auditing the Third National Bank, the auditor considered the loan portfolio, the client’s lending policies and procedures, economic conditions, delinquency and charge-off trends and established the following scope for loan reviews:

- All loans with principal balances that equal or exceed tolerable misstatement of $350,000.

- Twenty loans that were either originated or renewed during the period, selected at random.

- Problem loans with principal balances exceeding $110,000, and all other loans made to the borrowers of the problem loans. (As noted in Lesson 2, problem loans include delinquent loans, loans criticized by examiners, loans classified in the prior year’s audit, and loans modified in troubled debt restructurings.)
The auditor also selected other loans as necessary to obtain a cross-section of loans originated by each loan officer, loans in significant industry concentrations, and related party loans. Based upon a preliminary review of the loans selected, the auditor calculated that by using the preceding scopes, detailed loan reviews would be performed on 45%–50% of commercial business and commercial real estate loans. The loan reviews also covered related loan commitments and other off-balance-sheet credit instruments.

For each of the loans selected, the auditor examined the loan files and evaluated its collectibility. A loan classification system was used to assist in determining the degree of credit risk associated with the loan. If a loan was considered impaired, the auditor estimated the specific allowance needed based on the fair value of the collateral or the present value of the expected cash flows (or the aggregate collection method if the preceding options were not practical). A portion of the loan equal to the specific allowance was classified as loss. All of the remaining balances were considered to be unclassified if there appeared to be no additional loss exposure or were classified as substandard if there appeared to be a risk of additional loss. The following are examples of loans that were reviewed in determining the specific allowance:

- **4A Company had a $450,000 loan with the Bank.** The loan was current, it was well secured by collateral with a fair value of $700,000, and the company was financially strong. Thus, the loan was unclassified, and no specific allowance was considered necessary.

- **ABC Company Had a $105,000 Loan with the Bank.** The loan was current, but it was placed on nonaccrual because the borrower’s financial statements showed recurring losses and liquidity problems. The company was attempting to restructure its operations to restore its profitability. The loan was secured by inventory, plant, and equipment with an original appraised value of $600,000, but there was no documentation regarding the current value of the collateral. The auditor estimated that the land around the plant was worth at least $150,000 based on recent sales of property in the area. The auditor believed that there was a risk of loss on the loan, but the risk was not sufficient to consider the loan impaired. Thus, the auditor classified the loan as substandard.

- **XYZ Properties Had a $200,000 Loan with the Bank.** The loan was delinquent, and the collateral (rental real estate) was not producing sufficient cash flows to cover the debt payments. The auditor believed that the loan was impaired, and the potential loss was assessed based on the fair value of the collateral. (In this example, the fair value of the collateral was used to estimate the loss on an impaired loan.) The loan file contained an appraisal, which reported a market value of $320,000. However, the appraisal was over three years old, and it assumed that by now the property would be producing greater cash flows than actual current levels. The auditor discussed the matter with the loan officer and the appraiser, and, based on these discussions and the project’s current level of operations, estimated that the current market value of the property is $120,000 to $150,000. Thus, the auditor classified the loan as follows:

<table>
<thead>
<tr>
<th></th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loss [200,000 − 150,000]</td>
<td>$ 50,000</td>
</tr>
<tr>
<td>Substandard [150,000 − 120,000]</td>
<td>30,000</td>
</tr>
<tr>
<td>Unclassified</td>
<td>120,000</td>
</tr>
</tbody>
</table>

Exhibit 3-4, Exhibit 3-5, and Exhibit 3-6 show how the preceding loan reviews were documented. Based on the loan review and evaluation procedures, the auditor estimated the total allowance relating to specific loans to be $305,000.
Exhibit 3-4

Loan Review and Evaluation Form

Client: Third National Bank  
Balance Sheet Date: 12/31/X5

Completed by: Jean Credit  
Date: 1/10/X6

Part 1—Loan Information

Borrower: 4A Company  
Origination date: 1/15/X4

Loan type: Commercial business  
Maturity date: 7/15/X6

Original loan amount: $560,000  
Repayment terms: minimum of $100,000

Purpose of loan: working capital  
plus interest each year; balance at maturity

Loan officer: JB Smith  
Number of renewals: 0

Loan no.: 03-117-8  
Payment status: current

Interest rate: prime + 1%  
Is the loan on nonaccrual? no

Other information (personal guarantees, participations sold, letters of credit, etc.): none

Is the loan within legal lending limits? YES  

Recorded loan investment:

<table>
<thead>
<tr>
<th>Interim</th>
<th>Final</th>
</tr>
</thead>
<tbody>
<tr>
<td>Principal balance</td>
<td>450,000</td>
</tr>
<tr>
<td>Accrued interest</td>
<td>37,500</td>
</tr>
<tr>
<td>Premiums or (discounts)</td>
<td></td>
</tr>
<tr>
<td>Deferred loan costs or (fees)</td>
<td></td>
</tr>
<tr>
<td>RECORDED LOAN INVESTMENT</td>
<td>487,500</td>
</tr>
</tbody>
</table>

Part 2—Related Loans

(Other loans made by the client to this borrower)

<table>
<thead>
<tr>
<th>Loan No.</th>
<th>Loan Type</th>
<th>Principal Balance</th>
<th>Loan Term or Maturity Date</th>
<th>Payment Status</th>
<th>Collateral</th>
<th>Collateral Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>none</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Part 3—Borrower and Guarantor Financial Information

(Attach copies of financial statements or a form such as the “Borrower/Guarantor Financial Information Form,” from PPC’s Guide to Audits of Financial Institutions.)

Part 4—Collateral Summary

<table>
<thead>
<tr>
<th>Description</th>
<th>Total Value</th>
<th>Less Prior Liens</th>
<th>Value to Lender</th>
<th>Basis for and Date of Valuation (appraisal, market quote, etc.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>finished goods inventory</td>
<td>400,000</td>
<td>—</td>
<td>400,000</td>
<td>12/X5 inventory listing (at retail)</td>
</tr>
<tr>
<td>current A/R</td>
<td>300,000</td>
<td>—</td>
<td>300,000</td>
<td>12/X5 A/R aging (all current)</td>
</tr>
<tr>
<td>TOTAL</td>
<td>700,000</td>
<td>—</td>
<td>700,000</td>
<td></td>
</tr>
</tbody>
</table>
Do the valuation assumptions and conclusions appear to be reasonable?  YES  ☑  NO  
Explanation of NO answer: (Attach documentation for changes to collateral value estimates.)  

---

**Part 5—Specific Allowance or Allocation**

1. Is the loan impaired (considering payment history, ability and intent of borrower to repay the loan, and collateral value)?
   - YES  
   - NO  ☑  No specific allowance or allocation is necessary. Go to Part 6.

2. Is foreclosure probable? (See Lesson 2.)
   - YES  
   - NO  

3. Estimate the specific allowance or allocation using method a or b, as applicable. If neither method is practical, method c should be used. Place a check beside the method used. Classify the specific allowance or allocation amount as a loss in Part 6, and attach calculations supporting the loss amount.
   - a. Present value of expected cash flows. (Provide an allowance, if needed, to reduce the recorded loan investment to the present value of the expected cash flows to be collected, discounted using the effective rate of the loan, as discussed in Lesson 2.)
   - b. Fair value of the collateral. (Provide an allowance, if needed, to reduce the recorded loan investment to the fair value of the collateral.) This alternative must be used if foreclosure is probable.
   - c. Aggregate collection experience. Group with loans of similar characteristics and use historical data to determine expected amount and timing of future cash flows. Discount expected cash flows at the average effective interest rate of the loans.

---

**Part 6—Loan Classification**

<table>
<thead>
<tr>
<th></th>
<th>Auditor</th>
<th>Client</th>
<th>Regulators</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Interim</td>
<td>Year end</td>
<td>Interim</td>
</tr>
<tr>
<td>Unclassified</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Special mention (OAEM)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Substandard</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Doubtful</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Loss (from Part 5)</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Basis for auditor’s classification:  Good payment history, borrower is profitable with good cash flow; 70% loan to value ratio (based on recorded loan investment).

---

*  *  *
Exhibit 3-5

Loan Review and Evaluation Form

Client: Third National Bank  Balance Sheet Date: 12/31/X5
Completed by: Jean Credit  Date: 1/10/X6

Part 1—Loan Information

Borrower: ABC Company  Origination date: 9/25/X4
Loan type: Commercial business  Maturity date: 9/25/X6
Original loan amount: $145,000  Repayment terms: quarterly payments of $10,000 plus interest balance at maturity
Purpose of loan: expansion
Loan officer: BJ Jones  Number of renewals: 1
Loan no.: 7-665-3  Payment status: current
Interest rate: prime + 1.5%  Is the loan on nonaccrual? yes

Other information (personal guarantees, participations sold, letters of credit, etc.): none

Is the loan within legal lending limits? YES √ NO

Recorded loan investment:

<table>
<thead>
<tr>
<th></th>
<th>Interim</th>
<th>Final</th>
</tr>
</thead>
<tbody>
<tr>
<td>Principal balance</td>
<td>105,000</td>
<td>105,000</td>
</tr>
<tr>
<td>Accrued interest charged off 11/30/X5</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Premiums or (discounts)</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Deferred loan costs or (fees)</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>RECORDED LOAN INVESTMENT</td>
<td>105,000</td>
<td>105,000</td>
</tr>
</tbody>
</table>

Part 2—Related Loans
(Other loans made by the client to this borrower)

<table>
<thead>
<tr>
<th>Loan No.</th>
<th>Loan Type</th>
<th>Principal Balance</th>
<th>Loan Term or Maturity Date</th>
<th>Payment Status</th>
<th>Collateral</th>
<th>Collateral Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>none</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Part 3—Borrower and Guarantor Financial Information
(Attach copies of financial statements or a form such as the “Borrower/Guarantor Financial Information Form,” from PPC’s Guide to Audits of Financial Institutions.)

Part 4—Collateral Summary

<table>
<thead>
<tr>
<th>Description</th>
<th>Total Value</th>
<th>Less Prior Liens</th>
<th>Value to Lender</th>
<th>Basis for and Date of Valuation (appraisal, market quote, etc.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>inventory</td>
<td>140,000</td>
<td>—</td>
<td>140,000</td>
<td>inventory listing 9/30/X5</td>
</tr>
<tr>
<td>plant &amp; equipment</td>
<td>460,000</td>
<td>—</td>
<td>460,000</td>
<td>original appraisal 19X3</td>
</tr>
<tr>
<td>TOTAL</td>
<td>600,000</td>
<td>—</td>
<td>600,000</td>
<td></td>
</tr>
</tbody>
</table>
Do the valuation assumptions and conclusions appear to be reasonable?  YES ______  NO √

Explanation of NO answer: (Attach documentation for changes to collateral value estimates.)  Bank has been unable to obtain more recent information about the collateral. The current value of the assets is likely to be significantly less than $600,000. However, based on recent sales in this area, the land around the plant is likely to be worth at least $150,000.

---

**Part 5—Specific Allowance or Allocation**

1. Is the loan impaired (considering payment history, ability and intent of borrower to repay the loan, and collateral value)?
   - YES ______ Go to step 2.
   - NO √ No specific allowance or allocation is necessary. Go to Part 6.

2. Is foreclosure probable? (See Lesson 2.)
   - YES ______ Provide an allowance to reduce the loan to the fair value of the collateral, less estimated selling costs.
   - NO ______ Go to step 3.

3. Estimate the specific allowance or allocation using method a or b, as applicable. If neither method is practical, method c should be used. Place a check beside the method used. Classify the specific allowance or allocation amount as a loss in Part 6, and attach calculations supporting the loss amount.
   - a. Present value of expected cash flows. (Provide an allowance, if needed, to reduce the recorded loan investment to the present value of the expected cash flows to be collected, discounted using the effective rate of the loan, as discussed beginning in Lesson 2.)
   - b. Fair value of the collateral. (Provide an allowance, if needed, to reduce the recorded loan investment to the fair value of the collateral.) This alternative must be used if foreclosure is probable.
   - c. Aggregate collection experience. Group with loans of similar characteristics and use historical data to determine expected amount and timing of future cash flows. Discount expected cash flows at the average effective interest rate of the loans.

---

**Part 6—Loan Classification**

<table>
<thead>
<tr>
<th>Auditor Classification</th>
<th>Auditor Interim</th>
<th>Auditor Year end</th>
<th>Client Interim</th>
<th>Client Year end</th>
<th>Regulators</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unclassified</td>
<td></td>
<td></td>
<td>√</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Special mention (OAEM)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>√</td>
</tr>
<tr>
<td>Substandard</td>
<td>√</td>
<td>√</td>
<td></td>
<td>√</td>
<td></td>
</tr>
<tr>
<td>Doubtful</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Loss (from Part 5)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Basis for auditor’s classification: ABC’s financial statements show recurring losses and poor liquidity. Correspondence in loan file indicates that the company is trying to restructure its operations to restore its profitability. Because of these problems, repayment is considered questionable and loan is classified substandard. No specific allowance is provided because of collateral value.

* * *

Exhibit 3-6
Loan Review and Evaluation Form

<table>
<thead>
<tr>
<th>Client: Third National Bank</th>
<th>Balance Sheet Date: 12/31/X5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Completed by: Jean Credit</td>
<td>Date: 1/10/X6</td>
</tr>
</tbody>
</table>

Part 1—Loan Information

<table>
<thead>
<tr>
<th>Borrower: XYZ Company</th>
<th>Origination date: 5/30/X0</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loan type: Commercial real estate</td>
<td>Maturity date: 5/30/X9</td>
</tr>
<tr>
<td>Original loan amount: $250,000</td>
<td>Repayment terms: $4,650 per month</td>
</tr>
<tr>
<td>Purpose of loan: permanent financing</td>
<td></td>
</tr>
<tr>
<td>Loan officer: BJ Jones</td>
<td>Number of renewals: -0-</td>
</tr>
<tr>
<td>Loan no.: 02-815-6</td>
<td>Payment status: 60 days past due</td>
</tr>
<tr>
<td>Interest rate: 10%</td>
<td>Is the loan on nonaccrual? yes</td>
</tr>
</tbody>
</table>

Other information (personal guarantees, participations sold, letters of credit, etc.): none

Is the loan within legal lending limits? YES ✓ NO

Recorded loan investment:

<table>
<thead>
<tr>
<th>Principal balance</th>
<th>Interim</th>
<th>Final</th>
</tr>
</thead>
<tbody>
<tr>
<td>204,000</td>
<td>200,000</td>
<td></td>
</tr>
<tr>
<td>Accrued interest charged off 11/30/X5</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Premiums or (discounts)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Deferred loan costs or (fees)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

RECORDED LOAN INVESTMENT 204,000 200,000

Part 2—Related Loans

<p>| (Other loans made by the client to this borrower) |</p>
<table>
<thead>
<tr>
<th>Loan No.</th>
<th>Loan Type</th>
<th>Principal Balance</th>
<th>Loan Term or Maturity Date</th>
<th>Payment Status</th>
<th>Collateral</th>
<th>Collateral Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>none</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Part 3—Borrower and Guarantor Financial Information

(Attach copies of financial statements or a form such as the “Borrower/Guarantor Financial Information Form,” from PPC’s Guide to Audits of Financial Institutions.)
**Part 4—Collateral Summary**

<table>
<thead>
<tr>
<th>Description</th>
<th>Total Value</th>
<th>Less Prior Liens</th>
<th>Value to Lender</th>
<th>Basis for and Date of Valuation (appraisal, market quote, etc.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>20 unit apt complex</td>
<td>320,000</td>
<td>—</td>
<td>320,000</td>
<td>19X0 appraisal</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td>320,000</td>
<td>—</td>
<td>320,000</td>
<td></td>
</tr>
</tbody>
</table>

Do the valuation assumptions and conclusions appear to be reasonable?  

YES ☑ NO ☐

Explanation of NO answer: (Attach documentation for changes to collateral value estimates.) Appraisal is over 5 years old and it assumes greater cash flows than are currently being produced. Based on discussions with loan officer and appraiser (and current operations), a more appropriate value would be $120,000–$150,000.

---

**Part 5—Specific Allowance or Allocation**

1. Is the loan impaired (considering payment history, ability and intent of borrower to repay the loan, and collateral value)?

   YES ☑ Go to step 2.

   NO ───── No specific allowance or allocation is necessary. Go to Part 6.

2. Is foreclosure probable? (See Lesson 2.)

   YES ☑ Provide an allowance to reduce the loan to the fair value of the collateral, less estimated selling costs.

   NO ☑ Go to step 3.

3. Estimate the specific allowance or allocation using method a or b, as applicable. If neither method is practical, method c should be used. Place a check beside the method used. Classify the specific allowance or allocation amount as a loss in Part 6, and attach calculations supporting the loss amount.

   ───── a. Present value of expected cash flows. (Provide an allowance, if needed, to reduce the recorded loan investment to the present value of the expected cash flows to be collected, discounted using the effective rate of the loan, as discussed in Lesson 2.)

   ☑ b. Fair value of the collateral. (Provide an allowance, if needed, to reduce the recorded loan investment to the fair value of the collateral.) This alternative must be used if foreclosure is probable.

   ───── c. Aggregate collection experience. Group with loans of similar characteristics and use historical data to determine expected amount and timing of future cash flows. Discount expected cash flows at the average effective interest rate of the loans.
Part 6—Loan Classification

### Auditor

<table>
<thead>
<tr>
<th></th>
<th>Interim</th>
<th>Year end</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unclassified</td>
<td>120,000</td>
<td>120,000</td>
</tr>
<tr>
<td>Special mention (OAEM)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Substandard</td>
<td>30,000</td>
<td>30,000</td>
</tr>
<tr>
<td>Doubtful</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Loss (from Part 5)</td>
<td>54,000</td>
<td>50,000</td>
</tr>
</tbody>
</table>

### Client

<table>
<thead>
<tr>
<th></th>
<th>Interim</th>
<th>Year end</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unclassified</td>
<td>154,000</td>
<td>120,000</td>
</tr>
<tr>
<td>Special mention (OAEM)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Substandard</td>
<td></td>
<td>30,000</td>
</tr>
<tr>
<td>Doubtful</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Loss (from Part 5)</td>
<td>50,000</td>
<td>50,000</td>
</tr>
</tbody>
</table>

### Regulators

<table>
<thead>
<tr>
<th></th>
<th>Interim</th>
<th>Year end</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unclassified</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Special mention (OAEM)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Substandard</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Doubtful</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Loss (from Part 5)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Basis for auditor’s classification: Poor payment history and marginal operations make this an impaired loan. Loss determined based on estimated fair value of the collateral of $150,000; additional $30,000 potential loss is classified as substandard.

* * *

### Allowance Related to Classified Loans

The allowance relating to classified loans applies to all types of loans that are evaluated individually, which in this case study are commercial business and commercial real estate loans. As discussed in Lesson 2, the allowance for classified loans generally relates only to loans classified as substandard.

In performing the detailed loan reviews, the auditor classified certain loans as substandard. In addition, the client had classified a number of smaller loans that were not subject to auditor review as substandard. In the auditor’s experience, the client’s classification system had always been reliable. The auditor therefore classified the following amounts as substandard:

<table>
<thead>
<tr>
<th>Loans Reviewed</th>
<th>Loans Not Reviewed</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commercial business loans</td>
<td>$974,000</td>
<td>$485,000</td>
</tr>
<tr>
<td>Commercial real estate loans</td>
<td>383,000</td>
<td>173,000</td>
</tr>
<tr>
<td><strong>$1,357,000</strong></td>
<td><strong>$658,000</strong></td>
<td><strong>$2,015,000</strong></td>
</tr>
</tbody>
</table>

Historically, the client’s loss experience relating to classified loans (losses as a percentage of the related loans) has been as follows:

<table>
<thead>
<tr>
<th></th>
<th>Commercial Business Loans</th>
<th>Commercial Real Estate Loans</th>
</tr>
</thead>
<tbody>
<tr>
<td>Substandard</td>
<td>18%</td>
<td>15%</td>
</tr>
</tbody>
</table>

The auditor tested the historical loss percentages by reviewing charge-offs for the preceding five years. After considering the risks associated with currently classified loans, the auditor determined that credit risk may be slightly higher than normal because of uncertainties related to economic conditions and collateral values. Thus, the auditor believed that the loss percentages for both commercial business and commercial real estate loans should be raised to 20%. Applying the percentages to the substandard loans shown in the previous paragraph resulted in an allowance of $403,000 (20% × $2,015,000).
Allowances for Loan Pools

As noted in Lesson 2, allowances related to loan pools are normally determined by applying a loss percentage to each pool. In this case study, the bank evaluated single-family residential loans and consumer loans as separate loan pools. The bank determined loss percentages using historical losses, adjusted for current conditions. The following is a summary of historical loss percentages and the percentages used by the bank to determine its allowances:

<table>
<thead>
<tr>
<th>Losses as a Percentage of Loans</th>
<th>Historical</th>
<th>Bank’s Estimate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single-family residential</td>
<td>0.8%</td>
<td>1.0%</td>
</tr>
<tr>
<td>Consumer</td>
<td>0.5%</td>
<td>0.5%</td>
</tr>
</tbody>
</table>

While reviewing recent trends, the auditor noted that both delinquency and charge-off rates had been rising for both loan types. Based on that information and an assessment of economic conditions, the auditor concluded that increasing loss percentages over historical rates was appropriate for both loan types. The auditor decided that 1% was an appropriate loss percentage for single-family residential loans, but the loss percentage for consumer loans needed to be increased to 0.75%. Applying those percentages to the loan pool balances, the auditor estimated the allowance for loan pools as follows:

Allowance (Rounded to Thousands)

| Installment and other consumer loans (0.75% × $8,612,000) | $ 65,000 |
| Single-family residential loans (1% × $9,315,000)       | 93,000   |
| **Total**                                              | **$ 158,000** |

General Allowance for Other Losses in the Loan Portfolio

As noted in Lesson 2, a general allowance should be provided to cover other losses in the loan portfolio that are not addressed by the other components of the total allowance for loan losses. In this case study, the Bank provided a general allowance of $98,000, which was approximately 0.65% of the remaining loan portfolio and 0.19% of the total loan portfolio. After considering the condition of the loan portfolio, risk concentrations, economic conditions, trends in loan delinquencies, the Bank’s loss experience, and the risk of material misstatement of the other components of the allowance, the auditor concluded that the Bank’s general allowance was appropriate.

Concluding on the Recorded Allowance

After performing the loan reviews and the other procedures discussed in the preceding paragraphs, the auditor computed an estimated allowance and compared it to the Bank’s recorded allowance as follows:

| Specific allowances (amounts classified as loss) | $ 305,000 |
| Allowance for classified loans                   | 403,000   |
| Allowances for loans evaluated by pools          | 158,000   |
| General allowance for other losses inherent in the loan portfolio | 98,000   |
| **Total estimated allowance for loan losses**   | **964,000** |
| Less recorded allowance                          | (868,000) |
| **Difference**                                  | **$ 96,000** |

Exhibit 3-7 shows this summary on the “Summary of Estimated Allowance for Loan Losses” from PPC’s Guide to Audits of Financial Institutions.
### Exhibit 3-7

**Summary of Estimated Allowance for Loan Losses**

Client: Third National Bank  
Balance Sheet Date: 12/31/X5  
Completed by: Jean Credit  
Date: 1/29/X6

<table>
<thead>
<tr>
<th>WP Ref.</th>
<th>Principal Balance</th>
<th>Loss Percentage</th>
<th>WP Ref.</th>
<th>Allowance Amount (rounded)</th>
</tr>
</thead>
<tbody>
<tr>
<td>E-5</td>
<td>$16,137,000</td>
<td></td>
<td></td>
<td>$289,000</td>
</tr>
<tr>
<td>E-7</td>
<td>$50,000</td>
<td></td>
<td></td>
<td>$16,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$16,187,000</strong></td>
<td></td>
<td></td>
<td><strong>$305,000</strong></td>
</tr>
</tbody>
</table>

**SPECIFIC ALLOWANCES (LOSS ON IMPAIRED LOANS)**

- **Loans reviewed**  
  - E-5 $16,137,000
- **Loans not reviewed**  
  - E-7 $50,000

Total $16,187,000 $305,000

**ALLOWANCE FOR SUBSTANDARD LOANS**

- **Loans reviewed**  
  - E-5 $1,357,000
- **Loans not reviewed**  
  - E-7 $658,000

Total $2,015,000 $403,000

**ALLOWANCE FOR LOAN POOLS**

- Installment loans  
  - E-2 $8,612,000 $65,000  
- Single-family residential loans  
  - E-2 $9,315,000 $93,000

Total $17,927,000 $158,000

**GENERAL ALLOWANCE (UNALLOCATED)**

$15,071,000 $98,000

**TOTAL ESTIMATED ALLOWANCE FOR LOAN LOSSES**

$964,000

**TOTAL PER BOOKS**

- E-2 $51,200,000 $868,000

**DIFFERENCE** (See discussion in Lesson 2)

$96,000

---

The auditor assessed that difference and concluded that, by itself, it did not cause the financial statements to be materially misstated. Accordingly, it was recorded on the summary of audit differences so it can be aggregated with other audit differences and reevaluated at the end of the audit.
SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

37. Lynne, an auditor, is engaged to audit a financial institution. As part of her audit, she computes accrued interest receivable for each loan type as a percentage of loans receivable. Then Lynne compares the results the percentages from the prior period. Why might Lynne have performed this audit procedure?
   a. To perform analytical procedures related to the ending balances.
   b. To test subsidiary record and general ledger reconciliation.
   c. To assess the collectability of ending balances.
   d. To mitigate the risk of material misstatement for accrued interest assessed as high.

38. Like many financial institutions, Sunnyland City Bank (SCB) regularly incurs nonrefundable costs associated with the origination and purchase of new loans. SCB should amortize all of the following, except:
   a. Origination fees.
   b. Origination costs.
   c. The difference between the cost of initial investment in an acquired loan and the principal amount when purchased.
   d. Costs for nonaccrual loans.

39. Which of the following financial institutions correctly dealt with its origination costs?
   a. Alpha Institution expensed costs for preparing and processing loan documents.
   b. Beta Institution deferred costs related to unsuccessful loan originations.
   c. Gamma Institution expensed the idle time of its loan officers and underwriting staff.
   d. Delta Institution deferred all administrative costs related to origination.

40. George, an auditor, is engaged to audit Freedom Mutual, a financial institution. Freedom Mutual has a pool of single-family residential loan agreements that require the borrower to maintain an escrow account to cover property taxes and insurance. As part of his audit, George performs audit procedures related to escrow accounts. Which of the following procedures would likely have the most limited effectiveness?
   a. Tests of the reconciliation of subsidiary records to the general ledgers.
   b. Performance of analytical procedures related to the ending balances.
   c. Confirmation of escrow balances along with single-family residential loan balances.
SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. (References are in parentheses.)

37. Lynne, an auditor, is engaged to audit a financial institution. As part of her audit, she computes accrued interest receivable for each loan type as a percentage of loans receivable. Then Lynne compares the results from the prior period. Why might Lynne have performed this audit procedure? (Page 117)

   a. To perform analytical procedures related to the ending balances. [This answer is correct. When auditing accrued interest receivable, Lynne will want to perform analytical procedures related to ending balances. The procedure described in this scenario is one such procedure Lynne could perform. Alternatively, she could compute the number of days of accrued interest outstanding at the end of the current and prior year and compare the two amounts. Significant fluctuations should be investigated.]

   b. To test subsidiary record and general ledger reconciliation. [This answer is incorrect. Testing the reconciliation of subsidiary records to the general ledgers is a procedure that can be performed related to accrued interest receivable. The total accrued interest receivable balance on the loans receivable trial balance (or accrued interest trial balance, if applicable) should be reconciled to the general ledger control account at the balance sheet date. Any significant reconciling items should be investigated.]

   c. To assess the collectability of ending balances. [This answer is incorrect. Accrued interest receivable is included in the recorded loan investment, and, thus, collectability of accrued interest on specific loans is assessed as part of auditing the allowance for loan losses. For other types of loans that are not subject to detailed review, the auditor should consider the client’s policies for evaluating the collectability of accrued interest, assess the reasonableness of those policies, and determine whether the client is following those policies.]

   d. To mitigate the risk of material misstatement for accrued interest assessed as high. [This answer is incorrect. The auditor should consider recomputing the accrued interest balance on a sample of individual loans. Detailed tests of accrued interest calculations may be necessary in certain situations, such as if the risk of material misstatement of accrued interest receivable is high.]

38. Like many financial institutions, Sunnyland City Bank (SCB) regularly incurs nonrefundable costs associated with the origination and purchase of new loans. SCB should amortize all of the following, except: (Page 118)

   a. Origination fees. [This answer is incorrect. Under FASB ASC 310-20, loan origination fees should be deferred and amortized into interest income, generally using the interest method.]

   b. Origination costs. [This answer is incorrect. Under FASB ASC 310-20, certain origination costs should be deferred and amortized as a reduction of interest income over the life of the loan, generally using the interest method. Other origination costs should be expensed as incurred.]

   c. The difference between the cost of initial investment in an acquired loan and the principal amount when purchased. [This answer is incorrect. Under FASB ASC 310-20, the difference between the initial investment in an acquired loan and its principle amount when purchased should be recognized as an adjustment of yield over the life of the loan. All other costs related to purchased loans should be charged to expense as incurred.]

   d. Costs for nonaccrual loans. [This answer is correct. FASB ASC 310-20-35-17 states that deferred fees or costs should not be amortized during periods in which interest income is not being recognized because of concerns about the realization of principal or interest.]

39. Which of the following financial institutions correctly dealt with its origination costs? (Page 121)

   a. Alpha Institution expensed costs for preparing and processing loan documents. [This answer is incorrect. Under FASB ASC 310—20, this type of origination cost should have been deferred.]
b. Beta Institution deferred costs related to unsuccessful loan originations. [This answer is incorrect. Under FASB ASC 310-20, this type of origination cost should have been expensed.]

c. Gamma Institution expensed the idle time of its loan officers and underwriting staff. [This answer is correct. Under FASB ASC 310-20, this type of origination fee should be expensed, so Gamma Institution accounted for this amount correctly.]

d. Delta Institution deferred all administrative costs related to origination. [This answer is incorrect. Under FASB ASC 310-20, this type of cost should have been expensed.]

40. George, an auditor, is engaged to audit Freedom Mutual, a financial institution. Freedom Mutual has a pool of single-family residential loan agreements that require the borrower to maintain an escrow account to cover property taxes and insurance. As part of his audit, George performs audit procedures related to escrow accounts. Which of the following procedures would likely have the most limited effectiveness? (Page 121)

a. Tests of the reconciliation of subsidiary records to the general ledgers. [This answer is incorrect. Total escrow on the loans receivable trial balance (or other subsidiary ledger) should be reconciled to the general ledger control account at the balance sheet date. Any significant reconciling items should be investigated. There is nothing specific to indicate that this procedure would have limited effectiveness.]

b. Performance of analytical procedures related to the ending balances. [This answer is incorrect. The ending escrow balance may also be tested by comparing the current year’s balance as a percentage of single-family residential loans to the percentage in the prior year. Significant fluctuations should be investigated. There is nothing specific to indicate that this procedure would have limited effectiveness.]

c. Confirmation of escrow balances along with single-family residential loan balances. [This answer is correct. This procedure may have limited effectiveness unless the borrowers have received analyses of their escrow balances. If confirmation is desired, it is generally preferable to provide details of transactions within the accounts instead of individual balances.]
EXAMINATION FOR CPE CREDIT

Lesson 3 (AFITG101)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

33. Federated Mutual (a savings institution) takes on an acquisition, development, and construction (ADC) loan. What is the main benefit for the financial institution in this arrangement?
   a. The borrower must allow the institution access to its assets
   b. The institution will receive all payments from the borrower before the loan matures.
   c. ADC loans are easily accounted for.
   d. The institution receives profit participation in the project.

34. Federated Mutual enters into an ADC arrangement in which it provides all the financing for the acquisition and development of a real estate project. The total loan amount is $2 million, and the estimated fair value of the project at completion is $3,200,000. Interest on the ADC loan is 10%, and loan fees are 8% of the loan’s total amount. Loan fees and market interest rates are 4% and 8% respectively. Contractual interest income during the term of the loan is $408,000. Federated Mutual will receive 40% of the profits from the sale of the property. The expected residual profit is $1,200,000. Calculate Federated Mutual’s total profit participation to determine how this ADC loan should be accounted for.
   a. It should be accounted for as a direct investment in real estate.
   b. It should be accounted for as a loan.
   c. It should be accounted for as a real estate joint venture.
   d. Do not select this answer choice.

35. Federated Mutual has an ADC arrangement that should be accounted for as a joint venture. Which of the following statements applies?
   a. The arrangement should be included with loans on Federated Mutual’s balance sheet.
   b. Federated Mutual should record all project earnings, even those that will be earned next year.
   c. If collectability of principle or interest is in doubt, Federated Mutual should defer interest income.
   d. If the project suffers recurring operating losses, interest and fees must be recognized immediately.

36. Federated Mutual has an ADC arrangement that is classified as a joint venture. The borrower then pledges a substantial amount of liquid assets as security for the loan. The assets are unencumbered. Federated Mutual has less than a majority profit participation in this project. Does this arrangement qualify for a change in classification?
   a. Yes, it should be reclassified as a loan.
   b. Yes, it should be reclassified as a direct investment.
   c. No, this arrangement should not be reclassified.
   d. Do not select this answer choice.
37. When can the rule of 78s be used?
   a. To perform yield analysis on the interest income of loans.
   b. To accrete unearned discounts on installment loans into income.
   c. To test subsidiary records’ reconciliation with the general ledger.
   d. To account for costs related to originating and purchasing new loans.

38. Categorize the following origination costs that can be expensed and those that can be deferred.
   i. Costs related to software.
   ii. Costs for processing loan applications.
   iii. Depreciation.
   iv. Costs related to advertising.
   v. Costs for closing the loan transaction.
   vi. Costs to evaluate the prospective borrower’s financial condition.


39. Which of the following institutions is most likely to be materially affected by loan fees and costs?
   a. Mega Bank made a significant amount of new loans this year, but has not collected all the fees yet.
   b. Medium Bank had immaterial loan fees and costs this year.
   c. Small Credit Union does not charge loan fees when making loans to its members.
   d. Do not select this answer choice.

40. Dorothy, an auditor, is engaged to audit Pendleton National Bank. This bank specializes in construction loans, so it maintains a loans in process (LIP) account. During the course of her audit, Dorothy notes that LIP is a significant account. How should this change her audit procedures?
   a. She should test reconciliation of subsidiary accounts to the general ledger.
   b. She should perform analytical procedures related to ending balances.
   c. She should scan the trial balance for unusual items.
   d. She should include individual LIP amounts in her construction loan confirmations.
GLOSSARY

Acquisition, development, and construction (ADC) loans: Arrangements in which the lender (usually a savings institution) participates in the expected residual profit from a real estate project. In addition to acquisition, development, and construction, this term is also applied to loans on operating real estate properties.

Aggregate collection experience method: A method provided in authoritative guidance financial institutions can use to determine allowances relating to specific loans. Under this method, loans with similar risk characteristics are aggregated, and historical data is used to determine the loan loss for the group.

Commercial business loans: Commercial business loans can be made for a variety of business purposes. Common types include working capital or seasonal loans, equipment financing, and agricultural loans.

Direct lending: When installment loans are originated by a financial institution.

Expected cash flows method: A method provided in authoritative guidance financial institutions can use to determine allowances relating to specific loans. Under this method, the loan loss is the amount needed to reduce the recorded loan investment to the expected cash flows to be received from the loan, discounted at the effective rate of the loan.

Fair value of the collateral method: A method provided in authoritative guidance financial institutions can use to determine allowances relating to specific loans. Under this method, the loan loss is the amount needed to reduce the recorded loan investment to the fair value of the collateral.

Financial asset: A financial instrument that conveys a right to the entity.

Financial liability: A contract that imposes an obligation on the entity.

General reserve: A general allowance used by a bank to assure that the allowance for loan losses covers all the inherent losses in the loan portfolio.

Impaired loan: A loan for which it is probable that the lender will be unable to collect all amounts due under the contractual terms of the loan agreement.

Indirect lending: Installment loans are originated by other parties (such as an auto dealer) and sold to the institution.

Installment loans: Installment loans are made to consumers to finance the acquisition of consumer goods, such as automobiles, boats, appliances, furniture, or other consumer goods.

Market value of the loan method: A method provided in authoritative guidance financial institutions can use to determine allowances relating to specific loans. Under this method, loan losses are allowed to be determined based on the market value of the loan, if there is an observable market value for the loan. This alternative is rarely used.

Other commercial loans: Financial institutions offer a variety of other types of financing for businesses besides the traditional commercial business loans. Examples of other commercial loans include SBA loans and letters of credit.

Other consumer loans: In addition to installment loans, there are a number of other consumer loans that financial institutions make. Examples of these types of loans include home improvement loans, home equity lines of credit, student loans, and payday loans.

Participations: Participations (or shared lending arrangements) allow financial institutions to handle loan requests that exceed their lending limits without violating lending regulations or policies. Loan participation arrangements involve the sale of a portion of a loan by one institution (the lead lender) to one or more participating institutions (the participants).

Problem loans: Any loan with a significant risk of impairment.
**Real estate loans:** Real estate loans are loans secured by a lien on real estate. Most real estate loans can be classified into one of the following categories: (1) single-family residential loans, (2) commercial real estate loans, and (3) development and construction loans.

**Troubled debt restructuring (TDR):** A TDR occurs when the creditor for economic or legal reasons related to the debtor’s financial difficulties grants a concession to the debtor that it would not otherwise consider.
### INDEX

#### ACQUISITION, DEVELOPMENT, AND CONSTRUCTION (ADC) LOANS
- **Accounting**
  - Direct investments in real estate ........................................... 108, 109
  - Investments in real estate joint ventures ................................. 108
  - Loans .................................................................................................. 108
  - Authoritative literature .................................................................... 106
  - Classification of
    - Changes in ................................................................. 109
    - Direct investment in real estate .............................................. 106
    - Documentation ........................................................................... 106
    - Investment in real estate joint venture ..................................... 106
    - Loan ......................................................................................... 106
    - Defined ...................................................................................... 105
  - Personal guarantees, effect on accounting ........................................ 107
- **Internal Auditors**
  - Accounting ....................................................................................... 53
  - Loan costs and fees .......................................................................... 119
  - Allowance for loan losses, industry practices ................................... 44

#### BANKS
- **Allowance for loan losses, industry practices** .................................. 44

#### CREDIT UNIONS
- **Allowance for loan losses, industry practices** .................................. 48
  - Loan reviews .................................................................................... 31, 73

#### IN-SUBSTANCE FORECLOSURES
- **Accounting** ..................................................................................... 53

#### INTERNAL AUDITORS
- **Internal loan review activities** .......................................................... 31

#### INTERNAL CONTROL
- **Tests of controls—audits**
  - Loan document inspection ............................................................... 74

#### LOANS RECEIVABLE
- **Accounting literature** ....................................................................... 3
- **Accrued interest receivable** ............................................................... 117
- **Auditing literature** ............................................................................ 3, 5
- **Audit procedures, categories of** ....................................................... 6, 7
- **Automobile lease financing** .............................................................. 16
- **Classification of loans** ...................................................................... 44, 48, 74, 81
  - Collateral
    - General considerations ................................................................ 69
    - Lender’s rights to collateral ......................................................... 69
    - Valuation ...................................................................................... 70
  - Commercial business loans, described .............................................. 12, 17
  - Consumer loans, described ............................................................. 15
  - Credit card loans ........................................................................... 16
  - Credit monitoring and collection activities .................................... 31
  - Development and construction loans, described ............................. 13, 121
  - Evaluation of .................................................................................. 20
  - Home equity lines of credit .............................................................. 16
  - Home improvement loans ............................................................... 16
  - Installment loans, described ............................................................. 15
  - In-substance foreclosures
    - Accounting for ............................................................................ 53
    - Background .................................................................................. 53
    - Effect on accounting .................................................................... 53
    - Identification of ............................................................................ 53
  - Interest income ................................................................................ 116
  - Interim loan review activities ............................................................ 31
  - Lending activities, obtaining an understanding of ............................ 28
  - Lending risks
    - Collateral risk ............................................................................ 19
    - Concentration risk ...................................................................... 19
    - Consideration of .......................................................................... 18
    - Credit risk .................................................................................... 19
    - Fraud risk .................................................................................... 19
    - Interest rate risk ........................................................................... 19
    - Management risk .......................................................................... 19
    - Operations risk ............................................................................ 19
    - Regulatory or legal violations risk .................................................. 21
  - Letters of credit ................................................................................ 17
  - Loan evaluation activities ................................................................. 32
  - Loan fees and costs .......................................................................... 118
  - Loan file contents ............................................................................. 63
  - Loan reviews
    - Authorization ............................................................................. 65
    - Borrower performance, assessment of ......................................... 66
    - Credit unions, special considerations ........................................... 73
    - Discussions with loan officers ....................................................... 71
    - Document review procedures ....................................................... 65, 72
    - Extent of loan reviews, assessing the adequacy of ......................... 62
    - Legal obligation ............................................................................ 65
    - Objectives ...................................................................................... 61
    - Personal guarantees, assessment of ............................................. 68
    - Recurring engagements, limited document inspections .................. 72
    - Selection of loans .......................................................................... 61
    - Tests of controls ............................................................................ 74
    - Loans in process ............................................................................ 121
    - Nonaccrual loans ........................................................................... 53
    - Origination and disbursement activities ......................................... 28
    - Common credit scoring and risk-based lending control weaknesses ... 30
    - Credit scoring .............................................................................. 30
    - Online lending ............................................................................. 30
    - Risk-based lending ....................................................................... 29
    - Participations .................................................................................. 18
    - Payday loans ................................................................................ 16
    - Portfolio, obtaining an understanding of ....................................... 12
    - Problem loans, defined .................................................................. 61
    - Real estate loans, described ........................................................... 13
    - Regulatory literature ..................................................................... 5
    - Relevant assertions ......................................................................... 6
    - Rule of 72s .................................................................................... 116
    - Sales of .......................................................................................... 15
    - SBA loans ..................................................................................... 17
    - Servicing and accounting activities ............................................... 31
    - Share loans .................................................................................... 16
    - Single-family residential loans, described .................................... 13

---

**AFIT10**

**Companion to PPC’s Guide to Audits of Financial Institutions**

---

141
• Student loans ................................................... 16
• Types of loans ............................................... 12
• Unearned discounts ......................................... 116

SAVINGS INSTITUTIONS
• Allowance for loan losses, industry practices .............. 48

STATEMENTS OF FINANCIAL ACCOUNTING STANDARDS
• SFAS No. 5 .................................................. 3, 43
• SFAS No. 15 .................................................. 3, 49
• SFAS No. 65 .................................................. 4
• SFAS No. 91 .................................................. 4, 118
• SFAS No. 107 ................................................ 4
• SFAS No. 114 ............................................... 3, 48, 51, 53, 54, 74, 81
• SFAS No. 118 ............................................... 3
• SFAS No. 140 ............................................... 3, 18

STATEMENTS ON AUDITING STANDARDS
• SAS No. 57 ................................................. 5
• SAS No. 73 .................................................. 5
• SAS No. 106 ................................................ 6
• SAS No. 110 ................................................ 6

SUBSTANTIVE TESTS
• Timing of ..................................................... 96

TROUBLED DEBT RESTRUCTURINGS
• Troubled debt restructurings
  • Asset transfers ............................................ 51
  • Combination restructurings .............................. 51
  • Defined ................................................... 49
  • Determining occurrence ................................ 49
  • Financial difficulty ..................................... 50
  • Foreclosures ............................................. 51
  • Granting concessions .................................. 50
  • Modification of loan terms, described ............... 50
  • Modification of loan terms, SFAS No. 114 ........ 51
  • Substitute borrowers .................................. 52
COMPANION TO PPC’S GUIDE TO AUDITS OF FINANCIAL INSTITUTIONS

COURSE 2

AN INTRODUCTION TO AUDITS OF FINANCIAL INSTITUTIONS
AND RELATED PRE-ENGAGEMENT ACTIVITIES (AFITG102)

OVERVIEW

COURSE DESCRIPTION: This interactive self-study course provides an introduction to auditing of financial institutions. Lesson 1 introduces the reader to the basics of auditing, the applicable authoritative literature, and some of the unique aspects of audits of financial institutions. It also gives an overview of the financial institution industry. Lesson 2 discusses pre-engagement activities for audits and focuses on how they should be applied to financial institutions. Some of the activities discussed include client acceptance and continuance, engagement letters, FDICIA engagements, and the use of service organizations.

PUBLICATION/REVISION DATE: June 2010

RECOMMENDED FOR: Users of PPC’s Guide to Audits of Financial Institutions

PREREQUISITE/ADVANCE PREPARATION: Basic knowledge of auditing.

CPE CREDIT: 8 QAS Hours, 8 Registry Hours

Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at www.nasba.org for a listing of states that accept QAS hours.

FIELD OF STUDY: Auditing

EXPIRATION DATE: Postmark by June 30, 2011

KNOWLEDGE LEVEL: Basic

LEARNING OBJECTIVES:

Lesson 1—An Introduction to Auditing Financial Institutions and an Industry Overview

Completion of this lesson will enable you to:
- Recognize applicable authoritative literature for nongovernmental entities (including generally accepted auditing standards and the risk assessment standards) and the PPC risk assessment process.
- Identify the risk factors related to audits of financial institutions and the types of services CPAs can perform.
- Differentiate between the regulatory bodies and laws that affect financial institutions and their audits.

Lesson 2—Pre-engagement Activities for Audits of Financial Institutions

Completion of this lesson will enable you to:
- Identify client acceptance and continuance policies.
- Recognize the reasons to use an engagement letter.
- Assess issues related to FDICIA engagements, using the work of a specialist, and initial engagements.
- Summarize how use of internal auditors and service organizations will affect the audit.
TO COMPLETE THIS LEARNING PROCESS:

Send your completed Examination for CPE Credit Answer Sheet, Course Evaluation, and payment to:

Thomson Reuters
Tax & Accounting—R&G
AFITG102 Self-study CPE
36786 Treasury Center
Chicago, IL 60694-6700

See the test instructions included with the course materials for more information.

ADMINISTRATIVE POLICIES:

For information regarding refunds and complaint resolutions, dial (800) 323-8724 for Customer Service and your questions or concerns will be promptly addressed.
Lesson 1: An Introduction to Auditing Financial Institutions and an Industry Overview

INTRODUCTION

The objective of an audit is to express an opinion about whether the financial statements are fairly presented in conformity with the applicable financial reporting framework that is used by the entity. The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. The auditor plans, conducts, and reports the results of the audit in accordance with generally accepted auditing standards (GAAS).

Learning Objectives:

Completion of this lesson will enable you to:

- Recognize applicable authoritative literature for nongovernmental entities (including generally accepted auditing standards and the risk assessment standards) and the PPC risk assessment process.
- Identify the risk factors related to audits of financial institutions and the types of services CPAs can perform.
- Differentiate between the regulatory bodies and laws that affect financial institutions and their audits.

AUTHORITATIVE LITERATURE

Generally Accepted Accounting Principles

FASB ASC 105, Generally Accepted Accounting Principles (formerly SFAS No. 168), establishes the Financial Accounting Standards Board (FASB) Accounting Standards Codification as the source of generally accepted accounting principles for nongovernmental entities. This course is updated for changes in accounting standards. PPC’s Guide to Preparing Financial Statements provides detailed guidance on generally accepted accounting principles.

References to Accounting Standards. Dual references are included in the course when referring to a specific accounting standard. That is, references are provided for the specific Codification citation, as well as the corresponding superseded accounting pronouncement that originated the accounting guidance to assist readers with their transition to the codified standards. In situations where dual referencing is not included—that is, when only a Codification or pronouncement reference is present—the relevant cite represents guidance that is either (a) yet-to-be codified, (b) a grandfathered pronouncement, or (c) issued after the Codification became effective.

Generally Accepted Auditing Standards

Auditors of nonpublic entities should conduct their engagements in accordance with GAAS developed by the American Institute of Certified Public Accountants (AICPA). SAS No. 95 (AU 150), Generally Accepted Auditing Standards, as amended, establishes three levels in the GAAS hierarchy:

a. Auditing standards.

b. Interpretive publications.

c. Other auditing publications.

Auditing Standards. Generally accepted auditing standards consist of the ten general, field work, and reporting standards and Statements on Auditing Standards (SASs) issued by the AICPA’s Auditing Standards Board (ASB). SASs are codified within the framework of the ten standards. The AICPA Code of Professional Conduct requires members to comply with SASs.

The contents of the SASs contain professional requirements along with explanatory material. SAS No. 102 (AU 120), Defining Professional Requirements in Statements on Auditing Standards, clarifies the meaning of certain
terms used in SASs and defines the terminology that the ASB will use to describe the degrees of responsibility that the professional requirements impose on auditors and practitioners. Its provisions apply to existing SASs.

The auditor's degree of responsibility in complying with professional requirements can be identified through two categories.

- **Unconditional Requirements.** Unconditional requirements are those that an auditor must follow in all cases if the circumstances apply to the requirement. These requirements use the words "must" or "is required."

- **Presumptively Mandatory Requirements.** Auditors are also expected to comply with presumptively mandatory requirements if the circumstances apply to the requirement; however, in rare situations, a departure from the requirement is allowed if the auditor documents the justification and how alternative procedures that were performed were sufficient to achieve the objectives of the requirement. Presumptively mandatory requirements are identified by the word "should." If a SAS uses the words "should consider" for a procedure, the consideration of the procedure is presumptively required.

Explanatory material represents material that provides additional guidance on professional requirements or identifies other procedures or actions. An auditor is not required to perform other procedures or actions that are identified through explanatory material. These items require understanding and professional judgment regarding their applicability. Explanatory material is identified through the words "may," "might," and "could."

**Interpretive Publications.** Interpretive publications are not auditing standards, but rather recommendations on applying the SASs. Interpretive publications include Auditing Interpretations, appendices to the SASs, AICPA Audit and Accounting Guides, and AICPA Auditing Statements of Position. SAS No. 95 requires auditors to consider applicable interpretive publications. If the auditor does not apply an interpretive publication, the auditor should be prepared to explain how he or she complied with the underlying SAS provisions. The unconditional requirements and presumptively mandatory requirements discussed previously are not intended to apply to interpretive guidance issued by the AICPA.

**Other Auditing Publications.** Other auditing publications have no authoritative status but may help auditors understand and apply the SASs. Other auditing publications include AICPA publications not referred to in previous paragraphs, articles in professional journals, continuing professional education programs, textbooks, guide books, audit programs and checklists, and auditing literature published by state CPA societies and other organizations (for example, PPC guides). If auditors apply the guidance in other auditing publications, they should satisfy themselves that the guidance is both appropriate and relevant. Appropriateness refers to whether the guidance is technically sound. Relevance refers to whether the guidance is applicable to the circumstances of a particular audit engagement. Indicators of appropriateness include the extent to which the publication is recognized as being helpful and the professional qualifications of its author or issuer. There is a presumption that other auditing publications reviewed by the AICPA Audit and Attest Standards staff (such as auditing practice releases, AICPA risk alerts, and PITF Practice Alerts) are appropriate.

Professional Issues Task Force Practice Alert 01-1, *Common Peer Review Recommendations*, suggests, among other things, that firms have a system in place to ensure staff members are informed about current authoritative literature. This course is updated for changes in professional literature and includes guidance about how those changes might affect audits of nonpublic institutions. However, auditors are responsible for awareness and timely implementation of new pronouncements. The practice alert can be found at [www.aicpa.org/pubs/cpaltr/apr2001/supps/palert1.htm](http://www.aicpa.org/pubs/cpaltr/apr2001/supps/palert1.htm).

**Statement on Quality Control Standards**

Statement on Quality Control Standard No. 7, *A Firm’s System of Quality Control*, which superseded and replaced all previously existing SQCSs, establishes standards and provides guidance for a CPA firm’s responsibilities for its system of quality control for its accounting and auditing practice. SQCS No. 7 was effective for a firm’s system of quality control as of January 1, 2009.

SQCS No. 7 comprehensively addresses the quality control (QC) processes over a firm’s accounting and auditing practice. The standard places an unconditional obligation on the firm to establish a QC system designed to provide
reasonable assurance that the firm complies with professional standards and legal and regulatory requirements, and that it issues reports that are appropriate in the circumstances. *PPC’s Guide to Quality Control* provides guidance and practice aids to assist firms in developing, implementing, and maintaining a system of quality control.

**Clarity Project of the Auditing Standards Board**

In response to growing concerns regarding the complexity of auditing standards and to converge U.S. generally accepted auditing standards with International Standards on Auditing (ISA), the Auditing Standards Board (ASB) began a large-scale project (the Clarity Project) to revise all existing standards and to design a format under which all new standards will be issued. In March 2007, the ASB issued a discussion paper titled *Improving the Clarity of ASB Standards*, outlining its plans to revise the format, structure, and style of the professional standards issued by the ASB. The discussion paper is available at [www.aicpa.org/download/auditstd/Clarity_of_ASB_Standards_Discussion_Memo.pdf](http://www.aicpa.org/download/auditstd/Clarity_of_ASB_Standards_Discussion_Memo.pdf).

In response to comments received on the discussion paper and subsequent discussions, the ASB decided on final drafting conventions. Accordingly, the clarified and converged standards include the following sections:

- **Introduction.** Includes matters such as the purpose and scope of the SAS, subject matter, effective date, and other relevant introductory material.

- **Objectives.** Establishes objectives that allow the auditor to understand what he or she should achieve under the SAS. The auditor should use the objectives to determine whether additional procedures are necessary for their achievement and evaluate whether sufficient appropriate audit evidence has been obtained.

- **Definitions.** Where relevant, provides key definitions that are relevant to the standard.

- **Requirements.** States the requirements that the auditor is to follow unless the SAS is not relevant or the requirement is conditional and the condition does not exist.

- **Application and Other Explanatory Material.** Provides further guidance to the auditor in applying or understanding the requirements. While this material does not in itself impose a requirement, auditors should understand this guidance. How it is applied will depend on professional judgment in the circumstances considering the objectives of the SAS. The requirements section references the applicable application and explanatory material. Also, when appropriate, considerations relating to smaller and less complex entities are also included in this section.

At the date of this course, the Auditing Standards Board has issued a number of final standards and exposure drafts of proposed standards under the clarity and convergence project. Exhibit 1-1 provides a current listing of all final and proposed standards (including those that have been voted to ballot for final issuance or exposure). The ASB is working towards completing the project in 2011 with the possible exception of the following two AU sections:

- **AU 341, The Auditor’s Consideration of the Entity’s Ability to Continue as a Going Concern**, whose redraft and revision are being delayed in order to enable the proposed SAS to align with expected U.S. accounting standards.

- **AU 532, Restricting the Use of an Auditor’s Report**, whose redraft and revision are incorporated in the proposed SAS *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor’s Report*. However, due to an issue that has arisen, an ASB task force has been formed to consider a new standard addressing restricted-use reports.
## Exhibit 1-1

List of Final and Proposed Clarified Standards Issued to Date

<table>
<thead>
<tr>
<th>Clarified Standard</th>
<th>Existing Standards to Be Superseded</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Clarified Standard</strong></td>
<td><strong>Title</strong></td>
</tr>
<tr>
<td><strong>Final Clarified Standards</strong></td>
<td></td>
</tr>
<tr>
<td>Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With GAAS</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>Planning an Audit</td>
<td>311 Planning and Supervision</td>
</tr>
<tr>
<td>Materiality in Planning and Performing an Audit</td>
<td>312 Audit Risk and Materiality in Conducting an Audit</td>
</tr>
<tr>
<td>Evaluation of Misstatements Identified During an Audit</td>
<td></td>
</tr>
<tr>
<td>Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement</td>
<td>314 Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement</td>
</tr>
<tr>
<td>Consideration of Laws and Regulations in an Audit of Financial Statements</td>
<td>317 Illegal Acts by Clients</td>
</tr>
<tr>
<td>Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained</td>
<td>318 Performing Audit Procedures in Response to Assessed Risks &amp; Evaluating the Audit Evidence Obtained</td>
</tr>
<tr>
<td>Service Organizations</td>
<td>324 Service Organizations</td>
</tr>
<tr>
<td>SSAE, Reporting on Controls at a Service Organization</td>
<td></td>
</tr>
<tr>
<td>Audit Evidence</td>
<td>326 Audit Evidence</td>
</tr>
<tr>
<td>Audit Documentation</td>
<td>339 Audit Documentation</td>
</tr>
<tr>
<td>The Auditor’s Communication With Those Charged With Governance</td>
<td>380 The Auditor’s Communication With Those Charged With Governance</td>
</tr>
<tr>
<td>Other Information in Documents Containing Audited Financial Statements(a)</td>
<td>550 Other Information in Documents Containing Audited Financial Statements</td>
</tr>
<tr>
<td>Other Information in Relation to the Financial Statements as a Whole(a)</td>
<td>551 Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents</td>
</tr>
<tr>
<td>Required Supplementary Information(a)</td>
<td>558 Required Supplementary Information</td>
</tr>
<tr>
<td><strong>Exposure Drafts(b)</strong></td>
<td></td>
</tr>
<tr>
<td>Quality Control for an Audit of Financial Statements</td>
<td>161 The Relationship of Generally Accepted Auditing Standards to Quality Control Standards</td>
</tr>
<tr>
<td>Initial Audit Engagements, Including Reaudits—Opening Balances</td>
<td>315 Communications Between Predecessor and Successor Auditors</td>
</tr>
<tr>
<td>Terms of Engagement</td>
<td></td>
</tr>
<tr>
<td>Clarified Standard</td>
<td>Existing Standards to Be Superseded</td>
</tr>
<tr>
<td>-------------------</td>
<td>-------------------------------------</td>
</tr>
<tr>
<td><strong>Title</strong></td>
<td><strong>AU</strong></td>
</tr>
<tr>
<td>Consideration of Fraud in an Audit of Financial Statements</td>
<td>316 Consideration of Fraud in a Financial Statement Audit</td>
</tr>
<tr>
<td>Communicating Internal Control Related Matters Identified in an Audit</td>
<td>325 Communicating Internal Control Related Matters Identified in an Audit</td>
</tr>
<tr>
<td>Auditing Accounting Estimates, Including Fair Value Accounting Measurements and Related Disclosures</td>
<td>328 Auditing Fair Value Measurements and Disclosures</td>
</tr>
<tr>
<td></td>
<td>342 Auditing Accounting Estimates</td>
</tr>
<tr>
<td>Analytical Procedures</td>
<td>329 Analytical Procedures</td>
</tr>
<tr>
<td>External Confirmations</td>
<td>330 The Confirmation Process</td>
</tr>
<tr>
<td>Audit Evidence—Specific Considerations of Selected Items</td>
<td>331 Inventories</td>
</tr>
<tr>
<td></td>
<td>332 Auditing Derivative Instruments, Hedging Activities, and Investments in Securities</td>
</tr>
<tr>
<td></td>
<td>337 Inquiry of a Client’s Lawyer Concerning Litigation, Claims, and Assessments</td>
</tr>
<tr>
<td></td>
<td>901 Public Warehouses—Controls and Auditing Procedures for Goods Held</td>
</tr>
<tr>
<td>Written Representations</td>
<td>333 Management Representations</td>
</tr>
<tr>
<td>Related Parties</td>
<td>334 Related Parties</td>
</tr>
<tr>
<td>Using the Work of an Auditor’s Specialist</td>
<td>336 Using the Work of a Specialist</td>
</tr>
<tr>
<td>Audit Sampling</td>
<td>350 Audit Sampling</td>
</tr>
<tr>
<td>Consideration of Omitted Procedures After the Report Date</td>
<td>390 Consideration of Omitted Procedures After the Report Date</td>
</tr>
<tr>
<td>Evaluating Consistency of Financial Statements</td>
<td>420 Consistency of Application of Generally Accepted Accounting Principles</td>
</tr>
<tr>
<td>Forming an Opinion and Reporting on Financial Statements</td>
<td>410 Adherence to Generally Accepted Accounting Principles</td>
</tr>
<tr>
<td></td>
<td>508c Reports on Audited Financial Statements</td>
</tr>
<tr>
<td>Modifications to the Opinion in the Independent Auditor’s Report</td>
<td>431 Adequacy of Disclosure in Financial Statements</td>
</tr>
<tr>
<td></td>
<td>508c Reports on Audited Financial Statements</td>
</tr>
<tr>
<td>Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor’s Report</td>
<td>508c Reports on Audited Financial Statements</td>
</tr>
<tr>
<td></td>
<td>532 Restricting the Use of an Auditor’s Report</td>
</tr>
<tr>
<td>Subsequent Events and Subsequently Discovered Facts</td>
<td>508c Reports on Audited Financial Statements</td>
</tr>
<tr>
<td></td>
<td>530 Date of the Auditor’s Report</td>
</tr>
<tr>
<td></td>
<td>560 Subsequent Events</td>
</tr>
<tr>
<td></td>
<td>561 Subsequent Discovery of Facts Existing at the Date of the Auditor’s Report</td>
</tr>
<tr>
<td>Reporting on Financial Statements Prepared in Accordance With a Financial Reporting Framework Generally Accepted in Another Country</td>
<td>534 Reporting on Financial Statements Prepared for Use in Other Countries</td>
</tr>
<tr>
<td>Audits of Group Financial Statements (Including the Work of Component Auditors)</td>
<td>543 Part of Audit Performed by Other Independent Auditors</td>
</tr>
<tr>
<td>Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks</td>
<td>544 Lack of Conformity With Generally Accepted Accounting Principles</td>
</tr>
<tr>
<td></td>
<td>623c Special Reports</td>
</tr>
</tbody>
</table>
Clarified Standard | Existing Standards to Be Superseded
---|---
**Title** | **AU** | **Title**
Engagements to Report on Summary Financial Statements | 552 | Reporting on Condensed Financial Statements and Selected Financial Data
Reporting on Compliance With Aspects of Contractual Agreements or Regulatory Requirements in Connection With Audited Financial Statements | 623c | Special Reports
Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts, or Items of a Financial Statement | 623c | Special Reports
Filings With the U.S. Securities and Exchange Commission Under the Securities Act of 1933 | 711 | Filings Under Federal Securities Statutes
Interim Financial Information | 722 | Interim Financial Information

Notes:

a To address practice issues, these three clarified standards have been issued and assigned a specific SAS number (SAS Nos. 118–120). They also have an earlier effective date than the remainder of the clarified SASs. The effective date is for periods beginning on or after December 15, 2010, with early implementation permitted.

b This section includes both issued exposure drafts and those voted to ballot for exposure.

c The clarified standard supersedes certain paragraphs of the AU section.

* * *

When all of the standards have been clarified and converged and are in final form, they will be issued as one SAS that will be codified in AU section format. The effective date is expected to be for audits of financial statements for periods ending on or after December 15, 2012. When the new clarified SAS becomes effective, SASs issued prior to SAS No. 117 will be superseded. Early adoption of the clarified standards is not permitted unless indicated otherwise. (However, an auditor can implement aspects of the clarified standards if he or she complies with existing standards.)

Given the status of the clarity project and that most clarified standards will be effective on one date (no earlier than audits of 2012 calendar year ends), this course does not generally provide discussion on final or proposed clarified standards. Future editions of the course will provide guidance on the clarified and converged standards. Readers can obtain additional information on the clarity project and convergence with International Auditing Standards, including final and exposed standards, questions and answers, the convergence plan, and mapping of existing AU sections to clarity standards, at [www.aicpa.org](http://www.aicpa.org).

THE BASICS OF THE PPC AUDIT PROCESS

Generally accepted auditing standards require auditors to use information gathered about the entity and its environment (including internal control) to identify and assess the risks of material misstatement at both the overall financial statement and relevant assertion levels, and to determine the nature, timing, and extent of further audit procedures needed to respond to those risks. Further audit procedures are required to be performed to obtain audit evidence to support the auditor’s opinion.

This course describes a practical approach to that audit process to address the requirements of authoritative literature and have designed practice aids to assist auditors in meeting those requirements. PPC’s audit approach
is designed to be flexible and adaptable, allowing auditors to better leverage their knowledge of the client to tailor their audit procedures. The audit approach has been divided into the following broad steps:

**Step 1**  Perform procedures regarding acceptance/continuation of the client relationship, evaluate compliance with ethical requirements (including independence), and establish an understanding with the client in an engagement letter.

**Step 2**  Establish planning materiality and perform risk assessment procedures to gather information about the entity and its environment that may be relevant in identifying risks of material misstatement of the financial statements.

**Step 3**  Gather the information to understand and evaluate the design and implementation of the entity’s internal control system.

**Step 4**  Synthesize the information gathered, identify risks (both overall and specific) that could result in material misstatement of the financial statements, and develop an overall audit strategy.

**Step 5**  Assess the risks of material misstatement of the entity’s financial statements.

**Step 6**  Develop and perform appropriate responses (further audit procedures) to the assessed risks of material misstatement of the financial statements considering the overall audit strategy and planning materiality.

**Step 7**  Evaluate audit findings and evidence.

**Step 8**  Prepare required reports and communications.

Although the requirements and guidance may suggest a sequential process, the audit is a continuous process of gathering, updating, and analyzing information about the fairness of presentation of amounts and disclosures in the client’s financial statements. Therefore, the audit process is an iterative, nonlinear process, whereby the required procedures may be performed concurrently with other procedures. In addition, risks should be evaluated continuously throughout the audit.

**RISK ASSESSMENT IN THE AUDIT PROCESS**

**Introduction**

In March 2006, the Auditing Standards Board issued eight auditing standards, collectively referred to as the risk assessment standards. Most auditors believe that the changes caused by the new risk assessment standards are the most significant in recent history.

Overall, the risk assessment standards are focused toward ensuring the effectiveness of financial statement audits. In applying those standards, auditors explicitly consider higher risk areas by focusing on what is most likely to go wrong that could affect the financial statements. Auditors assess the risk that the financial statements are materially misstated and design and perform audit procedures to respond to those identified risks. The risk assessment standards have been thoroughly integrated into this course.

**What Is Risk Assessment?**

The term risk assessment in this course refers to an audit approach in which the auditor:

- Obtains a sufficient understanding of the client and its environment to identify and assess the risks of material misstatement of the financial statements.
- Concentrates audit effort in areas of the financial statements where there is a higher risk of material misstatement. Such areas may have a high risk because either inherent and/or control risk is higher.
- Provides linkage between the identified risks and the resulting audit procedures.
- Identifies lower-risk areas for which to perform less extensive procedures.

An audit approach based on risk assessment provides a method to identify higher-risk areas so that audit effort can be focused on those areas.

The auditor should leverage his or her knowledge of the client’s business and experience in prior audits to determine the level of assurance needed in significant audit areas. By focusing efforts in higher-risk areas and limiting procedures in lower-risk areas, the auditor performs a more effective and focused audit under an approach based on risk assessment.

**Planning Is the Key.** The key to performing a successful audit under professional standards is planning. During the planning process, the auditor gains sufficient knowledge of the client to identify risky audit areas and determine the procedures necessary to address identified risks. For lower-risk areas, the auditor determines what limited procedures will be necessary in light of the low assessed level of risk. The additional time spent during the planning process when applying risk assessment may be more than offset by efficiencies gained from limiting procedures in lower-risk areas. And because the auditor is focusing his or her efforts on higher-risk areas, the audit approach is more effective. Also, the auditor’s increased knowledge of the client’s business and operations can add value to client service. The auditor may be able to provide the client with more insightful and practical comments and recommendations about matters that might benefit the client’s business. Because of the increased emphasis in professional standards on obtaining an understanding of the entity and the design and implementation of internal control as a basis for the auditor’s assessment of risks, the auditor may identify more control deficiencies that are required to be reported to management and those charged with governance.

Because risk assessments require significant judgments, normally it is more effective and efficient to have an experienced auditor make the risk assessments and prepare the planning documents. However, all levels of the engagement team should be involved in the risk assessment process.

**Terminology**

Professional standards include specific terminology to describe the auditor’s responsibility for planning and performing an audit. Some of those terms, which are significant in the risk assessment process, are discussed in the following paragraphs.

**Audit Strategy.** The audit strategy is the auditor’s operational approach to achieving the objectives of the audit. It is a high-level determination of the audit approach by audit area. It includes the identification of audit areas with a higher risk of material misstatement, the overall responses to those higher risks, and the general approach to each audit area as being substantive procedures or a combined approach of substantive procedures and tests of controls. Professional standards require the auditor to establish an overall strategy for the audit.

**Audit Plan.** The audit plan is more detailed than the audit strategy and includes the nature, timing, and extent of audit procedures to be performed by audit team members to obtain sufficient appropriate evidence. The audit plan is commonly referred to as the audit program.

**Relevant Assertions.** One of the terms of central importance is relevant assertions. The assertions that are relevant for a particular class of transactions, account balance, or disclosure are those that have a meaningful bearing on whether the item is fairly stated. A routine example is that the valuation assertion is usually not relevant to the cash account unless currency translation is involved. Another example is that the valuation assertion is usually not relevant to the gross amount of the loans receivable balance, but is usually relevant to the related allowance for loan loss.

Audit standards give prominent recognition to the idea of relevant assertions. References to “decisions made at the relevant assertion level” mean decisions made about the relevant assertions within a class of transactions, account balance, or disclosure. The auditor assesses risks of material misstatement at the relevant assertion level and designs audit procedures to mitigate those assessed risks.

**Significant Risks.** Another term of importance in professional standards is significant risks. The full term significant risks that require special audit consideration indicates the basic idea. A risk is a significant risk if an analysis of
inherent risk indicates that the likely magnitude of the potential misstatement and the likelihood of the misstatement occurring are such that they require special audit consideration. The determination of whether a risk requires special audit consideration is based on an assessment of inherent risk and does not include consideration of controls. Significant risks generally relate to nonroutine transactions (i.e., transactions that are unusual due to their size or nature) and complex or judgmental matters. Transactions that are routine, noncomplex, and subject to systematic processing have lower inherent risks and are less likely to involve significant risks. Identified fraud risks are significant risks.

**Risk Assessment Procedures.** According to SAS No. 106 (AU 326.20), *risk assessment procedures* are a defined category of audit procedures performed near the beginning of an audit to obtain an understanding of the entity and its environment, including its internal control, for the purpose of assessing the risks of material misstatement at the financial statement and relevant assertion levels. The auditor should use the risk assessment to determine the nature, timing, and extent of further audit procedures. Risk assessment procedures consist of inquiry, observation, inspection, and analytical procedures.

**Risk of Material Misstatement.** The *risk of material misstatement* is the likelihood of a misstatement of the financial statements of a material amount. When considering audit risk at the overall financial statement level, the auditor should consider risks of material misstatement that relate pervasively to the financial statements taken as a whole and potentially affect many relevant assertions. The auditor should assess the risk of material misstatement at the relevant assertion level for classes of transactions, account balances, and disclosures. At the relevant assertion level, the assessment of risk of material misstatement is the combination of the auditor’s assessment of inherent risk and control risk. The auditor can make a combined assessment of inherent and control risk or assess the component risks separately and then combine them.

**Further Audit Procedures.** *Further audit procedures* are procedures an auditor performs in response to the assessed risks to reduce overall audit risk to an appropriately low level. They consist of substantive procedures, tests of controls, and other procedures, sometimes referred to as general procedures.

**Other Terms.** Some of the other terms that are worth noting include—

- Audit evidence.
- Reasonable assurance.
- Those charged with governance.

**Audit Evidence.** SAS No. 106 (AU 326.02) states:

> Audit evidence is all the information used by the auditor in arriving at the conclusions on which the audit opinion is based and includes the information contained in the accounting records underlying the financial statements and other information.

**Reasonable Assurance.** The scope paragraph of the auditor’s report includes a statement that generally accepted auditing standards (GAAS) require audits to be planned and performed to obtain reasonable assurance about whether the financial statements are free of material misstatement. That statement introduces the concept of materiality to the audit report and the auditor’s responsibility for detecting errors or fraud. SAS No. 104 clarifies that reasonable assurance is a high, but not absolute, level of audit assurance.

**Those Charged with Governance.** The reference to those charged with governance encompasses those situations in which an entity does not have an audit committee, but has a group responsible for oversight of the entity’s strategic direction and obligations related to accountability.
SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. What piece of authoritative literature establishes the hierarchy of generally accepted accounting principles for nongovernmental entities?
   a. FASB ASC 105.
   b. SAS No. 95.
   c. The risk assessment standards.
   d. Professional Issues Task Force Practice Alert 01-1.

2. When Joan, an auditor, examined the Statements on Auditing Standards (SASs) that apply to her audit, one requirement is phrased using the word “should.” Does Joan have to comply with this requirement?
   a. Yes.
   b. Maybe.
   c. No.

3. If Joan decides to use the PPC audit process during her audit of a financial institution, at what point during the audit would she evaluate her audit findings and the audit evidence? Note: Though guidance suggests a linear process, an audit is a continuous process that involves gathering, updating, and analyzing information about the fairness of presentation of amounts and disclosures in the client’s financial statements. Procedures may be performed concurrently. However, for the testing purposes of question 3, assume that the procedures of the PPC Audit Process are being performed sequentially.
   a. Step 2.
   b. Step 6.
   c. Step 7.
   d. Step 8.

4. Which of the following standards will retain its original title when the clarified standards are issued in 2011?
   a. Due Professional Care in the Performance Work.
   b. Illegal Acts by Clients.
   c. Audit Evidence.
   d. Audit Risk and Materiality in Conducting an Audit.

5. Which of the following statements most accurately describes the risk assessment standards?
   a. The risk assessment standards consist of ten standards issued by the Auditing Standards Board.
   b. They allow auditors to focus on higher risk areas by considering what is most likely to go wrong and affect the financial statements.
   c. They are in the same format as the International Standards on Auditing.
6. Define *audit plan*.

a. The auditor’s operational approach for achieving audit objectives, including identification of high-risk areas, responses, and a general approach to each audit area.

b. Assertions relevant to whether a class of transactions, disclosure, or account balance because has been fairly stated.

c. Information an auditor uses to arrive at conclusions upon which the audit opinion will be based, including information in the accounting records.

d. An audit program that includes information on the nature, timing, and extent of audit procedures the audit team will perform.
SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. (References are in parentheses.)

1. What piece of authoritative literature establishes the hierarchy of generally accepted accounting principles for nongovernmental entities? (Page 145)
   a. FASB ASC 105. [This answer is correct. FASB ASC 105, Generally Accepted Accounting Principles (formerly SFAS No. 168), establishes the Financial Accounting Standards Board (FASB) Accounting Standards Codification as the course of generally accepted accounting principles for nongovernmental entities.]
   b. SAS No. 95. [This answer is incorrect. SAS No. 95, Generally Accepted Auditing Standards, as amended, establishes the hierarchy of generally accepted auditing standards.]
   c. The risk assessment standards. [This answer is incorrect. The risk assessment standards were established in March 2006 by the Auditing Standards Board (ASB). These standards allow for increased effectiveness of audits of financial statements.]
   d. Professional Issues Task Force Practice Alert 01-1. [This answer is incorrect. This practice alert (titled Common Peer Review Recommendations) suggests that firms utilize a system that ensures its staff is informed about current authoritative literature.]

2. When Joan, an auditor, examined the Statements on Auditing Standards (SASs) that apply to her audit, one requirement is phrased using the word “should.” Does Joan have to comply with this requirement? (Page 146)
   a. Yes. [This answer is incorrect. Joan would be expected to comply with an unconditional requirement whenever circumstances apply. However, an unconditional requirement would use the word “must” or “is required,” not “should.”]
   b. Maybe. [This answer is correct. A requirement that uses the word “should” is considered a presumptively mandatory requirement. If circumstances apply, Joan is expected to comply with such requirements; however, with enough justification, a departure can be allowed in rare circumstances.]
   c. No. [This answer is incorrect. There are some circumstances in which Joan might be required to comply with the requirement. However, Joan would not be required to perform procedures or actions identified in explanatory material. This type of material is indicated by use of the words “may,” “could,” or “might.”]

3. If Joan decides to use the PPC audit process during her audit of a financial institution, at what point during the audit would she evaluate her audit findings and the audit evidence? Note: Though guidance suggests a linear process, an audit is a continuous process that involves gathering, updating, and analyzing information about the fairness of presentation of amounts and disclosures in the client’s financial statements. Procedures may be performed concurrently. However, for the testing purposes of question 3, assume that the procedures of the PPC Audit Process are being performed sequentially. (Page 150)
   a. Step 2. [This answer is incorrect. During step 2 of the PPC audit process, Joan will establish planning materiality and perform risk assessment procedures, as well as gather information about her client and its environment that may be relevant for the identification of risks of material misstatement at the financial statement level. She has not audited the information yet, so she cannot evaluate her findings.]
   b. Step 6. [This answer is incorrect. At this point in the process, Joan should develop further audit procedures and perform them in areas with assessed risk of material misstatement of the financial statements.]
c. Step 7. [This answer is correct. Step 7 of the PPC audit process is for Joan to evaluate her audit findings and her evidence. These steps are broad, and the PPC audit process is flexible and adaptable. This allows Joan to leverage her knowledge of her client to better tailor her audit procedures to this specific audit.]

d. Step 8. [This answer is incorrect. Step 8 is the final step in the PPC audit process. During this step, Joan will prepare the reports and communication required in an audit.]

4. Which of the following standards will retain its original title when the clarified standards are issued in 2011? (Page 148)

a. Due Professional Care in the Performance Work. [This answer is incorrect. AU 230, Due Professional Care in the Performance of Work, will be superseded and combined with AU 110, 120, 150, 201, 210 and 220 to be included in the clarified standard Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with GAAS.]

b. Illegal Acts by Clients. [This answer is incorrect. AU 317, Illegal Acts by Clients, is going to be renamed in the clarified standard as Consideration of Laws and Regulations in an Audit of Financial Statements.]

c. Audit Evidence. [This answer is correct. AU 326, Audit Evidence, is being reissued by the Auditing Standards Board under the clarified standards with the same title, Audit Evidence.]

d. Audit Risk and Materiality in Conducting an Audit. [This answer is incorrect. AU 312, Audit Risk and Materiality in Conducting an Audit, is being split into two standards when the standard is clarified by the Accounting Standard Boards. The two new standards will be named Materiality in Planning and Performing an Audit and Evaluation of Misstatements Identified During an Audit.]

5. Which of the following statements most accurately describes the risk assessment standards? (Page 151)

a. The risk assessment standards consist of ten standards issued by the Auditing Standards Board. [This answer is incorrect. In March 2006, the Auditing Standards Board issued eight, not ten, auditing standards.]

b. They allow auditors to focus on higher risk areas by considering what is most likely to go wrong and affect the financial statements. [This answer is correct. The risk assessment standards encourage this approach which should result in an increase in the effectiveness of audits of financial statements.]

c. They are in the same format as the International Standards on Auditing. [This answer is incorrect. The ASB began the Clarity Project to harmonize U.S. generally accepted auditing standards with the International Standards on Auditing. This project will revise all existing standards and is projected to be completed in 2011.]

6. Define audit plan. (Page 152)

a. The auditor’s operational approach for achieving audit objectives, including identification of high-risk areas, responses, and a general approach to each audit area. [This answer is incorrect. This is the definition of an audit strategy. Development of an overall strategy for an audit is required by the professional standards.]

b. Assertions relevant to whether a class of transactions, disclosure, or account balance because has been fairly stated. [This answer is incorrect. This is the definition of relevant assertions, a term used in the risk assessment standards that is of central importance.]
c. Information an auditor uses to arrive at conclusions upon which the audit opinion will be based, including information in the accounting records. [This answer is incorrect. This is the definition of audit evidence, which can be found in SAS No. 106 (AU 326.02).]

d. An audit program that includes information on the nature, timing, and extent of audit procedures the audit team will perform. [This answer is correct. An audit plan is more detailed than the audit strategy that will be employed by the auditor. Audit program is a common term for audit plan.]
AN INDUSTRY OVERVIEW FOR AUDITS OF FINANCIAL INSTITUTIONS

What Financial Institutions Are Covered by This Course?

In a very broad sense, there are many types of financial institutions in the United States. In addition to banks and other depository institutions, many people classify insurance companies, commercial and consumer finance companies, brokerage firms, mortgage bankers, and many other types of businesses as financial institutions. However, this course covers the following three types of financial institutions:

a. Commercial banks.

b. Savings institutions (also referred to as thrift institutions).

c. Credit unions.

The financial institutions covered by this course all have one important attribute in common—they accept funds from the public in the form of insured deposits and invest those funds in loans and other investments. Because deposits placed in the financial institutions covered by this course are federally insured, the institutions are subject to the supervision of federal and/or state regulatory agencies. In addition, most of these institutions routinely hire independent CPAs to perform either audits or agreed-upon procedures engagements on an annual basis.

HOW THE BUSINESS OF FINANCIAL INSTITUTIONS RELATES TO RISK MANAGEMENT

As with most commercial businesses, the long-term objective of financial institutions is to maximize profits. This is generally accomplished by maximizing the excess of interest earned over interest paid, which is known as the net interest margin. During the process of maximizing the net interest margin, financial institutions, like most commercial businesses, incur certain risks. Management’s ability to identify and respond to these risks, while still remaining competitive with other institutions, is an integral component of the auditor’s assessment of control risk. Expansion into new areas of business, or the acquisition of complex or higher-risk investments, increases the level of risk and may require additional management expertise.

In addition, when planning and performing audit engagements, the AICPA Industry Audit Risk Alert titled Financial Institutions Industry Developments—2009 Including Depository and Lending Institutions and Brokers and Dealers in Securities (the Industry Risk Alert) indicates that auditors should understand the economic conditions facing the industry in which the client operates. Economic activities relating to factors such as interest rates, availability of credit, consumer confidence, overall economic expansion or contraction, inflation, and labor market conditions are likely to have an effect on an entity’s financial statements, which has been especially true in the financial institutions industry during the current economic crisis.

Currently, the U.S. economy continues to experience instability. According to the National Bureau of Economic Research, the U.S. economy has been in a recession since December 2007. The length and severity of this recession remains unknown. However, the 2009 Industry Risk Alert indicates that certain positive signs have emerged, thus leading economists to begin to consider the likelihood and speed of economic recovery.

A 2007 Ernst & Young survey of audit committees across 12 different industries suggests that banks are more proactive than other industries in putting programs in place to effectively manage risk and in investing substantial resources, including time and education, in the programs. When planning an audit of a financial institution, the auditor should consider the general and specific risks of the institution and the institution’s process of assessing and controlling these risks. The following paragraphs discuss various risks that are incurred by financial institutions and the factors that the auditor should consider when planning an audit of a financial institution.

Credit and Other Asset Quality Risk

Credit risk is the risk that a borrower will be unable to repay its loan. Credit risk is measured as an institution’s total exposure to a borrower and includes loans outstanding, interest and fees receivable, and undrawn commitments.
to lend. Credit risk can be classified into industry risk and issuer risk. Industry risk occurs when an institution is dependent on the economic climate of an individual industry (such as the oil and gas industry). Issuer risk is the risk of an individual or company being unable to repay its debts. One of the most critical areas of concern in a financial institution engagement is the adequacy of the allowance for credit losses.

Other financial assets are subject to the risk of loss because of declining asset quality. For example, loan servicing rights may become impaired when falling interest rates result in high levels of prepayment.

**Interest Rate Risk**

Interest rate risk occurs when an institution’s interest-earning assets and interest-bearing liabilities are not matched according to dates on which interest rates change. Interest rate risk is normally thought of as exposure to interest rate movements that occur when a financial institution borrows funds on a short-term basis and lends at a fixed rate for a longer period of time. For example, if the institution has borrowed money for six months at a fixed rate and lent it for one year, also at a fixed rate, it will need to obtain new funding for the loan after six months. If interest rates rise, the institution will have to increase the rate of interest it pays on borrowings without being able to invest at a higher rate until the existing loan matures. Interest rate risk can also occur when an institution invests in rate-sensitive assets that are funded by long-term, fixed-rate liabilities. If interest rates fall, the institution may be unable to invest in assets that yield high enough interest rates to cover the interest expense on the fixed-rate liabilities. Interest rate risk can be managed by matching the repricing profiles of assets and liabilities.

In January 2010, the FDIC issued FIL2-2010 related to financial institution management of interest rate risk. This guidance cautions that current economic conditions present significant risk management challenges to depository institutions of all sizes. Institutions should not lose focus on their management of interest rate risk. For a number of institutions, increased loan losses and sharp declines in the value of certain securities portfolios are placing downward pressure on capital and earnings. In this interest rate environment, taking advantage of a steeply upward-sloping yield curve by funding longer term assets with shorter-term liabilities may pose risks to an institution’s capital and earnings in the event short-term interest rates rise. Financial institutions are expected to manage interest rate risk exposures using policies and procedures commensurate with their complexity, business model, risk profile, and scope of operations. FIL2-2010, which clarifies existing interest rate risk guidance, is available at www.fdic.gov.

**Liquidity Risk**

Liquidity risk is the risk associated with the demand for funds exceeding the supply of funds. If an institution invests in long-term assets and funds them through short-term deposits, there is a risk that the short-term deposits will be withdrawn and the institution will be unable to attract new deposits or convert its long-term assets into cash. Liquidity risk may be increased by overreliance on brokered or jumbo deposits because large amounts of money can be withdrawn in a short period of time. Liquidity risk can be measured as the total receipts due on any one day less the total payments due on that particular day.

Maturity of borrowings which cannot be met by liquidation of assets may force an institution to pay excessively high interest rates to attract new deposits or to sell long-term investments or loans at a loss. In extreme cases, lack of liquidity may cause an institution to default on its liabilities. When performing an audit of a financial institution, the auditor should consider the institution’s liquidity position and its ability to meet obligations as they become due. When considering the institution’s liquidity position, the auditor should consider the following:

- The treatment of demand liabilities. (For an institution with significant amounts of demand deposits, it may be misleading to include such liabilities at their earliest repayment dates. To do so might show a worst case position that does not reflect a realistic liquidity position. In some situations, it may be acceptable to include only a portion of demand liabilities at the earliest repayment date.)

- Commitments to make funds available on a particular date.

- Other commitments such as lines of credit available to customers. (Considerations similar to those that apply to demand liabilities also apply to commitments under lines of credit.)
• Marketable securities and loans held for sale, which may only be realizable at a discount in the event of a forced sale.
• Anticipated prepayments of long-term assets.
• Doubtful assets.
• Standby lines of credit from other financial institutions.
• Additional sources of funds, such as funds obtained through repurchase agreements.

If it appears that it may be necessary for the institution to sell long-term assets to obtain liquidity, the auditor should consider management’s classification and valuation of the assets and whether such sales will result in losses to the institution.

**Asset-liability Management**

As previously discussed, financial institutions incur certain risks in the process of maximizing profits. In order to limit these risks, while still maintaining profits, financial institutions must control the components contributing to the net interest margin. Managing an institution’s risks while maximizing the net interest margin requires planning and anticipation of future economic conditions. The continual comparison and evaluation by management of future payment streams, maturities, interest rates, and risk inherent in an institution’s assets and liabilities, considering expected changes in market interest rates, is known as asset-liability management. Asset-liability management is a strategy to promote matching investment alternatives to potential sources of funding in order to maximize the net interest margin, yet still maintain tolerable levels of risk.

Asset-liability management is often referred to as *position management*, since it is through an analysis of an institution’s total position that its risks are identifiable. In other words, an institution must consider the credit risk related to the future inflow of funds and the liquidity and interest rate risks related to the future transactions required to cover the gaps in the current portfolio. The difference between the amounts of assets and liabilities that will be repriced during a specific period of time is known as the asset-liability gap for that period. A negative gap exists when an institution has more interest-sensitive liabilities than interest-sensitive assets. A positive gap exists when an institution has interest-sensitive assets that exceed interest-sensitive liabilities. If an institution has a positive gap, earnings will normally increase when interest rates rise. Conversely, if an institution has a negative gap, earnings will normally decrease when interest rates rise.

There are many strategies that an institution can implement to best manage its asset-liability gap. The following are examples of such strategies:

• Restructuring the existing balance sheet by selling certain loans and investments.
• Shortening the repricing period on new loans and investments.
• Implementing hedging techniques through the use of futures, options, and interest-rate swaps.

Investments in futures, options, and interest-rate swaps are extremely sensitive to market movements and require close and specialized attention by both management and the auditor.

**Processing Risk**

Because of the large volume of information processed by financial institutions, the dependency on information technology to properly process transactions is a risk to all institutions. Related concerns include an institution’s use of a third-party data processor, the increasing use of electronic transfers to accomplish customer account transactions, and the authentication of customers using Internet-based services.

**Fiduciary Risk**

Financial institutions are sometimes entrusted with the custody of financial assets on behalf of customers or other third parties. In some cases, the institution may also act as manager of those assets. Examples of fiduciary activities
of small to mid-size institutions include trust departments and loan servicing for others. The risk of loss arises when institutions fail to properly manage the financial assets on behalf of others.

SERVICES CPAS COULD PROVIDE TO FINANCIAL INSTITUTIONS

There are various services that a CPA might provide to a financial institution. The nature, timing, and extent of the procedures performed will depend primarily on the scope of services requested by the institution. At the onset of an engagement, the auditor should reach an agreement with the institution regarding the nature of services to be provided to the institution. Before agreeing to accept an engagement, the auditor should be certain that he or she has adequate training and experience to complete the engagement. If the engagement is one of a specialized nature, the auditor should consider whether it is necessary to obtain additional training through seminars or other resources. The auditor should also ensure that any applicable independence requirements are met prior to accepting an engagement. The following paragraphs discuss the types of services that a CPA might provide and the various reports that a practitioner might issue for a financial institution.

In August 2003, the federal banking and thrift regulators issued rules governing their authority to take disciplinary actions against independent public accountants and accounting firms that perform audit and attestation services. The rules establish procedures under which the regulators can, for good cause, remove, suspend, or bar an accountant or firm from performing audit and attestation services for insured depository institutions with assets of $500 million or more. Under the rules, certain violations of law, negligent conduct, reckless violations of professional standards, or lack of qualifications to perform auditing services are considered good cause. In addition, the rules prohibit an accountant or accounting firm from performing these services if the accountant or firm has been removed, suspended, or debarred by one of the regulators, or if the U.S. Securities and Exchange Commission or the Public Company Accounting Oversight Board takes certain disciplinary actions against the accountant or firm. The rules also permit immediate suspensions of accountants and firms in limited circumstances. An accountant or firm can even be prohibited from auditing an institution as a result of a wrongdoing unrelated to the provision of audit services or in connection with services provided to a financial institution. The rules can be accessed on the FDIC’s website at www.fdic.gov and the OTS’s website at www.ots.treas.gov.

Audit Services

The primary service a CPA will provide to a financial institution is an audit of financial statements in accordance with generally accepted auditing standards (GAAS). In many ways, performing an audit of a financial institution in accordance with GAAS is similar to performing an audit of any business enterprise. However, there are aspects of an audit that are unique to financial institutions.

Many savings institutions and multi-bank holding companies present consolidating balance sheets and income statements for each majority-owned subsidiary and/or joint venture. In addition, many savings institutions present summary financial statements for each joint venture and service corporation. Normally, consolidating and summary financial statements are presented as additional information accompanying the basic financial statements.

FDICIA Audit Requirements. FDICIA has imposed several requirements and restrictions on banks and savings institutions. One of the requirements is that FDIC-insured institutions with total assets of $500 million or more must file annual audited financial statements prepared in conformity with generally accepted accounting principles with their regulators. FDICIA also imposes additional requirements for banks and savings institutions with total assets of $1 billion or more, as discussed later in this lesson.

OTS Audit Regulations. Although the OTS continues to recommend that all savings institutions be audited, savings institutions with total assets of less than $500 million and an examination CAMELS rating of 1 or 2 are generally exempt from the OTS audit requirements. However, the OTS has the authority to require an independent audit of any institution to address safety and soundness concerns. Institutions with a CAMELS rating of 3, 4, or 5 are required to obtain an independent audit, unless a regional director of the OTS issues a waiver. The CAMELS rating measures capital, asset, management, earnings, liquidity, and sensitivity to market risk.

Audit Requirements for Credit Unions. Due to the passage by Congress of the Credit Union Membership Access Act of 1998 (CUMAA), the National Credit Union Administration (NCUA) has issued new audit requirements for
credit unions. These audit requirements are intended to follow the requirements specified in CUMAA and also redefine the various types of audits that credit unions may conduct. Under the regulations, the audit requirements of a federal credit union’s supervisory committee (which is equivalent to the audit committee of a board of directors) can be fulfilled in one of the following four ways:

a. **Full-scope Audit.** The committee can engage an independent CPA to perform an opinion audit on the credit union’s financial statements. Under CUMAA, federally insured credit unions with $500 million or more in assets must have an opinion audit.

b. **Balance-sheet Audit.** The committee can engage an independent CPA to perform a balance-sheet only audit of the credit union’s financial statements. This option is only available to credit unions with less than $500 million in assets.

c. **Report on Examination of Internal Controls over Call Reporting.** The committee can engage an independent CPA to perform and report on management’s written assertions concerning the effectiveness of internal control over financial reporting in the credit union’s most recently filed semiannual or year-end call report. In this type of engagement, management must specify the criteria that its evaluation of internal control is based on. This type of engagement is only available for credit unions with less than $500 million in assets.

d. **Supervisory Committee Guide Audit.** The supervisory committee can engage any qualified individual to perform the audit in accordance with the prescribed minimum procedures in the NCUA Supervisory Committee Guide. This manual includes a list of minimum prescribed procedures that must be performed on every credit union audit. Independent CPAs performing a Supervisory Committee Guide audit should comply with SSAE No. 10 (AT 201).

### Additional Requirements for Banks and Savings Institutions with Total Assets of $1 Billion or More

Under FDICIA, the CPA is required to examine, attest to, and report on management’s assertion regarding the institution’s internal control and procedures for financial reporting for any bank or savings institution with total assets of $1 billion or more. Statement on Standards for Attestation Engagements (SSAE) No. 15 (AT 501), Examination of an Entity’s Internal Control Over Financial Reporting That is Integrated With an Audit of its Financial Statements, is the primary source of authoritative literature for auditors who report on a nonpublic institution’s internal controls as required by FDICIA. SSAE No. 15 (AT 501.18) states that the examination of internal control over financial reporting should be integrated with the audit of the financial statements and be planned to accomplish the objectives of both audits simultaneously.

### Alternatives to Audits for Banks and Savings Institutions with Total Assets of Less Than $500 Million

The FDIC, in its Financial Institution Letter FIL96-99, and the Federal Financial Institutions Examination Council (FFIEC), in its Interagency Policy Statement on External Auditing Programs of Banks and Savings Associations, encourage banks and thrifts not subject to the audit requirement in FDICIA to have an annual audit of the institution’s financial statements performed by an independent public accountant. If the institution’s directors or audit committee decide an annual audit is not appropriate, the policy statement provides the following two alternatives:

a. An audit of the institution’s balance sheet.

b. An examination level attestation engagement regarding management’s assertion about the effectiveness of the institution’s internal control over financial reporting in all or certain schedules of the institution’s regulatory reports.

The policy statement also allows for a small institution to have an attestation engagement regarding the effectiveness of internal control over preparation of the financial statements.

If the institution’s board of directors or its audit committee selects an audit of the institution’s balance sheet based on its assessment of the institution’s risk areas and scope of operations during a particular year, the CPA would audit the assets, liabilities, and equity of the institution under generally accepted auditing standards and opine on
the fairness of the presentation of the balance sheet. The CPA would not be expected to provide an opinion on the fairness of the presentation of the institution’s income statement, statement of changes in equity capital, or statement of cash flows. Therefore, the CPA would not need to consider presentation or disclosure issues that do not affect the balance sheet. However, this course recommends that the CPA apply some audit procedures to income statement accounts to determine whether these accounts reveal misstatements in the balance sheet.

If the institution’s board of directors or its audit committee selects the examination level attestation engagement, the board or audit committee should determine the institution’s high risk areas related to financial reporting based on a review and assessment of the institution’s activities. Management would then review its internal control over the preparation of the schedules related to these high-risk areas and document this review. Management would provide a written assertion to the CPA about the effectiveness of the institution’s internal control over financial reporting in the identified risk areas as of one designated regulatory report date. This assertion should describe the criteria on which management based its evaluation of internal control. The CPA would examine management’s assertion and provide an appropriate attestation report. (Although the FFIEC policy statement refers to a single assertion, management may have a number of assertions related to the institution’s internal control over financial reporting in certain schedules of the institution’s regulatory reports.)

If an institution does not have an audit of its financial statements and is subject to a state-required external auditing program (such as, a directors’ examination), the institution normally would not be expected to incur the cost of one of the two alternatives in addition to the state-required program. The procedures performed must include some procedures designed to test the risk areas of the institution, including its lending and investment securities activities. The FDIC encourages institutions to have these procedures performed for all risk areas on an annual basis. However, a small institution may choose to have its external auditing program cover one or two risk areas annually if no significant changes are occurring in the risk areas. All risk areas should be included in the external auditing program on a rotating basis at least every two or three years.

Agreed-upon Procedures Engagement for a Trust Department

Another service that a practitioner might provide to a financial institution is to perform an agreed-upon procedures engagement for a trust department. The nature of an agreed-upon procedures engagement for a trust department is very similar to a directors’ exam. The purpose of a trust department engagement is to perform certain procedures specified by the board of directors or trust committee and to report on the results of those procedures.

Student Loan Compliance Examinations

Another service a CPA may provide to a financial institution is a compliance examination on its student loan activities. The U.S. Department of Education has issued an audit guide for lenders and lender servicers who participate in the Federal Family Education Loan Program. The guide requires lenders that originate or hold student loans above a set threshold to have an annual compliance examination. (Servicers of such loans are also required to have an annual compliance examination.) The purpose of the lender examination is to provide assurance to the Department of Education that the lender has complied with certain requirements relative to its participation in the Federal Family Education Loan Program. SSAE No. 10, as amended, (AT 601), Compliance Attestation provides the guidance needed to perform this type of engagement.

Other Services

Other services a CPA might provide to a financial institution include tax and consulting services and various other special-purpose types of reports. For example, auditors of institutions that sell or service mortgage loans are often required to issue special-purpose reports related to these activities. Mortgage-servicing reports are beyond the scope of this course.

A DISCUSSION OF THE HIGH RISK NATURE OF AUDITS OF FINANCIAL INSTITUTIONS

No discussion of financial institution audits would be complete without acknowledging the risks associated with these engagements. When a CPA audits the financial statements of any business, he or she incurs certain risks.
However, when a CPA audits the financial statements of a financial institution, the risks associated with the engagement are multiplied simply because of the nature of the industry. The following paragraphs discuss the risks involved in performing financial institution audits and the factors that the auditor should consider before agreeing to accept these engagements.

**Nature of the Industry**

Banks, savings institutions, and credit unions operate in a highly risky and uncertain environment. Because financial institutions are subject to regulatory supervision, it is possible for a financial institution to fail, or to be placed in receivership, not only because of liquidity problems, but also because of failure to meet minimum regulatory capital requirements.

There are various factors that can cause a financial institution to fail. However, failures usually result from a combination of intense competitive forces, poor economic conditions, and poor management practices. Many financial institutions have historically had poor management and lending practices. This is evidenced by the numerous lawsuits that have been brought against auditors, law firms, board members, and officers for negligence and insider abuse. Although regulatory requirements have recently become more stringent and current practices have generally improved, these previous practices have resulted in many problem loans still being carried on the books of financial institutions today.

One factor that increases the risks associated with financial institutions is the nature of their assets. Loans often comprise the majority of a financial institution’s balance sheet. Because the values of these assets are determined using a great deal of estimation and judgment, the level of risk to the auditor is increased. To a great degree, auditors find it necessary to rely on the work of specialists (such as in-house and outside appraisers) to determine the value of loan collateral. Because auditors are often not adequately trained in this area, it can be difficult for an auditor to assess the qualifications and assumptions of these specialists.

Another factor that increases the risk of financial institution audits is the fact that many institutions have significant concentrations of credit risk. Because financial institutions generally concentrate their lending efforts in their own local area, many of their loans are tied either to the local economy or to borrowers associated with a particular industry (such as the automobile or oil and gas industry). Downturns in these industries, or in the local economy in general, can have a devastating impact on the financial health of an institution.

**State of the Economy**

When planning and performing an audit engagement, the auditor needs to understand the economic conditions related to the industry in which the client operates. Economic factors such as interest rates, availability of credit, consumer confidence, overall economic expansion or contraction, inflation, and labor market conditions often impact the financial statements of the institution being audited.

During 2008, the following unparalleled events occurred in the financial markets:

- The failure of a major investment bank.
- Acquisitions of several investment and commercial banks (some of which required assistance from federal agencies).
- The placement into conservatorship of the Federal National Mortgage Association (FNMA or Fannie Mae) and the Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac).
- A significant, publicly-registered money market fund declined below the industry standard of $1.00 per share on a market value basis due to a combination of holdings of short-term securities issued by the failed investment bank and major shareholder redemptions.

As a result of these extraordinary events, the condition of the fixed income markets worsened. Corporations and financial institutions typically recognized as creditworthy began experiencing difficulty borrowing money in the financial markets on any more than an overnight basis. Of significant concern to financial institutions was the decline in liquidity faced by the industry.
The U.S. government has taken unprecedented actions to prevent worsening economic conditions. In October 2008, the Emergency Economic Stabilization Act of 2008 (EESA) was signed into law and in February 2009, the American Recovery and Reinvestment Act (Recovery Act) was passed. Among other provisions, these laws serve to facilitate the sale of ailing banks and significantly increase the monetary programs available from the Federal Reserve. As stated in section 2 of the EESA bill, it “provide[s] authority and facilities that the Secretary of the Treasury can use to restore liquidity and stability to the financial system of the United States” to ensure the economic well-being of Americans. According to the 2009 Industry Risk Alert, “[t]he Recovery Act is designed primarily to combat the rising unemployment trends, put more money in the hands of consumers, and reduce the likelihood that state and local governments will need to raise taxes significantly.” The full effects of these Acts and other government interventions will take time to be felt throughout the economy; however, the primary goal is to increase market confidence and liquidity. The federal government developed a website at www.recovery.gov to facilitate a transparent process to ensure accountability for the execution of the plan using the billions of dollars included in the package.

AICPA Alerts. The financial and economic crisis that existed as of the date of this course may affect the entity’s operations, risks, and financial reporting. This in turn may affect the auditor’s responsibilities in providing auditing services. The AICPA issued a Financial Reporting Alert, Current Economic Instability: Accounting Issues and Risks for Financial Management and Reporting—2010 (AICPA Alert), to help identify and understand current accounting and regulatory developments affecting the entity’s financial reporting in the current economic environment. In addition, the AICPA Audit Risk Alert titled Depository and Lending Institution Industry Developments—2009 Including Depository and Lending Institutions and Brokers and Dealers in Securities (the Industry Risk Alert) contains information related to economic and industry developments. The Industry Risk Alert cautions that the recent economic conditions and regulatory actions described in the alert may cause additional risk factors that had not previously existed or did not have a material effect on audit clients in prior years. Some risks that the Industry Risk Alert indicates may affect a financial institution in the current economic environment are as follows:

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

These risk factors, as well as other information discussed in the Industry Risk Alert, are discussed where applicable throughout this course. The Audit Risk Alerts can be ordered at www.cpa2biz.com.

Beige Book. Eight times a year, the Federal Reserve District issues its Summary of Commentary on Current Economic Conditions, commonly referred to as the “Beige Book.” The report summarizes information on current economic conditions gathered by each Federal Reserve Bank by district and sector through reports from bank and branch directors and interviews with key business contacts, economists, market experts, and other sources. As auditors perform their risk assessment, the Beige Book is a useful resource for understanding the environment in which financial institutions are operating and how current conditions may affect the assessment of the risk of material misstatement of the financial statements. The latest Beige Book report can be obtained at www.federalreserve.gov/fomc/beigebook/2010.

Other Resources. The AICPA believes that individuals and businesses alike are in need of guidance to navigate financial challenges in a time of global economic turmoil. To provide this needed guidance, the AICPA has developed the “Economic Crisis and Recovery” at www.aicpa.org/economy. Currently, the guidance includes the following:

- Tools for minimizing the effects of a recession on CPA firms and their clients.
- Webcasts on credit and financing impacts.
- Articles on strategic planning, budgeting, and forecasting.
- CPE courses on fraud detection and maintaining the public trust.
- Professional development resources, including job postings.

The AICPA intends to continue to develop and add new resources to this centralized hub.

In addition, Moody’s Economy.com, a division of Moody’s Analytics, provides a source for analysis, data, forecasts, and information on the United States and world economies at www.economy.com.

Accountancy organizations, regulatory bodies, standard setters, and other international organizations have developed guidance, articles, and resources on issues related to the global financial crisis. The International Federation of Accountants (IFAC) has a section of its website devoted to “The Global Financial Crisis” (www.ifac.org/financial-crisis), which serves as an international clearinghouse of programs, articles, speeches, and other initiatives undertaken by IFAC, its independent standard-setting boards, members and associates, and others that are relevant to professional accountants and to other stakeholders in the accountancy profession.

Liability to Financial Statement Users

As with any business enterprise, the audited financial statements of a financial institution may be used by the board of directors, shareholders, and various third parties. These third-party users include regulatory agencies, depositors, and creditors. In addition, many financial institutions and holding companies have stock that is publicly traded.

Although an auditor’s report merely provides assurance that the financial statements are fairly stated in accordance with GAAP, outside users of financial statements and the general public do not always understand what this means. They often view an audit report as providing absolute assurance of the ongoing financial health and stability of an institution. If an institution becomes insolvent or other problems arise (such as management fraud), there is a good chance that these third-party users will look to the auditor to recover their losses. The auditor may be the only party with resources left to recover. If an institution becomes insolvent and the most recent audit report was not modified for a going concern problem, the auditor's ability to defend a negligence claim may be weakened. While it remains unclear to what extent auditors will be held liable to nonclients or third-party users of financial statements, courts have, in many cases, tended to expand auditors’ liability to third parties, depending on the severity of an auditor’s negligence.
Before accepting an engagement to audit the financial statements of a bank, savings institution, or credit union, the auditor should consider the many risks involved and whether or not he or she has adequate training and experience to complete the engagement. In addition, the auditor should assess the adequacy of the audit fee in comparison to the risks involved. If the auditor has decided not to carry professional liability insurance, he or she may want to reconsider this decision, bearing in mind the risks involved with financial institution audits. If the auditor does carry professional liability insurance, he or she should evaluate whether the coverage is adequate.
SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

7. Leslie’s client is a credit union that is dependent on the economic climate of the oil and gas industry. What type of risk is this?
   a. Credit risk.
   b. Interest rate risk.
   c. Liquidity risk.
   d. Issuer risk.

8. When Leslie creates a realistic picture of her client’s liquidity risk, which of the following must be taken into account?
   a. The earliest date that demand deposit liabilities must be paid.
   b. The earliest date that obligations under lines of credit must be paid.
   c. Additional sources of funds, such as those obtained through repurchase agreements.
   d. Anticipated payments of any short-term assets.

9. Define **asset-liability management**.
   a. Maximizing the excess of interest earned over interest paid.
   b. Matching investment alternatives to potential sources of funding.
   c. Selling long-term assets in order to obtain liquidity.
   d. Expanding into new areas of business.

10. Which of the following financial institutions has implemented a strategy that should help manage its asset-liability gap?
    a. Alpha Bank restructures its existing balance sheet by buying more loans and investments.
    b. Beta Bank lengthens the repricing period it allows on new loans and investments.
    c. Gamma Bank implements hedging techniques using futures and options.
    d. Delta Bank makes prepayments on long-term assets.

11. Don is engaged by the Mercer Credit Union to meet its audit requirements as described by the National Credit Union Administration (NCUA). Mercer is federally insured and has $750 million in assets. What type of audit must Don perform to meet the NCUA’s requirements?
    a. A full-scope audit.
    b. A balance-sheet audit.
    c. A report on examination of internal controls over call reporting.
    d. A supervisory committee guide audit.
12. The directors of Farthington Mutual, a financial institution with $300 million in assets, determine that an annual audit is not appropriate. What alternatives are available for the institution under the Federal Financial Institutions Examination Council’s (FFIEC) *Interagency Policy Statement on External Auditing Programs of Banks and Savings Associations*?

   a. An examination level attestation engagement.
   b. An audit of the income statement.
   c. An agreed-upon procedures engagement.
   d. A director’s examination.

13. Jane, an auditor, must decide whether to accept an engagement auditing a financial institution. Which of the following circumstances would make it easier for Jane to accept the high risks associated with such an engagement?

   a. Jane’s potential client is subject to regulatory supervision.
   b. Jane’s potential client concentrates its lending efforts in its local area.
   c. Jane carries a hefty amount of professional liability insurance.
   d. Jane will not provide absolute assurance of the institution’s stability and health.
SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. (References are in parentheses.)

7. Leslie’s client is a credit union that is dependent on the economic climate of the oil and gas industry. What type of risk is this? (Page 160)

   a. Credit risk. [This answer is correct. Credit risk can be classified into two subgroups—issuer risk and industry risk. Industry risk is the type of credit risk that applies to Leslie’s client. Industry risk occurs when an institution is dependent on the economic climate of an individual industry.]

   b. Interest rate risk. [This answer is incorrect. If Leslie’s client’s interest-bearing liabilities and interest-earning assets are not matched based on the dates that interest rates change, her client would have interest rate risk. The scenario described above refers to a different type of risk.]

   c. Liquidity risk. [This answer is incorrect. This term describes the risk that the demand for funds will exceed the financial institution’s supply of funds. This risk occurs based on the institution’s investments and deposits, not based on an economic climate.]

   d. Issuer risk. [This answer is incorrect. Issuer risk is a specific type of credit risk that refers to the risk that companies or individuals will not be able to repay their debts. This type of risk is not related to economic climates.]

8. When Leslie creates a realistic picture of her client’s liquidity risk, which of the following must be taken into account? (Page 161)

   a. The earliest date that demand deposit liabilities must be paid. [This answer is incorrect. This would show a worst case scenario that might not be the most realistic scenario. Depending on her client’s circumstances, it might be permissible for Leslie to show only a portion of the demand liabilities at the earliest repayment date.]

   b. The earliest date that obligations under lines of credit must be paid. [This answer is incorrect. Such a worst case scenario might be too negative to form a realistic picture of her client’s liquidity risk. Leslie must take this into account when considering lines of credit.]

   c. Additional sources of funds, such as those obtained through repurchase agreements. [This answer is correct. If a financial institution has an additional source of funds, this will help the institution’s liquidity position. It will help the institution in its ability to meet obligations as they become due.]

   d. Anticipated payments of any short-term assets. [This answer is incorrect. When determining her client’s liquidity risk, Leslie should take into account anticipated prepayments of long-term assets, but not short-term assets.]

9. Define asset-liability management. (Page 162)

   a. Maximizing the excess of interest earned over interest paid. [This answer is incorrect. This is known as the net interest margin. Maximizing this margin will allow a financial institution to maximize profits.]

   b. Matching investment alternatives to potential sources of funding. [This answer is correct. The management of a financial institution should continually be comparing future payment streams, interest rates, maturities, and inherent risk in liabilities and assets, as well as considering changes that are expected in market interest rates. This process is known as asset-liability management. It is also called position management.]
c. Selling long-term assets in order to obtain liquidity. [This answer is incorrect. This is an element of liquidity risk. Such sales could result in losses to the financial institution.]

d. Expanding into new areas of business. [This answer is incorrect. Expanding into new business areas is an action that will increase the risk associated with an audit of a financial institution. Other such risk areas include acquiring complex investments or higher-risk investments.]

10. Which of the following financial institutions has implemented a strategy that should help manage its asset-liability gap? (Page 162)

a. Alpha Bank restructures its existing balance sheet by buying more loans and investments. [This answer is incorrect. To better manage its asset-liability gap, Alpha Bank should sell loans or investments, not buy them.]

b. Beta Bank lengthens the repricing period it allows on new loans and investments. [This answer is incorrect. If Beta Bank shortened its repricing period instead of lengthening it, the action would help manage its asset-liability gap.]

c. Gamma Bank implements hedging techniques using futures and options. [This answer is correct. Gamma Bank could also implement hedging techniques by using interest-rate swaps. However, interest-swaps, futures, and options are very sensitive to market movements. If Gamma Bank implements this strategy, both the bank’s management and the auditor will have to give the hedging techniques close and specialized attention.]

d. Delta Bank makes prepayments on long-term assets. [This answer is incorrect. This is a factor that an auditor would have to consider when evaluating Delta Bank’s liquidity risk. Prepayments would not help the institution manage its asset-liability gap.]

11. Don is engaged by the Mercer Credit Union to meet its audit requirements as described by the National Credit Union Administration (NCUA). Mercer is federally insured and has $750 million in assets. What type of audit must Don perform to meet the NCUA’s requirements? (Page 163)

a. A full-scope audit. [This answer is correct. Because Mercer is federally insured and has over $500 million in assets, it is required by NCUA to have an opinion audit on its financial statements. Therefore, Don must be independent from the credit union to perform the audit.]

b. A balance-sheet audit. [This answer is incorrect. Due to Mercer’s level of assets, the credit union is ineligible for a balance-sheet-only audit. Only an institution with less than $500 million would qualify.]

c. A report on examination of internal controls over call reporting. [This answer is incorrect. In this type of engagement, Don would perform and report on Mercer’s management’s written assertions concerning how effective the institution’s internal control is over its financial reporting in its most recently filed year-end or semiannual report. However, because Mercer has over $500 million in assets, it is not eligible for this type of engagement.]

d. A supervisory committee guide audit. [This answer is incorrect. In this type of engagement, Don would perform the audit in accordance with the minimum procedures prescribed by the NCUA Supervisory Committee Guide. However, due to its asset level and its federally insured status, Mercer cannot meet its audit requirements with an engagement of this type.]
12. The directors of Farthington Mutual, a financial institution with $300 million in assets, determine that an annual audit is not appropriate. What alternatives are available for the institution under the Federal Financial Institutions Examination Council’s (FFIEC) Interagency Policy Statement on External Auditing Programs of Banks and Savings Associations? (Page 164)

a. An examination level attestation engagement. [This answer is correct. This type of engagement will be concerned with Farthington Mutual’s management’s assertion of the effectiveness of its internal control over financial reporting. The engagement will focus on either all of the institution’s regulatory reports or certain schedules.]

b. An audit of the income statement. [This answer is incorrect. If the directors of Farthington Mutual want to have an audit of a portion of the financial statement, the audit would be of the institution’s balance sheet. No opinion would be provided on the fairness of the presentation of the income statement, the statement of cash flows, or the statement of changes in equity capital.]

c. An agreed-upon procedures engagement. [This answer is incorrect. This type of procedure would not be appropriate for Farthington Mutual in this scenario. However, a CPA can be engaged to perform an agreed-upon procedures engagement for a trust department. This type of engagement would be similar to a director’s exam.]

d. A director’s examination. [This answer is incorrect. If Farthington Mutual were subject to a director’s examination as part of a state-required external auditing program, it would not normally be expected to also use one of the two alternatives mentioned by the FFIEC’s policy statement.]

13. Jane, an auditor, must decide whether to accept an engagement auditing a financial institution. Which of the following circumstances would make it easier for Jane to accept the high risks associated with such an engagement? (Page 169)

a. Jane’s potential client is subject to regulatory supervision. [This answer is incorrect. This extra level of scrutiny increases the risk associated with auditing financial institutions. Because of regulatory supervision, the institution could fail or be placed in receivership because it did not meet minimum regulatory capital requirements.]

b. Jane’s potential client concentrates its lending efforts in its local area. [This answer is incorrect. This concentration gives Jane’s potential client an extra level of credit risk. A downturn in the local area’s economy could have a devastating effect on the financial institution’s financial solvency.]

c. Jane carries a hefty amount of professional liability insurance. [This answer is correct. The risks of auditing a financial institution would make it inadvisable to accept the engagement if Jane did not carry professional liability insurance. If she carries a large amount, however, it will be easier for Jane to make the decision to accept the engagement.]

d. Jane will not provide absolute assurance of the institution’s stability and health. [This answer is incorrect. Though this is true, it does not mean Jane is safe from lawsuits if her client becomes insolvent, experiences management fraud, or has other problems. An audit simply provides assurance that the financial statements are fairly presented in accordance with generally accepted accounting procedures; however, the public often believes an audit report provides absolute assurance. If the institution fails, Jane risks being the target of lawsuits.]
THE REGULATORY STRUCTURE OF FINANCIAL INSTITUTIONS

Financial institutions are subject to governmental supervision and regulation, including periodic examinations by various regulatory agencies. The current federal financial regulatory system for insured depositories is complex, with three agencies responsible for regulation and supervision of commercial banking organizations and separate agencies primarily responsible for savings institutions and credit unions. Exhibit 1-2 illustrates the regulatory agencies that are primarily responsible for the financial institutions discussed in this course. The following paragraphs discuss each agency in more detail.

Exhibit 1-2
Primary Responsibilities of Federal Regulatory Agencies

<table>
<thead>
<tr>
<th>Type of Institution</th>
<th>Primary Regulator</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank Holding Company&lt;sup&gt;a&lt;/sup&gt;</td>
<td>Federal Reserve Board</td>
</tr>
<tr>
<td>National Bank</td>
<td>Office of Comptroller of the Currency</td>
</tr>
<tr>
<td>State Member Bank&lt;sup&gt;b&lt;/sup&gt;</td>
<td>Federal Reserve Board</td>
</tr>
<tr>
<td>State Nonmember Bank&lt;sup&gt;b&lt;/sup&gt;</td>
<td>Federal Deposit Insurance Corporation</td>
</tr>
<tr>
<td>Federal Savings and Loan or Savings Bank</td>
<td>Office of Thrift Supervision</td>
</tr>
<tr>
<td>State Savings and Loan&lt;sup&gt;b&lt;/sup&gt;</td>
<td>Office of Thrift Supervision</td>
</tr>
<tr>
<td>Savings and Loan Holding Company&lt;sup&gt;a&lt;/sup&gt;</td>
<td>Office of Thrift Supervision</td>
</tr>
<tr>
<td>Federal Credit Union</td>
<td>National Credit Union Administration</td>
</tr>
<tr>
<td>State Credit Union&lt;sup&gt;b&lt;/sup&gt;</td>
<td>National Credit Union Administration</td>
</tr>
</tbody>
</table>

Notes:

<sup>a</sup> May also be subject to Securities and Exchange Commission regulations.

<sup>b</sup> Would also be subject to applicable state banking department supervision and examination.

Office of Comptroller of the Currency (OCC)

The OCC is a bureau of the Department of Treasury. It is the chartering authority and primary federal supervisor for national banks. Besides serving as the chartering authority for national banks, the OCC’s primary regulatory responsibilities include evaluating applications for merger where the surviving bank is a national bank, enforcing operating regulations in and examining national banks, and declaring failing national banks insolvent. The OCC supervises national banks through four district offices, each headed by a Deputy Comptroller, and various field offices. The OCC’s regulatory authority overlaps that of the FRB and the FDIC. Because of the overlap, it is not unusual for the OCC to have regulatory authority for the subsidiary banks of a bank holding company but not to have authority for the holding company itself.
Federal Reserve System (FRS) and Federal Reserve Board (FRB)

The FRB supervises the FRS, which serves as a bank for banks. Some of the more important functions of the FRS include:

- Regulating the country’s money supply.
- Regulating the reserves of financial institutions within the U.S.
- Providing wire transfers of funds.
- Examining and supervising state-chartered member banks.
- Regulating the activities of bank holding companies and nonbanking affiliates.
- Facilitating clearance and collections of checks.
- Acting as fiscal agent, legal depository, and custodian of funds for the U.S. government.
- Collecting and interpreting economic data regarding money, credit, and other related matters.
- Monitoring financial practices of member banks.

The FRS is divided into 12 districts, each having a Federal Reserve Bank. Each Federal Reserve Bank, in addition to providing the appropriate banking functions listed previously, supervises bank holding companies within its district. The Federal Reserve Banks also serve a primary supervisory role in the examination of state-chartered member banks. All national banks must be members of the FRS. State-chartered banks have the option of being members.

Federal Reserve Regulations. An important part of the FRS is the promulgation of regulations that govern the operations of the banking system. Currently there are 33 regulations in effect. They are designated by letters of the alphabet ranging from A to GG. CPAs who provide services to financial institutions must become intimately familiar with many of the regulations and should have at least a working knowledge of all of the regulations. A description of each regulation may be obtained from the FRB website at www.federalreserve.gov/bankinforeg/reglisting.htm.

Federal Deposit Insurance Corporation (FDIC)

The FDIC is a government corporation that insures deposits of banks and savings institutions. Insurance limits are set by Congress and have increased over the years to the present limit of $100,000 per account per financial institution. Operations of the FDIC are generally financed by fees, based on deposits, charged to the member banks and savings institutions.

Effective April 1, 2006, the Federal Deposit Insurance Reform Act of 2005 raised the deposit insurance coverage on certain retirement accounts to $250,000 from $100,000. The basic insurance coverage for other deposit accounts, however, remained at $100,000. This law also gives the FDIC and the NCUA the authority to jointly increase the insurance limits (in increments of $10,000) on all deposit accounts (including retirement accounts) beginning in 2011 and every five years thereafter, based on the rate of inflation. Effective October 3, 2008, the Economic Stabilization Act of 2008 temporarily raises the basic limit on federal deposit insurance coverage from $100,000 to $250,000 per depositor. The legislation provides that the basic deposit insurance limit will return to $100,000 after June 30, 2010. In addition, unlimited deposit insurance coverage is available through December 31, 2009, for non-interest bearing deposit transaction accounts at institutions participating in the FDIC’s Temporary Liquidity Guarantee Program. More information related to the changes in deposit insurance coverage can be found on the FDIC’s website at www.fdic.gov/deposit/deposits/changes.html.

Insurance Fund. Pursuant to the provisions of the Federal Deposit Insurance Reform Act of 2005, the FDIC merged the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF) to form the Deposit Insurance
Fund (DIF) effective March 31, 2006. Prior to March 31, 2006, the FDIC administered two insurance funds, the BIF and the SAIF. The funds were administered separately, and their resources were not commingled. The BIF generally insured deposits of commercial banks and some savings banks. SAIF primarily insured deposits of savings and loan associations.

**FDIC Examinations.** One of the most important functions of the FDIC is the examination of insured state-chartered banks that are not members of the FRS. (Savings institutions are examined by OTS. Generally, the examination of national banks and state-chartered banks that are members of the FRS is done by OCC.) During these examinations, FDIC examiners review the bank’s policies and procedures, evaluate its loan and investment portfolios, and look for possible violations of banking regulations. At the conclusion of an examination, the examiners prepare a detailed report of their findings. The report is reviewed with management and the board of directors. If there are any serious deficiencies, the bank generally must prepare and implement a written plan of action to correct the deficiencies and report progress to the examiners.

**Failed Banks.** Another of the important functions of the FDIC is its role in managing failed banks and savings institutions. Because of its role as deposit insurer, the FDIC obviously has the paramount responsibility to protect the insurance funds discussed previously in the “Insurance Fund” paragraph.

**Office of Thrift Supervision (OTS)**

The OTS is the primary regulator for savings institutions. It is a bureau of the Department of Treasury and is responsible for the examination and supervision of all savings institutions. The FDIC has backup enforcement authority for savings institutions. Thus, the FDIC is empowered to recommend and order that an enforcement action be initiated against a savings institution, even when the OTS has decided not to initiate such an action.

The FDIC, OTS, FRB, and OCC work closely together to conform rules and regulations, to the extent possible, so the regulatory environment is similar between banks and savings institutions. However, CPAs must be familiar with the rules and regulations relating to the specific entity being serviced.

**National Credit Union Administration (NCUA)**

The NCUA was created by Congress in 1970 to charter, supervise, and regulate federal credit unions. The National Credit Union Share Insurance Fund (NCUSIF), a part of NCUA, insures deposits of all federal and many state-chartered credit unions. As with the FDIC, OCC, and OTS, NCUA is charged with supervising and examining member credit unions. NCUA may assess penalties for violations of laws, regulations, written agreements, reporting requirements, and deficiencies in call reports.

**Federal Financial Institutions Examination Council (FFIEC)**

The FFIEC was established on November 10, 1978, by the Federal Financial Institutions Examination Council Act. The purpose of FFIEC is to prescribe uniform principles and standards for the federal examination of financial institutions by the OCC, FDIC, FRB, OTS, and NCUA. The members of FFIEC include the Comptroller of the Currency, the Chairman of the Board of Directors of the FDIC, a Governor of the Board of Governors of the FRS designated by the Chairman of the Board, the Director of OTS, and the Chairman of the NCUA.

**Securities and Exchange Commission (SEC)**

Bank and thrift holding companies are subject to SEC registration and reporting provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934, unless a normal exemption is available. Generally, bank and thrift holding companies with 500 or more shareholders and $3 million or more in total assets must file applicable reports with the SEC. Financial statements, schedules, and other financial disclosures included in SEC filings, including annual reports to shareholders, must comply with Regulation S-X (especially Article 9 for bank and thrift holding companies), Regulation S-K, and Guide 3, *Statistical Disclosures for Bank Holding Companies*, among other requirements. Although SEC requirements and rules and regulations are beyond the scope of this course, generally OCC, FRB, FDIC, and OTS disclosure regulations are conformed to SEC rules and regulations.
State Regulators

State banking departments and agencies vary from one state to the next. They normally approve charters for new state banks, savings institutions, and credit unions, approve new branches (where branching is allowed by state law), determine the scope of banking operations within the state, and examine financial institutions. Most states require banks to carry FDIC insurance and thereby become subject to FDIC and applicable FRS rules and regulations. Some states are more permissive in the types of financial institution services that they allow. As a result, financial institutions may prefer state charters to federal charters.

Other Agencies

Although they are not regulatory agencies, other agencies that have a significant impact on various segments of the financial services industry include:

- **Federal Housing Administration (FHA).** The FHA, a federal agency under the Department of Housing and Urban Development (HUD), was established by the National Housing Act of 1934 to help stabilize the home mortgage market, improve housing construction standards, and encourage housing construction on reasonable terms. The FHA insures eligible mortgage loans at a cost to the lender of 0.5% of the related average principal outstanding, and provides a variety of subsidy programs. The Secretary of HUD establishes interest rates on FHA loans based on market factors.

- **Department of Veterans Affairs (VA).** The VA guarantees conventional home, condominium, and mobile home loans made by private lenders to eligible veterans of the U.S. armed forces. The interest rate on VA-guaranteed, single-family mortgage loans is the same as that on FHA loans set by the Secretary of HUD.

- **Federal National Mortgage Association (FNMA).** FNMA (usually called Fannie Mae) provides a secondary market in residential loans by buying, servicing, and selling mortgage loans. This activity is financed with debt issued in its own name. FNMA, owned by private shareholders, is the nation’s largest purchaser of residential mortgages. Many financial institutions hold various FNMA securities as investments.

  On September 6, 2008, the Federal Housing Finance Agency (FHFA) placed FNMA into conservatorship. In addition, the U.S. Department of Treasury agreed to provide up to $100 billion of capital as needed to ensure FNMA continues to provide liquidity to the housing and mortgage markets. As of September 2009, Fannie Mae continues to operate under conservatorship and the government sponsored entity (GSE) continues to struggle. (Fannie Mae lost more than $28 billion in the first six months of 2009.)

- **Government National Mortgage Association (GNMA).** GNMA (usually called Ginnie Mae) is a government agency under HUD. It was created in 1968 to assume certain functions formerly belonging to FNMA and to guarantee securities backed by mortgages insured or guaranteed by the federal government. GNMA pass-through, mortgage-backed securities are its primary product.

- **Federal Home Loan Mortgage Corporation (FHLMC).** FHLMC (usually called Freddie Mac) establishes an active secondary market in mortgages and deals only with government supervised lenders and qualifying mortgage companies. Freddie Mac provides funds to lenders by purchasing existing mortgages from the lenders’ portfolios. Freddie Mac is financed primarily by sale of guaranteed bond-like and pass-through mortgage certificates.

  On September 6, 2008, the Federal Housing Finance Agency (FHFA) placed FHLMC into conservatorship. In addition, the U.S. Department of Treasury has established a Preferred Stock Purchase Agreement with the company to ensure FHLMC can continue to provide stability and liquidity to the U.S. mortgage market. As of September 2009, Freddie Mac continues to operate under conservatorship and the government sponsored entity (GSE) continues to struggle. (Freddie Mac lost nearly $10 billion in the second quarter of 2009.)
LAWS THAT AFFECT FINANCIAL INSTITUTIONS

Congress has passed several laws that have had a profound effect on financial institutions and their auditors. These laws greatly expanded the ability of regulators to control financial institutions. This section discusses those expanded powers and their impact on auditors. Four of the most significant of those laws are—

- FDIC Improvement Act of 1991 (FDICIA).
- Credit Union Membership Access Act of 1998 (CUMAA).

Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA)

Congress passed FIRREA in August 1989. FIRREA restructured the regulatory system as follows:

- The Savings Association Insurance Fund (SAIF) was created under the FDIC. The permanent insurance fund of the FDIC was renamed Bank Insurance Fund (BIF). The resources of SAIF and BIF are not commingled.
- The OTS became the savings institutions’ primary regulator.
- The FDIC’s board of directors was expanded from three to five members. The board consists of the Comptroller of the Currency, the Chairman of the OTS, and three other members appointed by the President.
- Regulatory agencies were given the authority to assess civil money penalties of up to $1 million per day against insured depository institutions and “institution-affiliated parties” (including independent auditors) that violate written agreements or conditions imposed by the agency or that engage in unsafe or unsound practices.
- Regulatory agencies were given the authority to assess civil money penalties of up to $1 million per day for filing late, false, or misleading regulatory reports.
- Regulatory capital standards were changed from a percentage of liabilities to a leverage ratio, a tangible-capital requirement, and a risk-based capital requirement based on total assets.
- FIRREA established guidelines and entrance and exit fees for savings institutions electing to change their charter to that of a national bank.

FDIC Improvement Act of 1991 (FDICIA)

Congress passed the FDIC Improvement Act of 1991 (FDICIA) in December 1991. Many banking laws were changed by FDICIA. Also, FDICIA gave federal banking agencies new supervisory functions and responsibilities. More importantly from the CPA’s perspective, FDICIA mandated increased involvement in the regulatory process by outside auditors for banks and savings institutions with assets of $500 million or more.

Overview of FDICIA. FDICIA applies only to banks and savings institutions, and certain of its provisions apply only to institutions of specified sizes. It is divided into five sections:

- Title I—Safety and Soundness. Title I contains provisions related to safety and soundness, supervision, accounting, prompt corrective action, least-cost resolution of insolvent institutions, and federal insurance for state-chartered institutions.
- Title II—Regulatory Improvement. Title II implements improvements in the regulation of foreign banks, addresses customer and consumer protection issues, promotes community development, increases
whistle-blower protections, and addresses changes in Truth in Lending provisions of the Federal Deposit
Insurance Act.

- **Title III—Regulatory Improvement.** Title III addresses brokered deposits; establishes a risk-based
assessment system for funding the FDIC, BIF, and SAIF; and specifies deposit insurance guidelines for
investment contracts, retirement accounts, trust funds, and foreign deposits.

- **Title IV—Miscellaneous Provisions.** Title IV addresses several miscellaneous topics that have little impact
on the audit process.

- **Title V—Depository Institution Conversions.** Title V addresses the conversion of depository institutions from
state charters to national charters and mergers of depository institutions.

The two primary changes caused by FDICIA that have had the greatest impact on the independent auditor are:

- FDICIA mandated management reporting and related audit requirements.

- FDICIA mandated prompt corrective action by regulators.

**FDICIA-mandated Management Reporting and Related Audit Requirements.** Financial institutions report their
operations and financial positions to the appropriate regulatory agencies through Call Reports or Thrift Financial
Reports. These reports are governed by detailed instructions issued by the applicable agencies. FDICIA adds
another requirement to the reporting process by requiring institutions with total assets of $500 million or more at the
beginning of the year to file the following with the regulators:

- Audited financial statements.

- Management report stating management’s responsibilities for preparing the institution’s annual financial
statements, for establishing and maintaining an adequate internal control structure and procedures for
financial reporting, and for complying with designated laws and regulations.

In addition, for an institution with total assets of $1 billion or more as of the beginning of its fiscal year, the following
items should also be filed with the regulators:

- Management’s assessment on the effectiveness of internal control over financial reporting.

- Auditor’s attestation report regarding management’s assessment of internal control over financial
reporting.

When performing a FDICIA engagement, management’s assertion on internal control over financial reporting and
the auditor’s report regarding management’s assertion should cover both financial statements prepared in accord-
dance with GAAP and those prepared for regulatory reporting purposes.

**FDICIA-mandated Prompt Corrective Action by Regulators.** FDICIA establishes capital categories that are the
basis for the level of activity and supervision of insured depository institutions. As a financial institution falls lower on
the capital scale, the institution faces increasingly stringent requirements for action by the institution and the
regulator. Because of the impact on the financial statements in terms of disclosure and the ability of the institution
to continue as a going concern, the practitioner must be familiar with both the capital categories and the regulatory
activity that is mandated when an institution becomes less than adequately capitalized.

**Final Amendments to Annual Audit and Reporting Requirements.** On July 20, 2009, the final rule amending Part
363 of the FDIC’s regulations was published in the Federal Register. Part 363 applies to insured depository
institutions with total assets above certain thresholds and requires annual independent audits, assessments of the
effectiveness of internal control over financial reporting, and compliance with laws and regulations pertaining to
insider loans and dividend restrictions, the establishment of independent audit committees, and related reporting
requirements. The asset size threshold for reporting on an institution’s internal control is $1 billion and the threshold
for the other requirements generally is $500 million.
The final rule was implemented generally as proposed, but with certain modifications in response to comments received. FIL-33-2009, which is available at www.fdic.gov, provides a summary of the final rule and highlights certain amended annual and other reporting requirements.

Highlights of the final amendments are summarized as follows (unless noted otherwise, the revisions were effective August 6, 2009):

- **Annual Reporting Requirements**—The final regulations require disclosure of the internal control framework used to evaluate internal control over financial reporting and disclosure of any identified material weaknesses that have not been remediated prior to the institution’s fiscal year-end; provide relief from reporting for institutions that merged out of existence before the filing deadline; provide relief from reporting on internal control for institutions acquired during the fiscal year; require management’s assessment of compliance with laws and regulations pertaining to insider loans and dividend restrictions to state management’s conclusion regarding compliance and to disclose any noncompliance with such laws and regulations; and provide illustrative management reports.

- **Compliance by Subsidiaries of Holding Companies**—The final regulations revise the criteria for determining whether the audited financial statement and internal control examination requirements of Part 363 may be satisfied at a holding company level. Specifically, it requires the total assets of a holding company’s insured depository institution subsidiaries to comprise 75% or more of the holding company’s consolidated assets to comply with Part 363 financial statement reporting requirements at the holding company level. This revision is effective for fiscal years ending on or after June 15, 2010.

- **Independent Public Accountants**—The final regulations clarify the independence standards applicable to public accountants and enhance the enforceability of the compliance with these standards; require certain communications to audit committees; and establish a seven year retention requirement for audit working papers.

- **Financial Reporting**—The final regulations include a new guideline to clarify that financial reporting includes both financial statements prepared in accordance with GAAP and those prepared for regulatory purposes. In addition, the regulations clarify that internal control over financial reporting includes controls over the preparation of both GAAP and regulatory financial statements.

- **Filing and Notice Requirements**—The regulations extend the annual report filing deadline for nonpublic institutions from within 90 days to within 120 days after the end of its fiscal year and include a late filing notification requirement.

- **Audit Committees**—The final regulations specify the audit committee’s duties regarding the independent public accountant, require audit committees to ensure that audit engagement letters do not contain unsafe and unsound limitation of liability provisions, and require boards of directors to apply written criteria for evaluating audit committee members’ independence. The effective date for the requirement to develop and adopt a set of written criteria for determining whether a director who is to serve on the audit committee is an outside director and is independent of management is December 31, 2009.

These regulations are further discussed where applicable throughout the course. A complete copy of FIL-33-2009 and the final regulations can be obtained at www.fdic.gov.

**Credit Union Membership Access Act of 1998 (CUMAA)**

CUMAA was signed into law in August 1998 to amend the Federal Credit Union Act. CUMAA is divided into four sections:

- **Title I**—Credit Union Membership. Title I authorizes multiple group chartering for federal credit unions.

- **Title II**—Regulation of Credit Unions. Title II imposes new requirements on federal credit unions regarding financial statements and audits, member business loans, and charter conversions.
• **Title III—Capitalization and Net Worth of Credit Unions.** Title III establishes a new system of tiered capital requirements for all insured credit unions (except corporate credit unions) similar to those of insured banks and savings associations.

• **Title IV—Miscellaneous Provisions.** Title IV addresses several miscellaneous provisions with little impact on the audit process.

**Sarbanes-Oxley Act of 2002**

The Sarbanes-Oxley Act was signed into law on July 30, 2002. The Act imposes significant requirements for auditors of public companies. Major provisions of the Act include the following:

- Establishment of a five-member Public Company Accounting Oversight Board (PCAOB) under the supervision of the Securities and Exchange Commission, of which three members must not be and cannot have been CPAs.
- Limitations on the nonaudit services an audit firm may provide to public company audit clients.
- Required retention of audit workpapers for seven years.
- Requirement to report on internal control, perform tests of compliance with SEC rules and regulations, and perform concurring partner reviews.
- Required rotation of lead and reviewing audit partners on public company engagements every five years.
- Increased penalties for certain crimes and increases in the statute of limitations on securities fraud.
- Prohibition against auditing a public company whose CEO, CFO, Controller, or equivalents worked for the audit firm during the preceding year.

But what is the impact of Sarbanes-Oxley on auditors of nonpublic companies? The answer to that question remains unclear. It appears that some of the provisions of Sarbanes-Oxley or similar provisions will become requirements through state law or regulatory bodies and, therefore, impact auditors of nonpublic companies. While the Sarbanes-Oxley Act is only applicable to public companies and their accounting firms, Section 209 of the Act directs state regulators to make an independent determination as to whether the standards created by Sarbanes-Oxley shall be applied to small and midsized nonregistered accounting firms.

Since the passage of the Sarbanes-Oxley Act, a number of states have adopted, or are considering adopting, certain rules similar to those of the Sarbanes-Oxley Act that are applicable for small and midsized nonregistered accounting firms. Much of the state legislative and regulatory activity to date has focused on areas such as the limitation or disclosure of non-audit services for an audit client, and documentation and retention of audit workpapers. In addition, NASBA amended the UAA Model Rules to include a seven-year record retention requirement. The UAA rules are intended to provide guidance to state boards of accountancy in the form of a single uniform standard. Auditors should be alert for changes in legislation or regulations in the states in which they operate.

The Sarbanes-Oxley Act established the PCAOB under the supervision of the SEC to set auditing, quality control, ethics, independence, and other standards relating to the audits of public companies. The PCAOB has the authority to set standards governing the audits of public companies only; the AICPA continues to have the authority to set standards governing the audits of nonpublic companies and has actively developed and issued standards after the establishment of the PCAOB. This course incorporates guidance contained within AICPA standards. [This course is not intended to provide compliance with PCAOB auditing or accounting standards. For audits of public companies or audits of nonissuers performed in accordance with PCAOB standards, auditors should consult PPC’s Guide to PCAOB Audits. To order, call (800) 431-9025 or visit the PPC website at ppc.thomsonreuters.com.]

The AICPA is monitoring state and regulatory activities and working to limit the effects of Sarbanes-Oxley on nonpublic company auditors. Since the state legislative and regulatory environment continues to evolve regarding the adoption of rules similar to those of the Sarbanes-Oxley Act for nonpublic companies, auditors should be alert for developments in
their jurisdictions that may impact their firms or clients. Firms can obtain additional information on activities related to Sarbanes-Oxley on the AICPA’s website. Information on legislative, regulatory, or executive branch proposals at the state level is available at www.aicpa.org/Legislative+Activities+and+State+Licensing+Issues/State+News+and+Info/States/State+Activity+Related+to+SOX.htm and general information about the Sarbanes-Oxley Act is available at thecaq.aicpa.org/Resources/Sarbanes+Oxley. For information on activities of the PCAOB, including registration of firms, standards, inspection, and enforcement, visit its website at www.pcaobus.org.

**Independence.** In accordance with Section 36 of the Federal Deposit Insurance Act and Part 363 of the FDIC’s regulations, all financial institutions with total assets of $500 million or more must comply with the SEC’s auditor independence requirements. [Financial institutions with total assets of $500 million or more must also comply with the PCAOB’s auditor independence requirements. To the extent that any of the rules within any one of these independence standards (AICPA, SEC, and PCAOB) is more or less restrictive than the corresponding rule in the other independence standards, auditors must comply with the most restrictive rule.] One provision of Sarbanes-Oxley further defines auditor independence issues by restricting the nonaudit services an audit firm may provide to public company audit clients, including prohibitions against bookkeeping or other services related to the accounting records or financial statements of the client; the internal audit function; the design and implementation of financial information systems; appraisal, valuation, or actuarial services; and management or human resources services. (The PCAOB has been given the authority to expand the list of prohibited services.) Certain nonaudit services, including most tax services, may continue to be provided, but they must be approved in advance by the client’s audit committee. The changes in the SEC’s independence requirements as a result of Sarbanes-Oxley affect institutions subject to FDICIA requirements, whether public or not.

**Requirements for All Entities.** While the majority of the Sarbanes-Oxley Act directly affects only public companies and their auditors, it is important to note that there are two provisions of Sarbanes-Oxley that apply to all corporate entities, including financial institutions of all sizes. First, it is illegal for any corporate entity to punish whistleblowers or retaliate against any employee who reports suspected cases of fraud or abuse. Second, it is a crime to alter, cover up, falsify, or destroy any document that may be relevant to an official investigation.

**Regulatory Requirements.** The federal banking regulators have issued guidance to insured depository institutions about selected provisions of Sarbanes-Oxley related to corporate governance, audits, and reporting requirements. That guidance (FIL-17-2003) is intended to answer questions about the applicability of those portions of Sarbanes-Oxley to insured depository institutions supervised by the FDIC, based on whether they are public companies or subsidiaries of public companies, nonpublic companies with $1 billion or more in total assets (subject to the reporting requirements of FDICIA), or nonpublic FDIC-supervised banks with less than $500 million in total assets.

The applicability of Sarbanes-Oxley to institutions with $500 million or more in total assets is discussed in an attachment to the FIL. Another attachment to the FIL presents a detailed summary of selected provisions of Sarbanes-Oxley that the FDIC believes are relevant to FDIC-supervised banks with less than $500 million in total assets that are not public companies. These sound corporate governance practices are not mandatory for smaller, nonpublic institutions; however, the FDIC recommends that each institution consider implementing them to the extent feasible given its size, complexity, and risk profile.

FIL-17-2003 can be accessed on the FDIC’s website at www.fdic.gov. Also, the AICPA’s website at www.aicpa.org includes a separate area related to Sarbanes-Oxley implementation and the PCAOB.

Future editions of this course will be updated to incorporate any changes to accounting and auditing standards and the standards-setting process that impact financial institutions.

**Credit Union Insurance Stabilization Act**

The Credit Union Insurance Stabilization Act (Stabilization Act) became law on May 20, 2009 and incorporated several provisions of the NCUA’s strategy to promote stability in the credit union industry. The Stabilization Act:

- Created a temporary corporate credit union stabilization fund to mitigate stabilization costs.
- Extended the $250,000 insurance ceiling for share and deposit accounts through 2013.
- Provided the NCUSIF the authority to assess premiums over eight years to rebuild the equity ratio in the fund.
- Increased the NCUA regular and emergency borrowing authority levels.

Subsequent to the passage of the Stabilization Act, the NCUA took several actions that released the NCUSIF from its corporate stabilization obligations. The Stabilization Act is discussed further in PPC’s *Guide to Audits of Financial Institutions*.

**WHERE TO FIND REGULATORY INFORMATION**

The laws, regulations, and other guidance published by the regulatory agencies previously discussed are readily available to financial institution auditors. Most of the laws and regulations referred to throughout this course begin with the designation “12 USC” or “12 CFR.” These designations refer to Title 12 of either the U.S. Code or the Code of Federal Regulations, and they are available from various sources such as the following:

a. Many public and university libraries keep up-to-date copies of the U.S. Code, the Code of Federal Regulations and the *Federal Register*. Before investing in a comprehensive service, the auditor should check with local libraries to see if copies are available.

b. There are many comprehensive services that contain up-to-date copies of all laws and regulations affecting financial institutions.

c. Many of the laws and regulations affecting financial institutions are available on the Internet.

In addition to the laws and regulations discussed in the preceding paragraph, each regulatory agency also publishes periodic bulletins as new topics arise or as old topics need additional clarification. The OCC, for example, issues a wide range of bulletins covering accounting, operational, and other matters. Some of the OCC bulletins include the following:

a. Advisory Letters.

b. Banking Bulletins.

c. Banking Circulars.

d. Memoranda.

e. Staff Interpretive Letters.

Keeping up with all of the bulletins issued by the various regulatory agencies can be a challenge, especially since several of them are issued each month. Fortunately, there are a number of ways for financial institution auditors to stay current throughout the year. These methods include the following:

a. Subscriptions from the regulatory agencies.

b. Private services, such as the Bureau of National Affair’s *BNA’s Banking Report*.

c. Trade associations, such as the Financial Managers Society.
SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

14. Which of the following tasks is performed by the Office of the Comptroller of the Currency (OCC)?
   b. Insuring the deposits of banks and savings institutions.
   c. Supervising the Federal Reserve System (FRS).
   d. Regulating the country’s money supply.

15. What is the Office of Thrift Supervision’s (OTS) primary responsibility?
   a. Examining and supervising all savings institutions.
   b. Supervising and regulating federal credit unions.
   c. Releasing regulations to govern operations of the banking system.
   d. Examining state-chartered, insured banks that aren’t part of the FRS.

16. Which of the following would be considered a regulatory agency for a financial institution?
   a. The Federal Home Loan Mortgage Corporation (FHLMC).
   b. The Federal Housing Administration (FHA).
   c. The Department of Veterans Affairs (VA).
   d. The Federal Financial Institutions Examination Council (FFIEC).

17. Max has accepted an engagement to audit a local bank in his hometown. What change made by the FDIC Improvement Act of 1991 (FDICIA) will have the most affect on Max as an independent auditor?
   a. Converting depository institutions from state charters to national charters.
   b. Mandating prompt corrective action by regulators.
   c. Giving regulatory agencies the authority to assess civil money penalties.
   d. Restricting nonaudit services an audit firm is allowed to perform for public company audit clients.

18. The Credit Union Membership Access Act of 1998 (CUMAA) has four sections, each one affecting a different area related to credit unions. What does Title III of CUMAA address?
   a. Credit union membership.
   b. Safety and soundness.
   c. Regulatory improvement.
   d. Capitalization of credit unions.
19. OCC bulletins are a source of regulatory information, and cover both new topics and old topics that might need additional clarification. Which of the following is one of the bulletins released by the OCC?


b. Staff Interpretive Letters.

c. The BNA’s Banking Report.

d. Advisory Memoranda.
SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. *(References are in parentheses.)*

14. Which of the following tasks is performed by the Office of the Comptroller of the Currency (OCC)? *(Page 176)*

a. Declaring failing national banks insolvent. *[This answer is correct. The OCC is the primary federal supervisor and chartering authority for national banks. Some of its other responsibilities include declaring failing national banks insolvent, examining and enforcing operating regulations in national banks, an evaluating merger applications if the surviving bank is a national bank.]*

b. Insuring the deposits of banks and savings institutions. *[This answer is incorrect. This is done by the Federal Deposit Insurance Corporation (FDIC). The FDIC is a government corporation.]*

c. Supervising the Federal Reserve System (FRS). *[This answer is incorrect. The Federal Reserve Board (FRB) is responsible for supervising the FRS. However, some of the OCC’s regulatory authority overlaps both the FRB and the FDIC.]*

d. Regulating the country’s money supply. *[This answer is incorrect. This is one of the most important functions of the FRS. Other functions include providing wire transfers of funds and acting as the U.S. government’s fiscal agent, custodian of funds, and legal depository.]*

15. What is the Office of Thrift Supervision’s (OTS) primary responsibility? *(Page 178)*

a. Examining and supervising all savings institutions. *[This answer is correct. The OTS serves as the primary regulator for savings institutions; however, the FDIC has backup enforcement authority.]*

b. Supervising and regulating federal credit unions. *[This answer is incorrect. The National Credit Union Administration (NCUA) regulates, supervises, and charters federal credit unions.]*

c. Releasing regulations to govern operations of the banking system. *[This answer is incorrect. This is a service performed by the FRS. Currently, the FRS has released 33 regulations.]*

d. Examining state-chartered, insured banks that aren’t part of the FRS. *[This answer is incorrect. This is one of the FDIC’s most important functions.]*

16. Which of the following would be considered a regulatory agency for a financial institution? *(Page 178)*

a. The Federal Home Loan Mortgage Corporation (FHLMC). *[This answer is incorrect. FHLMC, commonly called Freddie Mac, is not a regulatory agency; however, it could have a significant impact on a financial institution. The FHLMC establishes an active secondary market for mortgages. It deals with qualifying mortgage companies and government supervised lenders only.]*

b. The Federal Housing Administration (FHA). *[This answer is incorrect. Though the FHA can have a significant impact on a financial institution, it is not considered a regulatory agency. The FHA helps to stabilize the home mortgage market, encourages housing construction, and improves housing construction standards. It also insured eligible mortgage loans to the lender at a cost.]*

c. The Department of Veterans Affairs (VA). *[This answer is incorrect. The VA does not regulate financial institutions; however, it could have an impact on the financial services industry. It guarantees loans made by private lenders for condos, conventional homes, and mobile homes to eligible veterans of the U.S. armed forces.]*

d. The Federal Financial Institutions Examination Council (FFIEC). *[This answer is correct. The FFIEC’s purpose is to prescribe uniform principles and standards for federal examinations of financial institutions. This includes examinations made by the FRB, OCC, OTS, FDIC, and NCUA.]*
17. Max has accepted an engagement to audit a local bank in his hometown. What change made by the FDIC Improvement Act of 1991 (FDICIA) will have the most affect on Max as an independent auditor? (Page 181)

a. Converting depository institutions from state charters to national charters. [This answer is incorrect. This subject is addressed in Title V of the FDICIA; however, it is not one of the two changes that has had the most impact on independent auditors like Max. Another topic addressed in Title V is mergers of depository institutions.]

b. Mandating prompt corrective action by regulators. [This answer is correct. FDICIA established capital categories as a basis for the level of activity and supervision of insured depository institutions. The lower an institution falls on the capital scale, the more stringent are the requirements for action by the institution and the regulator. Max must be familiar with the capital categories and the mandated regulatory activity should his client become less than adequately capitalized.]

c. Giving regulatory agencies the authority to assess civil money penalties. [This answer is incorrect. This change was made by the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA). If an insured depository institution violates written agreements or conditions that were imposed by the agency or if it engages in unsafe or unsound practices, the regulatory agency can assess penalties of up to $1 million per day. Similar penalties can also be assessed by the agency if the institution files late, misleading, or false regulatory reports.]

d. Restricting nonaudit services an audit firm is allowed to perform for public company audit clients. [This answer is incorrect. This is a provision of the Sarbanes-Oxley Act of 2002. Under this act, Max would not be independent from his client if he performs bookkeeping or other services related to financial statements or accounting records for the client.]

18. The Credit Union Membership Access Act of 1998 (CUMAA) has four sections, each one affecting a different area related to credit unions. What does Title III of CUMAA address? (Page 182)

a. Credit union membership. [This answer is incorrect. Title one of CUMAA deals with multiple group chartering for federal credit unions.]

b. Safety and soundness. [This answer is incorrect. This is the topic of provisions in Title I of the FDICIA, which does not apply to credit unions.]

c. Regulatory improvement. [This answer is incorrect. This is the topic of provisions in Titles II and III of the FDICIA. The regulation of credit unions is addressed by Title II of CUMAA.]

d. Capitalization of credit unions. [This answer is correct. Title III of CUMAA establishes a tiered system of capital requirements for insured credit unions (excluding corporate credit unions). This system is similar to the system used by insured banks and savings associations.]

19. OCC bulletins are a source of regulatory information, and cover both new topics and old topics that might need additional clarification. Which of the following is one of the bulletins released by the OCC? (Page 185)

a. The Code of Federal Regulations. [This answer is incorrect. The U.S. Code and the Code of Federal Regulations house the laws, regulations, and other guidance published by regulatory agencies (including the OCC). Places to access these publications include libraries, the Internet, and through comprehensive services.]

b. Staff Interpretive Letters. [This answer is correct. This is one of the bulletins released by the OCC. Other bulletins that are available include Banking Bulletins and Banking Circulars. These bulletins are released in addition to laws and regulations to provide additional clarification on topics.]

c. The BNA’s Banking Report. [This answer is incorrect. This is a private service that can help auditors of financial institutions keep up with all the bulletins issued by the various regulatory agencies. Other ways auditors can do this include subscriptions from the regulatory agencies or trade associations.]

d. Advisory Memoranda. [This answer is incorrect. The OCC released Advisory Letters, and it releases Memoranda; however, it does not release Advisory Memoranda.]
EXAMINATION FOR CPE CREDIT

Lesson 1 (AFITG102)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. List all of the levels of the generally accepted auditing standards (GAAS) hierarchy.
   
   i. Generally accepted accounting principles.
   
   ii. Auditing standards.
   
   iii. The internal revenue code.
   
   iv. Interpretive publications.
   
   v. Other auditing publications.

   a. i.
   
   b. ii. and v.
   
   c. ii., iv., and v.
   
   d. i., ii., iii., iv., and v.

2. Define interpretive publications.

   a. Ten general, reporting, and field work standards and Statements on Auditing Standards (SASs).
   
   b. Recommendations about applying the SASs, such as AICPA Audit and Accounting Guides and AICPA Auditing Statements of Position.
   
   c. Publications with no authoritative status that can help understand and apply the SASs, such as professional journal articles.
   
   d. Explanatory material that provides auditors additional guidance on professional requirements.

3. Leroy is performing an audit of a financial institution using the PPC audit process. At what point in the process will he assess the risk of material misstatement of his client’s financial statements? Note: Though guidance suggests a linear process, an audit is a continuous process that involves gathering, updating, and analyzing information about the fairness of presentation of amounts and disclosures in the client’s financial statements. Procedures may be performed concurrently. However, for the testing purposes of question 3, assume that the procedures of the PPC Audit Process are being performed sequentially.

   a. Step 1.
   
   b. Step 3.
   
   c. Step 5.
   
   d. Step 7.
4. When using the risk assessment audit approach described in this course, which of the following actions should be performed by the auditor?

a. Identifying high-risk areas for which less extensive procedures can be performed.
b. Obtaining a cursory or surface understanding of the client and its environment.
c. Linking audit procedures to specific portions of the client’s financial statements.
d. Concentrating the audit on financial statement areas with a higher risk of material misstatement.

5. Lisa is about to commence an audit under the professional standards. What should her key focus be if she wants to perform a successful audit under these standards?

a. Planning and gaining knowledge about the client.
b. Distributing work evenly among the audit areas.
c. Field work performed on location.
d. Adherence to all levels of the GAAS hierarchy.

6. Match the following terminology from the risk assessment standards with the correct definition:

<table>
<thead>
<tr>
<th>Terms</th>
<th>Definitions</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Significant risks</td>
<td>i. They allow the auditor to obtain an understanding of the entity and its environment and are performed at the beginning of an audit.</td>
</tr>
<tr>
<td>2. Risk assessment procedures</td>
<td>ii. They are performed as a response to assessed risks as an attempt to reduce audit risk to a low level that is appropriate.</td>
</tr>
<tr>
<td>3. Risk of material misstatement</td>
<td>iii. A high level of audit assurance, though not absolute.</td>
</tr>
<tr>
<td>4. Further audit procedures</td>
<td>iv. Inherent risk with a likely magnitude of potential misstatement that is also likely to occur. This type of risk requires special audit consideration.</td>
</tr>
<tr>
<td>5. Reasonable assurance</td>
<td>v. The likelihood that a misstatement of the financial statements will be material.</td>
</tr>
</tbody>
</table>

a. 1., iv.; 2., i.; 3., v; 4., ii.; 5., iii.
b. 1., v.; 2., ii.; 3., iv.; 4., i.; 5., iii.
c. 1., i.; 2., iii.; 3., ii.; 4., v.; 5., iv.
d. 1., iv.; 2., v.; 3., i.; 4., iii.; 5., ii.

192
7. Which of the following statements best describes an aspect of the financial institution industry?
   a. Financial institutions can maximize profits by maximizing the excess of interest earned over interest paid.
   b. Financial institutions are less active about managing risks, so auditors must fill the gap with extra auditing procedures.
   c. Insurance companies are a type of financial institution that is federally insured and supervised by federal or state regulatory agencies.
   d. The main objective for a financial institution is to maximize the amount of interest earnings it can pay out to its customers.

8. In which of the following scenarios should the auditor of the financial institution be aware of liquidity risk?
   a. First National Bank borrowed money for one year at a fixed rate. It then lent those funds for six months, also at a fixed rate.
   b. Second National Bank invests its funds in long-term assets. Its funds are generally accrued as short-term deposits.
   c. The Smithville Savings and Loan loans a sizable amount of money to a new start-up business with a promising product, but the business goes bankrupt.
   d. The Credit Union of Mac-town is dependent on the technology industry in Mac-town. In 2008, the town’s main employer, Techno City, moves to another state.

9. North Point Bank’s interest-sensitive assets exceed its interest-sensitive liabilities. How will its earnings be affected if interest rates rise?
   a. Earnings will increase.
   b. Earnings will decrease.
   c. Earnings will stay the same.
   d. Earnings are not depending on the asset-liability gap.

10. In which of the following scenarios does the financial institution have a problem related to fiduciary risk?
    a. Bank 1 depends on information technology for transaction processing.
    b. Bank 2 fails to properly manage financial assets on behalf of third parties.
    c. Bank 3 uses a third party data processor.
    d. Bank 4 analyzes its total position in an attempt to identify risks.
11. Julia is auditing the financial statements of a savings institution in accordance with GAAS. Her client presents consolidating balance sheets and income statements for each of its joint ventures and majority-owned subsidiaries. The client’s total assets for the audit period were $450 million. How will this affect Julia’s audit engagement?

   a. Julia’s client must have a supervisory committee guide audit as described in the Congress of the Credit Union Membership Access Act of 1998 (CUMAA).
   
   b. Julia should present the consolidated financial statements as additional information accompanying the basic financial statements.
   
   c. The additional information makes Julia’s client subject to the requirements of the Federal Deposit Insurance Corporation Improvement Act (FDICIA).
   
   d. If Julia’s client does not have a CAMELS rating of 1 or 2, she must withdraw from the engagement immediately.

12. Silverton Mutual is a savings institution with $1.3 billion in assets. Which of the following is an additional requirement that must be met by Silverton Mutual, but would not have to be met by a financial institution with assets totaling less than $1 billion?

   a. An attestation engagement.
   
   b. A balance-sheet audit.
   
   c. A supervisory committee guide audit.
   
   d. CAMELS rating.

13. Which of the following statements most accurately describes the potential risks and liabilities of auditing financial institutions?

   a. Audits of financial institutions have little associated risk when compared with audits of other industries.
   
   b. It is safe for auditor’s with no professional liability insurance to perform audits of financial institutions.
   
   c. As long as they are independent, auditors cannot be sued if the institution becomes insolvent.
   
   d. Auditors usually must rely on the work of specialists when estimating an institution’s assets.

14. Match the following types of financial institutions with their primary regulatory agency.

<table>
<thead>
<tr>
<th>Regulator</th>
<th>Institution</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Federal Reserve Board</td>
<td>i. State member bank</td>
</tr>
<tr>
<td>2. Office of Thrift Supervision</td>
<td>ii. State nonmember bank</td>
</tr>
<tr>
<td>3. Office of Comptroller of the Currency</td>
<td>iii. Bank holding company</td>
</tr>
<tr>
<td>4. National Credit Union Administration</td>
<td>iv. National bank</td>
</tr>
<tr>
<td>5. Federal Deposit Insurance Corporation</td>
<td>v. Federal or state credit union</td>
</tr>
<tr>
<td></td>
<td>vi. Federal or state savings and loan</td>
</tr>
<tr>
<td></td>
<td>vii. Federal savings bank</td>
</tr>
<tr>
<td></td>
<td>viii. Savings and loan holding company</td>
</tr>
</tbody>
</table>
a. 1., i. and ii.; 2., v.; 3., vi., vii., and viii; 4. iii.; 5., .iv.
b. 1., iv. and vii.; 2., vi. and viii.; 3., i.; 4., v.; 5., ii. and iii.
c. 1., i. and iii.; 2., vi., vii., and viii.; 3., iv.; 4., v.; 5., ii.
d. 1., ii.; 2., iii. and vii.; 3., i. and iv.; 4., v.; 5., vi. and viii.

15. If a savings institution or bank has its deposits insured by the Federal Deposit Insurance Corporation (FDIC), what is the insurance limit per account for basic insurance coverage?

a. $50,000.
b. $100,000.
c. $250,000.
d. $500,000.

16. Calvary National Bank has 750 shareholders and $5 million in total assets and does not meet the requirements for exemption. To what agency must the bank file reports, including its financial statements?

a. The National Credit Union Administration (NCUA).
b. The Office of Thrift Supervision (OTS)
c. The Federal Reserve Board (FRB).

17. Which of the following statements most accurately describes state regulators of financial institutions?

a. Their decisions always supersede the requirements of the Federal Reserve System (FRS) or FDIC.
b. If a financial institution is eligible for a state charter, it cannot use a federal charter instead.
c. They can approve new charters or branches and determine the scope of banking in the state.
d. They deal exclusively in servicing, buying, and selling mortgage loans and have private shareholders.

18. Match the following laws with one of the changes they made to the financial services industry.

<table>
<thead>
<tr>
<th>Law</th>
<th>Changes</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Financial Institutions Reform, Recover and Enforcement Act of 1989 (FIRREA)</td>
<td>i. Requires that audit workpapers be retained for seven years.</td>
</tr>
<tr>
<td>2. FDIC Improvement Act of 1991 (FDICIA)</td>
<td>ii. Authorized multiple group charters for federal credit unions.</td>
</tr>
<tr>
<td>3. Credit Union Membership Access Act of 1998 (CUMAA)</td>
<td>iii. Mandated an increased level of involvement by outside auditors in the regulatory process of banks and savings institutions with assets of $500 million or more.</td>
</tr>
</tbody>
</table>
a. 1., iii.; 2., i.; 3., ii.; 4., iv.

b. 1., ii.; 2., i.; 3., iv.; 4., iii.

c. 1., iv.; 2., iii.; 3., ii.; 4., i.

d. 1., i.; 2., ii.; 3., iii.; 4., iv.

19. Many of the provisions of the Sarbanes-Oxley Act only affect public companies. Which of the following of its provisions affects all corporate entities, including all financial institutions regardless of size?

a. Punishment of whistleblowers by a corporate entity is illegal.

b. The statute of limitations on securities fraud was increased.

c. Financial positions must be reported to appropriate regulatory agencies.

d. The OTS is now the primary regulator for savings institutions.
Lesson 2: Pre-Engagement Activities for Audits of Financial Institutions

INTRODUCTION

Most financial institution audits are performed as part of a continuing engagement with a client. This lesson explains the activities that take place (a) before an engagement is accepted and (b) in the early planning stages of an engagement. Many of these matters should receive attention annually before the start of a continuing engagement. However, they are particularly important and more extensive in the first audit of a new client. In addition to allowing the auditor to make a decision about the acceptance or continuance of a client relationship, pre-engagement activities also provide the auditor with important information that directly contributes to the assessment of risks and development of an audit strategy and detailed audit plan. This lesson focuses on considerations that are unique to audits of financial institutions, including the requirements of the FDIC Improvement Act of 1991 (FDICIA).

Learning Objectives:

- Identify client acceptance and continuance policies.
- Recognize the reasons to use an engagement letter.
- Assess issues related to FDICIA engagements, using the work of a specialist, and initial engagements.
- Summarize how use of internal auditors and service organizations will affect the audit.

Authoritative Literature

The authoritative pronouncements that establish requirements or provide guidance that most directly affects pre-engagement activities are as follows:

a. SAS No. 65 (AU 322), *The Auditor’s Consideration of the Internal Audit Function in an Audit of Financial Statements*, provides guidance when considering the work of internal auditors and using internal auditors to provide assistance in the audit of the financial statements.

b. SAS No. 70 (AU 324), *Service Organizations*, provides guidance for the auditor when the client uses a service organization to process transactions.

c. SAS No. 73 (AU 336), *Using the Work of a Specialist*, defines specialists within the context of the audit and provides requirements to the auditor when using their work.

d. SAS No. 84 (AU 315), *Communications Between Predecessor and Successor Auditors*, establishes the required communications that should occur prior to client acceptance when a change of auditors has taken place.

e. SAS No. 108 (AU 311), *Planning and Supervision*, provides requirements relating to client acceptance and continuance and establishing an understanding with the client, including the issuance of a written engagement letter.

f. Statement on Quality Control Standards (SQCS) No. 7 (QC 10), *A Firm’s System of Quality Control*, describes the quality control policies and procedures, including those that pertain to client acceptance and continuance, that a member firm’s quality control system should encompass.

g. Interpretation 101-3 (ET 101.05), *Performance of Nonattest Services*, of the AICPA’s *Code of Professional Conduct*, provides guidance regarding an auditor’s independence in relationship to an attest client when performing nonattest services.

h. The AICPA audit and accounting guide, *Depository and Lending Institutions: Banks and Savings Institutions, Credit Unions, Finance Companies and Mortgage Companies* (DEP), also provides guidance that should be considered during the pre-engagement phase of a financial institution audit.
In addition to the items listed, auditors need to comply with other ethical requirements of the AICPA’s Code of Professional Conduct when considering whether an engagement can be accepted or continued. The authoritative pronouncements are explained further at the relevant points in the following discussion.

The Auditing Standards Board is completing its large-scale project to redraft and revise all existing U.S. auditing standards to improve clarity and to converge with the International Standards on Auditing (ISAs). The ASB anticipates that the redrafted and clarified SASs, except those that address current issues, will be effective for audits of financial statements no earlier than for periods ending on or after December 15, 2012. Standards that address current issues could have earlier effective dates.

Regulatory Requirements

Besides the authoritative literature discussed in the previous paragraph, a CPA who is deciding whether to accept or continue a relationship with a financial institution must consider the regulatory environment and requirements related to audits of financial institutions. This is particularly true of financial institutions with assets of $500 million or more at the beginning of the year. An audit of these institutions must meet the requirements of FDICIA.

AN AUDITOR’S CLIENT ACCEPTANCE AND CONTINUANCE RESPONSIBILITIES

The auditor’s broad responsibilities under professional standards regarding client acceptance and continuance decisions are as follows:

- **Establishing Policies and Procedures.** SQCS No. 7 (QC10) requires CPA firms to establish policies and procedures for the acceptance and continuance of client relationships and specific engagements. According to SQCS No. 7, “the policies and procedures should be designed to provide the firm with reasonable assurance that it will undertake or continue relationships and engagements only where the firm:
  a. Has considered the integrity of the client, including the identity and business reputation of the client’s principal owners, key management, related parties, and those charged with its governance, and the risks associated with providing professional services in the particular circumstances;
  b. Is competent to perform the engagement and has the capabilities and resources to do so; and
  c. Can comply with legal and ethical requirements.”

The Quality Control Task Force of the AICPA has issued an Audit and Accounting Practice Aid, Establishing and Maintaining a System of Quality Control for a CPA Firm’s Accounting and Auditing Practice, that provides nonauthoritative guidance on quality control systems for firms of varying sizes. The practice aid has been revised for the issuance of SQCS No. 7 and is available on the AICPA’s website.

- **Timing of Procedures.** SAS No. 108 (AU 311) indicates that auditors should perform client acceptance and continuance procedures, including evaluating compliance with ethical requirements, prior to performing significant audit activities for the current engagement. Before accepting an engagement, auditors should also determine whether circumstances will allow an adequate audit and an unqualified opinion. If it appears that a qualified or disclaimer of opinion may be necessary, that should be discussed with the client.

- **Communicating with Previous Auditors.** SAS No. 84 (AU 315) and SAS No. 108 require a successor auditor to make certain inquiries of the predecessor auditor before accepting an engagement.

Client acceptance/continuance policies and procedures should provide reasonable assurance that:

- Engagements that are accepted can reasonably be expected to be completed with professional competence.

- The risks associated with providing professional services in the particular circumstances are appropriately considered.
Many auditors have traditionally viewed the client acceptance/continuance process as a means of gathering information that will allow a decision about whether to accept or continue a client relationship or a specific engagement. However, the information gathered generally has an impact on later steps in the audit process for those clients or engagements that are accepted. For example, acceptance/continuance procedures often provide critical information that can be used by the auditor when establishing an audit strategy, identifying and assessing risks, and developing a detailed audit plan, as well as for other audit purposes. SAS No. 106 (AU 326.02) specifically notes that audit evidence includes information obtained from client acceptance and continuance procedures.

If issues involving the acceptance or continuance of a client relationship or a specific engagement are identified and the firm decides to accept or continue the client relationship or the specific engagement, SQCS No. 7 requires that the firm document how the issues were resolved.

**Risk-based Perspective**

When deciding whether to accept or continue a client, the auditor considers the risks related to the engagement. This is a very high-level consideration of whether the risk level related to the engagement and the overall financial statements is greater than normal. For situations that pose greater than normal risk, firm policies determine when a new engagement should be declined and when the relationship with a continuing client should be terminated.

If a client with greater than normal risk is accepted or continued, there has to be an appropriate audit response to the risk level in the audit plan. A client with greater than normal risk poses a greater risk to the auditor from a business risk perspective (the auditor’s own business risk) and also involves a greater risk of material misstatement of the financial statements. Both SAS No. 99 (AU 316.34) and SAS No. 109 (AU 314.13) explicitly note that the auditor should consider whether procedures relating to the acceptance and continuance of clients and engagements may be relevant in the identification of risks of material misstatement.

For a new engagement, the auditor obtains a general understanding of management’s reputation and integrity and of the client’s industry, operations, and financial condition through discussions with management, predecessor auditors, and other knowledgeable parties. For a continuing engagement, the auditor considers the same factors, but also considers whether there have been changes that affect the auditor’s continuance decision.

The engagement acceptance or continuance decision normally focuses on factors that increase overall financial statement risk. What is the intended use of the financial statements? Do discussions with the predecessor auditor, regulators, attorneys, or others raise any concerns about management’s integrity? Are there increased risks due to indications of pressures, opportunities, or incentives for fraudulent financial reporting on the part of management? Is the institution in a precarious financial position that creates a question of going concern or the possibility of the imposition of regulatory sanctions? Consideration of this information might cause the auditor to decline to accept the engagement or to terminate the client relationship, or might cause the auditor to plan and perform the audit in a different manner.

The early identification of higher risk engagements can help ensure that audit personnel with adequate industry and overall audit experience are assigned to the engagement and that sufficient involvement of the partner and manager occur at all stages of the audit, but particularly during the risk assessment process. Also, the preliminary scheduling of audit work and estimates of audit time (and often, fee estimates) will be affected by any risks that have been identified through client acceptance or continuance. In addition, the reporting deadlines established need to allow sufficient time for dealing with the anticipated risk level. In some cases, greater than normal involvement of a second partner in the engagement may be advisable. Many of these matters are audit strategy issues.

**Client Acceptance: A Step-by-step Process**

Exhibit 2-1 presents a step-by-step decision-making process for evaluating new client acceptance in an audit engagement. The process depicted in the flowchart begins with certain decisions the firm should make regarding factors that impact the firm’s overall practice and proceeds through specific client and engagement considerations.

As illustrated in Exhibit 2-1, before accepting a new client, an auditor naturally wants to consider the following items:

a. Whether there are any professional reasons not to provide services to the client.
b. What services are to be provided.

c. Whether the firm meets ethical requirements, including independence.

d. Whether professional standards and other relevant requirements can be met in providing those services.

After accepting a new client, auditors should consider whether their engagement acceptance procedures provide information that may be relevant in identifying risks of material misstatement due to error or fraud. The annual evaluation for continuing engagements is discussed further later in this lesson.

**Prospective Client’s Reputation**

An auditor should consider the reputation of the prospective client, its management, and those charged with governance. Quality control standards require CPA firms to establish policies and procedures to minimize the likelihood of accepting or continuing association with a client whose management lacks integrity. Consideration should also be given to whether—

- Management and those charged with governance are knowledgeable about the business.
- Management and those charged with governance are committed to the application of appropriate accounting principles.
- The institution possesses an appropriate organizational structure, including the nature and purpose of related party relationships.
- Management and those charged with governance have an appropriate attitude about the financial reporting process, including internal controls.
- Management and those charged with governance reflect an appropriate attitude regarding the general nature of audit procedures to be applied, required time commitments and client resources, and level of effort necessary to complete the audit.

In connection with the auditor’s initial or recurring retention, the auditor might discuss or correspond with management about a significant issue, for example, a particular application of accounting principles or auditing standards. Unless all of those charged with governance are involved in managing the entity, SAS No. 114 (AU 380) indicates that significant issues that were discussed or were the subject of correspondence with management should be communicated with those charged with governance.

In October 2008, the AICPA issued a statement entitled *The Auditor’s Communication With Those Charged With Governance* (Redrafted), which will supersede AU 380, *The Auditor’s Communication With Those Charged With Governance*. The redrafted Standard will be issued as part of a document containing all clarified and redrafted SASs in codified format. The redrafted guidance is expected to be effective for audits of financial statements for periods beginning on or after December 15, 2010, but that date is subject to change as the clarified SASs are issued. Subsequent editions of this course will be updated for the redrafted SAS, as needed.
Exhibit 2-1

Evaluating New Client Acceptance

Do we want to perform services in this practice area?

Y

Do we want to perform services in this industry?

Y

Based on the results of client screening procedures, are there reasons that would cause us not to want to be associated with the client, including questionable integrity?

Y

Does the intended use of the financial statements create a sufficiently high-risk engagement to warrant discontinuing further acceptance consideration?

Y

Is the financial reporting system adequate to permit required procedures to be performed?

Y

Has the client imposed any scope limitations that cannot be mitigated?

Y

Does it appear that an unqualified opinion can be expressed or, if not, that the client will accept a different opinion? (Discuss the possible necessity of a qualified or disclaimer of opinion with the prospective client.)

Y

Does the firm have, or can it obtain, adequate personnel and technical expertise for the engagement?

Y

Are there any other circumstances that would warrant discontinuing further acceptance consideration?

Y

Is the prospective engagement cost/beneficial?

Y

Does the firm meet ethical requirements, including independence?

Y

Is there a predecessor auditor with whom professional standards require us to communicate?
Does the prospective engagement comply with the requirements of the firm’s acceptance and continuance policy and procedures, including obtaining the appropriate approvals?

Advise the client we have accepted engagement subject to discussions with the predecessor auditor.

Communicate with the predecessor auditor.

Has the communication with the predecessor auditor (or inability to do so) given us reason to question the integrity of management or otherwise reevaluate the decision to accept the client?

Does the prospective engagement comply with the requirements of the firm’s acceptance and continuance policy and procedures, including obtaining the appropriate approvals?

ACCEPT CLIENT

REJECT CLIENT

Note:

a If issues involving the acceptance or continuance of a client relationship or a specific engagement are identified and the firm decides to accept or continue the client relationship of the specific engagement, SQCS No. 7 requires that the firm document how the issues were resolved. (SQCS No. 7 is effective for a firm’s system of quality control as of January 1, 2009.)

* * *

Sources of Information. Neither quality control standards nor generally accepted auditing standards provide specific requirements on the depth of an investigation of a prospective client except for the requirement in SAS No. 84 (AU 315) to communicate with a predecessor auditor. If the prospective client is well known to the auditor, the only procedures could be inquiry of the predecessor auditor and review of the prior financial statements and reports. Depending on the auditor’s familiarity with the prospective client, the inquiry and analysis made before a client acceptance decision usually include the following:

- Specific inquiry of former accountants or auditors who have provided services to the client. (AU 315 defines predecessor auditor and provides guidance in various circumstances, as for example, when the last engaged auditor did not issue a report on financial statements.)

- Specific inquiry of the prospective client’s lawyer.

- Review of the prospective client’s most recent interim or annual financial statements, income tax returns, and reports to regulatory agencies.

- Consideration of the composition, qualifications, and autonomy of members of the board of directors and the audit committee or supervisory committee, including the number of outside directors.
In addition, the following might also be considered when assessing the prospective client’s reputation:

- Management’s response to suggestions made by predecessor auditors for improvements to internal controls.

- Inquiry of commercial credit agencies and business groups or associations, such as the Better Business Bureau.

- A background check performed by an investigative firm. The desirability of such a check might be suggested by indicators such as frequent changes in auditors or lawyers, or the results of inquiries, reviews, or considerations previously listed. In addition to the financial institution itself, subjects of background checks might include officers or key management personnel and related entities or affiliated parties.

Call Reports and other financial information are available online and can assist the auditor in assessing the prospective client. Call reports and Thrift Financial Reports can be obtained from the FDIC website at www2.fdic.gov/Call_TFR_Rpts. Other financial information about individual financial institutions can also be obtained from the FDIC website at www2.fdic.gov/idasp/main.asp. Credit Union information can be obtained through the NCUA at www.NCUA.gov/CuData.aspx. Additionally, when considered necessary based on the circumstances, online database services are available to assist the firm in obtaining information about the prospective client and its management. Such service providers, some of which are summarized in Exhibit 2-2, allow the firm to search for bankruptcy records, litigation history, Dun & Bradstreet reports, corporate filings, corporate affiliations, and newspapers or trade publications containing information on prospective clients and their management. These searches can be performed from the office at a relatively low cost. However, it is a good idea to check with legal counsel prior to performing a background check to determine if any federal, state, or local laws require permission from, or disclosure to, the prospective client. Prospective clients that limit access to their former auditors should be viewed with skepticism.

### Exhibit 2-2

<table>
<thead>
<tr>
<th>INFORMATION SOURCE</th>
<th>HOW TO CONTACT</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Credit Rating Services</strong></td>
<td></td>
</tr>
<tr>
<td>Dun &amp; Bradstreet Corporation</td>
<td><a href="http://www.dnb.com">www.dnb.com</a></td>
</tr>
<tr>
<td>Equifax</td>
<td><a href="http://www.equifax.com">www.equifax.com</a></td>
</tr>
<tr>
<td>Experian</td>
<td><a href="http://www.experian.com">www.experian.com</a></td>
</tr>
<tr>
<td>Moody’s Investors Services</td>
<td><a href="http://www.moodys.com">www.moodys.com</a></td>
</tr>
<tr>
<td>National Association of Credit Management (NACM)</td>
<td><a href="http://www.nacm.org">www.nacm.org</a></td>
</tr>
<tr>
<td>Standard &amp; Poor’s</td>
<td><a href="http://www.standardandpoors.com">www.standardandpoors.com</a></td>
</tr>
<tr>
<td>TransUnion</td>
<td><a href="http://www.transunion.com">www.transunion.com</a></td>
</tr>
<tr>
<td><strong>Online Database Services</strong></td>
<td></td>
</tr>
<tr>
<td>Access Information</td>
<td><a href="http://www.access-information.com">www.access-information.com</a></td>
</tr>
<tr>
<td>Choice Point AutoTrackXP</td>
<td><a href="http://atxp.choicepoint.com">http://atxp.choicepoint.com</a></td>
</tr>
<tr>
<td>Dialog</td>
<td><a href="http://www.dialog.com">www.dialog.com</a></td>
</tr>
<tr>
<td>Hoovers</td>
<td><a href="http://www.hoovers.com">www.hoovers.com</a></td>
</tr>
<tr>
<td>LexisNexis</td>
<td><a href="http://www.lexisnexis.com">www.lexisnexis.com</a></td>
</tr>
<tr>
<td>PUBLICDATA.com</td>
<td><a href="http://www.publicdata.com">www.publicdata.com</a></td>
</tr>
<tr>
<td>Standard &amp; Poor’s</td>
<td><a href="http://www.standardandpoors.com">www.standardandpoors.com</a></td>
</tr>
<tr>
<td><strong>General Business Information</strong></td>
<td></td>
</tr>
<tr>
<td>AT&amp;T Information</td>
<td><a href="http://www.anywho.com">www.anywho.com</a></td>
</tr>
<tr>
<td>Google Directory</td>
<td><a href="http://www.google.com/Top/Business/">www.google.com/Top/Business/</a></td>
</tr>
<tr>
<td>National White Pages</td>
<td><a href="http://www.switchboard.com">www.switchboard.com</a></td>
</tr>
</tbody>
</table>

* * *
The sources of information listed previously are generally as applicable to financial institutions as they are to other businesses. For financial institutions, there are several sources of additional information that are available, including:

- Regulatory examination reports.
- Communications from regulators.
- Communications with the audit committee.
- Recent Call Reports, Thrift Financial Reports, or other financial information submitted to the regulators.

**Regulatory Examination Reports.** One source of information the practitioner may be able to review when evaluating prospective financial institution clients is the reports issued by the institution’s examiners. These reports provide the institution’s CAMELS rating and other valuable background information about how the regulators view the financial institution, its strengths and weaknesses, and any problem areas that the institution faces. These ratings, which are awarded based on a regulatory examination, are intended to reflect the regulatory health of an institution. An institution with a CAMELS rating of 1 is considered to be extremely sound. On the other hand, an institution that is in imminent danger of failing is rated 5. The CAMELS rating system is named for the components of the institution that are rated: capital adequacy, asset quality, management, earnings, liquidity, and sensitivity to market risk.

The practitioner should, at a minimum, inquire about the results of the latest examination, any action required by the report of examination, and the intended course of action in response to the report. If warranted by the results of the inquiry, the practitioner should ask the institution for permission to review the examination report before accepting the engagement.

In February 2005, the federal banking and thrift regulatory agencies jointly issued an “Interagency Advisory on the Confidentiality of the Supervisory Rating and Other Nonpublic Supervisory Information.” The interagency advisory reminds all banking organizations that, except in very limited circumstances, they are prohibited by law from disclosing a report of examination or any portion thereof (including the institution’s CAMELS rating) or making any representations concerning the report or the report’s findings to nonrelated third parties without the prior written permission from their applicable federal banking agency. However, the interagency advisory also indicates that disclosure to an auditor may be included within the limited circumstances under which release of nonpublic supervisory information is allowed.

**Communications from Regulators.** In addition to reviewing any examination reports that have been received, the practitioner should ask if there have been any other communications from the applicable regulators. Particular emphasis should be placed on regulatory communications requiring action by the institution. Such communications may include supervisory agreements, memoranda of understanding, cease and desist orders, assessments of civil money penalties, and other communications.

One form this communication can take is a policy statement from federal bank and thrift regulatory agencies that sets forth the agencies’ policy relating to communications between examiners and auditors. Such a policy statement would make a wide range of regulatory information available to an institution’s external auditors. Although confidentiality is usually a major concern, this information could be available during the acceptance phase of an engagement.

**Communications with the Audit Committee.** Financial institutions are more likely than small commercial businesses to have audit committees. (The audit committee of a credit union is called a supervisory committee.) The audit committee is responsible for, among other things, the relationship between the external auditors and the institution. During the client acceptance or retention process, the auditor should generally communicate directly with the audit committee to ascertain whether there are any issues that the auditor should address before accepting the engagement.

**Communication with a Predecessor.** According to SAS No. 84 (AU 315.07):

Inquiry of the predecessor auditor is a necessary procedure because the predecessor auditor may be able to provide information that will assist the successor auditor in determining whether to accept the engagement. The successor auditor should bear in mind that, among other things,
the predecessor auditor and the client may have disagreed about accounting principles, auditing procedures, or similarly significant matters.

This means that a predecessor may have reached the conclusion that (a) the client lacks integrity or (b) the client may be changing auditors because of a dispute with the predecessor about audit scope or financial statement presentation. Naturally, this kind of information could influence an auditor’s decision on the desirability of accepting a prospective client.

SAS No. 84 (AU 315) defines the term predecessor auditor as an auditor who (a) reported on the most recent audited financial statements or was engaged to perform but did not complete an audit of the financial statements and (b) has resigned or been notified that his or her services have been or may be terminated. That may include an auditor who was engaged to perform an initial audit but did not complete the audit. It may also include an auditor who was engaged subsequent to the most recent audited financial statements (that is, a successor auditor) who did not complete the audit. In the latter case, there may be two predecessor auditors—the auditor who reported on the most recent audited financial statements and the successor auditor who did not complete the audit. SAS No. 84 communication about management integrity and other matters should be made of all predecessor auditors.

SAS No. 84 (AU 315) clarifies the timing of the communication with the predecessor by indicating that an auditor may make a proposal before communicating with the predecessor. The communication, however, is required before final acceptance of the engagement. In other words, the predecessor is not expected to respond to inquiries until the successor has been selected and has accepted the engagement subject to evaluation of the predecessor’s response.

The precise form of the communication with a predecessor is not specified by professional standards. For example, a written communication is not required—simply talking with the predecessor is enough. The essential aspects of the communication are as follows:

a. **Client Permission.** An auditor should ask the prospective client to authorize the predecessor to respond fully. (This is necessary because of the ethical requirement for confidentiality.)

b. **Specific Questions.** An auditor should ask specifically about certain matters such as:

   (1) Information that might bear on management’s integrity.

   (2) Disagreements with management on accounting principles, auditing procedures, or similar matters.

   (3) Communications with management regarding fraud, illegal acts by the client, and internal control matters.

   (4) The predecessor’s understanding of reasons for the change of auditors.

As a result of making inquiries of the predecessor auditor, the auditor should carefully consider the following situations when making the decision whether to accept a client:

- Disagreements occurred between the prospective client and the predecessor auditor over accounting principles or practices, financial statement disclosures, or audit scope.
- There is no clear reason for the cessation of the client relationship with the predecessor auditor.
- Access to the predecessor auditor’s workpapers has been denied.
- The prospective client has been denied service by other CPA firms.

If the prospective client refuses permission to talk with the predecessor, an auditor should find out why. Such a refusal is considered by many auditors to be sufficient reason to turn down an engagement. Professional standards do not require a written communication between the predecessor auditor and the successor auditor. In fact, many auditors prefer to make such communications orally. If the inquiries of the predecessor auditor are made orally, the communication can be documented in a separate memo or using some other method. However, the auditor can choose to make the required inquiries in writing.
Under SAS No. 50, as amended by SAS No. 97 (AU 625), communication with a predecessor auditor may also be necessary in proposing for a new client. SAS No. 50 applies if a potential client requests that a written proposal include the proposing auditor’s opinion on the application of an accounting principle to a specific transaction or on the type of opinion that may be rendered on the specific entity’s financial statements. Before the proposal is made, the auditor should ask the predecessor auditor about the accounting or reporting issue and available facts relevant to forming a judgment about the issue, including the form and substance of the transaction, how management has applied accounting principles to similar transactions, and whether the predecessor auditor and potential client have disagreed about the facts or application of relevant accounting or reporting standards.

If the predecessor has ceased operations, the auditor still should attempt the required communications, according to an AICPA Technical Practice Aid at TIS 8900.03. If the auditor cannot communicate with the predecessor, that fact should be considered in the acceptance decision. However, that does not mean the auditor must automatically decline the engagement. The auditor may be able to obtain sufficient information about client integrity and other matters from alternative sources (attorneys, regulators, reading the predecessor’s prior audit reports and other communications, etc.) to make the acceptance decision.

Some small institutions only have their financial statements audited on an as needed basis, or they may have a policy to have their financial statements audited once every two or three years. Prior to issuance of SAS No. 84, successor auditors were faced with the dilemma of deciding how many years back they had to go to determine if communications with a predecessor were necessary. SAS No. 84 (AU 315) clarifies that its provisions are not required if the most recent audited financial statements are more than two years before the beginning of the earliest period to be audited by the successor. For example, if the period to be audited by the successor begins January 1, 20X4 and the client’s last audit was for the year ended December 31, 20X1, then SAS No. 84 is not applicable. The successor auditor should make inquiries and/or review client documents (such as board of directors’ minutes or loan agreements) to determine if an audit has been performed within the previous two-year period.

**Assessment of Required Services**

Financial institution engagements generally involve one of the following types or combinations of services:

a. **Financial Statement Audit.** This is the normal audit of the client’s financial statements in accordance with generally accepted auditing standards. Banks and savings institutions with total assets of $500 million or more at the beginning of the year, or regulatory CAMELS ratings of 3, 4, or 5, are required to have financial statement audits. Banks and thrifts with total assets of less than $500 million may elect to have a full-scope auditor perform a balance sheet audit under the FFIEC’s *Interagency Policy Statement on External Auditing Programs of Banks and Savings Associations.*

b. **Examination Regarding Internal Control.** Banks and savings institutions with assets of $1 billion or more at the beginning of the year are required to have their internal controls over financial reporting examined annually. [SSAE No. 15 (AT 501.18) states that the examination of internal control over financial reporting should be integrated with the audit of the financial statements and be planned to accomplish the objectives of both audits simultaneously.] Also, banks and thrifts with total assets of less than $500 million may elect to have an examination level attestation engagement regarding management’s assertion about the effectiveness of the institution’s internal control over financial reporting in certain schedules of the institution’s regulatory reports. Institutions with total assets of less than $1 billion may also elect to have an attestation engagement regarding the effectiveness of internal control over financial reporting. This type of engagement is an integrated audit engagement performed under AT 501 and is equivalent in scope to a FDICIA internal control examination.

c. **Agreed-upon Procedures Engagement.** Auditors are sometimes engaged to perform agreed-upon procedures instead of financial statement audits for some credit unions and small banks.

d. **Other Reporting Services.** Financial institution engagements may involve a variety of additional reports, which may require additional procedures. Examples of such additional reports include the following:

   (1) **Internal Control Reporting.** In many instances, the auditor will be required or requested to provide a report about the client’s internal control over financial reporting. Normally, this report will be a by-product of the basic financial statement audit and will be issued in accordance with SAS No. 115.
(AU 325). However, in other situations, the auditor may be requested to provide a special report on internal controls, such as a report on the controls over IT operations in accordance with SAS No. 70 (AU 324), as amended.

The Auditing Standards Board recently issued two new standards that will replace SAS No. 70, Service Organizations. SAS No. 70 currently contains guidance for user auditors and for service auditors. One of the new standards is a SAS, Audit Considerations Relating to an Entity Using a Service Organization (AU 324), which provides revised guidance for an auditor of the financial statements of an entity that uses a service organization. The SAS is expected to be effective for audits of financial statements for periods ending on or after December 15, 2012. The second standard is a Statement on Standards for Attestation Engagements (SSAE), Reporting on Controls at a Service Organization (AT 801), which will be used by a service auditor reporting on controls at a service organization. SSAE No. 16 is effective for service auditors’ reports for periods ending on or after June 15, 2011. Earlier implementation is permitted. A future update of this course will incorporate the new standards.

(2) Loan Servicing. If the institution services loans for others, there are a variety of reports that may be needed. If the institution services loans for other private institutions, the auditor may be requested to provide a simple letter indicating the procedures performed on loans serviced for others. In those situations, no additional audit procedures may be needed. If the institution services loans for an organization such as the Government National Mortgage Association, special reports and special procedures will be required. (Refer to the applicable servicer’s guide for the specific requirements.) In other situations, the auditor may be requested to report on serviced loans in accordance with SAS No. 70 (AU 324), as amended; the Uniform Single Attestation Program for Mortgage Bankers, published by the Mortgage Bankers’ Association; or the SEC’s rules on asset-backed securities (Item 1122 of Regulation AB), as published in Release Nos. 33-8518 and 34-50905. Additional audit procedures will be required to issue those types of reports.

(3) Student Loans. Institutions that hold or originate student loans are required to have an annual compliance examination performed on the accuracy of information reported to the Department of Education.

In addition, the board of directors may request that special procedures be performed to address particular concerns or meet regulators’ requests. Thus, it is important for the auditor to obtain a clear understanding of the nature and scope of the services required.

Independence

The AICPA, state boards, the Securities and Exchange Commission, the PCAOB, the Department of Labor, and the Government Accountability Office of the United States each have their own independence rules. Some of the AICPA independence rules apply a team approach, which narrows the pool of those members of a firm who are subject to certain independence requirements by focusing on covered members. Covered members are those who are members of an attest engagement team or able to influence the engagement or attest engagement team. Under the AICPA rules, auditors may be able to structure the engagement team so that independence is not impaired. PPC’s Guide to GAAS provides a detailed discussion of those and other independence rules. Some specific considerations in applying independence rules in audit engagements for financial institutions are discussed in the remaining paragraphs of this subsection. In addition to the AICPA’s Code of Professional Conduct and underlying interpretations and rulings, a variety of independence-related resources are available to the auditor. The AICPA offers a webpage on its site that provides resources, publications, and recent developments on the topic of professional ethics. The website can be located at www.aicpa.org/members/div/ethics/index.htm. The AICPA also issues an Independence and Ethics Alert that addresses recent developments in independence and ethics, and provides information that assists auditors with their understanding of independence rules. In addition, the AICPA has issued a Practice Aid titled Independence Compliance: Checklists and Tools for Complying with AICPA, SEC, and PCAOB Independence Requirements (AICPA product no. 006660). This practice aid is designed to assist practitioners observe applicable independence rules. The publication can be ordered at www.cpa2biz.com.

If a bank or savings institution has total assets of $500 million or more, the auditor must comply with both the AICPA and the SEC auditor independence requirements. Because the SEC’s independence requirements encompass the independence standards and rules adopted by the PCAOB and approved by the SEC, the auditor must also meet...
the independence requirements of the PCAOB. To the extent that any of the rules within any one of these independence standards (AICPA, SEC, and PCAOB) is more or less restrictive than the corresponding rule in the other independence standards, auditors must comply with the most restrictive rule. An auditor should be aware of all applicable independence requirements before accepting an engagement.

Examples of common concerns for auditors of financial institutions relate to the following:

- **Loans from the Financial Institution to the Auditor or a Member of the Auditor’s Firm.** The AICPA Professional Ethics Executive Committee has issued Interpretation 101-5 (ET 101.07) and related rulings that prohibit most loans from a financial institution to a covered member (or his or her immediate family). Exhibit 2-3 summarizes the independence rules regarding loans.

- **Leasing Facilities from Clients.** If an audit firm leases facilities from a client, the lease is subject to the same restrictions as a loan from a client if the lease is a capital lease, as defined in FASB ASC 840 (formerly SFAS No. 13). In addition, the terms and conditions of the lease must be comparable to leases of a similar nature. (Ethics Ruling No. 91 at ET 191.182–183)

- **Uninsured Deposits.** If the auditor (or his or her immediate family) has a fully or partially uninsured checking account or other deposit account with the client, independence would not be impaired if the uninsured portion of the account is not material to the depositor’s net worth. If the uninsured amount is material, independence would not be considered impaired if the uninsured amount is reduced to an immaterial amount within 30 days from the date it became material. If the audit firm has a depository relationship with a financial institution client, independence would not be impaired with respect to that relationship if the likelihood of the financial institution experiencing financial difficulties is considered to be remote (Ethics Ruling No. 70 at ET 191.140–141).

- **Credit Union Membership.** Membership in a credit union client will impair the auditor’s independence unless all of the following criteria are met:
  
  - The auditor qualified for membership other than by virtue of providing professional services to the credit union.
  
  - Any loans from the credit union are permitted or grandfathered under AICPA ethics interpretations and rulings.
  
  - Any depository accounts maintained by the auditor or the firm in the credit union meet the conditions of Ethics Ruling No. 70 at ET 191.140–141, as discussed above (Ethics Ruling No. 75 at ET 191.150–151).

- **Performance of Internal Audit Services.** The AICPA’s guidance on providing internal audit assistance services and maintaining firm independence is located in Interpretation 101-3, *Performance of Nonattest Services*, under Rule of Conduct 101. (A related Ethics Ruling is No. 103 at ET 191.206–207.) The regulatory agencies’ internal audit policy statement, *Interagency Policy Statement on the Internal Audit Function and Its Outsourcing*, provides guidance on the independence of a practitioner who provides both external and internal audit services to an institution. Under that statement, auditors of banks and savings institutions with total assets of $500 million or more are prohibited from providing external audit services during the same period that the firm provides internal audit outsourcing services. For institutions with total assets less than $500 million, the policy statement encourages the internal audit outsourcing prohibition. If a small institution decides to use the same firm for internal and external audit services, the statement imposes certain preapproval and documentation requirements. The policy statement is available at www.fdic.gov/news/news/financial/2003/fil0321.html.

- **Nonattest Services.** The AICPA Professional Ethics Executive Committee has revised Interpretation 101-3 under Rule of Conduct 101: *Performance of Nonattest Services* (ET 101.05), which provides general guidelines and specific examples of the effect on independence of an auditor’s firm providing nonattest services for an attest client.
Nonattest Services. A frequent concern about meeting independence requirements is the effect of providing nonattest services, such as bookkeeping services, to the client. Concerns may arise that an auditor’s independence has been impaired in these circumstances.

According to Interpretation 1013, Performance of Nonattest Services, of the AICPA’s Code of Professional Conduct ET 101-3 (ET 101.05), before auditors perform nonattest services, they should determine that the requirements of Interpretation 101-3 have been met. Interpretation 101-3 requires the following with respect to the performance of nonattest services:

- The auditor should not perform management functions or make management decisions for the attest client.
- The client must agree to perform certain specific functions in connection with the nonattest services.
- The auditor should document in writing the understanding with the client regarding the nonattest services and the client’s responsibilities.

Under the Interpretation, independence is considered to be impaired if an auditor (or his or her firm) performs management functions or makes management decisions for an attest client. However, the auditor may assist management in those functions or decisions. For the auditor to remain independent, the client must agree to perform all of the following functions in connection with the engagement to perform nonattest services:

- Make all management decisions and perform all management functions.
- Designate an individual who possesses suitable skill, knowledge, or experience, preferably within senior management, to oversee the services.
- Evaluate the adequacy and results of the services performed.
- Accept responsibility for the results of the services.

In addition, the auditor should be satisfied that the client will be able to meet all of these criteria and make an informed judgment on the results of the nonattest services. In cases where the client is unable or unwilling to assume its responsibilities, the auditor’s performance of the nonattest services would impair independence.

The Interpretation also requires the auditor to document in writing his or her understanding with the client regarding the following:

- Objectives of the engagement (i.e., the nonattest services).
- Services to be performed.
- Client’s acceptance of its responsibilities.
- Auditor’s responsibilities.
- Any limitations of the engagement.

The Interpretation does not specify how the understanding is to be documented, so the auditor has flexibility. For example, the understanding might be documented in a separate engagement letter, in the workpapers, in an internal memo, or in the engagement letter obtained in conjunction with an audit engagement. It is believed common in many nonpublic audit engagements for auditors to also provide nonattest services, such as tax return preparation. Therefore, an engagement letter for the audit should include the language necessary to meet the auditor’s documentation requirements under Interpretation 101-3 (ET 101.05). However, the auditor can choose to document the understanding with the client about the performance of nonattest services other than in the engagement letter.
Exhibit 2-3

Independence Rules Regarding Loans from Clients

Is the client a financial institution?

- No
- Yes

Was the loan made under normal lending procedures, terms, and requirements?

- No
- Yes

Is the loan one of the following:

- No
- Yes

Does the loan meet the following conditions:

- No
- Yes

- a. The loan was obtained from a financial institution under that institution’s normal lending procedures, terms, and requirements.
- b. After becoming a covered member, the loan is kept current as to all terms at all times and those terms do not change in any manner not provided for in the original agreement (changes include a new or extended maturity date, a new interest rate or formula, revised collateral, or revised or waived covenants).
- c. The loan was:
  - (1) obtained from the financial institution prior to its becoming a client requiring independence; or
  - (2) obtained from a financial institution for which independence was not required and was later sold to a client for which independence is required; or
  - (3) obtained prior to February 5, 2001, and met the requirements of previous provisions of Interpretation 101-5 covering grandfathered loans; or
  - (4) obtained between February 5, 2001, and May 31, 2002, and the covered member was in compliance with the applicable independence requirements of the SEC during that period; or
  - (5) obtained after May 31, 2002, from a financial institution client requiring independence by a borrower prior to his or her becoming a covered member with respect to that client?

Has the loan, at all times, been current as to all terms?

- No
- Yes

Loan is grandfathered—Independence not impaired.

Loan to a client (or any officer, director, or any individual owning ten percent or more of the client’s outstanding equity securities or other ownership interests).
Notes:

a. Loans include, but are not limited to, loan commitments, lines of credit, loan guarantees, and letters of credit.

b. According to the definitions contained within the AICPA’s Code of Professional Conduct (ET 92.21), “normal lending procedures, terms, and requirements” are “reasonably comparable” to those relating to similar loans made to other borrowers during the period when the loan to the member was committed. The following factors should be considered in evaluating whether a loan was obtained under normal lending procedures, terms, and requirements:

   1. The relation of the loan amount to collateral value pledged and the credit standing of the member or the member’s firm.
   2. Repayment terms.
   3. Interest rate, including points.
   4. Closing costs.
   5. General availability of loans to the public.

c. Partially secured loans are treated as secured if the portion of the loan that exceeds the value of the collateral is not material to the covered member’s net worth.

d. For purposes of applying these provisions, the date of the loan commitment or the date that the line of credit is granted must be used and not the date the loan is closed or the funds are obtained.

e. A loan would no longer be considered grandfathered, if, after the latest of the indicated dates, the terms of the loan change in any manner not provided for in the original loan agreement. Changes in the terms might include, but are not limited to, a new or extended maturity date, a new interest rate or formula, revised collateral, or revised or waived covenants.

*          *         *

Certain activities performed as part of a nonattest service are considered to be management functions and, therefore, impair independence regardless of whether the auditor complies with the other requirements of Interpretation 101-3. The Interpretation lists common nonattest service activities and notes whether they are or are not considered to impair independence. The Interpretation specifically states that performance of the following general activities would impair an auditor’s independence (that is, they would preclude the auditor from being independent):

- Exercising authority on behalf of a client, such as authorizing, executing, or consummating a transaction, or having the authority to do so.
- Preparing source documents, in electronic or other form, that evidence the occurrence of a transaction.
- Having custody of client assets.
- Supervising client employees performing their normal recurring activities.
- Determining which of the auditor’s recommendations should be implemented.
- Reporting to the board of directors on behalf of management.
- Serving as a client’s stock transfer or escrow agent, registrar, or general counsel.
- Establishing or maintaining internal controls, including performing ongoing monitoring activities for a client. An AICPA white paper, Understanding Internal Control and Internal Control Services, addresses...
internal control over financial reporting and the types of internal control services that practitioners may be engaged to perform that would impair independence. The white paper can be found at www.journalofaccountancy.com.

Specific services addressed in the Interpretation include bookkeeping; nontax disbursement; benefit plan administration; investment—advisory or management; corporate finance—consulting or advisory; executive or employee search; business risk consulting; information systems—design, installation, or integration; appraisal, valuation, and actuarial services; forensic accounting services; and internal audit assistance services.

Interpretation 1013 (ET 101.05) also addresses tax compliance services. Preparing a tax return and transmitting the tax return and related payment, either electronically or in paper form, to a taxing authority does not impair independence as long as the auditor does not have custody or control of the client's funds and the individual overseeing the tax services (a) reviews and approves the return and payment and (b) signs the return prior to transmittal, if required for the filing. Signing and filing a tax return impairs independence unless the auditor has legal authority to do so and—

- the taxing authority has prescribed procedures, allowing the taxpayer to permit the auditor to sign and file a return on their behalf, that meet the standards for electronic return originators and officers outlined in IRS Form 8879, or
- an individual in client management who is authorized to sign and file the tax return provides the auditor with a signed statement that indicates—
  - The return being filed.
  - That the individual is authorized to sign and file the return.
  - That the individual has reviewed the return, including accompanying schedules, and it is true, correct, and complete to the best of their knowledge and belief.
  - That the individual authorizes the auditor to sign and file the return on behalf of the client.

The Interpretation also indicates that the auditor's representation of the client in an administrative proceeding before a taxing authority does not impair independence providing that auditor obtains the client's agreement prior to committing the client to a specific resolution with the taxing authority. Independence is impaired if the auditor represents the client in court or in a public hearing to resolve a tax dispute.

In addition, under Interpretation 1013 (ET 101.05), certain appraisal, valuation, or actuarial services are considered to impair independence. Performing appraisal, valuation, or actuarial services impairs independence if the results are material to the financial statements and the service involves significant subjectivity. For example, a material asset appraisal or business valuation generally involves significant subjectivity, and therefore would impair independence if performed for financial statement purposes. However, an actuarial valuation of a client's pension liabilities ordinarily does not require significant subjectivity and, therefore, would not impair independence even if the amount was material.

Under Interpretation 1013 certain types of forensic accounting services may impair independence. Independence is impaired if an auditor conditionally or unconditionally agrees to provide expert witness testimony for a client. However, under certain defined conditions, independence is not impaired if the auditor provides expert witness testimony for a large group of plaintiffs or defendants that includes the auditor’s client. If the auditor provides litigation services where he or she is a trier of fact, special master, court-appointed expert, or arbitrator in a matter involving a client, independence is impaired.

In some cases, the auditor may perform extended audit services for a client. Extended audit services may include assistance with the client’s internal audit function or an extension of audit services beyond the requirements of generally accepted auditing standards. Interpretation 1013 also addresses the impact of those services on the auditor’s independence. According to the Interpretation, performance of internal audit assistance services does not impair the auditor’s independence as long as the auditor is not an employee of the client or does not act in the
capacity of management (for example, determining the scope, risk, and frequency of internal audit activities). The auditor should be satisfied that the client understands its responsibility for directing the internal audit function. The general requirements of the Interpretation discussed previously (such as documenting the understanding with the client) also must be met. With respect to providing assistance with the internal audit function, the auditor should be satisfied that the board of directors and/or audit committee (if one exists) is fully informed of the engagement. Generally, performing procedures that are merely an extension of the auditor’s scope applied in the audit of the client’s financial statements (such as confirming loans receivable) would not impair the auditor’s independence even if the extent of testing exceeds the requirements of generally accepted auditing standards.

Should Proposing Journal Entries and Preparing Financial Statements in Connection with an Audit be Viewed as Bookkeeping and, Therefore, Nonattest Services? Interpretation 101-3 includes bookkeeping as an example of a nonattest service. Rather than define bookkeeping, the Interpretation provides several examples of services that would be considered bookkeeping. Two of those examples are (a) proposing standard, adjusting, or correcting journal entries or other changes affecting the financial statements to the client and (b) preparing financial statements based on information in the trial balance. Practice questions have arisen as to whether those examples mean that proposing journal entries and preparing financial statements in connection with an audit should be viewed as bookkeeping and, therefore, nonattest services subject to the Interpretation. As a practical matter, small and midsize nonpublic entities typically view proposing journal entries and preparing financial statements as part of the audit, and, based on implementation guidance provided in questions and answers published by the AICPA Professional Ethics Executive Committee (PEEC) during 2004 and 2005, it seems clear that PEEC did not intend for Interpretation 101-3 to require viewing those services as separate from the audit.

This course views bookkeeping services as services that involve processing an entity’s transactions or preparing an entity’s accounting records. For example, preparing an entity’s accounting journals and ledgers by entering information provided by management into Peachtree® or other accounting software is a bookkeeping service because it involves preparing an entity’s accounting records. Bookkeeping services that—

a. Constitute management functions, such as authorizing or approving purchase orders or preparing sales invoices, would impair independence.

b. Do not constitute management functions, such as recording disbursements approved by management, would not impair independence provided the auditor obtained the understanding with the entity required by the Interpretation. Failure to obtain the required understanding would impair independence. However, failure to comply with the Interpretation’s requirement to document that understanding would not impair independence but would be a violation of Rule 202, Compliance With Standards, of the AICPA’s Code of Professional Conduct.

Performing procedures in connection with an audit that are designed to address audit risk arising from the lack of control activities, such as reconciling carrying amounts of assets and liabilities with amounts reported by third parties, are not considered bookkeeping services by this course. Similarly, preparing financial statements as part of an audit would not be considered a bookkeeping service. Neither of those services involves processing the entity’s transactions or preparing its accounting records.

Proposing adjustments of an entity’s accounting records in connection with an audit also would not be considered a bookkeeping service. To illustrate, assume that as part of the audit of the financial statements the auditor proposes journal entries to capitalize improvements recorded as repairs expense and to charge to expense repairs capitalized as improvements; to record depreciation calculated using the auditor’s depreciation software; to recognize liabilities for subsequent disbursements; and to record the current and deferred income tax provisions. Those are adjustments of the accounting records prepared by the entity. Accordingly, this course does not view them as bookkeeping services and, therefore, does not view them as subject to the Interpretation.

Since the entity is required to accept responsibility for the fair presentation in the financial statements of financial position, results of operations, and cash flows in conformity with generally accepted accounting principles, the number of journal entries proposed in connection with an audit is not believed relevant to whether that is a bookkeeping service and, therefore, is not subject to the Interpretation. As a practical matter, however, the entity’s accounting records may be in such poor condition that the auditor cannot perform sufficient procedures to determine the journal entries needed to express an unqualified opinion. To overcome the scope limitation, book-
keeping services may be performed to bring those inadequate accounting records into substantial completion so that the auditor can perform the required procedures.

To illustrate, assume that an entity changed accounting software during the year and did not have sufficient controls in place to ensure the proper transfer of accounting information and since the conversion, totals of subsidiary ledgers have differed materially from the related general ledger account balances. In that situation, the auditor would be unable to perform sufficient procedures to determine the journal entries needed to express an unqualified opinion. That scope limitation could be overcome by having the entity, members of the auditor’s firm, or a bookkeeping service prepare adequate accounting records for the period from just prior to the conversion through year-end.

Auditors who are unable to make a judgment as to whether they are providing bookkeeping services are not prohibited from concluding that they are providing services subject to the Interpretation and following the Interpretation’s requirements.

Although the auditor may comply with the independence requirements of Interpretation 101-3 (ET 101.05) when performing bookkeeping services or assisting the client in drafting the financial statements, the auditor should consider whether a control deficiency exists that requires communication under SAS No. 115, Communicating Internal Control Related Matters Identified in an Audit. If the auditor prepares the financial statements because the client lacks sufficient expertise to do so and lacks the skills and competencies necessary to prevent, detect, and correct a material misstatement, this is a control deficiency that is most likely a significant deficiency or material weakness that would be required to be communicated under SAS No. 115. Before preparing financial statements for a client under these circumstances, the auditor might want to consider discussing with the client the potential implications of the SAS No. 115 communication. In certain cases, a client might decide that it would rather hire a different accounting firm to prepare the financial statements than to accept such a communication.

Additional Questions in Applying Interpretation 101-3. The following additional questions are likely to arise as auditors apply the requirements of Interpretation 101-3 (ET 101.05). The responses reflect this course’s views on such matters based on the guidance in the Interpretation and the related nonauthoritative guidance published by the AICPA. (The AICPA’s nonauthoritative guidance can be found on the website at www.aicpa.org.)

a. Providing Routine Advice to Clients.

**Question**—If a client calls the auditor and asks a technical question, would this be considered a nonattest service for which ET Interpretation 101-3 would apply?

**Response**—No, routine activities performed by the auditor, such as providing advice and responding to clients’ technical questions as part of the normal client relationship, are not considered nonattest services for which ET Interpretation 101-3 would apply.

b. Inadvertent Noncompliance.

**Question**—What if the auditor inadvertently fails to comply with the Interpretation’s requirement to document in writing the auditor’s understanding with the client?

**Response**—A failure to document the understanding with the client is not considered to impair a member’s independence provided such understanding has been established. Rather, such a failure, regardless of whether it was isolated or inadvertent, would be considered a failure to comply with an ethics standard under Rule 202, Compliance with Standards.

c. Assessing Whether an Individual Possesses Suitable Skill, Knowledge, or Experience.

**Question**—How does an auditor assess whether a client’s designated employee possesses suitable skill, knowledge, or experience as required by the Interpretation?

**Response**—It is not intended that the client employee possess a level of technical expertise equal to the auditor’s. The client employee need only understand the nonattest services enough to be able to provide
general direction for the services; understand the key issues the auditor identifies; make any required management decisions; and evaluate the adequacy of, and accept responsibility for, the results of the auditor’s work. The designated individual fulfills the competency requirement by possessing suitable skills, knowledge, and/or experience based on factors such as his or her understanding of the service, knowledge of the client’s business and industry, general business knowledge and education, and position at the client. The relative importance of those factors is considered in relation to the service being performed. The auditor may educate his or her client in order for them to assume these responsibilities. For example, if the auditor performs routine bookkeeping services for an attest client, he or she could ensure compliance with the requirements of the Interpretation by reviewing the proposed journal entries with the client and explaining in general terms how each entry affects the financial statements. The client should then be in a position to approve the journal entries and accept responsibility for the financial statements.

d. **Nonattest Services Performed before the Client Becomes an Attest Client.**

**Question**—The practitioner accepts an audit engagement for a client for whom he or she has previously provided only bookkeeping services. Prior to accepting the audit engagement, the practitioner does not have a written understanding with the client under Interpretation 1013 (ET101.05). Has the practitioner violated the requirements of the Interpretation?

**Response**—No, the ET 101-3 documentation requirement does not apply to nonattest services performed before the client becomes an attest client. The auditor would be permitted to prepare the required documentation upon acceptance of an audit engagement, provided the auditor is able to demonstrate his or her compliance with the other general requirements during the period covered by the financial statements, including the requirement to establish an understanding with the client. As a practical matter, practitioners who are initially engaged to only provide nonattest services but expect to subsequently be engaged to also provide attest services should consider structuring the engagement so that performance of the nonattest services will not impair independence for the attest services.

**Meeting Other Professional Standards and Requirements**

**Technical Expertise and Available Resources.** Rule 201 of the AICPA Code of Professional Conduct indicates that a firm should only undertake an engagement that can be reasonably expected to be completed with professional competence. Before accepting a new engagement, therefore, an auditor should consider whether resources available to the firm are sufficient to meet the requirements of the engagement, including matters such as:

- **a. Availability and qualifications of staff.**
- **b. Locations to be covered.**
- **c. Specialized accounting or auditing skills or knowledge needed.**

For out-of-state prospective engagements, auditors should also consider applicable state board of accountancy licensing and registration requirements for the firm and its personnel.

An auditor is not required to possess all of the skills and knowledge that might be required to complete an audit before accepting an engagement. For example, an auditor may not have the expertise to evaluate a complex IT environment. However, it is a good idea to consider resources that will be needed for successful completion before acceptance. In some cases, an auditor might want to seek the assistance of other auditors on an agency or consulting basis. Participation of others may range from availability to provide advice, all the way to active participation in parts of the engagement. However, if auditors from another firm participate in the engagement, it is important to consider possible independence and objectivity issues.

SQCS No. 7 (QC 10), *A Firm’s System of Quality Control*, requires firms to adopt quality control policies and procedures that provide reasonable assurance that the engagement partner (or other individual responsible for supervising the engagement and signing or authorizing someone else to sign the auditor’s report) has the necessary competencies for the engagement. The required competencies will vary depending on the client, industry, or type of service being provided. The quality control policies and procedures should also require that the
engagement partner have the appropriate capabilities, authority, and time to perform the role. Policies and procedures may include systems to monitor the workload and availability of engagement partners so as to allow these individuals to have sufficient time to adequately perform their responsibilities.

**Integrity and Objectivity.** Articles III and IV of the AICPA *Code of Professional Conduct* define integrity, objectivity, and independence. According to the standards, members should perform professional responsibilities with integrity and objectivity and should remain independent when performing auditing and attestation services.

Revised Ethics Ruling No. 112 (ET 191.224–.225) under Rule 102, *Integrity and Objectivity*, requires that clients be informed, preferably in writing, if the audit firm will outsource professional services to a third-party service provider. If the audit firm intends to use a third-party service provider (that is, an entity not controlled by the audit firm or an individual not employed by the audit firm), to perform portions of the audit, the client must be informed before confidential information is shared with the service provider. If the client objects, the auditor should perform the services without using the third party or should decline the engagement. The ethics ruling applies when another party is used, for example, to audit an element, account, or item of the financial statements or to act as a specialist. The ruling is not believed to apply when another audit firm performs a separate engagement, the results of which will be used by the auditor, for example, when another firm audits a subsidiary or equity method investee. In addition, the client is not required to be informed when a third party is used only for administrative support services, such as record storage or software application hosting. Ethics Ruling No. 1 (ET 391.001–.002) under ET Section 300, *Responsibilities to Clients*, requires a contractual agreement between the audit firm and the service provider to maintain the confidentiality of client information. This rule also requires members to be reasonably assured that the service provider has procedures in place to prevent the unauthorized release of confidential information.

SQCS No. 7 (QC 10), *A Firm’s System of Quality Control*, reiterates that the AICPA *Code of Professional Conduct* establishes the fundamental principles of professional ethics. The AICPA has issued nonauthoritative guidance, *Guide for Complying With Rules 102-505*, that assists members in complying with the Code when there are no explicit interpretations or rulings that apply to the particular situation. The guidance only applies to matters in the Code other than independence. The guide is available on the AICPA’s website at [www.aicpa.org](http://www.aicpa.org). Those principles include:

- Responsibilities.
- The public interest.
- Integrity.
- Objectivity and independence.
- Due care.
- Scope and nature of services.

SQCS No. 7 requires firms to establish policies and procedures designed to provide reasonable assurance that the firm and its personnel comply with relevant ethical requirements. *PPC’s Guide to Quality Control* provides a detailed discussion of the AICPA’s quality control standard requirements.

**Adequacy of Fees.** The auditor should consider how low the fee is likely to have to be to obtain the engagement, *all else being equal*, and, on that basis, consider whether the engagement is worth pursuing or accepting. To estimate profitability, the auditor needs to obtain information about the scope of the engagement; condition of the financial reporting system; required completion dates, such as whether the audit would occur in a slow period when staff otherwise would not be incurring billable hours; provision for interim payments; and actual hours incurred on prior audits. A significant consideration in determining fee adequacy is the likelihood the engagement will be renewed for a specific number of years with provision for fee increases (or expected increased efficiencies) for subsequent years. In such cases, the auditor can evaluate fee adequacy over an extended period.

**Opportunity for Practice Development.** An auditor might consider a potential engagement worth pursuing or accepting in spite of the fee level if the accounting firm wishes to develop experience, expertise, and reputation in
the financial institutions area as a basis for securing other engagements in the financial institutions area. Also, as previously mentioned, an accounting firm with a highly seasonal audit or tax practice can benefit from improved staff utilization on an engagement that occurs during the accounting firm’s slack season.

**Specialized Procedures When Using the Work of Another Accountant.** SAS No. 1 at AU 543 provides guidance when another auditor audits a division, branch, or subsidiary that is consolidated (either by a full consolidation or by the equity method) into the financial statements audited by the principal auditor. According to SAS No. 1 at AU 543.10, when a principal auditor makes use of the work and report of another auditor, whether reference to the other auditor is or is not made, the principal auditor is required to do the following:

a. Inquire about the professional reputation and standing of the other auditor by communication with the AICPA, applicable state society, other auditors, or bankers and credit grantors.

b. Obtain a representation on the other auditor’s independence under AICPA requirements.

c. Communicate with the other auditor and determine that he is:

   1. aware of the intended use of the financial statements he audited, and
   2. familiar with GAAP and GAAS and any other applicable standards.

Note that regardless of whether the principal auditor decides to make reference to the other auditor, an independence representation is necessary. The decision of when to make reference to another auditor’s work is beyond the scope of this course. A comprehensive discussion of when to refer to another auditor’s work can be found in PPC’s Guide to Auditor’s Reports.

It must be acknowledged that AU 543 only applies to another auditor engaged to audit the financial statements of a subsidiary, branch, or division. AU 543 does not apply to engagements where another auditor performs procedures on an element, account, or item of a financial statement. However, complying with the requirements of AU 543 whenever the work of another auditor is used is recommended.

**Special Considerations for Savings Institutions.** OTS regulations require savings institutions to obtain audits only under certain conditions. If an institution is required to have an audit under the OTS regulations, the auditor must meet the following independence and qualifications requirements:

a. The auditor must be registered or licensed to practice public accounting and be in good standing under the applicable state law.

b. The auditor must agree in the engagement letter to provide the OTS with copies of any workpapers, policies, and procedures regarding the services performed.

c. The auditor must be in compliance with the AICPA Code of Professional Conduct and meet the independence requirements of the SEC. Because the SEC’s independence requirements encompass the independence standards and rules adopted by the PCAOB and approved by the SEC, the auditor must also meet the independence requirements of the PCAOB. To the extent that any of the rules within any one of these independence standards (AICPA, SEC, and PCAOB) is more or less restrictive than the corresponding rule in the other independence standards, auditors must comply with the most restrictive rule.

d. The auditor must have received or be enrolled in a peer review program that meets guidelines acceptable to the OTS.

Savings institutions that are not required to have audits can voluntarily have audits. In those situations, the auditor does not have to meet the peer review program requirement discussed in item d. above.

**Engagement Acceptance Forms**

Before accepting an engagement, some firms find it useful to complete checklists that summarize relevant considerations. Formal documentation of the acceptance decision-making process is recommended. Information gath-
Considered in the client acceptance process should be considered when identifying risks that could result in material misstatement of the financial statements. Therefore, when performing client acceptance (and continuance) procedures, the auditor should be alert for risks that could result in misstatements at the financial statement level and at the relevant assertion level for classes of transactions, account balances, and disclosures. If the auditor makes a decision to accept the engagement, those risks should be considered.

**Annual Evaluation for Continuing Engagement**

An annual evaluation of clients and engagements should be performed as part of the planning process for continuing engagements. SQCS No. 7 (QC 10) and SAS No. 108 (AU 311) require the firm to assess its continuing association with a client and the engagement. The continuing auditor should consider the topics discussed in this section and reassess the desire and ability to retain the engagement. This reassessment is especially important if there has been a high degree of turnover in key management positions. Other reasons to reevaluate whether to continue serving the client include significant changes in ownership, financial condition, litigation status, nature of business, scope of the engagement, or other considerations that would have caused the auditor to reject the client had the conditions existed at the time of the original acceptance. Moreover, general economic conditions, industry risk factors, and other considerations may have changed since the initial client acceptance decision. The assessment should also consider matters such as (a) being aware of potential legal liability risks, (b) avoiding conflict of interest problems, and (c) monitoring compliance with independence rules. If the firm obtains information that would have caused it to decline an engagement had that information been available previously, SQCS No. 7 requires that policies and procedures on continuance of the engagement and the client relationship include consideration of (a) the professional and legal responsibilities that apply to the circumstances and (b) the possibility of withdrawing from the engagement or from both the engagement and the client relationship. For those engagements that will be continued, auditors should consider whether their engagement continuance procedures provide information that may be relevant in identifying risks of material misstatement due to error or fraud.

Once a client relationship has been established, the firm has more objective information to use in evaluating and reassessing the conclusions reached for each factor considered when the initial client acceptance decision was made. The review of factors affecting the continuance decision should be made in light of the increased knowledge about the client obtained from the prior audit(s) and consideration of changes that have occurred since the prior audit. SAS No. 108 (AU 311) indicates the auditor should perform this review at the beginning of an engagement to ensure that no circumstances have occurred since the last engagement that would cause the firm to discontinue providing services to the client. A decision to discontinue services to a client should be made before work commences on the engagement.

The continuance decision should be documented by the firm. The documentation should be done during the planning stage of the current year engagement. Information gathered in the client continuance process should be considered when identifying risks.
SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

20. Name one responsibility that a firm has for client acceptance and continuance under SQCS No. 7.
   a. Perform client acceptance and continuance procedures before significant audit activities.
   b. Make inquiries of the predecessor auditor before the engagement is accepted.
   c. Consider the client’s integrity and the risks associated with providing services in these circumstances.

21. The CPA firm of Myers & Tait have a longstanding client relationship with Biggerton Books. However, when the firm performs its continuance procedures this year, it is discovered that Biggerton has undergone several organizational and industry-related changes that dramatically increase risk level of the audit. The firm would like to continue the engagement despite the higher risks. How should the firm proceed?
   a. Because of the high risks associated with the engagement, the firm has no choice but to terminate the client relationship immediately.
   b. If continuance is acceptable under firm continuance policies and appropriate audit response is part of the audit plan, the firm can continue the engagement.
   c. Myers & Tait can continue the audit engagement with Biggerton Books with no changes from last year’s audit plan.

22. The Blankenship CPA firm must decide whether to accept several new audit clients. If the firm uses a system similar to that in the flow chart at Exhibit 2-1, which of these clients should be rejected?
   a. Client A does not have a predecessor auditor for the firm to contact.
   b. Client B works in an industry the firm does not currently work in.
   c. The firm discovers that it does not currently have the technical expertise to complete Client C’s engagement.
   d. Client D imposes a scope limitation that the firm cannot mitigate.

23. Before accepting an engagement to audit a financial institution, Greg reviews the institution’s regulatory examination reports as part of his client acceptance procedures. The reports include the institution’s CAMELS rating. What CAMELS rating indicates a financial institution that is extremely sound (i.e., an institution that would be a good client)?
   a. 1.
   b. 3.
   c. 5.
   d. 10.
24. Kelly is evaluating whether to accept an engagement to audit Birchfield Credit Union’s 2010 financial statements. The credit union has its financial statements audited annually. Kelly must contact the credit union’s predecessor auditor as part of her client acceptance procedures. Which of these individuals will Kelly need to contact, based on the information in SAS No. 84 (AU 315)?

Roy audited Birchfield’s 2008 financial statements.
Mabel audited Birchfield’s 2009 financial statements.
Jon was engaged to perform the audit of Birchfield’s 2010 financial statements, but did not complete the audit.
Larry is Birchfield’s internal auditor.

a. Mabel.
b. Roy.
c. Mabel and Larry.
d. Mabel and Jon.

25. Assume the same details as the question above. Based on the guidance in SAS No. 84 (AU 315), when should Kelly’s communication with the predecessor auditor take place?

a. Before submitting a written proposal to Birchfield.
b. Before final acceptance of the engagement with Birchfield.
c. After work on the audit engagement has begun.
d. Before Kelly reports on Birchfield’s financial statements.

26. Which of these institutions is required to have an examination regarding internal control?

a. Avery Mutual has $1.5 billion in assets.
b. Buyers Bank has $500 million in assets.
c. Carpathian Savings and Loan has a CAMELS rating of 4.
d. Davidson Bank has over $2 million in student loans.

27. Which of the following nonattest services can an auditor perform and still retain independence from an attest client?

a. Reporting to the board of directors on management’s behalf.
b. Assist management with its decision-making.
c. Having custody of the client’s assets.
d. Supervising the client’s employees during normal recurring activities.
28. Joe, an auditor, has taken a loan from Chelsea Bank to finance the purchase of his new car. The loan is collateralized by the automobile. Joe’s loan has been current at all times per its specified terms. Chelsea Bank asks Joe to consider performing their annual financial statement audit. Is Joe independent from the bank and, thus, able to consider accepting the engagement?

a. Joe’s independence is not impaired because the loan is grandfathered.

b. Joe’s independence is not impaired because the loan is permitted.

c. Joe’s independence is impaired by this loan.

29. All of the following accurately describe a firm’s client acceptance and continuance procedures, except:

a. An auditor must possess all skills and knowledge necessary to complete an audit before the engagement commences.

b. The firm must disclose use of a third-party service provider to clients if a confidentiality agreement is in place.

c. Nonattest services provided to a client disallows that client from ever becoming an attest client for the same firm.

30. While performing his annual evaluation of continuing audit clients, Mark discovers information that would have caused him to decline his engagement with Whammy! Inc. had he discovered it the previous year. What must he consider, according to SQCS No. 7?

a. Whether his familiarity with Whammy! because of last year’s engagement will help mitigate the problem.

b. What legal and professional responsibilities apply and the possibility of terminating the engagement and the relationship.

c. Whether the problem occurred because of a turn over in key management positions at Whammy! over the past few years.

d. Whether any economic conditions or other risk factors have changed in relation to this engagement.
SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. (References are in parentheses.)

20. Name one responsibility that a firm has for client acceptance and continuance under SQCS No. 7. (Page 198)
   
   a. Perform client acceptance and continuance procedures before significant audit activities. [This answer is incorrect. This is a requirement of SAS No. 108 (AU 311). This SAS also requires the firm to consider if circumstances will allow an unqualified opinion and an adequate audit. This consideration should also be done before accepting the engagement.]
   
   b. Make inquiries of the predecessor auditor before the engagement is accepted. [This answer is incorrect. This is a requirement of SAS Nos. 84 (AU 315) and 108 (AU 311) makes of successor auditors. The inquiries should be made before the engagement is accepted.]
   
   c. Consider the client’s integrity and the risks associated with providing services in these circumstances. [This answer is correct. SQCS No. 7 provides firms with a quality control system internally to provide the firm with reasonable assurance that it will undertake or continue relationships with clients that meet the standards of the firm. Other responsibilities under SQCS No. 7 include making sure that the firm is competent to perform the engagement, has the resources and capabilities to perform the engagement, and can comply with ethical and legal requirements.]

21. The CPA firm of Myers & Tait have a longstanding client relationship with Biggerton Books. However, when the firm performs its continuance procedures this year, it is discovered that Biggerton has undergone several organizational and industry-related changes that dramatically increase risk level of the audit. The firm would like to continue the engagement despite the higher risks. How should the firm proceed? (Page 199)
   
   a. Because of the high risks associated with the engagement, the firm has no choice but to terminate the client relationship immediately. [This answer is incorrect. Based on the guidance in the professional standards, Myers & Tait has other options in this scenario. The firm should use the information discovered during performance of its client continuance procedures to make its determination.]
   
   b. If continuance is acceptable under firm continuance policies and appropriate audit response is part of the audit plan, the firm can continue the engagement. [This answer is correct. The firm will need to take steps to mitigate the extra risk if they choose to continue the engagement. SAS Nos. 99 and 109 state that auditors should consider if client acceptance and continuance procedures are relevant in the identification of risks of material misstatement. Under SQCS No. 7, the firm will also need to document how any issues identified during the continuance procedures were resolved.]
   
   c. Myers & Tait can continue the audit engagement with Biggerton Books with no changes from last year’s audit plan. [This answer is incorrect. Because a client or engagement with a greater-than-normal risk poses business risk to the firm and because it involves a higher risk of material misstatement of the financial statements, the firm cannot perform the engagement exactly as they did in the previous year.]

22. The Blankenship CPA firm must decide whether to accept several new audit clients. If the firm uses a system similar to that in the flow chart at Exhibit Page 201, which of these clients should be rejected? (Page 201)
   
   a. Client A does not have a predecessor auditor for the firm to contact. [This answer is incorrect. Though the firm must contact a predecessor auditor if one exists, the lack of a predecessor auditor does not mean that the firm must reject the engagement outright based on the information in the exhibit.]
   
   b. Client B works in an industry the firm does not currently work in. [This answer is incorrect. If the firm wants to expand into the new industry, it can work to familiarize itself with the new industry by taking continuing professional education or using other methods. However, if the new industry is not one the firm is interested in expanding into, the firm should reject the client.]
c. The firm discovers that it does not currently have the technical expertise to complete Client C’s engagement. [This answer is incorrect. If a firm is about to obtain the technical expertise to complete the engagement, then the firm does not have to decline the new client.]

d. **Client D imposes a scope limitation that the firm cannot mitigate.** [This answer is correct. Based on the information in the flow chart, if the potential client imposes a scope limitation that cannot be mitigated, the firm should reject the engagement.]

23. Before accepting an engagement to audit a financial institution, Greg reviews the institution’s regulatory examination reports as part of his client acceptance procedures. The reports include the institution’s CAMELS rating. What CAMELS rating indicates a financial institution that is extremely sound (i.e., an institution that would be a good client)? *(Page 204)*

    a. 1. [This answer is correct. This is the strongest rating an institution can have under the CAMELS system. This system rates the institution’s capital adequacy, asset quality, management, earnings, liquidity, and sensitivity to market risk.]

    b. 3. [This answer is incorrect. On the existing CAMELS scale, a score of three would be average—not extremely sound, but not in danger of failure, either.]

    c. 5. [This answer is incorrect. A CAMELS rating of 5 is not a good sign for a potential financial institution client. In fact, it would be a sign of likely financial failure, which would significantly add to the risk if Greg chose to accept the engagement.]

    d. 10. [This answer is incorrect. The CAMELS rating system includes scores from 1 to 5 only.]

24. Kelly is evaluating whether to accept an engagement to audit Birchfield Credit Union’s 2010 financial statements. The credit union has its financial statements audited annually. Kelly must contact the credit union’s predecessor auditor as part of her client acceptance procedures. Which of these individuals will Kelly need to contact, based on the information in SAS No. 84 (AU 315)? *(Page 205)*

    Roy audited Birchfield’s 2008 financial statements.

    Mabel audited Birchfield’s 2009 financial statements.

    Jon was engaged to perform the audit of Birchfield’s 2010 financial statements, but did not complete the audit.

    Larry is Birchfield’s internal auditor.

    a. Mabel. [This answer is incorrect. Kelly does need to contact Mabel, as she is the CPA who reported on Birchfield’s most recent financial statements. However, based on the guidance in SAS No. 84 (AU 315), Mabel is not the only contact necessary in this scenario.]

    b. Roy. [This answer is incorrect. Because Birchfield has had a set of financial statements audited more recently than when Roy did his audit, he is not considered a predecessor auditor in relation to Kelly’s potential engagement.]

    c. Mabel and Larry. [This answer is incorrect. A company’s internal auditor is not part of the definition of predecessor auditor found in SAS No. 84 (AU 315); therefore, Kelly does not need to contact Larry to fulfill this part of her obligations.]

    d. Mabel and Jon. [This answer is correct. Under SAS No. 84 (AU 315), Kelly must contact the auditor who reported on the most recent financial statements (Mabel) and an auditor who was engaged to perform an audit of the financial statements who did not complete that audit (Jon). An auditor who resigned or was terminated would also be considered a predecessor auditor.]
25. Assume the same details as the question above. Based on the guidance in SAS No. 84 (AU 315), when should Kelly’s communication with the predecessor auditor take place? **(Page 205)**

   a. Before submitting a written proposal to Birchfield. [This answer is incorrect. There are instances when an auditor must communicate with the predecessor before submitting the written proposal for a potential engagement; however, these circumstances are governed by SAS Nos. 50 and 97 (AU 625), not SAS No. 84 (AU 315).]

   b. Before final acceptance of the engagement with Birchfield. [This answer is correct. Under SAS No. 84 (AU 315), the predecessor auditor does not have to respond to inquiries until Kelly has been selected by Birchfield as the successor auditor and she has accepted pending the predecessor’s response.]

   c. After work on the audit engagement has begun. [This answer is incorrect. Kelly’s communication with the predecessor auditor should have taken place before she reaches this point in the audit process.]

   d. Before Kelly reports on Birchfield’s financial statements. [This answer is incorrect. Kelly’s communication with the predecessor auditor should be part of her client acceptance procedures. Communication this late in the process would be too late.]

26. Which of these institutions is required to have an examination regarding internal control? **(Page 206)**

   a. Avery Mutual has $1.5 billion in assets. [This answer is correct. Because Avery Mutual has over $1 billion in assets, it is required to have its internal controls over financial reporting examined annually. This examination should be integrated with the audit of the financial statements.]

   b. Buyers Bank has $500 million in assets. [This answer is incorrect. Buyers Bank is required to have its financial statements audited in accordance with generally accepted auditing standards, based on the amount of assets it holds. It could also elect to have an attestation engagement regarding the effectiveness of internal control over financial reporting, but that is not mandatory.]

   c. Carpathian Savings and Loan has a CAMELS rating of 4. [This answer is incorrect. Because of this CAMELS rating, Carpathian Savings and Loan is required to have its financial statements audited in accordance with generally accepted auditing standards.]

   d. Davidson Bank has over $2 million in student loans. [This answer is incorrect. Davidson Bank is required to have an annual compliance examination performed on the accuracy of the information that it reports to the Department of Education. This is true for any institution that originates or holds student loans.]

27. Which of the following nonattest services can an auditor perform and still retain independence from an attest client? **(Page 209)**

   a. Reporting to the board of directors on management’s behalf. [This answer is incorrect. This would impair an auditor’s independence with respect to an attest client. Another example of an activity that would impair independence is exercising authority on behalf of a client.]

   b. Assist management with its decision-making. [This answer is correct. If an auditor performs management functions or makes manage decisions for an attest client, the auditor’s independence will be impaired; however, the auditor can assist with those decisions or functions if management takes responsibility for them and if the requirements of Interpretation 101-3 are met.]

   c. Having custody of the client’s assets. [This answer is incorrect. If the auditor has custody of an attest client’s assets, the auditor’s independence will be impaired. The auditor’s independence will also be impaired if he or she serves as the attest clients general counsel, registrar, or stock transfer or escrow agent.]

   d. Supervising the client’s employees during normal recurring activities. [This answer is incorrect. The supervision of an attest client’s employees as they perform normal recurring activities will impair an auditor’s independence.]
28. Joe, an auditor, has taken a loan from Chelsea Bank to finance the purchase of his new car. The loan is collateralized by the automobile. Joe’s loan has been current at all times per its specified terms. Chelsea Bank asks Joe to consider performing their annual financial statement audit. Is Joe independent from the bank and, thus, able to consider accepting the engagement? (Page 210)

   a. Joe’s independence is not impaired because the loan is grandfathered. [This answer is incorrect. An example of a loan that would be grandfathered is a home mortgage loan that Joe obtained from Chelsea Bank under its normal lending procedures, that has been current at all times since Joe became a covered member in relationship to the institution, and that meets the conditions described in the flow chart at Exhibit Page 210 regarding the date of the loan.]

   b. Joe’s independence is not impaired because the loan is permitted. [This answer is correct. Under these conditions, Joe’s loan is permitted and his independence will not be impaired with relation to Chelsea Bank. Another example of this type of loan would be one that is fully collateralized by cash deposits Joe has at the same institution.]

   c. Joe’s independence is impaired by this loan. [This answer is incorrect. If Joe had not met certain qualifications, such as keeping the loan current and having it fully collateralized by the automobile, then his independence would be impaired.]

29. All of the following accurately describe a firm’s client acceptance and continuance procedures, except: (Page 215)

   a. An auditor must possess all skills and knowledge necessary to complete an audit before the engagement commences. [This answer is correct. The auditor is not expected to possess all the needed skills and knowledge; however, before accepting an engagement, the auditor should consider what resources are available for gaining any information the auditor lacks.]

   b. The firm must disclose use of a third-party service provider to clients if a confidentiality agreement is in place. [This answer is incorrect. If the audit firm plans to outsource any of its professional services to a third-party service provider, this intent must be disclosed to the client, preferably in writing. If the client objects, the firm must either decline the engagement or perform the services in-house.]

   c. Nonattest services provided to a client disallows that client from ever becoming an attest client for the same firm. [This answer is incorrect. Interpretation 101-3 does not apply to nonattest services that are performed before a client becomes an attest client; thus, those services do not disallow the possibility that a nonattest client can become an attest client.]

30. While performing his annual evaluation of continuing audit clients, Mark discovers information that would have caused him to decline his engagement with Whammy! Inc. had he discovered it the previous year. What must he consider, according to SQCS No. 7? (Page 218)

   a. Whether his familiarity with Whammy! because of last year’s engagement will help mitigate the problem. [This answer is incorrect. Once an audit relationship has been established, an auditor will have more objective information to use in a subsequent audit. However, that is not what Mark must consider under SQCS No. 7.]

   b. What legal and professional responsibilities apply and the possibility of terminating the engagement and the relationship. [This answer is correct. Under SQCS No. 7, Mark must include these considerations in his continuance policies and procedures. If Mark decides to continue the engagement, he should consider whether the engagement continuance procedures provide information relevant in identifying risks of material misstatement due to fraud.]
c. Whether the problem occurred because of a turn over in key management positions at Whammy! over the past few years. [This answer is incorrect. The high turn over of such individuals would be important when considering continuing an engagement with a client; however, this consideration is not what SQCS No. 7 requires in Mark’s situation.]

d. Whether any economic conditions or other risk factors have changed in relation to this engagement. [This answer is incorrect. This is a consideration Mark should make when evaluating continuing an engagement with any client. It is not unique to Mark’s current situation with Whammy! Inc.]
ESTABLISHING THE TERMS OF THE ENGAGEMENT WITH THE CLIENT

After a new or continuing engagement has been accepted, SAS No. 108 (AU 311), Planning and Supervision, requires the auditor to establish an understanding with the client about the services to be performed for each engagement and to document that understanding through a written engagement letter. Although engagement letters have been a common, but optional, practice for many years, SAS No. 108 eliminated the previous alternative of documenting the understanding with the client in the workpapers only. The issuance of an engagement letter may reduce the business risk to the auditor by clarifying the responsibilities of each party and the objectives and limitations of the engagement.

Documenting the Understanding with the Client

SAS No. 108 indicates that the understanding with the client should include (a) the objectives of the engagement, (b) management’s responsibilities, (c) the auditor’s responsibilities, and (d) limitations of the engagement. The matters that generally are included in engagement letters are as follows:

- **The Objective of the Engagement (i.e., the expression of an opinion on the financial statements).**

- **Management’s Responsibilities.** Management is responsible for:
  - The financial statements and the selection and application of accounting policies;
  - Establishing and maintaining effective internal control over financial reporting;
  - Identifying and ensuring compliance with applicable laws and regulations;
  - The design and implementation of programs and controls to prevent and detect fraud;
  - Informing the auditor about all known or suspected fraud affecting the entity involving (1) management, (2) employees who have significant roles in internal control, and (3) others where the fraud could have a material effect on the financial statements;
  - Informing the auditor of his or her knowledge of any allegations of fraud or suspected fraud affecting the institution received in communications from employees, former employees, regulators, or others;
  - Making all financial records and related information available to the auditor;
  - Providing the auditor with a letter confirming certain representations made during the audit; and
  - Adjusting the financial statements to correct material misstatements and providing the auditor with a representation that the effects of any uncorrected misstatements are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

Management also has certain responsibilities when the auditor provides nonattest services, such as bookkeeping or tax return preparation.

- **The Auditor’s Responsibilities.** The auditor is responsible for:
  - Conducting the audit in accordance with generally accepted auditing standards and
  - Ensuring that those charged with governance are aware of internal control related matters that are required to be communicated under professional standards.

- **The Limitations of the Engagement.** The limitations of an audit conducted in accordance with generally accepted auditing standards generally include that:
  - An audit is designed to obtain reasonable rather than absolute assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud (i.e., a material misstatement may remain undetected);
An audit is not designed to detect immaterial errors or fraud;

The auditor may decline to express an opinion or to issue a report if he or she is unable to complete
the audit or to form an opinion; and

An audit is not designed to provide assurance about internal control or to identify deficiencies in
internal control.

In addition, auditors may include other matters as part of the understanding with the client. Some of the other
matters auditors may want to include are discussed later in this lesson.

**Reasons for an Engagement Letter**

When an auditor agrees to provide services to a client for a fee, a contract is created. The engagement letter allows
the auditor to reduce that contract to writing. Furthermore, engagement letters are an excellent tool for educating
clients about their own responsibilities and those of the auditor. If an engagement letter is properly written and
explained to the client, it can eliminate many misconceptions that clients may have, such as about who has
responsibility for the financial statements.

The overriding reason to use an engagement letter is to fulfill the requirements under SAS No. 108 (AU 311), but it
also helps to avoid misunderstandings with the client and the disagreements and disputes that such misunder-
standings can cause. The following reasons for using an engagement letter are generally recognized:

a. *To Document the Contractual Duties Agreed to by an Auditor and Client.*

b. *To Protect an Auditor from Legal Liability.* In today’s litigious environment, it is important that there is no
misunderstanding about the work to be performed, the client’s responsibility for the financial statements,
fees, payment terms, etc.

c. *To Provide the Staff Assigned to the Audit with an Understanding of the Work That Is Required.*

d. *To Meet Regulatory Requirements.* Many financial institutions must provide or make available on request
a copy of the engagement letter between the financial institution and the auditor.

e. *To Provide Client’s Agreement to Comply with Regulatory Requirements for Access to Certain Audit
Documentation.* In some cases, the engagement letter serves as advance approval for the auditor to allow
regulatory access to audit documentation and to fulfill other requirements.

Engagement letters are most effective when the client signs them before any services are rendered. While the
engagement letter is often addressed to the institution’s management, in some situations an auditor may establish
an understanding of the services to be performed with those charged with governance (which would normally
include the board of directors and audit committee, if one exists). Addressing the engagement letter to those
charged with governance may satisfy certain communication requirements under SAS No. 114 (AU 380), *The
Auditor’s Communication With Those Charged With Governance.* Communicating with those charged with gover-
nance early in the engagement is discussed later in this lesson.

**Suggested Content of Engagement Letter**

Drafting of engagement letters has been largely an individual undertaking. Because the engagement letter is
essentially a service contract, some auditors consult their attorneys when drafting it. In preparing the engagement
letter, the auditor should consider the particular client circumstances, including the extent of screening prior to
accepting the engagement, the perceived riskiness of the engagement, client attitudes and expectations, etc. The
auditor should also balance the desire for provisions that afford some protection against liability with potential
adverse client reaction to language deemed too negative or defensive.

The key elements commonly included in most engagement letters are:

a. Identification of the client.
b. Objective of the audit.

c. Description of the services to be provided (the auditor’s responsibilities).

d. Description of management’s responsibilities.

e. Limitations of the engagement.

f. Timing of the engagement.

g. Client assistance regarding the preparation of schedules.

h. Use of third-party service providers.

i. Explanation of how fees and expenses will be billed and payment terms.

j. Provisions related to suspension or termination of services.

k. Client signature.

Additional items that may be discussed in the engagement letter include responding to subpoenas and outside inquiries requesting access to the auditor’s workpapers, limitations on the auditor’s legal liability, staffing, designation of client contacts, record retention, availability of documents, use of specialists or internal auditors, arrangements involving predecessor auditors, alternative dispute resolution, and requests for additional services. SQCS No. 7, *A Firm’s System of Quality Control*, indicates that an audit firm should establish policies and procedures requiring that the identity and role of the engagement partner be communicated to management and those charged with governance.

Additional services may be added to an engagement after the engagement has begun. When clients request additional services, misunderstandings can be avoided by sending a letter or change order to the client detailing any agreed-upon changes in fees and services. The letter or change order should indicate that the terms of the original engagement letter apply to the additional services. If such a change order is used, the auditor should consider whether the additional services are nonattest services under Ethics Interpretation 1013, *Performance of Nonattest Services*. If nonattest services are added to the engagement, the auditor should meet the requirement in ET Interpretation 101-3 to document the understanding with the client regarding performance of the nonattest services. If the scope of agreed-upon services changes significantly, the auditor may want to consider issuing a separate engagement letter to cover the additional services.

**Regulatory Considerations**

The following matters should generally be covered in an engagement letter when the engagement is subject to FDICIA or other regulatory requirements:

- **Auditor’s Responsibility and Agreement to Provide Access to and Copies of Audit Documentation to Regulators.** The engagement letter should clearly describe the requirements that the auditor must meet related to providing access to and copies of audit documentation to the regulators. The AICPA has issued an auditing interpretation titled *Providing Access to or Copies of Audit Documentation to a Regulator* (AU 9339) that provides guidance on the auditor’s responsibility to provide access to and copies of audit documentation to regulators.

- **Acknowledgment.** Because the information obtained in auditing is confidential, the engagement letter should clearly indicate that the institution is giving the auditor its advance approval to comply with a regulatory request for documents. The acknowledgment should generally state that the institution will be informed about any requests for documents that the auditor receives from the regulators.

- **Fees.** The engagement letter should clearly indicate that the additional time required to satisfy regulatory requirements will be billed to the institution.
Limitation of Liability Provisions. In February 2006, the federal banking, thrift, and credit union regulatory agencies issued an "Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions in External Audit Engagement Letters." The advisory informs financial institutions' boards of directors, audit committees, management, and external auditors not to enter into engagement letters that incorporate “unsafe and unsound” limitation of liability provisions for audits of financial statements and audits of internal control over financial reporting. The advisory applies to all financial institution external audits, regardless of the size of the financial institution, whether the financial institution is public or not, and whether the external audit is required or voluntary.

The provisions the agencies deem unsafe and unsound can be generally categorized as an agreement by a financial institution that is a client of an external auditor to:

- Indemnify the external auditor against claims made by third parties;
- Hold harmless or release the external auditor from liability for claims or potential claims that might be asserted by the client financial institution, other than claims for punitive damages; or
- Limit the remedies available to the client financial institution, other than punitive damages.

Collectively, these categories of provisions are referred to in the advisory as “limitation of liability provisions.”

The advisory states that limitation of liability provisions could weaken the external auditor’s objectivity, impartiality, and performance and, therefore, reduce the regulatory agencies’ ability to rely on the external audit. Examples of unsafe and unsound limitation of liability provisions are given in an appendix to the advisory. Alternative dispute resolution (ADR) and waiver of jury trial provisions are not considered unsafe and unsound practices according to the advisory provided they do not incorporate any of the limitation of liability provisions discussed previously. Also, engagement letter provisions that waive the client’s right to seek punitive damages are not considered to be unsafe and unsound.

The advisory, which is available at www.fdic.gov (FIL-13-2006), is effective for audit engagement letters executed on or after February 9, 2006, the date it was published in the Federal Register. Auditors and financial institutions that have executed multi-year engagement letters are encouraged to review and amend those agreements if they contain any unsafe and unsound limitation of liability provisions.

In addition to the 2006 regulatory guidance concerning engagement letters, the AICPA’s Professional Ethics Executive Committee (PEEC) issued exposure drafts in September 2005 and September 2006 containing proposed ethics interpretations under Rule 101, Independence, addressing the impact that certain indemnification and limitation of liability provisions may have on a member’s independence when included in engagement letters or other client agreements. As a result of the diverse feedback received on these proposals, PEEC decided not to issue a revised proposal under Rule 101. Instead, they issued an interpretation under Rule 501, Acts Discreditable, reminding members that some regulators (including the SEC and the federal financial institution agencies) prohibit the use of indemnification and limitation of liability provisions, and that entering into such an agreement with a client that is subject to the regulators’ requirements would be considered an act discreditable to the profession. Ethics Interpretation 501-8 (ET 501.09), Failure to Follow Requirements of Governmental Bodies, Commissions, or Other Regulatory Agencies on Indemnification and Limitation of Liability Agreements with a Client, and requires members to comply with the requirements of such regulators on the use of these provisions when providing audit or other attest services that are required by such regulators. PEEC has indicated that the committee will continue to monitor events on this subject both nationally and internationally and consider what, if any, additional guidance may be appropriate.

All financial institutions with total assets of $500 million or more must comply with the SEC’s auditor independence requirements. Because the SEC’s independence requirements encompass the independence standards and rules adopted by the PCAOB and approved by the SEC, the auditor must also meet the independence requirements of the PCAOB. To the extent that any of the rules within any one of these independence standards (AICPA, SEC, and PCAOB) is more or less restrictive than the corresponding rule in the other independence standards, auditors must comply with the most restrictive rule. The SEC has taken the position that the types of arrangements described in the preceding paragraphs impair independence and as such, should not be used on SEC engagements.
Finally, there is an additional question as to whether these clauses would be enforced by a court and, if enforced, how they would be interpreted. As a result, caution should be exercised when an auditor considers using indemnification or limitation of liability provisions. It is recommended that auditors consult with their legal counsel and insurance carrier when assessing such language in the engagement letter.

**Privacy Considerations under the Gramm-Leach-Bliley Act and Related Regulations**

Section 501 of the Gramm-Leach-Bliley Act (GLB) requires the federal banking agencies, NCUA, and certain other federal agencies to establish standards for financial institutions relating to the administrative, technical, and physical safeguards for customer records and information. The implementation guidelines require financial institutions to, among other things, (a) require their service providers to implement appropriate measures to meet the objectives of the guidelines, and (b) where indicated by the institution’s risk assessment, monitor its service providers to confirm that they have satisfied their obligations regarding those measures.

These requirements have created the following practice issues:

- Will the institution’s privacy measures impact the auditor’s access to their client’s customer data?
- Are auditors considered service providers and, if so, what additional burdens does that impose on them?
- Will these guidelines affect the peer reviews of financial institution audits?

Regarding the first question, GLB prohibits financial institutions from disclosing nonpublic personal information to most nonaffiliated third parties, unless the institution provides adequate notice to the consumer and offers the consumer the ability to opt out of the disclosure. However, section 502(e)(4) of GLB specifically exempts the institution’s accountants and auditors from this prohibition.

The second question is more complex. According to the Federal Trade Commission (FTC) regulations under the GLB, financial institutions include tax preparers and financial planners. Thus, those rules apply to every for-profit tax preparer and financial planner and to nearly all accounting firms. However, apparently recognizing that CPAs already are subject to state laws and regulations prohibiting the disclosure of nonpublic personal information without the expressed consent of the client, the Financial Services Regulatory Relief Act of 2006 (FSRRA), passed on September 30, 2006, exempts CPAs from the disclosure provisions of these rules.

As a result of the FSRRA exemption, CPAs no longer have to send out annual privacy disclosure statements to their individual clients. This exemption was effective immediately, meaning the annual notice was not required for 2006.

However, FSRRA does not exempt CPAs from the safeguards provisions of GLB, which require CPAs to (a) secure client information; and (b) have written procedures to protect client financial information. CPAs typically have more than adequate security measures and documentation to meet those requirements. Also, some states may require annual notices similar to the FTC requirements. Those states were not affected by the FSRRA exemption and may continue to require such notices.

On November 17, 2009, the various federal financial institution regulatory agencies adopted a model privacy form that financial institutions may rely on as a safe harbor to provide disclosures under the privacy rules. Use of the model form is voluntary. Using the model form will satisfy the GLB requirements for notices and will obtain a legal safe harbor. The model privacy forms are available at [www.ftc.gov/privacy/privacyinitiatives/PrivacyModelForm.pdf](http://www.ftc.gov/privacy/privacyinitiatives/PrivacyModelForm.pdf) (including opt out to limit sharing) and [www.ftc.gov/privacy/privacyinitiatives/PrivacyModelForm_NoOptOut.pdf](http://www.ftc.gov/privacy/privacyinitiatives/PrivacyModelForm_NoOptOut.pdf) (with no opt out).

The peer review question relates to whether GLB will restrict auditors in their ability to make financial institution audit workpapers available for peer review. Section 502(e)(5) exempts disclosures to self-regulatory organizations from the GLB prohibitions discussed previously, and the *Banks, Credit Unions, and Other Lenders and Depository Institutions Industry Developments—2001/2* (the 2001/2 Audit Risk Alert) indicates that this provision covers peer reviews administered by the AICPA or a state society. Section 502(e)(8) exempts disclosures required to comply with federal, state, or local laws, rules or other applicable legal requirements, and some have interpreted this provision as covering peer reviews required by FDICIA or state accountancy laws and regulations.
Multi-year Engagement Letters

SAS No. 108 (AU 311) requires the auditor to establish an understanding with the client for each engagement and to document this understanding in the workpapers. However, this does not preclude the use of engagement letters that cover more than one year of services (for example, audits for the next three years). Some auditors have adopted the practice of including provisions in their engagement letters that cover each annual engagement unless subsequently modified. These auditors obtain a letter in the first year of a client relationship and do not require a new letter in each subsequent year. While this is a legally permissible practice, it is not advisable from a loss limitation standpoint because a client’s operations change over the years, as can the scope of an auditor’s engagement. In addition, outdated engagement letters might omit many of the legal protection clauses available to the auditor. In other situations, older engagement letters may not reflect recent developments that are required by professional standards or regulatory bodies. Since virtually all auditors today utilize computers as a part of their daily routine, the generation of engagement letters requires little time. Moreover, requiring a new letter each year forces the auditor to focus on the scope of services that it will be providing. If a multi-year engagement letter is used, however, auditors should document consideration of the understanding with the client in each year.

Early Communication with Those Charged with Governance

SAS No. 114 (AU 380) requires that the timing of communication with those charged with governance should be sufficiently timely to enable those charged with governance to take appropriate action. The auditor should communicate certain matters required under SAS No. 114, such as auditor responsibility and the planned scope and timing of the audit, early in the engagement, or for an initial engagement, as part of the terms of the engagement. The communication with those charged with governance could occur during the planning phase of the audit. If these matters are included in the engagement letter, and the engagement letter is sent to those charged with governance, a separate letter does not need to be sent.
SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

31. Which of the following statements best describes engagement letters?
   a. Engagement letters are a common practice in audit engagements, but ultimately they are optional.
   b. To be most effective, an engagement letter should be signed by the client before the audit report is issued.
   c. The most important benefit of an engagement letter is to fulfill the requirements of SAS No. 108 (AU 311).
   d. Due to its contractual nature, an engagement letter must be written by an attorney, not the auditor.

32. Jan is drafting an engagement letter for an audit of a financial institution client. Her client is subject to FDICIA requirements. What is an element that should be discussed in Jan’s engagement letter that is unique to this type of audit?
   a. The auditor’s responsibility to provide information to regulators.
   b. Provisions to limit the auditor’s legal liability.
   c. Provisions related to the termination of services.
   d. The use of specialists or internal auditors.

33. How are CPAs affected by the privacy considerations of the Gramm-Leach-Bliley Act (GLB) and related regulations?
   a. They must send out annual privacy disclosure statements to each individual client.
   b. They cannot receive nonpublic personal information about clients of financial institutions.
   c. They must secure client information and have written procedures for its protection.
   d. They are exempt from the GLB and able to disclose nonpublic personal information, as needed.
SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. (References are in parentheses.)

31. Which of the following statements best describes engagement letters? (Page 228)

a. Engagement letters are a common practice in audit engagements, but ultimately they are optional. [This answer is incorrect. This was true in the past, but SAS No. 108 (AU 311) now requires an auditor to document an understanding with a client through a written engagement letter.]

b. To be most effective, an engagement letter should be signed by the client before the audit report is issued. [This answer is incorrect. It is most effective for an client to sign an engagement letter before any services are rendered by the auditor.]

c. The most important benefit of an engagement letter is to fulfill the requirements of SAS No. 108 (AU 311). [This answer is correct. In addition, an engagement letter can help the firm avoid misunderstandings with the client and the disputes and disagreements that can result. Other benefits include protection from legal liability and documenting the contractual duties that are agreed to.]

d. Due to its contractual nature, an engagement letter must be written by an attorney, not the auditor. [This answer is incorrect. An auditor may want to consult his or her attorney when drafting an engagement letter, but the auditor usually writes the engagement letter.]

32. Jan is drafting an engagement letter for an audit of a financial institution client. Her client is subject to FDICIA requirements. What is an element that should be discussed in Jan’s engagement letter that is unique to this type of audit? (Page 229)

a. The auditor’s responsibility to provide information to regulators. [This answer is correct. Two other things that Jan should include in her engagement letter that would be unique to an audit of a financial institution are (1) the client’s acknowledgement and approval that Jan will have to provide normally confidential information to regulators and (2) information about fees related to additional time required to meet regulatory requirements.]

b. Provisions to limit the auditor’s legal liability. [This answer is incorrect. An advisory released by the federal banking, thrift, and credit union regulatory agencies advises financial institutions not to sign an engagement letter with this provision.]

c. Provisions related to the termination of services. [This answer is incorrect. This is one of the key elements of any engagement letter and would usually occur in most engagement letters. Provisions related to the suspension of services would also be included.]

d. The use of specialists or internal auditors. [This answer is incorrect. This additional item might be discussed in any engagement letter to which it applies; however, this topic is not unique to audits of financial institutions.]

33. How are CPAs affected by the privacy considerations of the Gramm-Leach-Bliley Act (GLB) and related regulations? (Page 231)

a. They must send out annual privacy disclosure statements to each individual client. [This answer is incorrect. After the Financial Services Regulatory Relief Act of 2006 (FSRRA) was passed, CPAs no longer have to send out such disclosure statements.]

b. They cannot receive nonpublic personal information about clients of financial institutions. [This answer is incorrect. A financial institution’s auditors and accountants are exempt from the GLB provisions that prohibits financial institutions from releasing nonpublic personal information to nonaffiliated third parties.]
c. They must secure client information and have written procedures for its protection. [This answer is correct. Even after passage of the FSRRA, CPAs are required to do both of these things by the GLB.]

d. They are exempt from the GLB and able to disclose nonpublic personal information, as needed. [This answer is incorrect. Both the GLB and state laws and regulations affect a CPA’s treatment of nonpublic personal information. CPAs must meet those requirements.]
FDICIA ENGAGEMENTS: SPECIAL CONSIDERATIONS

The audit regulations under the FDIC Improvement Act (FDICIA) place additional requirements on banks and savings institutions with assets of $500 million or more. The primary pre-engagement considerations are in the following areas:

a. Required services.

b. Qualifications of auditors.

c. Engagement letters.

d. Reporting changes of auditors.

This section covers each of those considerations.

Required Services

All banks and savings institutions with assets of $500 million or more are required to have full scope audits. For banks and savings institutions with total assets of $1 billion or more, an internal control examination is required by the FDIC Improvement Act of 1991 (FDICIA) to be performed in addition to an annual audit of the financial statements. [SSAE No. 15 (AT 501.18) states that the examination of internal control over financial reporting should be integrated with the audit of the financial statements and be planned to accomplish the objectives of both audits simultaneously.] In November 2005, the FDIC amended Part 363 of its regulations by raising the asset-size threshold from $500 million to $1 billion for internal control assessments by management and external auditors.

Qualifications of Auditors

The FDICIA audit regulations and guidelines prescribe certain independence and qualification requirements for auditors. The following is a summary of those requirements:

a. License. The auditor should be registered or licensed to practice as a public accountant and be in good standing under the laws of the applicable state.

b. Independence. The auditor must meet the independence requirements of both the AICPA and the Securities and Exchange Commission. Because the SEC’s independence requirements encompass the independence standards and rules adopted by the PCAOB and approved by the SEC, the auditor must also meet the independence requirements of the PCAOB. The SEC independence rules can be obtained on the SEC’s website at www.sec.gov. The AICPA’s rules were discussed previously. The PCAOB requirements may be obtained in their entirety from the PCAOB website at http://pcaobus.org/Standards/EI/Pages/default.aspx. To the extent that any of the rules within any one of these independence standards (AICPA, SEC, and PCAOB) is more or less restrictive than the corresponding rule in the other independence standards, auditors must comply with the most restrictive rule.

c. Peer Review. The auditor must have received a peer review or must be enrolled in a review program that is consistent with AICPA standards. The following guidelines apply to the peer review:

- The peer review should, if available, include at least one audit of an insured institution or consolidated holding company.

- The auditor must provide two copies of the peer review report, accompanied by any letter of comments and letter of response, to the FDIC. (If the report is other than unqualified, the auditor should provide a letter explaining any corrective actions taken.) The report should be filed with the FDIC by the earlier of (1) 15 days of receipt of notification that the report has been accepted by the appropriate standards review committee or (2) before the audit begins.

- Peer review workpapers should be retained by the reviewing firm for 120 days after the review report is filed with the FDIC.
• The peer review workpapers must be made available to the FDIC on request.

• The auditor, at the request of the regulators, must provide policies, procedures, and manuals, as well as audit documentation (including audit programs and administrative files), for any of the services performed.

• If terminated, the auditor should make certain notifications to the FDIC and the appropriate banking agency.

Engagement Letters

Engagement letters for engagements under the FDICIA audit regulations should cover significant matters such as the following:

• **Audit Documentation Access.** The engagement letter should acknowledge that access will be granted to the audit documentation, if requested by the regulators.

• **Attestation Service.** The attestation engagement regarding management’s assertion about internal control (required for institutions with assets of $1 billion or more) should be covered in an engagement letter. Because the examination of internal control over financial reporting should be integrated with the audit of the financial statements and be planned to accomplish the objectives of both audits simultaneously, a single engagement letter should be issued that covers both pieces of the integrated audit.

Reporting Changes of Auditors

FDICIA requires that certain notifications be made whenever a bank or savings institution with assets of $500 million or more at the beginning of the year changes its independent auditor. The financial institution must report the termination or resignation of an auditor to the regional director (supervision) in the FDIC region in which the institution is headquartered, the appropriate federal banking agency, and any appropriate state bank supervisor. Such notification must take place within 15 days of the termination of the auditor. FDICIA also requires the reporting of certain information by the terminated auditor. The FDICIA notification requirements are covered in the remainder of this section.

**Reporting the Termination or Resignation of an Auditor by the Institution.** FDICIA requires that a financial institution report the termination or resignation of its auditor to the regulatory bodies mentioned in the previous paragraph. The financial institution’s report of termination or resignation must:

a. Be signed and dated by the chair of the institution’s audit committee.

b. Be filed with the appropriate regulatory agencies within 15 days of the change.

c. Be sent to the auditor within 15 days of the change.

d. Include the reasons for the change and discuss any disagreements that have occurred at the management level concerning matters of accounting principle or practice, financial statement disclosure, or audit procedures or scope during the two most recent fiscal years and during any subsequent interim period.

**Auditor Reporting of Termination or Resignation.** The auditor is required to file a written report with the regulatory bodies mentioned above within 15 days of receiving the notice discussed in the previous paragraph from the financial institution. The report must state the reason for the termination or resignation, whether the auditor agrees with the assertions in the institution’s notice, and whether the institution’s notice discusses all disagreements, if any.

**Reasons for the Change.** A financial institution may change its auditor for a number of subjective reasons, and it may be reluctant to reveal the true reason for the change. Many times, the terminated auditor will not know the true reason why he or she is being replaced. When this situation occurs, the auditor’s letter to the regulators should state that the auditor is not in a position to agree or disagree with the institution’s stated reason for changing its principal auditor.
Reporting Disagreements. The term *disagreements* should be interpreted broadly. It should include all disagreements, not just those not resolved to the auditor’s satisfaction. On the other hand, initial differences of opinion based on incomplete facts or preliminary information that are later resolved based on additional facts or information should generally not be considered disagreements.

It is the opinion of this course that disagreements that must be reported are those that occur at the decision-making level such as between the engagement partner and the chief financial officer or chief executive officer. A “disagreement” between the in-charge accountant and the institution’s accounting manager would not be a disagreement if the CFO and the engagement partner reached an agreement on that issue. However, differences of opinion between the audit firm and client management do not have to rise to the level of the board of directors to be considered disagreements.

Selection of Auditors. A financial institution is not required to report the initial selection of auditors, although it may do so in the notification of termination discussed in the preceding paragraph. However, an institution that is subject to the FDICIA audit requirements must satisfy itself that the auditor it wishes to engage meets the auditor qualifications set forth in Guidelines 13–15 to the FDICIA audit regulations. Those guidelines cover the following qualifications:

- General qualifications
- Independence
- Peer reviews

No specific procedures are required by institutions to assess the auditor’s qualifications. However, it is likely that institutions will, at a minimum, ask the auditor to represent that he or she meets Guidelines 13–15. Written representations about the firm’s qualifications could take the form of a letter. In addition to providing representations, the institution may also request the auditor to present a copy of his or her latest peer review report, along with any letter of comments or letter of response.

**USING THE WORK OF A SPECIALIST: SPECIAL CONSIDERATIONS**

The difference between using the work of another auditor and using the work of a specialist is that the specialist would generally be expected to have skills and knowledge of another profession or occupation. Such specialists commonly used in auditing financial institutions include actuaries, information technology specialists, geologists, valuation specialists, real estate appraisers, etc.

SAS No. 73 (AU 336) provides guidance for situations in which the auditor uses the work of a specialist as evidence in performing substantive tests to evaluate material financial statement assertions. SAS No. 73 applies in the following circumstances:

a. Management engages or employs a specialist and the auditor uses that specialist’s work as audit evidence in performing substantive tests to evaluate material financial statement assertions.

b. Management engages a specialist employed by the auditor’s firm to provide advisory services and the auditor uses that specialist’s work as audit evidence in performing substantive tests to evaluate material financial statement assertions.

c. The auditor engages a specialist and uses that specialist’s work as audit evidence in performing substantive tests to evaluate material financial statement assertions.

SAS No. 73 (AU 336) applies to specialists hired by the client or the auditor, including specialists engaged by the client for advisory services who are employees of the auditor’s firm. SAS No. 73 does not apply to specialists employed by the auditor’s firm or outside professionals who effectively function as members of the audit team. For instance, if the auditor’s firm employs an appraiser and uses that appraiser as part of the audit team to evaluate carrying values of properties, then SAS No. 73 does not apply. SAS No. 108, *Planning and Supervision*, applies in that situation. Also, if the auditor uses an IT specialist, whether employed by the auditor’s firm or on a contract basis, as part of the audit team to help determine the effect of information technology on the audit, understand the
institution’s controls, or design and perform tests of controls (when applicable) and substantive tests, SAS No. 108, rather than SAS No. 73, applies to the work of that specialist.

SAS No. 73 (AU 336) indicates that the auditor should evaluate the qualifications of the specialist to determine whether the specialist has the necessary skills or knowledge in the particular field. Factors that should be considered in assessing a specialist’s qualifications include the following:

a. The professional certification, license, or other recognition of the competence of the specialist in the particular field.
b. The reputation and standing of the specialist in the views of peer and others familiar with the specialist’s capability or performance.
c. The specialist’s experience in the type of work under consideration.

The auditor should obtain an understanding of the nature of the work performed or to be performed by the specialist, including an understanding of the following matters:

a. The objectives and scope of the specialist’s work.
b. The specialist’s relationship to the client. (Preferably the specialist will not be related to the client. If a related specialist is used, the auditor may need to perform additional procedures to test the reasonableness of the specialist’s assumptions, methods, or findings.)
c. The assumption or methods used.
d. A comparison of the methods or assumptions used with those used in the preceding period.
e. The appropriateness of using the specialist’s work for the intended purpose. (In some situations, it may be necessary to contact the specialist to determine whether the specialist is aware that his or her work will be used for corroborating financial statement assertions.)
f. The form and content of the specialist’s finding that would enable the auditor to evaluate whether those findings support the related assertions in the financial statements.

For specialists such as appraisers and actuaries, the preceding matters can generally be assessed based on reading the specialist’s report.

INITIAL ENGAGEMENTS: SPECIAL CONSIDERATIONS

SAS No. 108 (AU 311) provides guidance on considerations for planning an initial audit engagement. Since the auditor generally lacks experience with the client, additional planning procedures are generally necessary in order to develop the audit strategy and audit plan. The following matters should normally be considered when beginning an initial audit:

- The nature and extent of audit procedures that will be necessary to obtain sufficient appropriate audit evidence about opening balances.
- The nature and extent of audit procedures necessary to obtain reasonable assurance concerning the consistency of application of accounting principles between the current year and the preceding year.
- Significant issues that were discussed with management and others during the auditor retention process, their impact on the audit strategy and audit plan, and any communication that may be necessary with those charged with governance.
- Arrangements regarding the review of a predecessor auditor’s workpapers, when applicable.
- The competence and experience of firm personnel that are necessary to respond to anticipated significant risks.
- Any other procedures for initial audit engagements that are required by the firm’s system of quality control such as engagement quality control review of the audit strategy or reports that will be issued.
SQCS No. 7 (QC 10) defines engagement quality control review as “a process designed to provide an objective evaluation, by an individual or individuals who are not members of the engagement team, of the significant judgments the engagement team made and the conclusions they reached in formulating the report.”

Audit Objectives in an Initial Engagement

The auditor’s objectives in applying additional procedures in an initial engagement usually fall into one or more of the following categories:

a. To obtain preliminary knowledge of the client, its business, its operating characteristics, and its internal control, particularly its control environment and financial reporting system.

b. To assess the reasonableness of the opening balances of significant balance sheet accounts.

c. To obtain reasonable assurance of the accounting principles and their method of application in the prior year.

The standard audit report does not include a reference to consistency of application of accounting principles. However, when there is a material lack of comparability in financial statements caused by a change in accounting principles, the auditor must add a fourth explanatory paragraph that refers to the inconsistency.

Preliminary Knowledge of Client. Pre-engagement activities and the risk assessment procedures necessary to obtain an understanding of the client and its environment are usually more extensive and time-consuming in an initial engagement. Naturally, the auditor’s knowledge increases as the engagement progresses. The practice aids in PPC’s Guide to Audits of Financial Institutions provide procedures that can help an auditor perform an initial engagement.

Reasonableness of Opening Balances. In an initial engagement, the auditor’s objective is to assess the reasonableness of opening balances of significant balance sheet accounts. Normally, in most engagements, there is no need for the auditor to express an opinion on the opening balances. Accordingly, the audit procedures applied to opening balances are usually more limited than the procedures applied to the closing balances of the current period.

One exception to this guidance relates to the allowance for loan losses. Historical charge-offs are a significant factor in assessing the adequacy of the allowance relating to certain types of loans. Accordingly, the auditor should perform analytical procedures or other procedures to assess the reasonableness of charge-offs over the past five years. After determining the appropriate historical loss rate for each group of loans with similar risk characteristics, management should consider those current qualitative or environmental factors that are likely to cause the estimated credit losses on these loans as of the evaluation date for the allowance for loan and lease losses to differ from the group’s historical loss experience.

Nature of Opening Balances. The auditor focuses on the opening balances that affect the current period’s ending balances or that affect results of operations for the current period. The extent of additional procedures applied to the opening balance depends on the extent to which items in the opening balance are also in the closing balance and on the audit approach to the ending balance. Generally, the account balances that the auditor is concerned with will fall into one of the following categories:

a. All, or a substantial portion, of the ending balance is accounted for by the opening balance, and the audit approach in a continuing engagement is to focus on the items that increase or decrease the opening balance to substantiate the ending balance (e.g., premises and equipment and capital accounts).

b. All, or a substantial portion, of the ending balance is accounted for by the opening balance, and the audit approach in a continuing engagement is to substantiate directly all or most of the items in the ending balance (e.g., loans receivable and other borrowings).

c. The account balance turns over at least once each accounting period, and none of the items in the opening balance are normally included in the ending balance (e.g., cash and due from banks, federal funds purchased or sold).
Naturally, the auditor’s additional procedures are most extensive for the first category and, if reliance is placed on a predecessor auditor, the degree of reliance is normally considerable. The auditor’s procedures are generally the least extensive for the second category because the audit procedures applied to the ending balance also support the opening balance. For the last category, the auditor’s primary concern is the effect of misstatement of the opening balance on the current period’s operating results.

With the passage of time, certain opening balances are more easily determinable. For example, after a year the valuation of loans receivable may be more certain. The adequacy of year end accruals and accounts payable liabilities may be more easily evaluated if a year has passed.

Generally, the decision to place reliance on the predecessor should be made by audit area (e.g., the auditor may decide to rely on the predecessor’s report and his or her review of the predecessor’s workpapers extensively in the deposit accounts area, but not at all in auditing the allowance for loan losses).

**Avoid Overauditing.** One of the greatest sources of inefficiency in an initial engagement is a more extensive review of a predecessor’s workpapers than is necessary to achieve the auditor’s objectives. Simply because there are workpapers that can be reviewed, the auditor might do more work in an area than would be done if no reliance on a predecessor were possible.

**Consistency.** The accounting principles and methods of application followed in the prior period should be identified to permit the auditor to evaluate whether there has been a change in accounting principles or their method of application. Usually, there is no problem in identifying significant accounting principles (e.g., methods for accounting for loan losses). However, the auditor must also be concerned with the methods of application (e.g., how deferred loan fees and accrued interest on impaired loans are considered in determining the allowance for loan losses). Also, the auditor must be concerned with the year-end closing routines followed at the end of the prior and current periods because of the effect on current operating results (e.g., the dates and methods of establishing cutoffs).

**Balance Sheet Only Initial Audit.** The basic guidance in this course applies to an initial audit that is a balance sheet only engagement. Therefore, the auditor’s opinion will not address the income statement. After performing the risk assessment procedures and assessing the risk of material misstatement related to the balance sheet audit, the auditor might conclude that the assessed risks at the relevant assertion level will be appropriately addressed through a selection of basic or extended audit procedures performed on the balance sheet along with the preliminary and final analytical procedures. The auditor might consider audit procedures related to the income and expenses audit program steps if they address risks at the relevant assertion level based on the assessed risks of what could go wrong relative to classes of transactions, balance sheet accounts, and disclosures. For example, the auditor may determine that a risk exists for the real estate investments accounts and decide that extended analytics and/or testing of real estate investment expense, preacquisition and acquisition costs, and development cost accounts will be performed.

**Replacing a Predecessor Auditor**

When a predecessor auditor has completed an audit of prior periods’ financial statements, it is usually efficient and effective for the successor auditor to place reliance on the predecessor’s report and his or her review of the predecessor’s workpapers to determine how much evidence the successor must obtain to substantiate beginning balances. This avoids duplication of effort and helps to keep the audit fee reasonable. This reliance is not required by professional standards because it is primarily a matter of audit efficiency. Also, no expression of reliance is appropriate in the audit report because the successor auditor’s responsibilities for opening balances and consistency are not reduced. However, if the successor is to reaudit periods already reported on by the predecessor, the successor auditor should not place reliance on the report of the predecessor auditor. Also, if the successor signs an acknowledgment letter such as that discussed later in this section, the workpapers may need to clarify what is meant by “reliance on the predecessor.” Workpaper documentation considerations for this situation are discussed later in this lesson.

The first essential step when there is a predecessor is to obtain the client’s permission for reviewing and copying the predecessor’s workpapers and files relating to the most recently completed audit. It is usually efficient to routinely cover this matter when the initial required communication is made concerning management integrity.
After the client’s permission to communicate with the predecessor has been obtained, the auditor usually has the following concerns:

- a. Consideration of the predecessor’s reputation, independence, and general competence.
- b. Review of the predecessor’s audit workpapers overall and in detail for specific asset and liability accounts.
- c. Consideration of the reporting options for the prior period’s financial statements.

**Consideration of Predecessor’s Reputation and Independence.** When a principal auditor uses the work and report of another auditor, whether reference to the other auditor is made or not, the principal auditor should, according to SAS No. 1 (AU 543.10), perform procedures such as the following:

- a. Inquire about the professional reputation and standing of the other auditor by communication with the AICPA, applicable state society, other auditors, or bankers and credit grantors.
- b. Obtain a representation on the other auditor’s independence under AICPA requirements.
- c. Communicate with the other auditor and determine that the auditor is:
  1. aware of the intended use of the financial statements he audited, and
  2. familiar with GAAP and GAAS and any other applicable standards.

These steps are not required when a successor auditor relies on the report of a predecessor. However, unless the predecessor is well-known to the auditor, it may be prudent to find out about the predecessor’s professional reputation.

**Review of the Predecessor’s Workpapers.** SAS No. 84, *Communications Between Predecessor and Successor Auditors* (AU 315.11), states that predecessor auditors should ordinarily allow the successor auditor to review—

... working papers, including documentation of planning, internal control, audit results, and other matters of continuing accounting and auditing significance, such as the working paper analysis of balance sheet accounts, and those relating to contingencies.

The term *audit results* as used above refers to audit differences, conclusion memos, etc.

Auditors should note that SAS No. 84 does not require the predecessor to allow access to those listed workpapers. The extent of access to the workpapers permitted by the predecessor is a matter of judgment. Reasons for not granting access could include pending litigation or unpaid fees.

Normally, the predecessor’s workpapers are reviewed at the predecessor’s office at a time convenient to the predecessor. Often the impressions gained merely by visiting the predecessor’s office are helpful in assessing the predecessor’s competence.

**Reliance on the Predecessor.** SAS No. 84 notes that the amount of audit evidence to be obtained by the successor auditor relating to opening balances and consistency in application of accounting principles is a matter of professional judgment. SAS No. 84 (AU 315.12) states:

Such audit evidence may include the most recent audited financial statements, the predecessor auditor’s report thereon, the results of inquiry of the predecessor auditor, the results of the successor auditor’s review of the predecessor auditor’s working papers relating to the most recently completed audit, and audit procedures performed on the current period’s transactions that may provide evidence about the opening balances or consistency.

In other words, the predecessor’s workpapers alone do not constitute sufficient evidence. The successor auditor’s review of the predecessor auditor’s workpapers may affect the nature, timing, and extent of the successor auditor’s
work relating to the opening balances and consistency; however, the audit work performed and the conclusions reached are solely the responsibility of the successor auditor.

For example, the successor auditor may review the predecessor’s workpapers related to fixed assets and be satisfied with the predecessor’s assessment of internal control, substantive tests, and evaluation of misstatements. Based on this review, and the results of the successor’s procedures on current year transactions and analytical procedures on accumulated depreciation, the successor may conclude that additional procedures on prior year transactions are not considered necessary.

**Purposes of Reviewing Predecessor’s Workpapers.** The variety of purposes served by reviewing the predecessor’s workpapers are outlined in Exhibit 2-4. These purposes are generally accomplished in two stages—overall review of the workpapers and a detailed review of the workpapers for specific asset and liability accounts.

Exhibit 2-4

**Purposes Served by Review of a Predecessor Auditor’s Workpapers**

To make an *evaluation* of:

1. the general competence of the predecessor;
2. the predecessor’s adherence to generally accepted auditing standards; and
3. the procedures applied to specific asset and liability accounts.

To obtain *information* on:

1. the control environment, the financial reporting system and, in some cases, related control activities;
2. aspects of contracts, agreements, and matters of continuing accounting or auditing significance;
3. accounting principles and methods of application used in the prior period;
4. the nature and amount of any misstatements in opening balances;
5. any disagreements with management’s accounting estimates;
6. detailed schedules of accounting data carried forward from prior periods;
7. violations of banking laws or regulations; and
8. regulatory criticisms in prior periods.

* * *

**Overall Review of Predecessor’s Workpapers.** The overall review of the predecessor’s workpapers is intended to provide the auditor with a basis for evaluating the predecessor’s general competence and general adherence to generally accepted auditing standards. Some departures from professional standards or good practice, such as failure to use written audit programs, poorly organized and sloppily prepared workpapers, failure to confirm loans receivable, and failure to obtain client and attorney representations, may be quickly noted.
During the overall review of the predecessor’s workpapers, the auditor should give particular attention to matters that would identify potential problem areas in the audit. In particular circumstances, some or all of the following procedures might be useful:

a. Read the predecessor’s planning memo and other planning workpapers. (This may assist in identifying risks, significant audit areas and the nature of the predecessor’s procedures in those areas.)

b. Read the predecessor’s management letter or communication of internal control related matters, and client and attorney representation letters. (This helps to assess the condition of the financial reporting system and to identify unusual accounting or auditing risks.)

c. Scan the workpaper summary of adjusting journal entries. (This provides an indication of the client’s expectations on accounting assistance and helps to identify potential risks that may result in time-consuming areas.)

d. Scan the summary and evaluation workpaper that accumulates uncorrected misstatements. (This helps to identify risk areas and identifies possible uncorrected misstatements in opening balances.)

e. Read the predecessor’s engagement summary memo (if available). (This may identify potential risk areas of the engagement and how the predecessor addressed those risk areas.)

f. Scan the time budget—planned and actual. (This helps to identify areas that required more than the anticipated time and can identify risk areas.)

A predecessor may be sensitive about permitting review of the planned and actual time budget. In that case, the auditor may merely inquire about areas that caused difficulty.

**Detailed Review of Specific Workpapers.** If the auditor’s overall review of the workpapers indicates that reliance on the predecessor’s report is likely to be efficient and effective, then a detailed review of the workpapers for specific asset and liability accounts is the next step.

Approaches to the detailed review of the predecessor’s workpapers vary considerably in practice. Some auditors use the same checklist on supervision and review that is used in the CPA firm’s own practice and apply it to the predecessor’s workpapers. Some auditors use special audit programs that are designed specifically for reliance on a predecessor. These approaches are certainly acceptable, but they may not be particularly efficient for many engagements.

The following approach is usually efficient and effective in most audit engagements. Scan the suggested additional audit procedures for an initial engagement for each specific account balance before inspecting the predecessor’s workpapers for that balance. For some account balances, most or all of the procedures can be accomplished in the predecessor’s office. For other account balances, the procedures should be performed when applying procedures to the client’s accounting records. When the predecessor’s workpapers will be needed for later application of auditing procedures, request copies of the predecessor’s workpapers.

This approach allows selective reliance on the predecessor and permits the most efficient and effective approach to be used for a particular account balance. It is important to avoid the tendency of making a detailed review of all workpapers simply because they are available. After the review, the auditor should prepare audit programs for the current audit and include those additional procedures for opening balances that are appropriate in the circumstances.

**Successor Auditor Acknowledgment Letter.** Prior to obtaining access to the predecessor’s workpapers, SAS No. 84 requires the successor and predecessor auditor to reach an understanding as to the use of the predecessor’s workpapers. Many predecessor firms require successors to sign an acknowledgment letter prior to granting access to their workpapers. (There is a nonauthoritative example letter in SAS No. 84.) The purpose of the letter is to document the understanding between the successor and predecessor auditor regarding the use of the predecessor’s workpapers.
As a practical matter, the letter is believed to constitute an agreement between firms. It may provide some protection to the predecessor should litigation arise, and the successor may gain access to additional workpapers by signing the letter. While there may be no harm to the successor in signing such letters, this is a legal issue and firms might wish to consult their legal counsel. The following paragraphs discuss some of the issues that the letter raises.

The letter states the understood purpose of the successor’s review of workpapers. It, in essence, says that the purpose is to assist the successor in planning his or her audit. In particular, the letter states that the successor does not intend to use the audit results documented in the predecessor’s workpapers as audit evidence except as contemplated in SAS No. 84.

Audit programs may contain special additional procedures for initial audits, and those programs could refer to reliance on the predecessor. This is not believed to create an inconsistency when the successor has signed an acknowledgment letter such as the one in SAS No. 84. This is because the reliance is to determine how much evidence the successor will need to obtain regarding the beginning balances—not to use specific predecessor workpapers as audit evidence. Auditors should be cautious, however, to avoid statements in their workpapers indicating that specific predecessor workpapers are being used as audit evidence.

If the successor auditor signed an acknowledgment letter similar to the one in SAS No. 84, the successor auditor would be precluded from commenting on whether the predecessor’s audit was performed in accordance with generally accepted auditing standards. This does not, however, relieve the successor of the responsibility under SAS No. 84 if he or she believes the financial statements on which the predecessor reported may require revision. That standard requires the successor to request that the client arrange for the client, the successor, and the predecessor to discuss and attempt to resolve the matter.

As noted in Exhibit 2-4, one of the purposes of reviewing the predecessor’s workpapers is to evaluate the predecessor’s adherence to generally accepted auditing standards. The letter does not preclude that evaluation, it only precludes the successor from commenting orally or in writing about that evaluation.

If, based on his or her review of the predecessor’s workpapers, the successor decides to perform additional procedures on beginning balances because he or she does not believe the predecessor performed a GAAS audit, the successor is precluded from commenting to the client as to the reasons for performing additional procedures if he or she has signed an acknowledgment letter similar to the letter in SAS No. 84. However, if the successor discovers that the predecessor did not perform a GAAS audit through means other than the review of the predecessor’s workpapers (for example, if discovered while the successor performs audit procedures), then the successor is not precluded from commenting to the client as to the reasons for performing additional procedures.

If the successor is provided copies of the predecessor’s workpapers, the letter requires the predecessor’s permission before access to the successor’s workpapers is voluntarily provided to a third party. In some engagements the successor may be required by law, regulation, or audit contract to provide access to regulators.

Consideration of Reporting Options. When a predecessor auditor has audited the prior period’s financial statements, there are several options in the presentation of financial statements in the current period. Exhibit 2-5 presents an outline of these options. As explained later in this section, the choice of options affects procedures the predecessor should apply.

Single-period. One option is to present only the current period’s financial statements. This approach does not change the auditor’s responsibility in applying auditing procedures for opening balances or for consistent application of accounting principles. However, it does avoid a number of problems that potentially may arise when the financial statements audited by a predecessor are presented (e.g., as explained below, reissuance requires the predecessor to apply additional procedures). Also, even when reference is made instead of reissuance, complications arise if there are changes in the manner of presentation of the prior period’s statements (e.g., changes in classification or extent of aggregation). However, single-period financial statements may not meet the client’s needs.
Exhibit 2-5

Reporting Options in Replacing a Predecessor

PRESENT SINGLE-PERIOD FINANCIAL STATEMENTS

PRESENT COMPARATIVE FINANCIAL STATEMENTS

1. Reference. Refer to predecessor’s audit and report in the scope paragraph, but do not present predecessor’s report.

2. Reissuance. Present predecessor’s reissued report on prior period’s financial statements.


* * *

Comparative. If comparative financial statements are presented, two of the alternatives are, technically, equally acceptable.

a. The predecessor may reissue the report on the prior period financial statements.

b. The successor may refer to the predecessor’s report in the scope paragraph of the report on the current period financial statements.

Usually the simplest and least costly of these two alternatives for the client is for the successor to refer to the predecessor’s report.

If the predecessor auditor’s report is reissued, the predecessor must apply several procedures, and the cost to the client is likely to be increased. SAS No. 58 (AU 508.71) indicates that the predecessor should do the following:

a. Read the financial statements for the current period.

b. Compare the prior period financial statements that the predecessor reported on with the financial statements to be presented for comparative purposes.

c. Obtain a representation letter from the successor auditor and the management of the former client.

The purpose of the representation letter from the successor is to determine whether the successor’s audit revealed any matters that might have a material effect on the line items or disclosures in the financial statements reported on by the predecessor. The representation letter from management addresses whether any prior management representations made have changed and whether any subsequent events have occurred which affect the prior period financial statements.

If the successor reports on all periods presented, the guidance for reaudits in PPC’s Guide to Audits of Nonpublic Companies should be followed. Further discussion of reaudits is beyond the scope of this course.

No Reliance on a Predecessor Auditor

In an initial engagement, there are a variety of circumstances when there is no reliance on a predecessor auditor. Generally, these circumstances fall into one of the following categories:

a. A business previously audited by a predecessor auditor.

b. A business with no previous audit but with previous accounting services.

c. An existing business with no previous accounting or auditing services.
d. A new business that began operations in the current period.

e. The successor is reauditing periods already reported on by the predecessor.

**Previous Audit by a Predecessor.** When no reliance is placed on the predecessor, the auditor’s primary sources of audit evidence are the client’s accounting records, documents in the client’s possession, and analytical procedures. In many cases, analytical procedures can be very effective in an initial engagement because of the passage of time. For example, loan losses in the opening balance should be readily identifiable. Usually, in an initial engagement, physical examination or confirmation of items in an opening balance are not practical.

**Predecessor Performed a Directors’ Examination or Supervisory Committee Engagement.** The predecessor accountant may have only performed a directors’ examination (or supervisory committee agreed-upon procedures engagement) instead of a full-scope audit. The FDIC, in its Financial Institution Letter FIL9699, and the Federal Financial Institutions Examination Council (FFIEC), in its *Interagency Policy Statement on External Auditing Programs of Banks and Savings Associations*, encourage all banks and thrifts to have an annual audit of the institution’s financial statements performed by an independent public accountant. However, the FDIC recognizes that some state-chartered institutions have a state-required agreed-upon procedures engagement (i.e., a directors’ examination) as their external auditing program. The policy statement indicates that an institution’s audit committee or board of directors is responsible for deciding what type of external auditing program best meets the needs of the institution based on its size and complexity. Although directors’ exams appear to be becoming less common, this service may still be performed in some instances.

An auditor is not required to communicate with a predecessor accountant who performed a directors’ examination or supervisory committee engagement before accepting an audit engagement. However, it is usually worthwhile to communicate with a predecessor accountant, determine the nature and extent of procedures performed in the prior year engagement, and obtain copies of detailed schedules of account balances or other pertinent workpapers.

The auditor’s responsibility regarding opening balances is not reduced when the predecessor performed a directors’ examination or supervisory committee engagement. Accordingly, the additional procedures for an initial engagement when no reliance on the work of a predecessor is planned or possible are generally appropriate. However, the evidence obtained from reviewing the predecessor’s workpapers, along with analytical procedures and tests of ending balances, may be sufficient to achieve certain audit objectives relating to beginning balances (such as objectives relating to confirmation of loans receivable or deposit accounts). Also, considerable time may be saved because of the availability of detailed schedules.

**No Previous Accounting or Auditing Services.** Generally, the most time-consuming and difficult initial audit engagement is for an existing institution with no previous accounting or auditing services. The additional audit procedures that must be applied to opening balances are the same procedures referred to earlier for circumstances when no reliance on the work of a predecessor is planned or possible. However, there is an increased likelihood that the condition of the accounting records will not permit the application of necessary procedures.

In an initial engagement, the auditor’s primary concern with significant current asset balance sheet accounts is the effect on current operating results. Unless the auditor can determine the reasonableness of the opening balances in these accounts, it will usually be necessary to disclaim an opinion on results of operations, cash flows, and consistency. Even though the auditor does not express an opinion on consistency, the inability to evaluate whether there has been an accounting change that would require a fourth explanatory paragraph is a scope limitation.

Naturally, the auditor should assess the possibility of this type of scope limitation at the start of the engagement and discuss the type of report that will be necessary with management and those charged with governance. SAS No. 108 (AU 311.06) states:

> . . . before accepting the engagement, the auditor should ascertain whether circumstances are likely to permit an adequate audit and expression of an unqualified opinion and, if they will not, the auditor should discuss with the client the possible necessity for a qualified opinion or disclaimer of opinion.

As a practical matter, the auditor should discuss the possibility of other than an unqualified opinion with the client whenever that circumstance arises.
Even when a scope limitation will preclude expression of an unqualified opinion, the auditor should not ignore opening balances of current asset accounts as it may be possible to identify and correct a material distortion of operating results.

**Newly Chartered Institutions.** The initial audit of a newly chartered institution does not usually have the difficulties associated with other initial engagements. Generally, the additional audit procedures for an initial engagement do not apply because those procedures are directed to opening balances, which are zero for a new entity since there is no prior period balance sheet.

Nevertheless, some modifications of the procedures for a continuing engagement may be necessary. More attention is focused on equity accounts and the transactions involved in the creation and capitalization of the institution. Also, long-term assets, such as property and equipment, require more attention in this type of engagement because more detailed work is necessary to establish ownership and acquisition cost.

There may also be unique accounting problems associated with the founding of a new institution (e.g., accounting principles for development stage companies may apply). Also, the absence of historical experience may make it more difficult to audit accounting estimates such as the allowance for loan losses. SAS No. 57 (AU 342.10) indicates that ordinarily, in evaluating the reasonableness of an accounting estimate, the auditor should obtain an understanding of how management developed the estimate and use one or a combination of the following approaches:

a. Review and test the process used by management to develop the estimate.

b. Develop an independent expectation of the estimate to corroborate the reasonableness of management’s estimate.

c. Review subsequent events or transactions occurring prior to completion of fieldwork.

In an initial audit engagement of a new institution, the auditor may have little basis for developing an independent expectation. Thus, the auditor will need to place greater emphasis on the other approaches, particularly the review of subsequent events and transactions.
SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

34. Which of the following is one of the FDICIA independence and qualification requirements for auditors?
   
   a. The auditor must be licensed with the FDIC.
   
   b. The auditor must meet the AICPA and PCAOB independence requirements.
   
   c. The auditor must undergo peer review consistent with AICPA standards.

35. Michael is auditing a bank with assets of over $500 million. During the course of the engagement, the bank terminates the engagement with Michael. What are Michael’s responsibilities after the termination?
   
   a. Michael must file a written report with the regional director of the bank’s FDIC region, the appropriate federal banking agency, and any appropriate state supervisor within 15 days of receiving notice from the bank.
   
   b. Michael must file a notice with the bank within 15 days of the change; the notice should be signed and dated by the partners of Michael’s firm and include reasons for the change.
   
   c. Michael must file a written report that discloses the true reason that he was terminated by the bank in this situation, and the report must be filed with all applicable regulators, as well as the bank itself.
   
   d. All responsibilities under the FDICIA in this scenario rest with the bank, not with Michael.

36. George plans to hire a specialist to assist in his audit of a financial institution. Based on the guidance in SAS No. 73 (AU 336), what must George consider when assessing the specialist’s qualifications?
   
   a. The specialist’s experience with financial institutions.
   
   b. The scope and objectives of the specialist’s work.
   
   c. The information in the specialist’s report.
   
   d. The specialist’s relationship to his client.

37. Jessica is performing an initial audit of a financial institution. One of her first steps is to assess the reasonableness of opening balances. How should Jessica proceed?
   
   a. Jessica can place reliance on the report submitted by the predecessor auditor, but that decision should be made by audit area.
   
   b. Opening balances do not become easier to determine as experience is gained with a client, so Jessica’s procedures will be the same as for a continuing client.
   
   c. If the account balance turns over at least once an accounting period, Jessica must perform extensive audit procedures.
   
   d. Because this is an initial audit, overauditing is not a concern; Jessica must perform all possible procedures.
38. Which of the following statements best describes an aspect of an initial audit engagement?

a. If the auditor will rely on the work of the predecessor auditor, the comparative financial statements must be issued in the current period.

b. If the predecessor performed a directors’ examination, the successor is not required to communicate with the predecessor.

c. The initial audit of a newly chartered institution will require more audit procedures than any other type of initial engagement.

d. Analytical procedures are not effective in an initial audit when no reliance is placed on the predecessor auditor.
SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. (References are in parentheses.)

34. Which of the following is one of the FDICIA independence and qualification requirements for auditors? (Page 236)

a. The auditor must be licensed with the FDIC. [This answer is incorrect. Instead of being licensed with the FDIC, the auditor must be licensed or registered to practice as a public accountant under the laws of the applicable state and be in good standing under those laws.]

b. The auditor must meet the AICPA and PCAOB independence requirements. [This answer is incorrect. The auditor has to meet independence requirements of the SEC, AICPA, and the PCAOB. The SEC rules were revised to implement the provisions of Title II of the Sarbanes-Oxley Act.]

c. The auditor must undergo peer review consistent with AICPA standards. [This answer is correct. There are several guidelines that must be met for this qualification. One example is that the peer review must include at least one audit of a consolidated holding company or an insured institution, if available.]

35. Michael is auditing a bank with assets of over $500 million. During the course of the engagement, the bank terminates the engagement with Michael. What are Michael’s responsibilities after the termination? (Page 237)

a. Michael must file a written report with the regional director of the bank’s FDIC region, the appropriate federal banking agency, and any appropriate state supervisor within 15 days of receiving notice from the bank. [This answer is correct. This report must state the reason for Michael’s termination, if Michael agrees with the assertions in the bank’s notice, and if the bank’s notice covers all disagreements.]

b. Michael must file a notice with the bank within 15 days of the change; the notice should be signed and dated by the partners of Michael’s firm and include reasons for the change. [This answer is incorrect. The bank must file notice within 15 days of the change. The bank’s notice should be signed and dated by the chair of the bank’s audit committee, be filed with the appropriate regulatory agencies, be sent to Michael, and include reasons for the change and discussion of any disagreements.]

c. Michael must file a written report that discloses the true reason that he was terminated by the bank in this situation, and the report must be filed with all applicable regulators, as well as the bank itself. [This answer is incorrect. The bank may be reluctant to reveal the real reason it terminated Michael. If that is the case, Michael’s letter should state that he is not in a position to disagree or agree with the bank’s stated reason for changing its principal auditor.]

d. All responsibilities under the FDICIA in this scenario rest with the bank, not with Michael. [This answer is incorrect. As the principal auditor, Michael also has notification responsibilities under FDICIA. These would be the same responsibilities Michael would have if he resigned from the engagement.]

36. George plans to hire a specialist to assist in his audit of a financial institution. Based on the guidance in SAS No. 73 (AU 336), what must George consider when assessing the specialist’s qualifications? (Page 239)

a. The specialist’s experience with financial institutions. [This answer is correct. Two other things that George must consider include the specialist’s certification (or license or other recognition of competence in the field) and the specialist’s reputation and standing.]

b. The scope and objectives of the specialist’s work. [This answer is incorrect. This is something George must consider when obtaining an understanding of the specialist’s work on the engagement. At this time, George will also have to consider the assumption or methods used by the specialist.]
c. The information in the specialist’s report. [This answer is incorrect. If the specialist is an appraiser or actuary, reading the report will allow George to understand the nature of the specialist’s work in order to proceed with the audit. The specialist will not provide a report until after being hired and then completing work on the audit engagement.]

d. The specialist’s relationship to his client. [This answer is incorrect. George must consider the specialist’s relationship with his financial institution client when he forms an understanding of the work done by the specialist. It would be best if the specialist were not related to the client, but if that is the case then George may need to perform additional procedures to test the reasonableness of the specialist’s assumptions, methods, or findings.]

37. Jessica is performing an initial audit of a financial institution. One of her first steps is to assess the reasonableness of opening balances. How should Jessica proceed? (Page 241)

a. Jessica can place reliance on the report submitted by the predecessor auditor, but that decision should be made by audit area. [This answer is correct. Jessica could rely on the predecessor extensively in the deposit accounts area, but not rely on the predecessor at all when auditing the allowance for loan losses.]

b. Opening balances do not become easier to determine as experience is gained with a client, so Jessica’s procedures will be the same as for a continuing client. [This answer is incorrect. Certain account balances will prove more easily determinable with time; therefore, Jessica will have to perform more audit procedures for an initial audit.]

c. If the account balance turns over at least once an accounting period, Jessica must perform extensive audit procedures. [This answer is incorrect. For opening balances that turn over this frequently, Jessica will have fewer audit procedures to perform. Her primary concern will be what effect misstatement of the opening balance could have on the operating results of the current period.]

d. Because this is an initial audit, overauditing is not a concern; Jessica must perform all possible procedures. [This answer is incorrect. Overauditing is a significant source of inefficiency on an initial engagement. Jessica should consider how much work is necessary before relying on the predecessor auditor.]

38. Which of the following statements best describes an aspect of an initial audit engagement? (Page 247)

a. If the auditor will rely on the work of the predecessor auditor, the comparative financial statements must be issued in the current period. [This answer is incorrect. The auditor can present either single-period financial statements or comparative financial statements, depending on what will meet the needs of the client. If comparative statements are used, there are two alternatives: the successor can rely on the predecessor’s report or the predecessor can reissue the report.]

b. If the predecessor performed a directors’ examination, the successor is not required to communicate with the predecessor. [This answer is correct. However, the auditor’s responsibility for the opening balances is not reduced in these circumstances; therefore, additional procedures will generally be appropriate.]

c. The initial audit of a newly chartered institution will require more audit procedures than any other type of initial engagement. [This answer is incorrect. Usually, this type of initial engagement does not have the difficulties associated with other types of initial engagements; though it will require some modifications to the audit procedures used during a continuing engagement.]

d. Analytical procedures are not effective in an initial audit when no reliance is placed on the predecessor auditor. [This answer is incorrect. Because of the passage of time, analytical procedures can be very effective under these circumstances.]
USING AN INTERNAL AUDITOR

Some larger institutions may have formal internal audit functions that perform a variety of duties, including documentation and testing of internal controls, teller cash counts, internal loan reviews, and other procedures. Other institutions may assign various internal audit duties to operations or financial personnel, but they do not have a formal internal audit function. This section applies to audits of institutions that have formal internal audit functions.

Internal audit is an aspect of an institution’s internal control, and the auditor should obtain an understanding of it as part of the overall understanding of internal control. In addition, if the entity has internal auditors, SAS No. 99, Consideration of Fraud in a Financial Statement Audit (AU 316.23), notes that the auditor should inquire of them about the risks of fraud. After obtaining that understanding, the auditor may be able to use internal auditors to reduce the work on the financial statement audit if their use is efficient. Internal auditors may be used in the following ways:

a. Direct Use. The auditor may use internal auditors to perform certain procedures (such as performing tests of controls or substantive tests) under the external auditor’s direction and supervision.

b. Indirect Use. The auditor may be able to use the regular work performed by the internal auditors during the year to:

   (1) assist in obtaining an understanding of internal control (such as by obtaining documentation relating to the entity’s internal control and responding to the auditor’s inquiries), and

   (2) modify the nature, timing, or extent of further audit procedures (i.e., tests of controls or substantive procedures).

An auditor may use internal auditors or their work in one or a combination of ways on a given audit engagement. The following paragraphs discuss general considerations for using internal auditors as well as considerations for both direct and indirect use.

Assessing the Competence and Objectivity of Internal Auditors

Before using internal auditors to reduce the work required on the financial statement audit, the auditor should first assess the objectivity and competence of the internal auditors. That assessment helps determine the degree to which the external auditors can make use of the internal auditors. The auditor bases the assessment on information obtained from prior experience with the internal auditors, discussions with management, and other sources.

According to SAS No. 65 (AU 322), The Auditor’s Consideration of the Internal Audit Function in an Audit of Financial Statements, assessing the competence of the internal auditors should include consideration of such factors as the following:

a. The internal auditors’:

   (1) Education and experience.

   (2) Professional certifications.

   (3) Continuing professional education.

   (4) Performance evaluations.

b. Internal audit policies, programs, and procedures.

c. Practices for assigning internal auditors to specific tasks or projects.

d. Supervision and review of internal auditors’ activities.

e. Quality of the internal auditors’ workpaper documentation, reports, and recommendations.
According to SAS No. 65, assessing the objectivity of internal auditors should include consideration of such factors as the following:

a. Organizational status of the internal auditor who is responsible for the internal audit function, such as whether:
   
   (1) the internal auditor reports to an officer with sufficient authority to ensure (a) broad internal audit coverage and (b) adequate consideration of, and action on, the internal auditor’s findings and recommendations;

   (2) the internal auditor has direct access and reports regularly to the board of directors or audit committee; and

   (3) the board of directors or audit committee oversees employment decisions relating to the internal auditor.

b. Policies that maintain the internal auditors’ objectivity with respect to specific areas. Examples of such policies include those that prohibit internal auditors from auditing areas where:
   
   (1) they were recently assigned or are about to be assigned after transferring from internal audit, and

   (2) they have relatives in important or audit-sensitive positions.

In certain instances, internal auditors may be involved in original accounting functions, such as reconciliation of due from accounts or official checks. Internal auditors most likely would not be considered objective in those areas, and reduction of the independent auditor’s work based on the internal auditors’ work in those areas would not be appropriate.

Using Internal Auditors Directly

SAS No. 65 (AU 322) indicates that internal auditors may be used to provide direct assistance to the auditor by performing some aspect of the auditors’ work. Examples of direct assistance include the following:

a. Obtaining an Understanding of Internal Control. Internal auditors can assist with procedures related to the control environment, risk assessment, information and communication, financial reporting system, and monitoring.

b. Performing Tests of Controls. Internal auditors can perform certain tests of controls, such as reperformance or document inspection tests, which can make tests of controls more cost-effective to use.

c. Performing Substantive Tests. Internal auditors can perform routine substantive tests, especially in nonsensitive areas, such as the following:

   (1) Procedures relating to confirmations with customers, including investigation of responses with exceptions or application of alternate procedures for nonreplies.

   (2) Tests of account reconciliations.

   (3) Tests of details of specific transactions, such as asset purchases and sales.

SAS No. 65 (AU 322) provides the following guidance regarding the direct use of internal auditors:

a. Competence and Objectivity of the Internal Auditors. The independent auditor should assess the internal auditors’ competence and objectivity.

b. Nature of the Audit Area. The extent to which internal auditors’ work can be used to reduce the independent auditor’s work is a matter of judgment based on the following:

   (1) The materiality of the audit area.
(2) The assessed risk of material misstatement for the assertions being tested.

(3) The amount of judgment involved in evaluating the results of the tests being performed.

As those factors increase, the extent to which internal auditors can be used decreases. Accordingly, it is generally more efficient to use internal auditors for routine, nonsubjective procedures and low-risk assertions in significant audit areas because that allows the independent auditor to achieve greater reductions in his or her own work.

c. Responsibilities of the Independent Auditor. The independent auditor should supervise, review, evaluate, and test the internal auditors’ work to the extent considered necessary. The extent of the supervision, review, and testing required should generally be based on the two preceding factors—competence and objectivity of the internal auditors and the nature of the audit area. However, regardless of the circumstances, the independent auditor should:

(1) inform the internal auditors about matters relevant to their procedures (such as their responsibilities, objectives of their tests, and possible accounting or auditing issues), and

(2) explain that all significant accounting and auditing issues that are identified by the internal auditors should be brought to the independent auditor’s attention.

Also, the independent auditor generally should test some of the internal auditors’ work by reperforming some of their procedures.

Using Internal Auditors Indirectly

SAS No. 65 (AU 322) indicates that independent auditors can use internal auditors indirectly by using the internal auditors’ regular work during the year to reduce the work needed for the financial statement audit. The following are examples of how that work can be used:

a. Understanding of Internal Control. Internal auditors often prepare their own documentation of the entity’s internal control, and the independent auditor may be able to use that documentation in obtaining an understanding of internal control.

b. Modifying the Nature, Extent, and Timing of Further Audit Procedures. The internal auditor’s work may provide sufficient evidence that will allow the independent auditor to modify the nature, extent, and/or timing of tests of controls (when assessing control risk at either a moderate or low level) or substantive procedures. For example:

(1) If the internal audit work is equivalent to tests of controls, that may allow the auditor to modify the nature, extent, or timing of control testing the auditor might otherwise have done.

(2) The role and organization of internal auditors within the entity along with the nature of their testing may contribute to a strong control environment and, correspondingly, a lower assessment of risks at the financial statement level. As a result, the auditor may have a higher level of confidence that would allow the performance of audit procedures at an interim date, modification of the nature of audit procedures where, in some cases, less persuasive audit evidence might be needed, or reduction in the extent of evidence that is needed.

(3) If the internal audit work is equivalent to substantive tests (such as confirmation of accounts with depositors), the auditor may be able to consider that as evidence provided from other substantive procedures. In sampling applications, the internal auditors’ work might be used to reduce the other procedures risk, which in turn would reduce the required sample size. In nonsampling applications, the internal auditors’ work might be used to reduce the desired percentage of coverage from scope testing.
The extent of modification to the nature, extent, and timing of further audit procedures is a matter of judgment based on such factors as the following:

- The nature, timing, and extent of the internal auditors’ work.
- The results of the internal auditors’ work (such as the number and types of deviations or misstatements noted).
- The competence and objectivity of the internal auditors.
- The quality and extent of documentation of the internal auditors’ work.
- The nature of the assertions involved.

The effectiveness of the internal audit function should be taken into account when the auditor makes his or her risk assessments and compiles related documentation. In some cases, depending on the nature of the risks, an effective internal audit function may be a mitigating factor that allows the auditor to reduce his or her risk assessments in certain areas.

When using the work of the internal auditor indirectly, the auditor has a responsibility to test the work of the internal auditor. The extent of the tests depends on the auditor’s judgment about the importance of the audit objectives. Tests may include reperformance of procedures performed by the internal auditor. In addition, the auditor may examine similar items and observe the internal auditor’s procedures. For example, the auditor may perform certain inquiry and observation tests of internal audit work when the internal auditors are providing indirect assistance to the auditor.

Other factors to consider when testing the regular work performed by the internal auditor throughout the period include whether:

- The scope of the work is appropriate to meet the external auditor’s objectives.
- The audit programs are adequate.
- The internal auditor’s workpapers adequately document the work performed (including appropriate supervision and review).
- Conclusions reached are appropriate in the circumstances.
- Reports are consistent with the results of the work performed.

While considering the scope of work and audit programs of internal auditors, the auditor should determine whether the internal auditor has had unrestricted access to corporate as well as local records and personnel. For example, does the internal auditor have unrestricted access to the computerized general ledger? Are there areas, such as officers’ travel and entertainment expenses that are off-limits to the internal auditors? Limitations on the scope of the internal auditors’ work have implications for the objectivity of internal auditors as well as the effectiveness of their work.

**Coordination with Internal Audit.** The auditor should determine the internal auditor’s audit plan for the period under audit if the auditor intends to indirectly use the work of the internal auditor. If the work of the internal auditor is a significant factor in determining the nature, timing, and extent of the auditor’s procedures, it is desirable for the internal auditor and external auditor to agree in advance on the extent of audit coverage (such as sample sizes and locations visited) and the extent of the external auditor’s supervision and review.

When the audit plan anticipates that the work of the internal auditor is a significant factor influencing the nature, timing, and extent of audit procedures, the auditor should consider including the involvement of internal auditors as a matter in the engagement letter and in the communication to those charged with governance.
Documentation

When using the work of internal auditors, either directly or indirectly, the auditor should document the following in the workpapers:

- The auditor’s assessment of the competency and objectivity of the internal audit function and the basis for that assessment.
- The areas in which the auditor is using the work of the internal auditors and whether the auditor is using the internal auditor directly or indirectly.
- The procedures performed to test the work of the internal auditors.
- Any significant findings or issues discussed with internal auditors.

The auditor’s documentation of these items may be in the form of a memo. The inquiries of internal auditors about fraud required by SAS No. 99 should also be documented.

Caution about Overusing the Work of Internal Auditors

Independent auditors should be careful not to overuse the work of internal auditors. The independent auditor is ultimately responsible for the results of the financial statement audit, and, therefore, he or she should make the risk assessments and judgments about such matters as materiality, sufficiency of audit evidence, and evaluation of results of audit procedures. In addition, the independent auditor normally should perform his or her own tests for audit areas or assertions in which either the risk of material misstatement or the degree of subjectivity involved is high. Examples of such areas include the following:

- Assessing the adequacy of the allowance for loan losses.
- Assessing the need for accrual or disclosure of loss contingencies.
- Assessing the need for disclosure of related-party transactions or subsequent events.

In the preceding examples, internal auditors may assist in gathering information in those areas, but the independent auditor should make the decisions and judgments. The auditor normally considers the effectiveness of the internal audit function when making risk assessments. Furthermore, for those areas or assertions in which use of internal auditors is appropriate, the independent auditor should generally reperform some of the internal auditors’ work rather than merely relying on a review of their workpapers.

USING A SERVICE ORGANIZATION

Use of Service Organizations

SAS No. 70, Service Organizations (AU 324), is applicable whenever a service organization provides services that are part of the client’s information system by affecting—

a. how the client’s transactions are initiated,

b. the accounting records, supporting information, and specific financial statement accounts involved in processing and reporting the client’s transactions,

c. the accounting processing involved from initiation of the client’s transactions to their inclusion in the financial statements, or

d. the financial reporting process used to prepare the client’s financial statements.

Some service organizations are subsidiaries or affiliates of financial institutions. The discussion in this section relates to service organizations that are unrelated to the institution being audited.
The Auditing Standards Board recently issued two new standards that will replace SAS No. 70, Service Organizations. SAS No. 70 currently contains guidance for user auditors and for service auditors. One of the new standards is a SAS, Audit Considerations Relating to an Entity Using a Service Organization (AU 324), which provides revised guidance for an auditor of the financial statements of an entity that uses a service organization. The SAS is expected to be effective for audits of financial statements for periods ending on or after December 15, 2012. The second standard is Statement on Standards for Attestation Engagements (SSAE) No. 16, Reporting on Controls at a Service Organization (AT 801), which will be used by a service auditor reporting on controls at a service organization. SSAE No. 16 is effective for service auditors’ reports for periods ending on or after June 15, 2011. Earlier implementation is permitted. A future update of this course will incorporate the new standards.

SAS No. 70 (AU 324) does not apply to a service organization’s services that are not a part of the client’s information system, and it may apply to some, but not all, of the services provided by a service organization.

When obtaining an understanding of internal control, which includes the evaluation of design and implementation, the auditor should determine the significance of service organization processing to the client’s internal control over financial reporting. When significant, the auditor should gather information and form an understanding about service organization controls. Typically, in making a determination of whether the service organization processing is significant to the client, the auditor considers the interaction of the client’s controls (user controls) with the service organization and the nature and materiality of transactions affected by the service organization.

Practice Alert 992 (PA Section 16.140), How the Use of a Service Organization Affects Internal Control Considerations, highlights and clarifies factors an auditor should consider when auditing the financial statements of an entity that uses a service organization. Practice Alerts provide information and nonauthoritative guidance on issues that may present audit concerns for practitioners.

SAS No. 70 (AU 324) should be viewed together with, rather than separate from, SAS No. 109 (AU 314). The basic requirements for consideration of controls are prescribed by SAS No. 109; SAS No. 70 only supplements that guidance to address situations when the client’s transactions are subject to a service organization’s controls. For example, SAS No. 70 does not change the basic requirement of SAS No. 109, as amended, to obtain an understanding of controls sufficient to assess the risk of material misstatement of the financial statements and enable the auditor to—

a. design tests of controls, when applicable, and

b. design substantive procedures.

SAS No. 70 (AU 324) provides guidance on assessing the significance of a service organization’s controls to the controls over the cycle of initiating, recording, processing, and reporting transactions. Generally, if the client has effective controls, the service organization’s controls over its services are not a significant part of the controls over the cycle. The client is more likely to have effective controls in place when it interacts with the service organization. To illustrate—

a. In some situations, the client’s interaction is low, and therefore the service organization’s controls are the only controls to which the transactions are subject.

b. In other situations, the client has a high degree of interaction and has effective controls over the cycle so that the service organization’s controls are redundant. For example, a client that uses a service organization to process its payroll transactions, including the required tax filings, may implement effective controls over those transactions through reconciliations and by testing the service organization’s calculations.

Depending on the facts and circumstances, the auditor may not need to obtain an understanding of the service organization’s controls in order to assess the risk of material misstatement and plan and perform the audit. That may be, for example, because the client has effective user controls and the services provided by the service organization are generally limited to processing and recording the transactions, as contrasted to transaction initiation and authorization. In other situations, the nature of the services being provided by the service organization do not affect the client’s information system. However, the auditor should carefully consider the nature of the services to determine if there could be a potential impact on the financial statements.
When the auditor needs to obtain an understanding of the service organization’s controls by performing risk assessment procedures, information about the controls may come from a variety of sources, such as—

a. User manuals.
b. System overviews.
c. Technical manuals.
d. The contract between the client and the service organization.
e. Reports by service auditors, internal auditors, or regulatory authorities on the information system and other controls placed in operation by the service organization.
f. Inquiring of or observing personnel at the client or at the service organization.

In addition, if the services and the service organization’s controls over those services are highly standardized, information obtained through the auditor’s prior experience with the service organization may be helpful when obtaining the understanding.

If the auditor assesses control risk at a low or moderate level for one or more financial statement assertions, the auditor should identify one or more controls over those assertions and gather audit evidence about their operating effectiveness. Those may be client controls or service organization controls. For example, if a service organization initiates trades for the client under a discretionary arrangement, all of the information available to the auditor is based on the service organization’s information. The auditor may be unable to sufficiently limit audit risk without obtaining audit evidence about the operating effectiveness of one or more of the service organization’s controls. An example of such controls is establishing independent departments to provide the investment advisory services and the holding and servicing of securities, then reconciling the information about the securities that is provided by each department.

Audit evidence about the operating effectiveness of service organization controls may be gathered through tests performed by the user auditor or by an auditor engaged by either the user auditor or the service organization—

a. as part of an engagement for a service auditor to report on the controls placed in operation by the service organization and the operating effectiveness of those controls, as described in SAS No. 70,
b. as part of an agreed-upon procedures engagement, or
c. to work under the direction of the user auditor.

**Types of Service Auditor’s Reports.** A service auditor is an auditor who reports on the processing of transactions by a service organization. There are three primary types of service auditor’s reports—

a. *Reports on Controls Placed in Operation.* A report on controls placed in operation expresses an opinion on a description of the controls at a service organization as of a specified date. The opinion indicates whether the controls described (1) are presented fairly in all material respects and (2) were suitably designed to provide reasonable assurance that the control objectives specified in the description would be achieved if complied with satisfactorily. This type of report, also known as a "Type 1 SAS No. 70 report," may be helpful in providing a sufficient understanding of the service organization controls. However, this type of report has the following limitations:

(1) This type of report is not intended to provide any evidence of the operating effectiveness of controls that would support assessing control risk as either low or moderate.

(2) The report gives assurance only with respect to the control objectives specified in the description. There is no assurance that the specified objectives include all those that would be relevant to the user.
(3) The report may contain a caveat that the stated control objectives may be achieved only if the user applies controls contemplated in the design by the service organization. (The auditor should be alert to this type of caveat and determine whether the user organization has implemented the necessary procedures as required by SAS No. 109. For example, completeness of processing payroll transactions may depend on the user organization’s validating that all payroll records sent were processed by checking a control total.)

b. **Reports on Controls Placed in Operation and Tests of Operating Effectiveness.** A report on controls placed in operation and tests of operating effectiveness adds tests of controls to the report on design. The service auditor applies tests of controls to determine whether the specified policies and procedures in the description are operating with sufficient effectiveness to achieve the specified control objectives. This type of report, also known as a “Type 2 SAS No. 70 report,” may be helpful in determining whether controls have been implemented and assessing control risk at either a low or moderate level when relevant controls are applied only at the service organization. This type of report is subject to the same limitations as the report on design with respect to specified control objectives [items a.(2) and a.(3)].

c. **Reports on Agreed-upon Procedures.** A report on agreed-upon procedures may cover tests of controls, substantive tests, or both. If the service auditor is engaged to perform procedures at the request of the auditor of the user organization, the appropriate form of report is an agreed-upon procedures report. Agreement must be reached among the user organization and its auditor and the service organization and service auditor on the specific procedures to be performed. This type of report may be more effective for the user auditor than the more general reports on internal control because it can be directed to those policies and procedures or financial statement assertions of direct interest to the user auditor in the circumstances.

**Using a Service Auditor’s Report.** A service auditor’s report may be used to—

a. **Gather Information When Obtaining an Understanding of Internal Control at the Service Organization.** A report on design may be sufficient for this purpose. (In this situation, the report should be obtained during the planning stage of the audit.) As a practical matter, whenever the client uses a service organization to provide services that are part of the client’s information system, the auditor should inquire whether the client has received a service auditor’s report. If it has, the auditor should read the report for information that may be useful in planning the audit.

b. **Assess Control Risk as Either Low or Moderate for Transactions Processed at the Service Organization to Modify Substantive Procedures.** A report on operating effectiveness or an agreed-upon procedures report on tests of controls would be necessary for this purpose. The auditor is responsible for evaluating the evidence provided by the service auditor’s report and for determining its effect on the control risk assessment.

c. **Obtain Evidence of Balances or Transactions Processed by the Service Organization to Be Used as Part of the Evidence Necessary to Support the Opinion on Financial Statements.** A report on agreed-upon procedures that are substantive tests would be necessary for this purpose.

If the auditor uses a service auditor’s report for these purposes, the auditor should make inquiries concerning the service auditor’s reputation, competence, and independence. In making those inquiries, the auditor should consider the guidance in SAS No. 1 (AU 543), *Part of Audit Performed by Other Independent Auditors*. In addition, for the auditor to use a service auditor’s report, the report must be issued by a licensed CPA. Therefore, the auditor should consider the need to verify that the issuing entity is properly licensed and peer reviewed. The auditor also should read the report to determine whether it provides information the auditor needs, for example, by addressing service organization controls relevant to the assertion the auditor is testing. If the service auditor’s report is not sufficient to meet the auditor’s objectives, the auditor should gather the desired information from other sources.

The auditor should not make reference to the report of the service auditor as a basis, in part, for the opinion on financial statements. The service auditor is not responsible for examining any portion of the financial statements of the client. Even when a service auditor performs substantive tests, the decisions on the nature, timing, and extent of those procedures are not made by the service auditor.
A service auditor’s report on controls placed in operation expresses an opinion on a description of the controls at a service organization as of a specified date. A report that is as of a date outside the current reporting period may be useful in obtaining an understanding of the controls placed in operation at a service organization if it is supplemented with current information from other sources. If the service auditor’s report is as of a date prior to the beginning of the period being audited or at an interim date during the period, the user auditor should normally update the information in the description of controls to determine whether there have been any changes relevant to the audit. Procedures to update information in the description of controls may include:

a. Discussions with client personnel in a position to know about changes at the service organization.

b. Reviewing current documentation and correspondence from the service organization.

c. Discussions with service organization personnel or with the service auditor.

If significant changes have occurred, the auditor should gain an understanding of the changes and consider their effect on the audit.
SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

39. Consideration of which of these factors will help an auditor assess the objectivity of an internal auditor?
   - a. Review and supervision of an internal auditor’s activities.
   - b. The internal auditor’s education and performance evaluations.
   - c. Internal audit policies, procedures, and programs.
   - d. The organizational status of the internal auditor responsible for each audit function.

40. How does SAS No. 70 (AU 324) affect an audit of an entity that uses a service organization?
   - a. It applies to all services provided by a service organization, including those that aren’t a part of the client’s information system.
   - b. If a service organization is used, the auditor must always gather enough information to form an understanding of the organization’s controls.
   - c. SAS No. 70 (AU 324) supplements the requirements of SAS No. 109 (AU 314) when a service organization is involved in the consideration of controls.

41. What type of service auditor’s report is used to gather information while obtaining an understanding of the service organization’s internal control?
   - a. Reports on controls placed in operation.
   - b. Reports on agreed upon procedures.
SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. (References are in parentheses.)

39. Consideration of which of these factors will help an auditor assess the objectivity of an internal auditor? (Page 254)

   a. Review and supervision of an internal auditor’s activities. [This answer is incorrect. This will allow the auditor to assess an internal auditor’s competence. The quality of the internal auditor’s reports, recommendations, and workpaper documentation can also be considered.]

   b. The internal auditor’s education and performance evaluations. [This answer is incorrect. The auditor would use this to assess the internal auditor’s competence. Other things than can be assessed include experience, professional certifications, and continuing professional education.]

   c. Internal audit policies, procedures, and programs. [This answer is incorrect. The internal auditor’s competence can be evaluated using these considerations. Additionally, the auditor can assess practices for assigning the internal auditors to projects or specific tasks.]

   d. The organizational status of the internal auditor responsible for each audit function. [This answer is correct. Based on the guidance in SAS No. 65 (AU 322), these considerations will help the auditor assess the internal auditors’ objectivity. Another related consideration is of policies that maintain the internal auditors’ objectivity related to specific areas.]

40. How does SAS No. 70 (AU 324) affect an audit of an entity that uses a service organization? (Page 258)

   a. It applies to all services provided by a service organization, including those that aren’t a part of the client’s information system. [This answer is incorrect. The SAS does not apply when a service organization’s services are not part of the client’s information system. It is possible for SAS No. 70 (AU 324) to apply to some, but not all, of the services that the service organization provides.]

   b. If a service organization is used, the auditor must always gather enough information to form an understanding of the organization’s controls. [This answer is incorrect. The auditor only needs to gather this information if the service organization has a significant affect on the client’s internal control over financial reporting.]

   c. SAS No. 70 (AU 324) supplements the requirements of SAS No. 109 (AU 314) when a service organization is involved in the consideration of controls. [This answer is correct. SAS No. 70 (AU 324) does not change SAS No. 109’s basic requirement to obtain an understanding of controls that is sufficient to assess the risk of material misstatement of the financial statements. SAS No. 70 (AU 324) provides guidance on assessing how significant the service organization’s controls are to the entity’s controls over the cycle of initiating, recording, processing, and reporting transactions.]

41. What type of service auditor’s report is used to gather information while obtaining an understanding of the service organization’s internal control? (Page 260)

   a. Reports on controls placed in operation. [This answer is correct. This type of service auditor’s report would be sufficient for this information gathering purpose. The report should be obtained during the audit planning stage.]

   b. Reports on agreed upon procedures. [This answer is incorrect. This type of report would allow the auditor to obtain evidence related to the balances or transactions processed by the service organization that could be used as part of the evidence necessary to support the auditor’s opinion on the financial statements.]
EXAMINATION FOR CPE CREDIT

Lesson 2 (AFITG102)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

20. Client acceptance and continuance procedures should provide a firm with reasonable assurance of which of the following?

   a. The engagement is expected to be completed with professional competence.

   b. No risks will be associated with providing the professional services.

   c. The client is fiscally able to pay its bill on time.

   d. That there have been absolutely no changes to a continuing client’s operations.

21. The CPA firm of Morris, Michaels, & Mayer decides to accept a new engagement despite issues that arose when the firm applied its client acceptance procedures. According to SQCS No. 7, what must the firm do?

   a. Withdraw from the engagement immediately.

   b. Document how the issues were resolved.

   c. Discuss issues with the predecessor auditor.

   d. Assign a second partner to the engagement.

22. List all of the following items that should be considered before accepting a new client.

   i. Any professional reasons for not providing services to the client.

   ii. The services that the firm will provide to the client.

   iii. If the firm meets the necessary ethical requirements (including independence requirements).

   iv. If professional standards and other requirements can be met when providing the services.

   v. If the client acceptance and continuance procedures provided information relevant to identifying risks of material misstatement due to fraud or error.

   a. i. and ii.

   b. iii., iv., and v.

   c. i., ii., iii., and iv.

   d. i., ii., iii., iv., and v.
23. Charlie is considering whether to accept an engagement to audit Gale National Bank. As part of his client acceptance procedures, he must investigate the bank’s reputation. Because his prospective client is a financial institution, there are several sources of information Charlie can consult in addition to those available for all businesses. Which of the following is an example of this type of information source?

a. Communications from regulators.
b. Inquiry of former accountants or auditors.
c. Review of the most recent financial statements.
d. Inquiry of commercial credit agencies.

24. The CPA Depot is evaluating whether to accept new engagements with several clients. Which of the following potential engagements should the firm consider declining?

a. North Bank’s audit committee has no outstanding issues for the auditor to address.
b. South Bank received a CAMELS rating of 2 in its regulatory examination report for the previous year.
c. East Bank’s predecessor auditor believes that the financial institution’s management lacks integrity.
d. Management of West Bank and the auditors agree on the application of accounting principles.

25. Which of the following statements most accurately describes an auditor’s communication with a potential client’s predecessor auditor?

a. The communication must take place in writing and included in the workpapers.
b. If the client refuses to allow contact with the predecessor, the auditor must automatically decline the engagement.
c. The auditor must still attempt communication, even if the predecessor has ceased operations.
d. Communication with a predecessor is always required, even if the client’s most recent audit was three years ago.

26. Devon Financial has assets of approximately $200 million and a CAMELS rating of 2. The financial institution originates and holds student loans. What type of engagement is required for this entity?

a. A full-scope financial statement audit.
b. A balance-sheet-only audit.
c. An internal control examination.
d. An annual compliance examination.

27. In which of the following scenarios is the auditor independent from the financial institution and, thus, able to perform its full-scope audit?

a. Emma has an uninsured checking account with Pennyworth Bank, but the account is not material to her net worth.
b. Because of the professional services Floyd provided the United Credit Union, he qualified for membership.
c. Gert provides both internal and external auditing services to Clover Mutual, an institution with total assets of $750 million.
d. Harvey makes management decisions for Payton Bank, as well as performing other nonattest services.
28. If an auditor provides nonattest services to an audit client, list all of the following that must be documented in writing under Interpretation 101-3.

i. Engagement objectives. v. Services that will be performed.
ii. Management functions. vi. Auditor responsibilities.
iii. Client acceptance of its responsibilities. vii. Location of source documents.

a. iii. and vi.

b. i., ii., and iv.

c. i., iii., iv., v., and vi.

d. i., ii., iii., iv., v., vi., vii., and viii.

29. Performance of which of the following is a bookkeeping service that would impair an auditor’s independence with relation to an attest client?

a. Proposing journal entries to the client.

b. Approving or authorizing purchase orders.

c. Recording disbursements approved by management.

d. Preparing financial statements as part of an audit.

30. Jester Savings and Loan is not required to have an audit under the OTS regulations; however, its management decides to voluntarily have an audit anyway. Which of the following qualifications from the OTS regulations would an auditor not have to meet in this scenario?

a. The auditor must be enrolled in a peer review program or have received a peer review that meets guidance acceptable to the OTS.

b. The auditor must be licensed or registered to practice public accounting and be in good standing under the state law that applies.

c. The auditor must meet the SEC’s independence requirements and be in compliance with the AICPA Code of Professional Conduct.

d. In the engagement letter, the auditor must agree to provide the OTS with copies of workpapers, procedures, and policies that relate to the services performed.

31. When writing an engagement letter for an audit engagement, the responsibilities of the client’s management and the responsibilities of the auditor should be listed. Which of the following would be the responsibility of the auditor?

a. Conducting the audit in accordance with GAAS.

b. The selection of accounting policies.

c. The design of controls to prevent fraud.

d. Maintaining effective internal control over financial reporting.
32. List all of the following elements that are a key part of most engagement letters.

- i. Client identification.
- ii. Description of auditor and management responsibilities.
- iii. Multi-year clauses.
- iv. Explanation of fees.
- v. Audit objective.
- vi. Additional services added after the engagement begins.
- vii. Engagement limitations.
- viii. Client signature.

a. ii., iii., iv., and v.
b. i., ii., iv., v., vii., and viii.
c. i., ii., iv., vi., vii., and viii.
d. i., ii., iii., iv., vi., vii., and viii.

33. The typical engagement letter drafted by the firm of Jenkins, Taylor, & Michaels includes a statement that the client will indemnify the auditor against claims made by third parties, a clause that says alternative dispute resolution (ADR) will be used to solve any disagreements between the client and the firm, and a provision that waives the client’s right to punitive damages. Can these clauses be used in the engagement letter for a financial institution audit?

a. Yes, all three clauses can be used.
b. Only the ADR clause can be used.
c. Only the indemnification clause must be eliminated.
d. No, none of these clauses can be used.

34. Larson & Larson is a CPA firm that audits financial institutions regulated by the FDIC. The firm is about to undergo peer review, per the FDICIA requirements. Which of the following guidelines apply?

a. Workpapers from the peer review must be retained by the reviewing firm for 120 days after the review report is filed with the FDIC.
b. All reviewed engagements must be audits of consolidated holding companies, insured institutions, or other financial institutions.
c. The firm must provide two copies of the peer report to the FDIC, OTS, OCC, NCUA, and all other regulators of financial institutions.
d. If terminated, the firm and the financial institution client must undergo ADR by a representative from the FDIC.

35. SAS No. 73 (AU 336) provides guidance when an auditor uses the work of a specialist. Under which circumstances would SAS No. 73 not apply?

a. A specialist is engaged by the client and the auditor uses his work as audit evidence.
b. A specialist is engaged by the auditor and his work is used as audit evidence.
c. A specialist is employed by the auditor’s firm and functions as part of the audit team.
d. A specialist employed by the auditor’s firm is engaged for advisory services by the client.
36. Harriet is performing an initial audit engagement for a financial institution client. Which categories will the audit objectives for her additional procedures apply to?

   i. Obtaining preliminary knowledge of the client, its business, its internal control, and its operating characteristics.
   ii. Assessing the reasonableness of the opening balances for significant balance sheet accounts.
   iii. Obtaining reasonable assurance of the accounting principles and the method of application used in the prior year.

   a. i.
   b. i. and ii.
   c. ii. and iii.
   d. i., ii., and iii.

37. Which of the following statements best describes the successor auditor’s concerns when asked to replace an auditor on an engagement?

   a. The auditor must express any reliance on a predecessor auditor in the current year’s audit report.
   b. The same steps for relying on the work and report of another auditor are required when relying on a predecessor auditor.
   c. The predecessor is not required to allow the successor access to workpapers, especially if there is pending litigation or unpaid fees.
   d. The predecessor’s workpapers constitute sufficient audit evidence on their own, which greatly enhances the successor’s audit efficiency.

38. Walter is performing an initial audit and must decide whether to rely on the work of the predecessor auditor. To help make his decision, he performs an overall review of the predecessor’s workpapers. Which of the following could help Walter with this overall review?

   a. Scan the workpaper summary of adjusting journal entries.
   b. Assess the condition of the client’s financial reporting system.
   c. Having knowledge of SAS No. 99.
   d. Use special audit programs designed for reliance on the predecessor.

39. Angie’s client has internal auditors, and she would like to use their work indirectly to help her obtain an understanding of the client’s internal control. What should Angie do?

   a. Allow internal auditors to assist with procedures related to the control environment or risk assessment.
   b. Allow the internal auditors to perform certain routine substantive tests in nonsubjective areas.
   c. Allow the internal auditors’ documentation of her client’s internal control to help her gain the understanding.
   d. Allow the internal auditors to perform certain tests of controls, such as document inspection.
40. A firm accepts an engagement to audit a financial institution. The institution uses a service organization and has an internal audit function. Define *service auditor* in this scenario.

a. The independent auditor who reports on the institution’s financial statements.

b. An internal auditor that is an employee of the financial institution.

c. An auditor who reports on the service organization’s processing of transactions.

d. The financial institution’s predecessor auditor.
GLOSSARY

Auditing standards: Ten general, field work, and reporting standards and Statements on Auditing Standards (SASs) issued by the American Institute of Certified Public Accountants’ (AICPA’s) Auditing Standards Board (ASB). SASs are codified within the framework of the ten standards.

Audit plan: The nature, timing, and extent of audit procedures to be performed by audit team members to obtain sufficient appropriate evidence.

Audit strategy: A high level determination of the audit approach by audit area.

Call report: A detailed statement of a bank’s operating and financial condition.

CAMELS rating: The CAMELS rating system is named for the components of the institution that are rated: capital adequacy, asset quality, management, earnings, liquidity, and sensitivity to market risk. Financial institutions can be rated from 1 to 5 (1 being the best rating).

Client acceptance and continuance policies and procedures: They should provide reasonable assurance that engagements that are accepted can reasonably be expected to be completed with professional competence and that the risks associated with providing professional services in the particular circumstances are appropriately considered.

Credit risk: The risk that a borrower will be unable to repay its loan.

Engagement letter: A letter written by the CPA to the client that represents the contractual understanding between the CPA and the client of the work to be performed, signed by both the CPA and the client.

Federal Deposit Insurance Corporation (FDIC): A government corporation that insures deposits of banks and savings institutions.

Federal Financial Institutions Examination Council (FFIEC): Prescribes uniform principles and standards for the federal examination of financial institutions by the OCC, FDIC, FRB, OTS, and NCUA.

Federal Reserve Board (FRB): Supervisor of the Federal Reserve System (FRS), a bank for banks. It has several functions, including regulating the country’s money supply and examining and supervising state-chartered banks.

Fiduciary risk: The risk of loss when institutions fail to properly manage financial assets on behalf of others.

Further audit procedures: Procedures an auditor performs in response to the assessed risks to reduce overall audit risk to an appropriately low level.

Generally accepted auditing standards (GAAS): Standards developed by the AICPA. The GAAS hierarchy includes (1) auditing standards, (2) interpretive publications, and (3) other auditing publications.

Independence: To be free from conflicts of interest and bias, self-governing, impartial, not subject to control by others, not requiring or relying on something else, not contingent, and acting with integrity and objectivity (i.e., with judgment that is unimpaired and without bias or prejudice). Independence is the cornerstone on which the audit, or attest, function of the accounting profession is based.

Industry risk: When an institution is dependent on the economic climate of an individual industry.

Integrity: An unimpaired condition or firm adherence to a code of especially moral or artistic values. Integrity is an essential component of independence but is also a quality which all CPAs, even those who are not independent, must possess.

Interest rate risk: When an institution’s interest-earning assets and interest-bearing liabilities are not matched according to dates on which interest rates change.
**Internal auditor:** Part of the formal internal audit function that can be found in some larger financial institutions. Internal auditors perform a variety of duties, including documentation and testing of internal controls, teller cash counts, and internal loan reviews.

**Interpretive publications:** These are recommendations on applying the SASs and include Auditing Interpretations, appendices to the SASs, AICPA Audit and Accounting Guides, and AICPA Auditing Statements of Position. SAS No. 95 requires auditors to consider applicable interpretive publications.

**Issuer risk:** The risk of an individual or company being unable to repay its debts.

**Liquidity risk:** The risk associated with the demand for funds exceeding the supply of funds.

**National Credit Union Administration (NCUA):** An organization created by Congress in 1970 to charter, supervise, and regulate federal credit unions.

**Net interest margin:** The excess of interest earned over interest paid.

**Nonattest services:** Services, such as bookkeeping, that could possibly impair an auditor’s independence with respect to an attest client. The provisions of Interpretation 101-3 should be adhered to.

**Objectivity:** The use of external facts and not thoughts and feelings. As a quality it means impartial and unbiased, free from personal bias and prejudice.

**Office of Comptroller of the Currency (OCC):** A bureau of the Department of Treasury that, among other things, is the chartering authority and primary federal supervisor for national banks.

**Office of Thrift Supervision (OTS):** A bureau of the Department of Treasury responsible for the examination and supervision of all savings institutions.

**Other auditing publications:** These publications have no authoritative status but may help auditors understand and apply the SASs. They include certain AICPA publications, articles in professional journals, continuing professional education programs, textbooks, guide books, audit programs and checklists, and auditing literature published by state CPA societies and other organizations.

**Predecessor auditor:** An auditor who (a) reported on the most recent audited financial statements or was engaged to perform but did not complete an audit of the financial statements and (b) has resigned or been notified that his or her services have been or may be terminated.

**Processing risk:** The risk of depending on information technology to properly process transactions.

**Reasonable assurance:** A high, but not absolute, level of audit assurance.

**Relevant assertions:** These assertions are relevant for a particular class of transactions, account balance, or disclosure if they have a meaningful bearing on whether the item is fairly stated.

**Risk assessment:** An audit approach based on risk assessment provides a method to identify higher risk areas so that audit effort can be focused on those areas.

**Risk assessment procedures:** A defined category of audit procedures performed near the beginning of an audit to obtain an understanding of the entity and its environment, including its internal control, for the purpose of assessing the risks of material misstatement at the financial statement and relevant assertion levels.

**Risk assessment standards:** Eight auditing standards (SAS Nos. 104 to 111) issued in March 2006 by the ASB. The changes caused by the new risk assessment standards are believed to be the most significant in recent history. The overall objective of the risk assessment standards is to promote the auditor’s use of the audit risk model.

**Risk of material misstatement:** The likelihood that a misstatement of the financial statements will be of a material amount.
**Securities and Exchange Commission (SEC):** Bank and thrift holding companies are subject to SEC registration and reporting provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934, unless a normal exemption is available.

**Service organization:** A service organization impacts the audit of a financial institution when its services are part of the client’s information system. SAS No. 70 applies when this type of service organization is involved.

**Significant risks:** A risk is significant if an analysis of inherent risk indicates that the likely magnitude of the potential misstatement and the likelihood of the misstatement occurring are such that they require special audit consideration.

**Specialist:** Individuals that are generally expected to have skills and knowledge of another profession or occupation. Specialists commonly used in auditing financial institutions include actuaries, information technology specialists, geologists, valuation specialists, and real estate appraisers.
INDEX

A

ADMINISTRATION OF THE AUDIT
- Accepting a new or continuing client ..................................................... 198
- Establishing terms of the engagement ...................................................... 227

ASSET-LIABILITY MANAGEMENT .............................................................. 162

AUDIT OBJECTIVES
- Initial audit .................................................................................................. 240

AUDITORS, CHANGES OF
- Auditor reporting of termination or resignation ........................................... 237
- Client reporting of termination or resignation of an auditor ......................... 237
- FDICIA requirements .................................................................................. 237
- Peer review report of successor firm ........................................................... 237
- Reasons for the change ................................................................................ 237
- Reporting disagreements ............................................................................. 238
- Reporting selection of new auditors ............................................................ 238
- Successor auditor qualifications .................................................................... 238
- Going concern modification ......................................................................... 238

AUDIT PLANNING
- Accepting a new or continuing client .......................................................... 198
- Establishing terms of the engagement ........................................................ 202
- Initial engagements ....................................................................................... 239
- Knowledge of business and industry ........................................................... 240
- Service organizations .................................................................................. 257

AUDIT PROCEDURES
- Additional procedures in initial audit ............................................................ 240, 248

AUDIT PROCESS .......................................................................................... 150

AUDIT PROGRAMS
- Initial audit .................................................................................................. 240

AUDIT STRATEGY
- Definition ...................................................................................................... 152

B

BANKS
- FDICIA audit requirements ......................................................................... 163, 164
- Regulatory agencies ..................................................................................... 176

CAMELS RATING ......................................................................................... 204

CLIENT ACCEPTANCE
- Assessing required services ......................................................................... 206
- Communications with regulators ................................................................. 204
- Independence evaluation ............................................................................. 208
- Regulatory examination reports ................................................................. 204
- Regulatory requirements ............................................................................. 188
- Risk assessments ......................................................................................... 189

COMMUNICATIONS WITH CLIENT
- Engagement letter ....................................................................................... 227
  - Benefits .................................................................................................... 228
  - Documenting the understanding with the client ......................................... 227
  - Multi-year letters ...................................................................................... 232
  - Suggested content .................................................................................... 228

COMMUNICATIONS WITH PREDECESSOR AUDITOR .................................. 204, 241

CONFIRMATION AND CORRESPONDENCE LETTERS
- Engagement letter ...................................................................................... 227
- Predecessor auditor ...................................................................................... 205

CONSOLIDATING FINANCIAL STATEMENTS ................................................. 163

CONTINUING ENGAGEMENT EVALUATION ............................................. 218

CPA SERVICES PROVIDED FOR FINANCIAL INSTITUTIONS
- Attestation engagement regarding controls over regulatory reporting .......... 164, 165
- Audit services ................................................................................................ 163
- Balance sheet audit ...................................................................................... 164
- Directors’ examinations ............................................................................. 165
- FDICIA reports ............................................................................................ 163, 164
- Other services ............................................................................................. 165
- Student loan compliance examinations ....................................................... 165
- Supervisory committee engagements ......................................................... 163
- Trust department ........................................................................................ 165

CREDIT UNION MEMBERSHIP ACCESS ACT OF 1998 ............................... 182

CREDIT UNIONS
- Agreed-upon procedures engagements ....................................................... 163
- Audit requirements ....................................................................................... 163
- Independent considerations .......................................................................... 208
- Regulatory agencies ..................................................................................... 176

E

ENGAGEMENT LETTERS
- Limitation of liability provisions .................................................................. 230
- Regulatory considerations ............................................................................ 226

F

FDIC IMPROVEMENT ACT OF 1991 (FDICIA)
- Attestation engagement—internal control over financial reporting
  - Authoritative literature .............................................................................. 163, 164
  - Auditor qualifications ................................................................................ 236, 238
  - Audit requirements .................................................................................... 163, 164, 181
  - Engagement letter requirements .............................................................. 237
  - Overview .................................................................................................. 180
  - Prompt Corrective Action regulations ....................................................... 181
  - Purpose ..................................................................................................... 180
  - Reporting .................................................................................................. 164
  - Requirements ............................................................................................ 163, 164, 181, 236

FEDERAL RESERVE BANKS
- General information .................................................................................... 177
- Equity investments ....................................................................................... 163

G

GENERALLY ACCEPTED AUDITING STANDARDS ..................................... 145
- Auditing standards ....................................................................................... 145
- Clarity project ............................................................................................... 147
- Interpretive standards ................................................................................ 146
- Other auditing publications ........................................................................ 146

I

INDEPENDENCE
- Appraisal, valuation and actuarial services ................................................. 212
- ET 101-3 Q&A ............................................................................................ 214
- Forensic services ........................................................................................ 212
- Nonattest services ...................................................................................... 209
- Preparing financial statements ................................................................... 213
- Proposing journal entries .......................................................................... 213
- Requirements ............................................................................................... 207
- Tax compliance services ............................................................................ 212

INITIAL AUDIT
- Additional procedures ............................................................................... 240, 244, 248
- Audit objectives ........................................................................................... 240
- Audit program ............................................................................................. 240, 244, 245

275
**Statements on Auditing Standards—SAS**

- SAS No. 1 .................................................. 217, 242, 247, 260
- SAS No. 50 .................................................. 206
- SAS No. 57 .................................................. 248
- SAS No. 58 .................................................. 246
- SAS No. 65 .................................................. 253
- SAS No. 70 .................................................. 257, 259
- SAS No. 84 ........................... 197, 198, 202, 204, 205, 206, 242, 244, 246
- SAS No. 97 .................................................. 206
- SAS No. 99 .................................................. 199, 253, 257
- SAS No. 106 .................................................. 198
- SAS No. 108 .................................................. 197, 198, 218, 227, 238, 239
- SAS No. 109 .................................................. 199, 258, 259

**Supervisory Committee Engagements**

- Authoritative literature .................................. 163
- Definition .................................................. 163

---

**Trust Department (Fiduciary Activities) Engagements**

- Nature of engagements .................................. 165

**U.S. Government Agencies**

- Department of Veterans Affairs (VA) ............ 179
- Federal Home Loan Mortgage Corporation (FHLMC) 179
- Federal Housing Administration (FHA) ............ 179
- Federal National Mortgage Association (FNMA) 179
- Government National Mortgage Association (GNMA) 179

**Workpapers**

- Review of predecessor’s workpapers ............ 241, 242, 247
COMPANION TO PPC’S GUIDE TO AUDITS OF FINANCIAL INSTITUTIONS

COURSE 3

FORECLOSED ASSETS, REAL ESTATE INVESTMENTS, CASH, OTHER ASSETS, AND LIABILITIES (AFITG103)

OVERVIEW

COURSE DESCRIPTION: This interactive self-study course covers elements involved in the audit of a financial institution. Lesson 1 discusses accounting and auditing considerations related to foreclosed assets and real estate investments, including various methods that can be used (e.g., the specific identification method and the full accrual method) and the impairment of real estate investments. Lesson 2 examines the accounting and auditing procedures that apply to cash, other assets, and liabilities, including discussion of such topics as the types of cash and deposit accounts used by financial institutions, premises and equipment, intangible assets, borrowings, and official checks.

PUBLICATION/REVISION DATE: June 2010

RECOMMENDED FOR: Users of PPC’s Guide to Audits of Financial Institutions

PREREQUISITE/ADVANCE PREPARATION: Basic knowledge of auditing.

CPE CREDIT: 8 QAS Hours, 8 Registry Hours

Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at www.nasba.org for a listing of states that accept QAS hours.

FIELD OF STUDY: Auditing

EXPIRATION DATE: Postmark by June 30, 2011

KNOWLEDGE LEVEL: Basic

Learning Objectives:

Lesson 1—Foreclosed Assets and Real Estate Investments

Completion of this lesson will enable you to:

• Summarize preliminary information related to foreclosed assets and real estate investments related to the authoritative literature, fair value, and audit procedures.
• Identify accounting and auditing considerations related to foreclosed assets and the costs of real estate development and construction projects in the audit of a financial institution.
• Compare and contrast the methods used to account for real estate sales, and summarize how to choose the right method to account for real estate sales and how to audit a financial institution’s real estate sales.
• Identify accounting treatments for real estate investments that have been impaired.

Lesson 2—Cash, Other Assets, and Liabilities

Completion of this lesson will enable you to:

• Compare and contrast the different types of accounts an institution may have related to cash, due from banks, and interest-bearing deposits, summarize the process of clearing checks, and identify audit procedures related to cash that would apply in the audit of a financial institution.
• Assess issues related to auditing other types of assets (e.g., federal funds, premises and equipment, and intangible and other assets) that might occur in the audit of a financial institution.
• Compare and contrast the different types of deposit accounts, and identify related audit procedures related to deposit accounts that would apply in the audit of a financial institution.
• Compare and contrast the different types of borrowings, and summarize audit procedures used during audits of financial institutions to obtain audit evidence related to liabilities other than deposit accounts (e.g., borrowings, official checks, accounts payable, and accrued expenses).

TO COMPLETE THIS LEARNING PROCESS:

Send your completed Examination for CPE Credit Answer Sheet, Course Evaluation, and payment to:

Thomson Reuters
Tax & Accounting—R&G
AFITG103 Self-study CPE
36786 Treasury Center
Chicago, IL  60694-6700

See the test instructions included with the course materials for more information.

ADMINISTRATIVE POLICIES:

For information regarding refunds and complaint resolutions, dial (800) 431-9025 for Customer Service and your questions or concerns will be promptly addressed.
Lesson 1: Foreclosed Assets and Real Estate Investments

INTRODUCTION

Financial institutions often receive assets from borrowers in settlement of loans, either voluntarily or involuntarily. Involuntary settlements are referred to as foreclosures. Voluntary settlements occur when the borrower transfers assets to the institution without foreclosure proceedings. In either case, the assets received are accounted for as foreclosed assets. Different financial institutions have different names for foreclosed assets, such as the following:

a. Banks and credit unions generally use one of the following terms:
   (1) Other real estate owned (OREO) or other real estate (ORE).
   (2) Other property owned (OPO) or repossessions (repos), for non-real estate assets.

b. Savings institutions generally use the terms real estate owned (REO) and personal property owned (PPO).

Financial institutions may also make limited investments in real estate, subject to regulatory restrictions. Banks and savings institutions may invest in real estate through service corporations or real estate joint ventures, subject to certain regulations. However, most real estate held by financial institutions is either part of operating facilities or acquired through foreclosure. Guidance in this lesson applies to real estate held either directly by the institution or through subsidiaries or joint ventures.

Learning Objectives:

Completion of this lesson will enable you to:

- Summarize preliminary information related to foreclosed assets and real estate investments related to the authoritative literature, fair value, and audit procedures.
- Identify accounting and auditing considerations related to foreclosed assets and the costs of real estate development and construction projects in the audit of a financial institution.
- Compare and contrast the methods used to account for real estate sales, and summarize how to choose the right method to account for real estate sales and how to audit a financial institution’s real estate sales.
- Identify accounting treatments for real estate investments that have been impaired.

Authoritative Literature

There is a variety of accounting literature relating to foreclosed assets and real estate. The primary sources of authoritative guidance relating to foreclosed assets are—

a. FASB ASC 360-10, Property, Plant, and Equipment—Overall (formerly SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets), provides guidance on recognizing and measuring impairment of real estate, foreclosed assets, and long-lived assets.

b. AICPA Audit and Accounting Guide, Depositary and Lending Institutions: Banks and Savings Institutions, Credit Unions, Finance Companies and Mortgage Companies (DEP) provides guidance for auditing foreclosed assets.

The primary sources of authoritative guidance regarding real estate are—

a. FASB ASC 360-20, Property, Plant, and Equipment—Real Estate Sales, (formerly SFAS No. 66, Accounting for Sales of Real Estate) provides accounting guidance for sales of foreclosed real estate and real estate held for investment.

b. FASB ASC 835-20, Interest—Capitalization of Interest, (formerly SFAS No. 34, Capitalization of Interest) discusses how to account for interest costs relating to real estate that is undergoing development or construction activities.
c. FASB ASC 970-340, Real Estate—Other Assets and Deferred Costs, (formerly SFAS No. 67, Accounting for Costs and Initial Rental Operations of Real Estate Projects) provides real estate accounting and reporting guidance for pre-acquisition costs, amenities, incidental operations, revisions of estimates, selling costs, and rental costs.

d. FASB ASC 970-360, Real Estate—Property, Plant, and Equipment, (formerly SFAS No. 67, Accounting for Costs and Initial Rental Operations of Real Estate Projects) includes real estate accounting and reporting guidance for direct and indirect project costs, cost allocation to project components, abandonments, changes in use, and impairment.

e. DEP provides guidance for auditing real estate transactions and balances.

In addition to those pronouncements, the Emerging Issues Task Force has addressed several issues relating to accounting for real estate transactions.

Other guidance that affects real estate investments made through real estate partnerships and joint ventures is FASB ASC 970-323, 970-605, and 970-835 (formerly AICPA SOP 78-9, Accounting for Investments in Real Estate Ventures). This guidance essentially applies the accounting principles of FASB ASC 323-10 (formerly APB Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock) to investments in noncorporate real estate entities. Accounting for equity investments is discussed in PPC’s Guide to Audits of Financial Institutions. PPC’s Guide to Real Estate provides detailed guidance on accounting for real estate ventures.

Presentation of Assets and Liabilities. Although financial information normally is presented based on costs incurred, there are a number of situations in which other, more current information is either required or useful to the users of the presentation. Recent accounting literature indicates a gradual move to providing more fair value information, and some nonpublic entities find that fair value information is useful to the primary readers of their financial statements. Under generally accepted accounting principles, fair values can be used for only specific items in the financial statements or, in some cases, as a comprehensive basis for all items in the financial statements. In addition, GAAP requires fair value disclosures in several areas, principally for financial instruments. This lesson includes discussion on fair value accounting, when appropriate under GAAP, for foreclosed assets and real estate investments.

Fair Value Measurements. FASB ASC 820-10 (formerly SFAS No. 157, Fair Value Measurements) provides a common definition of fair value, establishes a framework to measure fair value within GAAP, and expands the disclosures about fair value measurements. It generally applies under other accounting pronouncements that require or permit fair value measurements, such as measuring fair value of real estate investments, but it does not expand the use of fair value in any new circumstances. Disclosure requirements are discussed in PPC’s Guide to Audits of Financial Institutions. PPC’s Guide to Real Estate and PPC’s Guide to Preparing Financial Statements contain discussions of the fair value measurement model as it applies to real estate.

FASB ASC 820-10-35-55A (formerly FASB Staff Position (FSP) No. FAS 157-3, “Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active”) clarifies the application of fair value measurements, in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. FASB ASC 820-10-35-51A through 35-55H (formerly FSP FAS 157-4 Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly) provides additional details on determining fair value when there has been a significant decrease in the volume or level of activity for an asset or liability. The guidance includes several factors to evaluate when assessing the significance of the decrease. The guidance is effective for interim and annual periods ending after June 15, 2009.

The Fair Value Option. FASB ASC 825-10 (formerly SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities) permits entities to choose to measure prescribed financial instruments at fair value. Such elections (a) are made on an instrument-by-instrument basis, (b) are irrevocable, and (c) require changes in fair value to be recognized in earnings. This option was to provide entities the chance to reduce earnings volatility caused by measuring related assets and liabilities differently, such as measuring the liability at fair value but
measuring the asset at historical cost. Generally, the Statement permits the fair value option for all financial assets and financial liabilities except the following, which are specifically excluded:

a. An investment in a subsidiary that is required to be consolidated by the entity.

b. A variable interest in a variable interest entity that is required to be consolidated by the entity.

c. Obligations for pension and other postretirement and postemployment benefits, share-based payments, compensated absences, and costs associated with exit or disposal activities.

d. Amounts recognized under FASB ASC 840 (formerly SFAS No. 13, Accounting for Leases).

e. Deposit and similar liabilities of financial institutions.

f. Financial instruments classified by the issuer as a component of equity.

Generally, a financial asset is defined as a financial instrument that conveys a right to the entity, and a financial liability is defined as a contract that imposes an obligation on the entity. For example, an entity could elect the fair value option for an investment that would otherwise be accounted for using the cost or equity method. Similarly, an entity could elect the fair value option for a fixed-rate long-term note.

The disclosure requirements of the Statement only apply if an entity has elected the fair value option. Those requirements generally look at how the election affects the measurement of those assets and liabilities. For example, the Statement requires disclosure of the reason for electing the fair value option and information about differences between the fair values and contractual cash flows. In addition, the measurement and disclosure requirements of FASB ASC 820-10 (formerly SFAS No. 157) apply to those assets and liabilities.

Organization of This Lesson

Topics covered in this lesson include:

a. Audit procedures for obtaining audit evidence supporting foreclosed assets and real estate investments.

b. Accounting and auditing considerations for foreclosed assets.

c. Considerations that apply to both foreclosed real estate and real estate investments.

d. Acquisition, development, and construction costs for real estate.

e. Sales of real estate.

f. Impairment of real estate.

AUDIT PROCEDURES USED TO OBTAIN AUDIT EVIDENCE

The third standard of fieldwork states:

The auditor must obtain sufficient appropriate audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit. (AU 150.02)

SAS No. 106 (AU 326), Audit Evidence, states that those audit procedures consist of the following:

- Risk assessment procedures.
- Tests of controls.
Substantive procedures.

Risk assessment procedures and tests of controls contribute to the formation of the auditor’s opinion, but do not, by themselves, provide sufficient appropriate audit evidence. SAS No. 110 (AU 318), *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, states that regardless of the assessed risk of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure. Substantive procedures consist of (a) tests of details of classes of transactions, account balances, and disclosures, and (b) substantive analytical procedures.

**Relevant Assertions for Foreclosed Assets and Real Estate Investments**

Relevant assertions for a particular audit area are assertions that have a meaningful bearing on whether the related account balances, transaction classes, or disclosures are fairly stated. The relevant assertions for foreclosed assets and real estate investments generally are as follows:

- **Existence or Occurrence (E/O)**—Foreclosed assets and real estate investments reported in the balance sheet exist. Gains and losses on sales of foreclosed assets and real estate investments reported in the statement of income represent valid transactions that occurred during the period and pertain to the entity.

- **Completeness (C)**—Foreclosed assets and real estate investments include all amounts owned by the institution at the balance sheet date. All gains and losses on sales of foreclosed assets and real estate investments that should be included in the statement of income are recorded. Related disclosures are complete.

- **Rights or Obligations (R/O)**—Foreclosed assets and real estate investments are owned by the institution.

- **Valuation or Allocation (V)**—Foreclosed assets and real estate investments are properly recorded and valued in accordance with GAAP. Depreciation is properly recorded when necessary, and other revenues and expenses related to real estate investments are allocated and reported. Capitalized costs are appropriately accounted for. Gains and losses on sales of foreclosed assets and real estate investments are properly recognized.

- **Cutoff (C/O)**—Foreclosed assets and real estate investments are recorded in the proper accounting period.

- **Accuracy or Classification (A/C)**—Foreclosed assets and real estate investments are properly classified and described in the balance sheet. The financial statements include all required disclosures related to foreclosed assets and real estate investments that are required by GAAP.

The auditor uses relevant assertions in assessing the risks of material misstatement by considering the different types of potential misstatements that may occur, and then designing audit procedures that are responsive to the assessed risks. For each relevant assertion within an account balance, class of transaction, or disclosure, the auditor assesses the risks of material misstatement and, based on that assessment, determines the nature, timing, and extent of the substantive procedures necessary to obtain sufficient appropriate audit evidence.

The auditor’s considerations when responding to assessed risks of material misstatement at the relevant assertion level; the PPC core audit programs—which include basic, extended, and other audit procedures; and considerations when choosing substantive procedures, including substantive analytical procedures and tests of details, are discussed in *PPC’s Guide to Audits of Financial Institutions*. Auditors should be familiar with those concepts when designing the nature, timing, and extent of substantive audit procedures for foreclosed assets and real estate investments.
SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. Harvest National Bank takes possession of real estate from a borrower in settlement of a loan. Under which of the circumstances below would this transaction be considered a foreclosure?
   a. The settlement is voluntary on behalf of the borrower.
   b. The settlement is involuntary on behalf of the borrower.

2. Gina, an auditor, is engaged to audit a financial institution. What piece of authoritative guidance establishes a framework to measure fair value within GAAP that Gina might refer to if the institution presents assets and liabilities using fair values?
   a. FASB ASC 820-10.
   b. FASB ASC 825-10.
   c. FASB ASC 970-340.
   d. FASB ASC 970-360.
SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. (References are in parentheses.)

1. Harvest National Bank takes possession of real estate from a borrower in settlement of a loan. Under which of the circumstances below would this transaction be considered a *foreclosure*? (Page 281)

   a. The settlement is voluntary on behalf of the borrower. [This answer is incorrect. Voluntary settlements occur when the borrower transfers assets to the institution without foreclosure proceedings.]

   b. The settlement is involuntary on behalf of the borrower. [This answer is correct. Involuntary settlements are referred to as foreclosures. However, the assets received would be accounted for as foreclosed assets in both voluntary and involuntary settlements.]

2. Gina, an auditor, is engaged to audit a financial institution. What piece of authoritative guidance establishes a framework to measure fair value within GAAP that Gina might refer to if the institution presents assets and liabilities using fair values? (Page 282)

   a. FASB ASC 820-10. [This answer is correct. FASB ASC 820-10 (formerly SFAS No. 157, *Fair Value Measurements*) provides a common definition of fair value, establishes a framework to measure fair value within GAAP, and expands the disclosures about fair value measurements. It generally applies under other accounting pronouncements that require or permit fair value measurements, such as measuring fair value of real estate investments (which may apply in Gina’s audit), but it does not expand the use of fair value in any new circumstances.]

   b. FASB ASC 825-10. [This answer is incorrect. FASB ASC 825-10 (formerly SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*) permits entities to choose to measure prescribed financial instruments at fair value.]

   c. FASB ASC 970-340. [This answer is incorrect. FASB ASC 970-340, *Real Estate—Other Assets and Deferred Costs*, provides real estate accounting and reporting guidance for pre-acquisition costs, amenities, incidental operations, revisions of estimates, selling costs, and rental costs.]

   d. FASB ASC 970-360. [This answer is incorrect. FASB ASC 970-360, *Real Estate—Property, Plant, and Equipment*, includes real estate accounting and reporting guidance for direct and indirect project costs, cost allocation to project components, abandonments, changes in use, and impairment.]
ACCOUNTING AND AUDITING CONSIDERATIONS FOR FORECLOSED ASSETS

As noted at the beginning of this lesson, foreclosed assets include assets obtained through foreclosure and assets voluntarily transferred by the borrower in settlement of a loan, such as a deed in lieu of foreclosure.

The auditor’s primary concerns in auditing foreclosed assets are whether—

- Initial foreclosures are recorded correctly.
- Foreclosed assets are carried properly on the client’s books after foreclosure.
- Gains and losses on sales of foreclosed assets are accounted for properly.

Accounting at Foreclosure

FASB ASC 310-40-40-3 (formerly SFAS No. 15, Paragraph 28), as amended, states that assets received in full settlement of a loan should be recorded at their fair value (less cost to sell if the assets will be disposed of) at the date of foreclosure (or transfer). The recorded amount becomes the new cost basis of the asset. Selling costs should include only the direct costs of selling the property, such as sales commissions, legal and transfer fees, and other closing costs. Costs not directly related to the sale (for example, insurance and property taxes incurred while the property is being sold and other holding costs) should not be considered in this calculation.

The rationale for recording foreclosures and asset transfers at fair value is that they are not merely reversals of the original loans. They are distinct transactions between borrowers and lenders that represent exchanges of loans for assets. The fair value of a foreclosed asset is used to establish an exchange price for recording the transaction. Measurement of loan impairment is required to be based on the fair value of the collateral when the institution determines that foreclosure is probable.

Foreclosure under a Second Lien. A lender may occasionally make a real estate loan secured by a second lien on the collateral. When the borrower defaults on that type of loan and the lender forecloses, the lender must either pay off the first lien or acquire the property subject to the first lien. In the latter case, the lender must make payments to the first lienholder, even if the lender had no legal obligation on the first lien before the foreclosure. If the property is acquired subject to a first lien, the lender should record the first lien as a liability. It should not be netted against the asset.

Foreclosed Real Estate Previously Sold and Accounted for under FASB ASC 360-20. Financial institutions often finance sales of their own real estate. Those real estate sales should be accounted for in accordance with FASB ASC 360-20 (formerly SFAS No. 66). A number of methods of accounting for real estate sales are prescribed depending on the circumstances (as discussed later in this lesson). If the institution subsequently forecloses on real estate previously sold, the transaction could be accounted for in the following manner:

- If the sale was originally accounted for under the full accrual method, the property should be recorded at its fair value (less selling costs) in accordance with FASB ASC 310-40 and 470-60 (formerly SFAS No. 15), as amended.

- If the sale was originally accounted for under a method other than the full accrual method, and the transaction was in substance a sale (that is, the transaction was accounted for using the installment, cost recovery, or reduced profit method), the property should be recorded at the lower of its fair value (less selling costs) or the recorded investment in the loan. (In this situation, the recorded investment in the loan is net of any deferred gain on sale.)

- If the sale was originally accounted for under a method other than the full accrual method, and the transaction was not in substance a sale (that is, the transaction was accounted for using the deposit method or as a leasing or financing arrangement), the property was never removed from the institution’s books. In this situation, the property should continue to be recorded at its carrying amount before foreclosure. However, the fact that the property was reacquired through foreclosure may indicate that it is impaired.
Does Troubled Debt Restructuring Accounting Apply to All Foreclosures? Auditors disagree on whether FASB ASC 310-40 and 470-60 (formerly SFAS No. 15) apply to all foreclosures. Some auditors believe that troubled debt restructuring accounting does not apply to situations in which the fair value of the collateral exceeds the recorded loan investment (plus any senior debt). They believe that FASB ASC 310-40-15-12 (formerly Paragraph 7 of SFAS No. 15) specifically excludes those types of foreclosures. They also note that such foreclosures would result in recognition of a gain on foreclosure, which they believe is inappropriate. Instead, the auditors believe that foreclosed property should be recorded at the lower of fair value or the recorded investment in the loan. On the other hand, other auditors believe that troubled debt restructuring accounting should be applied to all foreclosures (except those discussed in the previous paragraph), even if that would result in recognizing a gain on foreclosure. Their position is based on a literal reading of FASB ASC 310-40-35-6 and 310-40-40-2 through 40-4 (formerly SFAS No. 15, Paragraph 28), as amended.

However, other auditors believe that the fair value of foreclosed property is usually less than the recorded loan investment (plus any senior debt). Consequently, situations that might result in a gain on foreclosure are rare. Also, such situations should be viewed with skepticism because normally a borrower finds a way to refinance or renegotiate a loan if the value of the collateral is truly more than the debt balance. However, in the exceptional case in which the fair value of foreclosed property exceeds the debt on the property, best practices indicate that such property should be recorded at fair value (less selling costs, if applicable). Regardless of whether FASB ASC 310-40 and 470-60 (formerly SFAS No. 15) apply, the foreclosure is a separate transaction, and the fair value of the collateral is the most appropriate amount at which to record the transaction. However, in those situations, it is important that the fair value of the asset be well supported, preferably by the report of a qualified appraiser.

Auditing Initial Foreclosures. Auditing the initial recording of foreclosures is usually accomplished by testing new foreclosures for the period. The auditor typically selects new foreclosed assets based on a dollar cutoff and examines support for ownership of the asset, such as a deed or title. In addition, the auditor determines that the asset was recorded at its fair value (less selling costs, if applicable) at the date of foreclosure (or other amount for real estate previously sold, as previously discussed). Many financial institutions obtain appraisals of foreclosed assets soon after foreclosure. Thus, the auditor can generally use those appraisals to determine fair value at the date of foreclosure. If a recent appraisal is not available, the auditor typically assesses the reasonableness of the client’s estimate of the property’s fair value based on sales of similar properties, past appraisals (adjusted for current conditions), or other methods.

Accounting after Foreclosure

Repairs and Physical Improvements. The cost of repairs or physical improvements to a foreclosed asset should be capitalized if they significantly increase the fair value of the asset. Otherwise, they should be expensed as incurred.

For foreclosed real estate, construction and development costs, including capitalized interest, should theoretically be accounted for in accordance with FASB ASC 835-20 (formerly SFAS No. 34) and FASB ASC 970-340 and 970-360 (formerly SFAS No. 67), which are discussed later in this lesson. That guidance should be followed for foreclosed real estate projects that are undergoing extensive development or construction, such as a building being completely remodeled over a two-year period. However, most repairs and physical improvements to foreclosed real estate, such as repaving a parking lot or replacing a roof, are more limited in scope and cost. In those types of situations, interest capitalization is generally not necessary, and the auditor can merely follow the guidance in the preceding paragraph.

Accounting for Foreclosed Assets Held for Sale. According to FASB ASC 360-10-45-9 (formerly Paragraph 30 of SFAS No. 144), a property or disposal group (properties to be disposed of together as a group in a single transaction and liabilities directly associated with those properties that will be transferred in the transaction) to be sold should be classified as held for sale in the period in which all of the following criteria are met:

a. Management, having the appropriate approval authority, commits to a plan to sell the property or disposal group.

b. The property or disposal group is available for immediate sale in its present condition, subject only to usual and customary sales terms for such properties.
c. The institution has initiated an active program to locate a buyer and other actions required to complete the plan to sell the property or disposal group.

d. The sale of the property or disposal group is probable, and transfer of the property or disposal group is expected to qualify for recognition as a completed sale within one year. Exceptions to this criterion are discussed later in this lesson.

e. The property or disposal group is being actively marketed for sale at a price that is reasonable relative to its current fair value.

f. Actions required to complete the plan indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn.

Property held for sale should be reported at the lower of its carrying amount or fair value less costs to sell. Assets classified as held for sale should not be depreciated, and expected future losses associated with operations of long-lived assets to be sold should not be accrued. Assets classified as held for sale should be presented separately on the balance sheet. For asset groups, both assets and liabilities should be presented separately; they should not be offset and presented as a single amount.

If the criteria for classification as held for sale are met after the date of the balance sheet but before issuance of the financial statements, property should continue to be classified as held and used in the financial statements when issued.

If property held for sale is reclassified as held and used, the reclassified property should be measured at the lower of (a) its carrying amount before being classified as held for sale, adjusted for depreciation expense that subsequently would have been taken or (b) its fair value when reclassified.

**Accounting for Foreclosed Assets to Be Held and Used or Held for Disposal Other Than by Sale.** GAAP requires that foreclosed assets (whether classified as held and used or held for disposal other than by sale) be reviewed for impairment whenever conditions indicate that the carrying amount of an asset may not be recoverable. To determine recoverability, the institution should estimate the total future cash flows (undiscounted and without interest charges). An impairment loss is recognized if the estimated future cash flow is less than the carrying amount of the asset; otherwise, an impairment loss is not recognized. The measurement of an impairment loss for foreclosed assets (whether classified as held and used or held for disposal other than by sale) should be based on the fair value of the asset compared to the carrying amount.

An example of a foreclosed asset to be held and used is a foreclosed commercial office building that the financial institution decides to use as its new office facilities.

After foreclosure, foreclosed assets (whether classified as held and used or held for disposal other than by sale) should be accounted for in the same way as similar long-lived assets. Accordingly, depreciation should be recorded on depreciable property, and impairment should be assessed and measured using the FASB ASC 360-10 (formerly SFAS No. 144) rules for assets held and used.

**Auditing the Carrying Amount of Foreclosed Assets.** As previously noted, most foreclosed assets are carried at the lower of their carrying amount or current fair value, less selling costs. The auditor should determine whether the foreclosed assets are carried at the proper value at the balance sheet date. First, for assets selected for testing, the auditor typically examines supporting documentation for any significant capitalized costs that were added to the assets during the period. Then the auditor compares the cost of each foreclosed asset held for sale selected for testing to its current fair value less selling costs at the balance sheet date. If the client periodically obtains an updated appraisal on a foreclosed asset, the auditor can use the updated appraisal to assess the asset. However, if an appraisal is not available for a particular asset, the auditor assesses the reasonableness of the client’s estimate of the property’s fair value based on sales of similar properties, past appraisals (adjusted for current conditions), or other methods. (A further discussion of impairment of real estate occurs later in this lesson.)

**Auditing Sales of Foreclosed Assets**

The auditor typically tests significant gains and losses on sales of assets to determine whether they are properly recognized. That means the auditor examines documentation supporting the proceeds received from the sale and
recomputes the gain recognized. If the property sold was real estate, the auditor also determines whether the sale was accounted for in accordance with FASB ASC 360-20 and 970 (formerly SFAS No. 66), as discussed later in this lesson.

**Estimating Future Cash Flows**

FASB ASC 360-10-35-29 (formerly SFAS No. 144) offers the following guidelines for estimating future cash flows to assess impairment:

- Future cash flows are the future cash inflows to be generated from using and disposing of the asset, less the future outflows necessary to obtain those inflows.
- The cash flows should be undiscounted and should not include interest charges that will be expensed when incurred.
- Estimates should incorporate the institution’s own assumptions about the use of the asset.
- All available evidence should be considered in estimating the cash flows.
- If alternative courses of action to recover the carrying amount of the asset are under consideration or a range of possible future cash flows is estimated, the likelihood of those possible outcomes should be considered. A probability-weighted approach may be useful in such cases.
- Future cash flow estimates used to test the recoverability of an asset (including one for which development is substantially complete) should be based on the existing service potential of the asset when tested. If the asset is under development, the estimated future cash flows should be based on the expected service potential when development is substantially complete.
- If a long-lived asset under development is part of an asset group in use, estimates of future cash flows used to test recoverability should include the cash flows associated with future expenditures necessary to maintain the group’s existing service potential, as well as those necessary to substantially complete the asset under development.

FASB ASC 360-10-35-30 through 35-35 (formerly Paragraphs 16–21 of SFAS No. 144) contain additional guidance on estimating future cash flows used to test a long-lived asset for recoverability.

**Types of Future Cash Flows.** The types of cash flows to be considered in estimating future net cash flows are:

- Costs to complete the property.
- Holding costs (including any cash flows from operating the property).
- Selling price.
- Disposition costs.

See *PPC’s Guide to Real Estate* for further discussion of the types of cash flows and considerations for estimating future cash flows.

**ACCOUNTING AND AUDITING CONSIDERATIONS FOR COSTS OF REAL ESTATE DEVELOPMENT AND CONSTRUCTION PROJECTS**

The following paragraphs summarize the primary accounting rules for the costs of real estate development and construction projects. They also include a discussion of the major audit considerations. The discussion applies primarily to real estate investments, but it also applies to foreclosed real estate projects that are undergoing extensive development or construction.
Cost Capitalization

FASB ASC 970-340 and 970-360 (formerly SFAS No. 67), as amended, provide the primary guidance on accounting for real estate acquisition, development, and construction costs. Exhibit 1-1 provides an overview of the cost capitalization rules for real estate costs.

Exhibit 1-1

Overview of Cost Capitalization Rules

- Preacquisition or acquisition cost
- Does the cost relate to real estate acquisition or development activities?
- Development cost
- Neither
- Is the cost directly related to the project?
- Yes
- Capitalize as cost of the project.¹
- No
- Are development activities currently underway?²
  - Yes
  - Capitalize as cost of the project.
  - No
    - Expense as incurred.
Notes:

a. In some exceptional cases, development costs may be capitalized even though development is not underway.

b. Preacquisition costs can be capitalized only after property acquisition becomes probable.

*          *         *

Preacquisition and Acquisition Costs

Preacquisition and acquisition costs are incurred in connection with the purchase of real estate. Preacquisition costs are incurred before the purchase, and acquisition costs are incurred on or near the purchase date. Examples of those costs include the following:

- Earnest money deposits.
- Purchase options.
- Legal and other closing costs.

The accounting rules for preacquisition and acquisition costs vary depending on whether the real estate is acquired through foreclosure or purchased for development or investment. In property acquired through foreclosure, preacquisition and acquisition costs are primarily legal costs and other foreclosure expenses, and they should be charged to expense as incurred. In property acquired for investment or development, FASB ASC 970-360-25-2 (formerly SFAS No. 67) indicates that costs that are “clearly associated” with the acquisition should be capitalized.

In addition to the “clearly associated” condition, FASB ASC 970-340-25-3 (formerly Paragraph 4 of SFAS No. 67) states that preacquisition costs can be capitalized only if all of the following conditions are met:

- The costs are “directly identifiable” with a specific property.
- The costs would be capitalized if the property were already owned.
- It is probable that the property will be acquired.

To satisfy the third condition, FASB ASC 970-360-25-2 (formerly SFAS No. 67) states that the prospective purchaser (a) must be actively seeking to acquire the property and (b) must have the ability to obtain financing for the acquisition. Also, the third condition is not met if there is an indication that the property is not for sale. Also, FASB ASC 970-340-25-6 (formerly EITF Issue No. 97-11, Accounting for Internal Costs Relating to Real Estate Property Acquisitions), states that internal costs of preacquisition activities incurred in connection with the acquisition of a nonoperating property that are directly identifiable with the acquired property and that were incurred after acquisition of the specific property was considered probable should be capitalized.

Only direct preacquisition costs can be capitalized. Direct costs are not limited to payments to third parties (that is, external costs). They also include costs of primary activities (for example, internal costs, such as allocations of salary costs for time spent negotiating the terms of purchase, determining the feasibility of the project, and arranging financing). Internal preacquisition costs should be capitalized only after acquisition of the specific property becomes probable.

Based on the preceding discussion, this course presents the following approach to accounting for preacquisition costs:

a. Capitalize direct costs relating to specific properties after acquisition is probable, and expense other preacquisition costs.

b. At least annually (or before preparing financial statements), consider the conditions (other than the “clearly associated” condition) listed above and assess whether it is still probable that the related property will be acquired.
Development and Construction Costs

Development and construction costs are the direct and indirect costs involved in developing land, constructing buildings, or making other physical improvements. Examples of direct costs include costs of the following:

- Land grading and clearing.
- Streets and utility connections.
- Physical construction of buildings and similar improvements.

Indirect costs include the following:

- Field office administration costs.
- Cost accounting.
- Interest, taxes, and insurance costs.

Accounting for Development and Construction Costs. Development and construction costs that are “clearly associated” with a real estate project should be capitalized. Best practices indicate that development and construction costs should normally be capitalized only while development or construction activities are underway. For this purpose, development and construction activities include more than mere physical development and construction. They include all of the activities that are essential for the project to be completed, such as the following:

- Planning and design of the project.
- Physical development and construction.
- Project supervision.

Cost Capitalization on Project Components. A large real estate project may have several components, such as individual building units, tracts, or phases. Typically, those components are developed according to the project’s plan. In many cases, each component will be in a different stage of development. For example, physical construction may be occurring in one component while design work or surveying is taking place in another component. Sometimes development or construction for certain components cannot begin until other components are completed.

When a real estate project has multiple components, it would be a good idea to evaluate the costs associated with each major component separately. Generally, if a component is undergoing development or construction (either physical development, design, or planning activities), its costs should be capitalized. Costs relating to components for which there is no development or construction activity should be expensed unless one of the following conditions is met:

- The component cannot be developed until another component is completed, for example, until streets are completed to provide access to the component.
- Development or construction has been temporarily interrupted, and capitalization is allowed under the guidance discussed in the following paragraph.

Effect of Temporary Interruptions on Cost Capitalization. Under the principle discussed in the preceding paragraphs, capitalization of development and construction costs should begin when development and construction activities begin, and it should end when development and construction ends. That raises the issue of how temporary interruptions in development and construction activities affect cost capitalization. If the guidance in FASB ASC 835-20-25-2 through 25-7 (formerly SFAS No. 34) is applied to other development and construction costs, the following should be considered:

- Interruptions that occur because the owner intentionally suspends development and construction activities require that capitalization stop until the activities are resumed.
• Temporary interruptions that are externally imposed (for example, by weather conditions or governmental agencies) do not prevent cost capitalization. If the interruption is expected to last for an extended period, such as six months or more, capitalization should stop.

• Temporary interruptions that are inherent in the development process, such as waiting for mandatory inspections by government agencies or utility companies, do not prevent cost capitalization. If the interruption is expected to last for an extended period, such as six months or more, capitalization should stop.

• Temporary interruptions to overcome unanticipated problems (such as technical problems, litigation, or labor disputes) do not prevent cost capitalization.

• Brief interruptions normally do not prevent cost capitalization if their effects are immaterial. Accordingly, cost capitalization can continue through brief interruptions if it does not materially overstate capitalized project costs or net income.

• Interruptions that are expected to last for an extended period, such as six months or more, require that capitalization stop.

Interest Costs

As previously noted, FASB ASC 835-20-25-2 through 25-7 (formerly SFAS No. 34) provides the accounting guidance for interest capitalization for “qualifying assets,” including real estate being developed. According to FASB ASC 835-20-25-3 (formerly Paragraph 17 of SFAS No. 34), interest should be capitalized on an asset whenever all of the following conditions are met:

• Capitalized costs (such as acquisition, development, and construction costs) for the asset have been incurred.

• Activities that are necessary to prepare the asset for its intended use are in progress.

• Interest cost is being incurred. (It is not necessary to have debt that is secured by the property.)

Capitalization Method. Under FASB ASC 835-20-25-2 through 25-7 (formerly SFAS No. 34), the interest cost to be capitalized each period is based on the following formula:

\[
\text{Interest capitalized each period} = \text{Average accumulated expenditures} \times \text{Interest capitalization rate}
\]

Average Accumulated Expenditures. Average accumulated expenditures is the average net balance of capitalized costs of all components of the real estate project that are undergoing development or construction during the period. The capitalized balance used in calculating the average should be net of property sold, but it is not net of impairment writedowns. The average may be calculated from year end, quarterly, monthly, or even daily balances. For example, if monthly balances are used, the average qualifying assets for the year can be determined by adding the prior year net cost of the project to each month end’s balance and then dividing the total by 13.

Interest Capitalization Rate. The basic principle in GAAP is that the interest to be capitalized is the interest cost that theoretically would have been avoided if the project did not exist. If the institution incurred a specific debt to finance a project, the interest rate on that debt can generally be used to capitalize interest on the project. (If the average qualifying assets exceed the amount of any specific debt, the interest capitalized on the excess should be determined based on an average rate of other interest-bearing liabilities during the period.) Since financial institutions rarely incur specific debts to finance their real estate projects, however, the interest capitalization rate should generally be based on the institution’s total interest cost incurred during the capitalization period and can be determined using the following formula:
Interest capitalization rate = \[
\frac{\text{Interest cost incurred during the period}}{\text{Average interest-bearing liabilities during the period}}
\]

For financial institutions, the capitalization rate is usually determined based on the institution’s average cost of funds. Accordingly, interest cost incurred in the preceding formula should include interest on all of the institution’s interest-bearing liabilities, including interest-bearing deposit accounts and borrowings. It should also include amortization of discounts and premiums on those liabilities.

**Limitation on Capitalized Interest.** FASB ASC 835-20-30-6 (formerly Paragraph 15 of SFAS No. 34) states that capitalized interest during the period cannot exceed the amount of interest actually incurred. The limitation is consistent with the principle that the interest to be capitalized is the interest cost that theoretically would have been avoided if the project did not exist.

**Example 1-1: Interest capitalization on a land development project**

Assume that a development project is estimated to cost $300,000, excluding interest. The institution plans to complete the project in 12 months. Month end and average capitalized cost balances for the 12 months are as follows:

<table>
<thead>
<tr>
<th>Month</th>
<th>Cost Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>1st</td>
<td>$230,000</td>
</tr>
<tr>
<td>2nd</td>
<td>236,000</td>
</tr>
<tr>
<td>3rd</td>
<td>244,000</td>
</tr>
<tr>
<td>4th</td>
<td>253,000</td>
</tr>
<tr>
<td>5th</td>
<td>259,000</td>
</tr>
<tr>
<td>6th</td>
<td>267,000</td>
</tr>
<tr>
<td>7th</td>
<td>274,000</td>
</tr>
<tr>
<td>8th</td>
<td>278,000</td>
</tr>
<tr>
<td>9th</td>
<td>284,000</td>
</tr>
<tr>
<td>10th</td>
<td>291,000</td>
</tr>
<tr>
<td>11th</td>
<td>297,000</td>
</tr>
<tr>
<td>12th</td>
<td>300,000</td>
</tr>
<tr>
<td></td>
<td><strong>$267,750</strong></td>
</tr>
</tbody>
</table>

The institution had interest cost for the period of $3,505,254 and average interest-bearing liabilities of $64,058,011, resulting in a capitalization rate of 5.47%. Capitalized interest for the period can be calculated as follows:

<table>
<thead>
<tr>
<th>Average qualifying assets</th>
<th>$267,750</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capitalization rate</td>
<td>5.47%</td>
</tr>
<tr>
<td>Capitalized interest, as calculated</td>
<td>$14,646</td>
</tr>
</tbody>
</table>

The actual amount of interest capitalized during the period is $14,646, which is the lesser of the calculated amount and total interest cost of $3,505,254.

**Property Taxes and Insurance Costs**

FASB ASC 970-340-25-8 (formerly SFAS No. 67, Paragraph 6) states that property taxes and insurance costs that relate to a specific project should be capitalized whenever interest is being capitalized. Accordingly, the guidance on cost capitalization provided in the previous paragraphs also applies to property taxes and insurance costs.

**Capitalized Costs and Recoverability**

When the recoverability of the investment in a real estate project is questionable, the natural tendency for many accountants is to stop capitalizing development costs, especially indirect costs. But FASB ASC 835-20-25-7
(formerly SFAS No. 34, Paragraph 19) states that interest capitalization should not be discontinued even if GAAP requires the carrying amount of the asset to be reduced. Instead the provision for losses on the asset should be increased. The same principle could also be considered to apply to real estate development costs. Thus, project costs should continue to be capitalized, and impairment should be assessed separately. Real estate impairment is discussed in more detail later in this lesson.

Cost Allocation

FASB ASC 970-360-30-1 (formerly Paragraph 11 of SFAS No. 67) establishes a hierarchy of methods to use in allocating acquisition, development, and construction costs to each component of a real estate project. Those methods are (in order of preference):

a. Specific identification method.

b. Relative value method.

c. Other methods.

One method may be used for the entire project, or different methods can be used for different types of costs. However, after an allocation method is initially selected for a project (or type of cost), changing methods in subsequent periods can be accounted for as a change in accounting principle. [FASB ASC 250-10 (formerly SFAS No. 154, Accounting Changes and Error Corrections) requires changes in accounting principle to be treated retrospectively, primarily through balance sheet adjustments. PPC’s Guide to Preparing Financial Statements provides guidance on accounting for change in accounting principle.]

Specific Identification Method. The specific identification method involves recording each cost directly to the project component to which it belongs. According to FASB ASC 970-360-30-1 (formerly SFAS No. 67), specific identification should be used whenever practical. It is best suited to allocation of direct project costs for specific components. However, many common costs (costs that benefit more than one component of a project) are difficult to allocate using specific identification. When that is the case, other methods should be used.

Relative Value Methods. Relative value methods should be considered first when the specific identification method cannot be used. FASB ASC 970-360-30-1 (formerly SFAS No. 167, Paragraph 11) and DEP Paragraph 11.31 state that relative value methods should be applied as follows:

a. Land cost and all other common costs incurred prior to construction should be allocated based on the relative fair value of each land parcel before construction.

b. Construction costs should be allocated on the basis of the relative sales value of each component.

Example 1-2: Cost allocation using relative value methods

Assume that a land development project consists of two tracts of single-family home lots. The first tract has 30 lots with a selling price of $30,000 each. The second tract has 10 lots with a selling price of $75,000 each. No appraisal is available for the separate tracts. In that situation, development costs can be allocated as follows:

<table>
<thead>
<tr>
<th>Component</th>
<th>Number of Lots</th>
<th>Selling Price</th>
<th>Allocation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lower-priced lots</td>
<td>30</td>
<td>$30,000</td>
<td>$900,000</td>
</tr>
<tr>
<td>Higher-priced lots</td>
<td>10</td>
<td>$75,000</td>
<td>750,000</td>
</tr>
<tr>
<td>Total sales value</td>
<td></td>
<td></td>
<td>$1,650,000</td>
</tr>
</tbody>
</table>

Assuming capitalized costs total $1,320,000, 55% (or $726,000) should be allocated to the lower-priced lots, and 45% (or $594,000) should be allocated to the higher-priced lots. Those costs can then be allocated to individual lots using a similar approach.
Other Allocation Methods. Other allocation methods may be used as approximations of relative value methods or as alternative methods if neither the specific identification nor relative value methods is practical. The following are examples of other allocation methods:

a. *Equal Allocation.* Costs can be allocated equally to each component when all of the components (1) have the same characteristics, (2) are approximately the same size, and (3) will be sold for approximately the same price.

b. *Square Footage.* Square footage allocation is best suited to situations where all the components have the same characteristics (features, zoning, access, amenities, etc.) except for size and will be sold for approximately the same price per square foot.

c. *Frontage Size.* Cost allocation based on frontage size may be used when components with greater frontage are expected to have higher selling prices. Obviously, each component must have some frontage area to use frontage size allocation. Frontage refers to the boundary line that faces primary streets or access roads in a project.

Audit Considerations

The audit procedures used to test real estate acquisition, development, and construction costs normally consist of the following:

a. *Vouching Additions.* Documentation supporting certain costs capitalized during the period is examined to determine whether they are properly capitalizable. Testing is normally performed for significant items using a dollar cutoff. However, sampling may be used if there are many small additions.

b. *Testing Interest Capitalization.* The client’s calculations are reviewed and tested to determine whether interest is properly calculated. This involves consideration of such factors as:

   (1) Whether the capitalization rate and average qualifying asset amounts were calculated properly.

   (2) Whether sufficient activities were occurring during the period to warrant interest capitalization.

c. *Testing Cost Allocation.* The auditor should review the client’s cost allocation to determine whether costs were allocated properly to the components of the project, especially to any components that were sold. This involves consideration of the following factors:

   (1) Whether the client used specific identification or relative value methods, if practical, or an appropriate approximation.

   (2) Whether relative sales values and relative fair values are reasonable and supportable.

   (3) Whether the cost allocations were calculated correctly.
SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

3. Which of the following financial institutions has correctly accounted for foreclosure assets?
   a. Bank One receives assets in full settlement of a loan and records them at the amount of the original loan, less payments made on the loan by the borrower.
   b. Bank Two makes a real estate loan that is secured by a second lien on the collateral. When the borrower defaults on the second lien, the bank forecloses and pays off the first lien.
   c. Bank Three forecloses on property previously sold and accounted for under FASB ASC 360-20 using the full accrual method. The bank records the property at the lower of its fair value or the recorded investment in the loan.
   d. Bank Four makes repairs to a property after foreclosure. The repairs significantly increase fair value. The bank expenses the costs as incurred.

4. Rock Savings, a financial institution, forecloses on a commercial office building and then decides to relocate its offices into the new facilities. How should this asset be accounted for by the financial institution?
   a. It should be reported at the lower of fair value or its carrying amount. It should not be depreciated.
   b. It should be reviewed for impairment and then accounted for the same way as similar long-lived assets.

5. Leo, an auditor, is engaged to audit a financial institution. During the course of his audit, Leo examines documentation supporting proceeds the institution received and recomputes the gain that was associated. What is Leo auditing?
   a. Troubled debt restructuring.
   b. The carrying amount of foreclosed assets.
   c. Initial foreclosures.
   d. Sales of foreclosed assets.

6. Failsafe Mutual incurs costs for development activities related to a real estate asset owned by the financial institution. The development activities are currently underway. How should the institution account for these costs?
   a. Capitalize the amount as a cost of the project.
   b. Capitalize the amount as a cost of the project after property acquisition is probable.
   c. Expense the costs as they are incurred.

7. Failsafe Mutual incurs interest costs related to real estate being developed. These costs can be capitalized. When accounting for these costs, what would the institution calculate if it divided the interest cost incurred during the period by the average interest-bearing liabilities during the period?
   a. Average accumulated expenditures.
   b. The capitalization method.
   c. The interest capitalization rate.
   d. The limitation on capitalized interest.
8. Collin, an auditor, is engaged to audit Failsafe Mutual. As part of his audit procedures for testing real estate acquisition, development, and construction costs, Collin considers whether Failsafe Mutual used the specific identification or relative value methods, if practical, or an approximation that would be considered appropriate. This consideration would be part of what audit procedure?

a. Vouching additions.

b. Testing interest capitalization.

c. Testing cost allocation.
SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. (References are in parentheses.)

3. Which of the following financial institutions has correctly accounted for foreclosure assets? (Page 287)

   a. Bank One receives assets in full settlement of a loan and records them at the amount of the original loan, less payments made on the loan by the borrower. [This answer is incorrect. FASB ASC 310-40-40-3, as amended, states that assets received in full settlement of a loan should be recorded at their fair value (less cost to sell if the assets will be disposed of) at the date of foreclosure (or transfer). The recorded amount becomes the new cost basis of the asset. The rationale for recording foreclosures and asset transfers at fair value is that they are not merely reversals of the original loans. They are distinct transactions between borrowers and lenders that represent exchanges of loans for assets.]

   b. Bank Two makes a real estate loan that is secured by a second lien on the collateral. When the borrower defaults on the second lien, the bank forecloses and pays off the first lien. [This answer is correct. When the borrower defaults on that type of loan and the lender forecloses, the lender must either pay off the first lien or acquire the property subject to the first lien. In the latter case, the lender must make payments to the first lienholder, even if the lender had no legal obligation on the first lien before the foreclosures. If the property is acquired subject to a first lien, the lender should record the first lien as a liability. It should not be netted against the asset.]

   c. Bank Three forecloses on property previously sold and accounted for under FASB ASC 360-20 using the full accrual method. The bank records the property at the lower of its fair value or the recorded investment in the loan. [This answer is incorrect. If the sale was originally accounted for under the full accrual method before foreclosure, the property should be recorded at its fair value (less selling costs) in accordance with FASB ASC 310-40 and 470-60, as amended. Bank Three would account for the property in the manner described above if the sale was originally accounted for under a method other than the full accrual method, and the transaction was in substance a sale (that is, the transaction was accounted for using the installment, cost recovery, or reduced profit method).]

   d. Bank Four makes repairs to a property after foreclosure. The repairs significantly increase fair value. The bank expenses the costs as incurred. [This answer is incorrect. The cost of repairs or physical improvements to a foreclosed asset should be capitalized if they significantly increase the fair value of the asset. Otherwise, they should be expensed as incurred.]

4. Rock Savings, a financial institution, forecloses on a commercial office building and then decides to relocate its offices into the new facilities. How should this asset be accounted for by the financial institution? (Page 289)

   a. It should be reported at the lower of fair value or its carrying amount. It should not be depreciated. [This answer is incorrect. This would be true of a foreclosed asset that meets all the criteria to be considered as held for sale under FASB ASC 360-10-45-9. Because Rock Savings has decided to use the asset, it does not qualify as held for sale, so it should not be accounted for in this manner.]

   b. It should be reviewed for impairment and then accounted for the same way as similar long-lived assets. [This answer is correct. The asset described above would be considered a foreclosed asset to be held and used. After foreclosure, foreclosed assets (whether classified as held and used or held for disposal other than by sale) should be accounted for in the same way as similar long-lived assets. Accordingly, depreciation should be recorded on depreciable property, and impairment should be assessed and measured using the FASB ASC 360-10 rules for assets held and used.]
5. Leo, an auditor, is engaged to audit a financial institution. During the course of his audit, Leo examines documentation supporting proceeds the institution received and recomputes the gain that was associated. What is Leo auditing? (Page 289)

   a. Troubled debt restructuring. [This answer is incorrect. This audit procedure does not apply to a troubled debt restructuring. There is disagreement among auditors as to whether FASB ASC 310-40 and 470-60 apply to all foreclosures.]

   b. The carrying amount of foreclosed assets. [This answer is incorrect. When auditing the carrying amount of foreclosed assets, Leo would perform different audit procedures, such as examining supporting documentation for any significant capitalized costs that were added to the assets during the period and comparing the cost of each foreclosed asset held for sale selected for testing to its current fair value less selling costs at the balance sheet date.]

   c. Initial foreclosures. [This answer is incorrect. When auditing initial foreclosures, Leo would perform different audit procedures, such as testing new foreclosures for the period.]

   d. Sales of foreclosed assets. [This answer is correct. The auditor typically tests significant gains and losses on sales of assets to determine whether they are properly recognized. The audit procedures described above would allow Leo to do this. If the property sold was real estate, he would also determine whether the sale was accounted for in accordance with FASB ASC 360-20 and 970.]

6. Failsafe Mutual incurs costs for development activities related to a real estate asset owned by the financial institution. The development activities are currently underway. How should the institution account for these costs? (Page 291)

   a. Capitalize the amount as a cost of the project. [This answer is correct. FASB ASC 970-340 and 970-360, as amended, provide the primary guidance on accounting for real estate acquisition, development, and construction costs. If a cost relates to real estate development activities and the development activities are currently underway, the institution can capitalize the amount as a cost of the project.]

   b. Capitalize the amount as a cost of the project after property acquisition is probable. [This answer is incorrect. According to FASB ASC 970-340 and 970-360, if the costs related to real estate acquisition and the cost was directly related to the project, the institution could capitalize the amount as a cost of the project. However, if the costs were preacquisition costs, they could only be capitalized after property acquisition became probable.]

   c. Expense the costs as they are incurred. [This answer is incorrect. Under FASB ASC 970-340 and 970-360, costs related to a real estate asset are expensed as incurred when they are (1) related to neither real estate acquisition nor development activities, (2) acquisition costs not related to the project directly, or (3) development costs for activities that are not currently underway.]

7. Failsafe Mutual incurs interest costs related to real estate being developed. These costs can be capitalized. When accounting for these costs, what would the institution calculate if it divided the interest cost incurred during the period by the average interest-bearing liabilities during the period? (Page 294)

   a. Average accumulated expenditures. [This answer is incorrect. This is calculated by taking the average net balance of capitalized costs of all components of the real estate project that are undergoing development or construction during the period. The capitalized balance used in calculating the average should be net of property sold, but it is not net of impairment writedowns.]

   b. The capitalization method. [This answer is incorrect. Under FASB ASC 835-20-25-2 through 25-7, the interest cost to be capitalized each period is calculated by multiplying the average accumulated expenditures by the interest capitalization rate.]
c. The interest capitalization rate. [This answer is correct. The basic principle in GAAP is that the interest to be capitalized is the interest cost that theoretically would have been avoided if the project did not exist. Since financial institutions rarely incur specific debts to finance their real estate projects, however, the interest capitalization rate should generally be based on the institution’s total interest cost incurred during the capitalization period, and it can be determined using the formula specified above.]

d. The limitation on capitalized interest. [This answer is incorrect. FASB ASC 835-20-30-6 states that capitalized interest during the period cannot exceed the amount of interest actually incurred. This limitation is consistent with the GAAP principle that the interest to be capitalized is the interest cost that theoretically would have been avoided if the project did not exist.]

8. Collin, an auditor, is engaged to audit Failsafe Mutual. As part of his audit procedures for testing real estate acquisition, development, and construction costs, Collin considers whether Failsafe Mutual used the specific identification or relative value methods, if practical, or an approximation that would be considered appropriate. This consideration would be part of what audit procedure? (Page 297)

a. Vouching additions. [This answer is incorrect. When performing this audit procedure, Collin should examine documentation supporting certain costs capitalized during the period to determine whether they are properly capitalizable. Testing is normally performed for significant items using a dollar cutoff. However, sampling may be used if there are many small additions. The consideration made by Collin in this scenario is not considered part of this vouching process.]

b. Testing interest capitalization. [This answer is incorrect. When performing this audit procedure, Collin should review the client’s calculations and test them to determine whether interest is properly calculated. This involves consideration of such factors as: (1) whether the capitalization rate and average qualifying asset amounts were calculated properly and (2) whether sufficient activities were occurring during the period to warrant interest capitalization. The consideration made by Collin in this scenario is not considered part of the tests of interest capitalization.]

c. Testing cost allocation. [This answer is correct. When performing this audit procedure, Collin should review the client’s cost allocation to determine whether costs were allocated properly to the components of the project, especially to any components that were sold. This involves consideration of the following factors: (1) whether the client used specific identification or relative value methods, if practical, or an appropriate approximation, (2) whether relative sales and relative fair values are reasonable and supportable, and (3) whether the cost allocations were calculated correctly.]
METHODS USED TO ACCOUNT FOR REAL ESTATE SALES

Before 1993, regulatory agencies often prescribed their own accounting rules for real estate sales. Now, however, all financial institutions must follow FASB ASC 360-20 and 976 (formerly SFAS No. 66), which do not provide detailed guidance on accounting for losses on real estate sales. The guidance merely states that losses on those sales should be recognized when incurred. However, the FASB Statement provides the following accounting methods for recognizing gains on sales of real estate:

a. Full accrual method.
b. Installment method.
c. Deposit method.
d. Cost recovery method.
e. Reduced profit method.
f. Percentage-of-completion (performance-of-services) method.
g. Financing, leasing, or profit-sharing method.

The most commonly used methods are the full accrual, installment, and deposit methods. Under both the full accrual and the installment methods, the institution recognizes a sale and records a loan receivable. Under the deposit method, a sale is not recorded and the property remains on the institution’s books. These three methods are discussed in the following paragraphs. The other methods are discussed in detail in PPC’s Guide to Real Estate.

Calculating Gains on Sales of Real Estate

The gain on sale of real estate is generally determined by subtracting the book value of the real estate sold (along with any selling costs) from the sales value of the property. For this purpose, book value is net of accumulated depreciation and any valuation allowances.

What Is Sales Value? Exhibit 1-2 shows how to determine sales value. The components of the calculation are—

a. Contract Sales Price. This is the sales price specified in the sales contract. The contract sales price typically consists of cash, assumption of existing debt, notes payable to the seller, or some combination of the three.
b. Additional Proceeds. Payments that are, in substance, additional sales proceeds include the following:

(1) Fees, points, or prepaid interest that are paid in advance and will be applied in the future against the seller’s receivable.

(2) Proceeds from an option that the buyer exercises to purchase the property.

(3) Present value of a land lease in connection with the sale of a building.
c. Discount to Reduce the Seller’s Receivable to Present Value. Generally, if the seller’s receivable does not bear interest at a market rate (or higher), the receivable should be discounted to a market rate. The discount also reduces the sales value.
d. Present Value of Seller Services to Be Performed without Compensation or at Less Than Prevailing Rates. If the seller is required to perform additional services, such as managing the property for a specific period of time, sales value is reduced by the present value of those services in excess of the compensation that will be received.
Exhibit 1-2

Determining Sales Value

Contract sales price
+ Additional sales proceeds
  − Discount to reduce seller’s receivable to present value
  − Present value of seller services to be performed without compensation or at less than prevailing rates

= Sales value

* * *

Full Accrual Method

When Is It Used? The full accrual method is used when (a) the seller no longer has any obligations with respect to the property and (b) the collectibility of the sales price and additional proceeds is reasonably assured (or the uncollectible portion can be reasonably estimated). FASB ASC 405 (formerly SFAS No. 66) provides a list of specific conditions that must be met to use the full accrual method, as discussed later in this lesson.

How Is Gain Recognized? Under the full accrual method, the entire gain on the sale is recognized at the date of sale. To illustrate the full accrual method, consider the following facts:

Example 13: Accounting for real estate sale under the full accrual method.

Buyer (B) agrees to buy a tract of raw land from Seller (S) for $251,000 in cash. The land has a cost of $140,000. Under the full accrual method, the entire gain of $111,000 ($251,000 − $140,000) is recognized. S records the transaction as follows:

<table>
<thead>
<tr>
<th>DR</th>
<th>CR</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash $ 251,000</td>
<td></td>
</tr>
<tr>
<td>Land $ 140,000</td>
<td>Gain on sale of land $ 111,000</td>
</tr>
</tbody>
</table>

Installment Method

When Is It Used? The installment method is commonly used for sales in which the seller provides some of the financing and either—

- The buyer does not make a sufficient down payment or
- The payment terms on the seller’s receivable are not adequate.

The assumption behind the installment method is that the buyer is not sufficiently committed to the property to ensure that the seller’s receivable will be repaid. However, to use the installment method, there should be reasonable assurance that the seller’s investment in the property (the book value of the property sold) is recoverable if the buyer defaults, as discussed later in this lesson. Also, the installment method may be used to record partial sales of real estate if collection of the sales price is not reasonably assured.

How Is Gain Recognized? Under the installment method, gain is generally recognized proportionately as the sales value is collected. The formula for determining the gain to be recognized each period under the installment method is:
In applying this formula, a gain percentage is calculated as of the sale date by dividing the gain by the sales value, and that percentage is applied to the principal payments received. If the seller provides services without compensation, the imputed compensation should be recognized as revenue as the services are performed. In that case, the seller should allocate the principal payments received between those that relate to the sale of real estate and those that relate to the additional services.

FASB ASC 360-20-55-8 (formerly Paragraph 57 of SFAS No. 66) states that, under the installment method, it is not necessary to discount sellers’ receivables that have below market interest rates. It is generally more conservative not to discount the receivable when applying the installment method.

The principal payments received in the preceding formula include both principal payments on the buyer’s note to the seller and principal payments made on existing debt assumed by the buyer. However, according to FASB ASC 360-20-40-32 (formerly EITF Issue No. 88-24, Effect of Various Forms of Financing under SFAS No. 66), those payments should not include any funds obtained from (a) the seller or (b) loans that are secured by the property, even if those loans are provided from third parties. For example, assume that the buyer obtained a second mortgage from another financial institution to, among other things, finance the first three annual payments on the seller’s receivable. In that situation, gain could not be recognized from the first three principal payments because they are funded through other debt on the property.

Additional Gain Recognition. FASB ASC 360-20-40-32 (formerly EITF Issue No. 88-24) outlines additional circumstances in which gain should be recognized under the installment method. The EITF concluded that the seller should recognize as income the excess of the deferred gain balance over the sum of the following:

- **Seller’s Receivable.** The current balance of the seller’s receivable.
- **Contingent Liability.** The amount of contingent liability to the seller for other loans, for example, loans guaranteed or collateralized by the seller or existing debt assumed by the buyer without the seller being released from liability.

The excess deferred gain is recognized as income in addition to any gain recognized based on principal payments received.

The excess deferred gain normally arises because either—

- The seller finances only a small portion of the sales value, and the rest is financed through third-party debt on the property. (In that situation, the deferred gain balance may equal or exceed the seller’s receivable balance.)

- The seller’s receivable has been reduced significantly through payments funded from third-party debt on the property. (In that situation, the seller’s receivable balance is being reduced, but deferred gain has not been recognized because the payments were funded from debt on the property.)

In those situations, the deferred gain exceeds the principal balance of the receivable, resulting in a negative net receivable. However, even if there is a negative net receivable, the amount of additional gain that can be recognized must be reduced by the amount of the seller’s contingent liability on the property.

**Example 1-4: The installment method**

Assume the same facts as described in Example 1-3 except that B makes a $10,000 down payment and gives S a note for the remaining $241,000. The note is payable in 20 annual payments of $12,050, plus interest at prime plus 1%. Assuming the conditions for using the installment method are met, the journal entry to record the sale on 1/1/X1 (the sale date) is as follows:
Cash $ 10,000
Note receivable from B 241,000
Land $ 140,000
Gain on sale of real estatea 4,400
Deferred gain 106,600

Note:

a $111,000
$251,000 $10,000 = $4,400 (rounded)

Exhibit 1-3 shows the payments made and the gain recognized after each of the first four payments are made. The seller’s journal entries for those years are as follows:

1/1/X2

DR CR
Cash $ 36,050
Deferred gain 5,300
Note receivable from B $ 12,050
Interest income 24,000
Gain on sale of real estate 5,300

1/1/X3

DR CR
Cash $ 35,050
Deferred gain 5,300
Note receivable from B $ 12,050
Interest income 23,000
Gain on sale of real estate 5,300

1/1/X4

DR CR
Cash $ 34,050
Deferred gain 5,300
Note receivable from B $ 12,050
Interest income 22,000
Gain on sale of real estate 5,300

1/1/X5

DR CR
Cash $ 32,050
Deferred gain 5,300
Note receivable from B $ 12,050
Interest income 20,000
Gain on sale of real estate 90,700
Exhibit 1-3

Example of Gain Recognition under the Installment Method

### Payments

<table>
<thead>
<tr>
<th>Year</th>
<th>Principal</th>
<th>Interest</th>
<th>Total</th>
<th>Loan Balance</th>
<th>Cumulative Principal Payments</th>
</tr>
</thead>
<tbody>
<tr>
<td>X1</td>
<td>$</td>
<td>$</td>
<td>$</td>
<td>$241,000</td>
<td>$10,000&lt;sup&gt;a&lt;/sup&gt;</td>
</tr>
<tr>
<td>X2</td>
<td>12,050</td>
<td>24,000</td>
<td>36,050</td>
<td>228,950</td>
<td>22,050</td>
</tr>
<tr>
<td>X3</td>
<td>12,050</td>
<td>23,000</td>
<td>35,050</td>
<td>216,900</td>
<td>34,100</td>
</tr>
<tr>
<td>X4</td>
<td>12,050</td>
<td>22,000</td>
<td>34,050</td>
<td>204,850</td>
<td>46,150</td>
</tr>
<tr>
<td>X5</td>
<td>12,050</td>
<td>20,000</td>
<td>32,050</td>
<td>192,800</td>
<td>58,200</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Year</th>
<th>Gain Recognized&lt;sup&gt;b&lt;/sup&gt;</th>
<th>Deferred Gain Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>X1</td>
<td>$4,400</td>
<td>$106,600</td>
</tr>
<tr>
<td>X2</td>
<td>5,300</td>
<td>101,300</td>
</tr>
<tr>
<td>X3</td>
<td>5,300</td>
<td>96,000&lt;sup&gt;c&lt;/sup&gt;</td>
</tr>
<tr>
<td>X4</td>
<td>5,300</td>
<td>90,700</td>
</tr>
<tr>
<td>X5</td>
<td>90,700</td>
<td>—</td>
</tr>
<tr>
<td>Total</td>
<td>$111,000</td>
<td>—</td>
</tr>
</tbody>
</table>

Notes:

- <sup>a</sup> Consists of the $10,000 down payment.
- <sup>b</sup> $111,000 total gain = $251,000 sales value × Principal payments for the period.
- <sup>c</sup> After the fourth payment on 1/1/X5, B’s cumulative payments are sufficient to recognize the remainder of the gain on the full accrual method.

### Deposit Method

**When Is It Used?** The deposit method is typically used in any of the following circumstances:

- The sale has not been completed.
- The seller has merely given the buyer an option to buy the property.
- The seller guarantees a return on the buyer’s investment for a limited period and the property is currently experiencing operating deficits.

In those situations, the earnings process is not considered complete, and the sale cannot be recognized.

**How Is Gain Recognized?** When the deposit method is used, the seller accounts for the transaction as if no sale had occurred. Accordingly, under the deposit method—

- No gain is recognized. (FASB ASC 360-20-40-29 (formerly Paragraph 21 of SFAS No. 66) states that a loss should be recognized when the sales contract is signed if the book value of the property exceeds the sum
of the deposit received, the fair value of the seller’s receivable, and the existing debt assumed by the buyer. Also, if the seller determines that it is probable that the buyer will default and the seller will reacquire the property, a valuation allowance may be needed if the property has declined in value.)

- The seller does not record a receivable from the buyer.
- The seller continues to keep the property (and any existing debt on that property) on the books.
- All payments received from the buyer are recorded as deposits (liability) by the seller, except nonrefundable interest payments received. Those interest payments can be offset against holding costs paid by the seller on the property (such as property taxes and interest on existing debt on the property).
- Principal payments made by the buyer on existing debt (which is still recorded on the seller’s books) should be reflected by the seller as reductions of the debt balance and increases in the deposit liability.
- The seller continues to record revenues and expenses relating to the property, including depreciation of buildings and improvements. [However, if the property has been classified as held for sale in accordance with FASB ASC 360-10-45-9 (formerly Paragraph 30 of SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets), depreciation of the property should not be recorded.]

**Example of the Deposit Method.** The preceding examples in this section are not well suited to the deposit method. Accordingly, the following facts are used in Example 1-5:

**Example 1-5:** Accounting for real estate sale under the deposit method.

On 1/1/X1, Seller (S) sells raw land with a book value of $300,000 to Buyer (B) for $505,000. B makes a token down payment of $5,000. B also assumes existing debt of $150,000, but S remains liable on the debt. S finances the remaining sales value of $350,000 with a second lien mortgage. Payment terms on the assumed debt are $15,000 per year plus interest at 8%. Terms on the seller’s receivable are interest only at 10% for nine years with a balloon payment of $350,000 plus interest at the end of the 10th year. Recovery of the seller’s investment is uncertain, and the deposit method is determined to be the most appropriate accounting method.

Under the deposit method, the sale is not recognized, and the seller’s receivable is not recorded. Both the property and existing debt remain on S’s books. Thus, the journal entry made on the date of sale is:

\[
\begin{align*}
\text{DR} & \quad \text{CR} \\
\text{Cash} & \quad \$5,000 \\
\text{Deposit liability} & \quad \$5,000
\end{align*}
\]

On 1/1/X2, B makes payments of $27,000 ($15,000 principal and $12,000 interest) on the assumed debt and $35,000 (interest) on the seller’s receivable. S’s entries to record those payments are:

**Assumed debt payment**

\[
\begin{align*}
\text{DR} & \quad \text{CR} \\
\text{Note payable (liability on property sold)} & \quad \$15,000 \\
\text{Deposit liability} & \quad \$15,000
\end{align*}
\]

**Seller’s receivable payment**

\[
\begin{align*}
\text{DR} & \quad \text{CR} \\
\text{Cash} & \quad \$35,000 \\
\text{Deposit liability} & \quad \$35,000
\end{align*}
\]

Note that no entry was made for the $12,000 of interest paid on the assumed debt. Under FASB ASC 360-20 (formerly SFAS No. 66), the seller records only the principal payments on assumed debt.
Sometimes, the seller may retain the existing debt and the buyer may agree to give the seller an all-inclusive or wraparound loan. In those arrangements, the seller is still responsible for making payments on the existing debt, but the buyer gives the seller the money to make those payments.

**Example 1-6: Accounting for real estate sale under the deposit method with wraparound loan.**

In Example 1-5, if the seller received a $500,000 wraparound loan instead of a $350,000 second lien, the journal entries to record the payments would be as follows:

**Existing debt payment**

<table>
<thead>
<tr>
<th>DR</th>
<th>CR</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense</td>
<td>$12,000</td>
</tr>
<tr>
<td>Notes payable</td>
<td>15,000</td>
</tr>
<tr>
<td>Cash</td>
<td>$27,000</td>
</tr>
</tbody>
</table>

**Seller’s receivable payment**

<table>
<thead>
<tr>
<th>DR</th>
<th>CR</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$62,000</td>
</tr>
<tr>
<td>Deposit liability</td>
<td>$50,000</td>
</tr>
<tr>
<td>Interest expense</td>
<td>$12,000</td>
</tr>
</tbody>
</table>

**Example 1-7: Accounting for real estate sale under the deposit method with subsequent refinancing.**

Referring to Example 1-5, assume that after the first payments were made, B obtained new bank financing, paid off the assumed debt, and obtained an irrevocable letter of credit to back the seller’s receivable. The transaction would then qualify for the full accrual method. The journal entry to record the sale and recognize the gain is as follows:

<table>
<thead>
<tr>
<th>DR</th>
<th>CR</th>
</tr>
</thead>
<tbody>
<tr>
<td>Note payable (liability on property sold) ($150,000 — $15,000)</td>
<td>$135,000</td>
</tr>
<tr>
<td>Note receivable</td>
<td>350,000</td>
</tr>
<tr>
<td>Deposit liability [$5,000 + $15,000 + $35,000]</td>
<td>$55,000</td>
</tr>
<tr>
<td>Land</td>
<td>$300,000</td>
</tr>
<tr>
<td>Gain on sale [($505,000 — $300,000) + $35,000]</td>
<td>$240,000</td>
</tr>
</tbody>
</table>

The gain on the sale consists of the sales value of the land less its book value ($505,000 — $300,000) or $205,000 plus the interest income on the seller’s receivable of $35,000 that was originally recorded as an additional deposit.

**CHOOSING THE RIGHT METHOD TO ACCOUNT FOR REAL ESTATE SALES**

FASB ASC 360-20 (formerly SFAS No. 66) prescribes the accounting method to be used for recognizing gain on a real estate sale. The method to be used generally depends on the terms of the sale.

**The Primary Conditions for Using the Full Accrual Method**

Sellers of real estate usually prefer to use the full accrual method of profit recognition, whenever possible. The full accrual method should be used only when all of the following conditions are met:

a. *Completed Sale.* The sale must have been consummated.

b. *Risks and Rewards Transferred.* The sale must transfer the risks and rewards of ownership to the buyer, and the seller must be free from continuing involvement with the property.
c. **Superior Lien.** The seller’s lien on the property must be superior to all other liens on the property, with certain exceptions.

d. **Adequate Investment.** The buyer’s investments (both initial and continuing investments) must meet the minimum guidelines established by FASB ASC 360-20-40-9 through 40-24 (formerly SFAS No. 66).

If one of those conditions is not met, a method other than the full accrual method must be used. Those conditions are discussed in the following paragraphs.

**Has the Sale Been Consummated?**

Generally, a sale is considered consummated when it is closed. FASB ASC 360-20-40-7 (formerly SFAS No. 66) lists the following criteria for determining whether a sale has been completed:

a. **Binding Contract.** There is a contract that binds both parties.

b. **Exchange of Consideration.** All consideration (such as cash, notes, and deeds) has been exchanged.

c. **Financing Arrangements.** If the seller is responsible for arranging financing for the buyer, that financing has been arranged.

d. **Closing Requirements.** All of the conditions needed to close the sale (such as title policy, surveys, inspections, and permits) have been met.

If the sale has not been consummated (that is, if all of the preceding conditions are not met), the transaction should generally be accounted for using the **deposit method**. However, FASB ASC 360-20-40-28 (formerly SFAS No. 66) allows a special exception when the property being sold is rental property that is still under construction. In those cases, the seller normally will not be able to get a certificate of occupancy, which is a requirement for closing. In such cases, the transaction should be accounted for using the percentage-of-completion method.

**Does the Sale Transfer the Risks and Rewards of Ownership?**

Under FASB ASC 360-20-40-5 (formerly SFAS No. 66), one of the primary conditions for gain recognition is that the seller must have transferred substantially all the risks and rewards of owning the property. Usually, the most important question is—Does the seller still have most of the risk on the property (such as the risk of unprofitable operations, obsolescence, or decline in value)?

FASB ASC 360-20-40-38 through 40-64 (formerly SFAS No. 66) describes common forms of continuing involvement with the property and discusses how those situations should be accounted for. Exhibit 1-4 shows the accounting methods that should be used for various types of seller involvement.

**Does the Seller Have a Superior Lien?**

If the seller finances the sale, it should have a superior lien to all other debt on the property, except for the following:

- **An existing loan** at the date of sale.
- **Any future loan** that is provided for in the sales agreement, if the proceeds of that debt will be applied first to pay the seller’s receivable.

Generally, the lien superiority condition is met if the seller has a bona fide first lien that has been filed with the appropriate government officials. That condition is not met, however, if either—

- The seller has a second lien behind other loans, except for those listed above.
- The seller has agreed to allow a future loan to have a first lien (or other lien ahead of the seller’s receivable), except for the loans listed above.
### Exhibit 1-4

**Examples of Accounting for Continuing Seller Involvement**

<table>
<thead>
<tr>
<th>Financing, Leasing, or Profit Sharing Arrangement</th>
<th>Percentage-of-completion Method (Performance-of-services Method)</th>
<th>Deposit Method or Other Methods</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Seller guarantees the buyer’s investment or a return on that investment for an extended period. FASB ASC 360-20-40-41 (formerly ¶ 28)</td>
<td>• Seller guarantees the buyer’s investment or a return on that investment for a limited period, and current operations cover all expenses and other payments. FASB ASC 360-20-40-41 (formerly ¶ 28)</td>
<td>• Seller guarantees the buyer’s investment or a return on that investment for an extended period, and current operations do not cover all expenses and other payments. FASB ASC 360-20-40-41 (formerly ¶ 28)</td>
</tr>
<tr>
<td>• Seller is required to support operations of the property for an extended period. FASB ASC 360-20-40-42–40-43 (formerly ¶ 29–31)</td>
<td>• Seller is required to support operations of the property for a limited period. FASB ASC 360-20-40-42–40-43 (formerly ¶ 29–31)</td>
<td>• Seller is required to support operations of the property for a limited period. FASB ASC 360-20-40-42–40-43 (formerly ¶ 29–31)</td>
</tr>
<tr>
<td>• Seller has option or obligation to repurchase the property. FASB ASC 360-20-40-38 (formerly ¶ 26)</td>
<td>• Seller is required to develop the property or build facilities or amenities, and development costs can be reasonably estimated. FASB ASC 360-20-40-61–40-63 (formerly ¶ 41–42)</td>
<td>• Seller is required to develop the property, etc., but development costs cannot be estimated. FASB ASC 360-20-40-61–40-63 (formerly ¶ 41–42)</td>
</tr>
<tr>
<td>• Buyer has an option to force seller to repurchase the property. FASB ASC 360-20-40-38 (formerly ¶ 26)</td>
<td>• Seller has an ownership interest in the property or buyer after the sale (also known as a partial sale.) FASB ASC 360-20-40-56–40-59 (formerly ¶ 38–39)</td>
<td>• Seller sells property improvements and leases the underlying land to the buyer. FASB ASC 360-20-40-56–40-59 (formerly ¶ 38–39)</td>
</tr>
<tr>
<td>• Seller is a general partner in a partnership that buys the property, and the seller holds a significant receivable. FASB ASC 360-20-40-40 (formerly ¶ 27)</td>
<td>• Seller is a general partner in a partnership that buys the property, and the seller holds a significant receivable. FASB ASC 360-20-40-40 (formerly ¶ 27)</td>
<td>• Seller has an ownership interest in the property or buyer after the sale (also known as a partial sale.) FASB ASC 360-20-40-56–40-59 (formerly ¶ 38–39)</td>
</tr>
</tbody>
</table>

#### Note:

a References in parentheses are to paragraphs in FASB ASC 360-20 (formerly SFAS No. 66).

* * *

If the lien superiority condition is not met, the seller’s receivable is considered to be “subject to future subordination.” In such cases, the seller does not have the first right to the property if the buyer defaults. Consequently, recoverability of the seller’s investment in the property is not assured. FASB ASC 360-20-40-31 (formerly SFAS No. 66) requires that the cost recovery method should be used when the lien superiority condition is not met.

**Are the Buyer’s Investments Adequate?**

**What Constitutes the Buyer’s Investments?** There are two investments that must be considered in determining whether the full accrual method can be used—the initial investment and the continuing investment. The initial
investment is the buyer’s down payment, and the continuing investment represents the payments made on the seller’s receivable over the loan term. However, those payments can be made in forms other than cash. Exhibit 1-5 shows the forms of investments that can and cannot be considered part of the buyer’s investments under FASB ASC 360-20-40-9 through 40-18 (formerly SFAS No. 66).

**Exhibit 1-5**

**SFAS No. 66 Requirements—Forms of the Buyer’s Investments**

<table>
<thead>
<tr>
<th>Forms That Can Be Considered Part of the Buyer’s Investments</th>
<th>Forms That Cannot Be Considered Part of the Buyer’s Investments</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Cash. FASB ASC 360-20-40-10 (formerly ¶ 9)</td>
<td>• Payments by the buyer for improvements to the property. FASB ASC 360-20-40-13 (formerly ¶ 10)</td>
</tr>
<tr>
<td>• Payments by the buyer to third parties to reduce existing debt against the property. FASB ASC 360-20-40-10 (formerly ¶ 9)</td>
<td>• A permanent loan commitment by an independent third party to replace a loan made by the seller. FASB ASC 360-20-40-13 (formerly ¶ 10)</td>
</tr>
<tr>
<td>• Additional proceeds paid in cash that are part of sales value. FASB ASC 360-20-40-10 (formerly ¶ 9)</td>
<td>• Any funds that have been loaned or otherwise provided (directly or indirectly) by the seller, b FASB ASC 360-20-40-13 (formerly ¶ 10)</td>
</tr>
<tr>
<td>• Notes payable to the seller, backed by letters of credit from an independent financial institution. FASB ASC 360-20-40-10 (formerly ¶ 9)</td>
<td>• Loans obtained from third parties that have been guaranteed or secured by the seller for the buyer, b FASB ASC 360-20-40-13 (formerly ¶ 10)</td>
</tr>
<tr>
<td>• Notes payable to the seller, backed by surety bonds that have all the rights and obligations of irrevocable letters of credit (that is, surety bonds that give the seller the same rights of collection, place on the surety the same obligation to pay, and give the surety the same recourse to the buyer if the buyer defaults). [FASB ASC 360-20-40-11 and 40-12; 360-20-55-3 (formerly EITF 87-9)]</td>
<td>• Loans obtained by the buyer from third parties, either directly or through assumption, and secured by the property. (This also includes payments to the seller that are funded by such loans,) b [FASB ASC 360-20-40-17 (formerly EITF 88-24)]</td>
</tr>
<tr>
<td>• Other consideration, after it has been converted to cash without recourse to the seller. FASB ASC 360-20-40-10 (formerly ¶ 9)</td>
<td>• Assets securing the buyer’s note payable to the seller. FASB ASC 360-20-55-66 and 55-67 (formerly EITF 88-12)</td>
</tr>
<tr>
<td></td>
<td>• Notes payable to the seller backed by private mortgage insurance. [FASB ASC 360-20-40-12 (formerly EITF 87-9)]</td>
</tr>
</tbody>
</table>

**Notes:**

a References in parentheses are to paragraphs in FASB ASC 360-20 (formerly SFAS No. 66) or Emerging Issues Task Force Issues.

b For purposes of the continuing investment test, FASB ASC 360-20-40-20 (formerly SFAS No. 66, Paragraph 12), states that a future loan from an established lending institution need not be subtracted from the buyer’s investment if (1) the loan has market terms and (2) the loan proceeds are conditional on specified development or construction on the property.

* * *

**Assessing the Initial Investment.** The minimum initial investment required under FASB ASC 360-20-55-1 and 55-2 (formerly SFAS No. 66) depends on whether there has been a recent permanent loan or loan commitment placed by an independent institution for the maximum amount of financing available on that type of property. If there has been no recent loan or commitment, the minimum required investment is a specified percentage of the sales value.
(defined in Exhibit 1-2). Exhibit 1-6 lists the percentage requirements specified in FASB ASC 360-20-55-1 and 55-2 (formerly SFAS No. 66).

**Exhibit 1-6**

**Table of Minimum Initial Investment**

<table>
<thead>
<tr>
<th>Type of Property</th>
<th>Percentage of Sales Value&lt;sup&gt;a&lt;/sup&gt;</th>
</tr>
</thead>
<tbody>
<tr>
<td>LAND to be developed:</td>
<td></td>
</tr>
<tr>
<td>Within 2 years from sale date.</td>
<td>20%</td>
</tr>
<tr>
<td>After 2 years.</td>
<td>25</td>
</tr>
<tr>
<td>SINGLE FAMILY HOMES, CONDOMINIUM UNITS, TOWNHOMES, AND 1–4 FAMILY RESIDENCES&lt;sup&gt;b,c&lt;/sup&gt;</td>
<td></td>
</tr>
<tr>
<td>Buyer’s primary residence.</td>
<td>5</td>
</tr>
<tr>
<td>Buyer’s secondary or recreational residence.</td>
<td>10</td>
</tr>
<tr>
<td>MULTI-FAMILY RESIDENTIAL PROPERTY</td>
<td></td>
</tr>
<tr>
<td>Primary residence:</td>
<td></td>
</tr>
<tr>
<td>Current cash flow is adequate to cover all debt payments.</td>
<td>10</td>
</tr>
<tr>
<td>Cash flow is not adequate (including start-up situations).</td>
<td>15</td>
</tr>
<tr>
<td>Secondary or recreational residence:</td>
<td></td>
</tr>
<tr>
<td>Current cash flow is adequate to cover all debt payments.</td>
<td>15</td>
</tr>
<tr>
<td>Cash flow is not adequate (including start-up situations).</td>
<td>25</td>
</tr>
<tr>
<td>OFFICE BUILDINGS, SHOPPING CENTERS, INDUSTRIAL BUILDINGS, AND SIMILAR PROPERTIES</td>
<td></td>
</tr>
<tr>
<td>Current cash flow is adequate to cover all debt payments; property is subject to long-term leases to parties with good credit ratings.</td>
<td>10</td>
</tr>
<tr>
<td>Single-tenant properties sold to a buyer with a good credit rating.</td>
<td>15</td>
</tr>
<tr>
<td>All other.</td>
<td>20</td>
</tr>
<tr>
<td>HOTELS, MOBILE HOME PARKS, MARINAS, AND OTHER INCOME-PRODUCING PROPERTIES</td>
<td></td>
</tr>
<tr>
<td>Current cash flow is adequate to cover all debt payments.</td>
<td>15</td>
</tr>
<tr>
<td>Cash flow is not adequate (including start-up situations).</td>
<td>25</td>
</tr>
</tbody>
</table>

**Notes:**

<sup>a</sup> Sales value was defined earlier in this lesson.

<sup>b</sup> If the sale is financed under an FHA or VA insured program, the normal down payment required under these programs can be used to determine the required initial investment.

<sup>c</sup> If the remaining portion of the sales value is financed by the seller and collectibility of the seller’s receivable cannot be supported by reliable evidence of collection experience, then the minimum initial investment must
be at least 60% of the difference between the sales value and the maximum amount of financing available through FHA or VA insured programs or through independent financial institutions.

* * *

GAAP does not explain what a recent loan or commitment is. One interpretation is that a loan or commitment made over a year before the sale generally would not be considered recent. However, even a loan made within a year of the sale may not be recent if there have been significant changes in interest rates or lending conditions since the loan or commitment was made.

If an independent financial institution has recently placed a permanent loan or made a firm permanent loan commitment for the maximum amount of financing available, the initial investment requirement is the greater of the following:

a. The value determined using the table in Exhibit 1-6.

b. The lesser of:

(1) 25% of sales value.

(2) \[
\text{Sales Value} - \left( 1.15 \times \frac{\text{amount of the recent permanent loan or commitment}}{\text{recent permanent loan or commitment}} \right)
\]

As a general rule, the initial investment will not be less than the table value determined using Exhibit 1-6, and it will not be larger than 25% of sales value. The table values can be used in practice to determine whether the initial investment is adequate.

**What If the Initial Investment Test Is Not Met?** If the initial investment test is not met, one of the following accounting methods generally should be used to recognize gain on the sale:

a. **Installment Method.** The installment method is used when recovery of the seller’s investment in the property is reasonably assured.

b. **Cost Recovery Method.** The cost recovery method is used in either of the following situations:

   (1) Recovery of the seller’s investment is uncertain.

   (2) The seller’s investment has already been recovered, and the recovery of the rest of the sales value is uncertain. (This situation normally occurs when the book value of the property sold is very small in relation to the sales value.)

The deposit method can also be used when the conditions for using the cost recovery method are met.

**Determining When Recovery Is Reasonably Assured.** GAAP does not explain how to determine when recovery of the seller’s investment is reasonably assured. One method is to base the determination on:

- **Likelihood of Default.** This consideration should be based on the buyer’s financial condition and credit history as well as the terms of the seller’s receivable. For example, if the buyer has a strong financial condition, has a good credit history, and is unconditionally and fully liable on the note, the likelihood of default would be considered remote. In that situation, the buyer’s financial condition and credit history indicate that the buyer has the ability to make the required payments, and the recourse (or liability) provisions indicate that the buyer is legally obligated to perform on the note. A similar situation exists when the property is generating enough cash flow to cover all debt payments and other obligations. In those instances, recovery of the seller’s investment may be considered reasonably assured.
• **Fair Value of the Property.** Another strong indicator of recoverability is the fair value of the property. Generally, if the fair value of the property is at least equal to the principal balance of the seller’s receivable (less deferred income, if any), recovery of the seller’s investment may be considered reasonably assured. Obviously, the fair value determination cannot be based solely on the contract sales price of the property. However, the sales price could be supported by recent sales of similar property. For example, if similar real estate has been sold recently at prices that are close to the contract sales price, then the property’s contract price might be considered to be approximately equal to its fair value. Thus, in that example, the recovery of the seller’s investment could be considered reasonably assured.

**Assessing the Continuing Investment.** FASB ASC 360-20-40-19 (formerly SFAS No. 66) requires the buyer to pay an amount each year at least equal to the annual principal and interest payment needed to amortize the total debt for the purchase of the property over a period of:

a. *For land,* 20 years.

b. *For other real estate,* the normal term of a first mortgage loan by an independent financial institution.

FASB ASC 360-20-40-24 (formerly SFAS No. 66) states that the initial and continuing investment tests should be applied both annually and cumulatively. However, if the initial investment is adequate and the continuing investment test is met on an annual basis, the requirements generally will also be met cumulatively.

In determining whether the continuing investment requirements are met, any excess of the initial investment over the required amount can be considered part of the buyer’s continuing investment. Also, the excess continuing investment for one year can be carried over to the next year. However, as noted in Exhibit 1-5, the following amounts should be subtracted in determining the buyer’s actual continuing investment:

- Funds directly or indirectly provided by the seller (such as loans from the seller or loans guaranteed by the seller).
- Funds obtained through debt that is secured by the property.

**What Interest Rate Should Be Used?** GAAP does not explain what interest rate to use in determining the annual interest payments required under the continuing investment test. One method that could be used to determine the rate is that the rate should be the greater of the contractual interest rate or the market rate as of the sale date. That means the buyer should be required to make annual payments that are at least equal to those that would be required if the buyer had obtained third-party financing. Thus, using the greater of the contract or market rate is consistent with the spirit of GAAP.

**What Constitutes a Normal Term?** Another difficult area is determining what loan term should be used in applying the continuing investment test to property other than raw land. Currently, real estate loans vary widely in length and payment terms. There are acquisition loans, construction loans, mini-perm loans (short or medium term loans covering the period after construction is completed but before long-term financing is obtained), and permanent loans. For the continuing investment test, one method is to base the loan term on long-term permanent loans, which normally cover substantially all of the remaining economic life of the property. Those loans typically have terms ranging from 20 to 30 years for new office or retail buildings and are amortized in regular loan payments rather than large balloon payments.

**Example of the Continuing Investment Test.** To illustrate how to apply the continuing investment test, assume the following facts:

a. Raw land is sold for $500,000.

b. Terms are:

   1. $150,000 down, interest only at 8% ($28,000 per year) for nine years, which approximates a market rate of interest.
(2) The balance of $350,000 plus interest due in the 10th year.

c. Development of the land will begin within two years from the sale date.

Exhibit 1-7 shows one method that can be used to compare the cumulative required payments with the cumulative actual payments. Since the buyer's investment in Years 7–9 is less than the amount required under FASB ASC 360-20-40 (formerly SFAS No. 66), the continuing investment test is not met. Accordingly, the total gain cannot be recognized on the full accrual basis at the date of sale, and one of the accounting methods listed in the "What If the Continuing Investment Test Is Not Met" paragraph must be used. Note that a deficiency at the end of any year means that the continuing investment test is not met. Thus, if a schedule of required and actual payments is prepared, it is not necessary to extend it beyond the first negative year. (In other words, the schedule in Exhibit 1-7 would not need to extend beyond Year 7, the first year that the cumulative required payments exceed the cumulative actual payments.)

### Exhibit 1-7

**Example of the Continuing Investment Test**

<table>
<thead>
<tr>
<th>Year</th>
<th>Required Investment</th>
<th>Actual Investment</th>
<th>Excess (Deficiency)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Annual</td>
<td>Cumulative</td>
<td>Annual</td>
</tr>
<tr>
<td>Sale</td>
<td>$ 100,000</td>
<td></td>
<td>$ 150,000</td>
</tr>
<tr>
<td>1</td>
<td>36,500 $</td>
<td>135,600 $</td>
<td>28,000</td>
</tr>
<tr>
<td>2</td>
<td>35,600</td>
<td>171,200</td>
<td>28,000</td>
</tr>
<tr>
<td>3</td>
<td>35,600</td>
<td>206,800</td>
<td>28,000</td>
</tr>
<tr>
<td>4</td>
<td>35,600</td>
<td>242,400</td>
<td>28,000</td>
</tr>
<tr>
<td>5</td>
<td>35,600</td>
<td>278,000</td>
<td>28,000</td>
</tr>
<tr>
<td>6</td>
<td>35,600</td>
<td>313,600</td>
<td>28,000</td>
</tr>
<tr>
<td>7</td>
<td>35,600</td>
<td>349,200</td>
<td>28,000</td>
</tr>
<tr>
<td>8</td>
<td>35,600</td>
<td>384,800</td>
<td>28,000</td>
</tr>
<tr>
<td>9</td>
<td>35,600</td>
<td>420,400</td>
<td>28,000</td>
</tr>
<tr>
<td>10</td>
<td>35,600</td>
<td>456,000</td>
<td>378,000</td>
</tr>
</tbody>
</table>

**Notes:**

- **a** The $50,000 excess initial investment is the excess of the down payment of $150,000 over the required down payment of $100,000 (20% of $500,000). These amounts can be determined using a present value calculator.

- **b** The required payment is the payment required to amortize $350,000 over 20 years at 8%.

* * *

If the actual annual payments are level, it is possible to easily determine whether the continuing investment test is met without scheduling required and actual payments, as follows:

Excess of actual initial investment of $150,000 over required initial investment of $100,000

\[ \frac{50,000}{7,600} = 6.58 \]

Since 6.58 years is less than the actual payout term of the note (10 years), the continuing investment test is not met.
Importance of Collectibility. Even if the buyer’s investments are adequate under FASB ASC 360-20-40 (formerly SFAS No. 66), that only suggests that the buyer is obligated to pay the entire sales value. It does not necessarily indicate that the buyer is able to make the required payments. If collectibility of the sales value is uncertain as of the sale date, the continuing investment test is not considered to be met. That evaluation should be based on the facts and circumstances of the transaction. For example, if raw land is sold for development as residential lots and security is limited to the tract sold, the seller may evaluate whether revenues from lot sales will be sufficient to enable the buyer to make the required payments, and the seller may require one or more individuals to personally guarantee the debt. On the other hand, the seller of an income-producing office building may primarily consider anticipated changes to the current income stream in evaluating collectibility.

What If the Continuing Investment Test Is Not Met? When the continuing investment test is not met, the accounting method to be used should be one of the following, depending on the circumstances:

a. Reduced Profit Method. The reduced profit method should be used when the following conditions are met:

   (1) The initial investment requirement was met.

   (2) Annual payments by the buyer will be enough to cover both:

   (a) Principal and interest (at the greater of the contract interest rate or a market rate) on the maximum first mortgage loan that could be obtained on the property from an independent financial institution.

   (b) Interest at market rates on the excess of the actual total debt on the property over such maximum first mortgage loan.

   If either of the preceding conditions is not met, then one of the following accounting methods should be used.

b. Installment Method. The installment method should be used if recovery of the seller’s investment in the property is reasonably assured.

c. Cost Recovery Method. The cost recovery method should be used if either:

   (1) Recovery of the seller’s investment is uncertain.

   (2) The seller’s investment has already been recovered and the recovery of the rest of the sales value is uncertain. (This situation normally occurs when the book value of the property sold is very small in relation to the sales value.)

The deposit method can also be used if the conditions for using the cost recovery method are met.

Changing Accounting Methods

Often a real estate sale may not meet all of the full accrual method conditions until sometime after the sale date. In those cases, the sale is initially accounted for using the appropriate method as of the sale date. If the installment method or cost recovery method is initially used and later all of the full accrual conditions are met, FASB ASC 360-20-55-12 and 360-20-55-15 (formerly Paragraphs 61 and 64 of SFAS No. 66) state that the accounting method should be changed to the full accrual method, and any remaining deferred gain should be recognized at that time.

For example, assume that a sale of land to be developed within two years meets all the conditions for using the full accrual method except the initial investment test and that the sale should be accounted for under the installment method. When the buyer has made cumulative payments equal to 20% (from Exhibit 1-6) of the sales value, the remaining deferred gain should be recognized. Example 1-4 and Exhibit 1-3 illustrate that type of change.

GAAP does not specifically address changing from any accounting methods other than the installment and cost recovery methods. However, it is possible to apply the preceding guidance to other methods. For example, if a
transaction is accounted for by the deposit method because it has not yet closed, it is appropriate to change to the full accrual method after closing provided all of the other conditions discussed in “The Primary Conditions for Using the Full Accrual Method” paragraph are met.

**AUDITING AN INSTITUTION’S REAL ESTATE SALES**

The primary purpose of auditing real estate sales is to determine that sales are bona fide transactions and that gains and losses are accounted for appropriately. This is accomplished primarily through tests of individual sales transactions occurring during the year. This discussion covers the nature and extent of procedures used to audit real estate sales.

**Determining the Extent of Testing**

Gains and losses on sales of real estate are usually recorded in the same general ledger account. (Separate accounts may be used for sales of foreclosed real estate and sales of investment property. The procedures in this section may be applied to each account, or the sales may be tested together.) The auditor should scan the entries to the account to identify individually significant items. The account should generally be scanned even if the balance is insignificant because it may consist of large gains offset by large losses. A cutoff amount (such as 1/3 of tolerable misstatement) should be established to identify individually significant gains and losses. The cutoff amount may be lowered if necessary to achieve the desired percentage of coverage. The auditor may also select additional items based on other characteristics, such as sales to related parties or gain transactions that are likely to require an accounting method other than the full accrual method.

**Procedures Used to Audit Real Estate Sales**

This lesson presents two approaches to testing real estate sales, depending on the number and complexity of the transactions—

- **Detailed Approach.** This approach is generally used for complex transactions and sales resulting in significant gains or losses, such as sales of large land tracts or commercial properties. It may also be used for transactions in which there is possible continuing seller involvement with the property sold.

- **Shortcut Approach.** This approach is used for relatively simple transactions that (1) result in relatively small gains or losses, such as sales of single-family homes to customers and (2) rarely involve significant continuing seller involvement.

Both approaches involve examination of documentation relating to the sale. They differ in the extent of the auditor’s review and the documentation of the auditor’s procedures. The approaches are discussed in the following paragraphs.

**Detailed Approach.** Under the detailed approach, the auditor reviews in detail the relevant documents supporting the real estate sale, such as the following:

- **Closing Statement.** The closing statement normally documents that the sale has been consummated, as required by FASB ASC 360-20-40-7 (formerly SFAS No. 66). In many situations, it also shows the sources of the sales proceeds. The auditor should vouch any funds received at or before closing that constitute the buyer’s initial investment.

- **Sales Contract.** The sales contract outlines the rights and obligations of the buyer and seller. Thus, it often discloses the nature and extent of any continuing seller involvement. It may also discuss the repayment terms for any seller financing provided.

- **Loan Documentation.** The loan agreement and mortgage note outline the repayment terms of the seller financing provided, which allows the auditor to assess the buyer’s initial and continuing investments in the property sold. The deed of trust normally discloses the seller’s lien position and highlights conditions indicating that the seller’s receivable is subject to future subordination.
After reviewing the preceding documentation, the auditor considers whether the sale was accounted for properly. This generally involves the following procedures:

- **Gain (Loss) Calculation.** The auditor tests the client’s calculation to determine that the gain or loss was appropriately computed. This generally involves verifying both the sales value (as defined in Exhibit 1-2) and the cost of the property sold.

- **Accounting Method.** The auditor determines that (1) the proper method was used to account for the sale and (2) that method was properly applied. This generally involves consideration of the factors discussed related to the accounting methods used and chosen for real estate sales.

### Shortcut Approach

The audit assertions tested using the shortcut approach are the same as those tested using the detailed approach. However, since the sales transactions tested under the shortcut approach are normally simple and there is little chance of continuing seller involvement, it is usually easier to test the gain or loss calculations and assess the accounting methods used. Accordingly, the auditor’s procedures can generally be limited to a brief review of the following:

- **Closing Statement.** As previously noted, the closing statement normally documents the completion of the sale and discloses the sources of the sales proceeds. Funds received on or before closing should be vouched.

- **Loan Documentation.** Normally, reviewing the mortgage note is sufficient to determine the buyer’s initial and continuing investment. Examination of the deed of trust can determine the seller’s lien position.

While reviewing that documentation, the auditor should be alert for any unusual provisions of the sales contract or financing arrangements that may affect the accounting for the sale, such as seller guarantees or covenants that might result in significant continuing seller involvement. If those matters are noted, they should be investigated. The auditor’s procedures can usually be documented by placing tickmarks on a schedule of real estate sales transactions to indicate the documents reviewed, testing of the gain or loss calculations, and assessment of the accounting methods used.

### Testing Recognition of Previously Deferred Gains

In addition to testing current year sales, the auditor also typically tests previously deferred gains that are recognized during the year. This can normally be accomplished by selecting larger gains based on a dollar cutoff and recomputing the gains that should be recognized under the applicable accounting method (installment method, etc.).
SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

9. Heartland National Bank (HNB) sells a piece of real estate and must calculate the gain. If the following amounts apply to the sale, what would be HNB’s sales value?

   - Contract sales price: $350,000
   - Additional sales proceeds: $10,000
   - Discount to reduce the seller’s receivable to present value: $15,000
   - Present value of seller services to be performed without compensation or at less than prevailing rates: $5,000

   a. $320,000.
   b. $340,000.
   c. $350,000.
   d. $380,000.

10. HNB uses the full accrual method to account for a sale of real estate. How would it recognize any gain from the sale?

   a. HNB would recognize the entire gain on the sale on the date the property was sold.
   b. HNB would recognize the gain proportionally as the sales value is collected.
   c. HNB would account for the transaction as if no sale occurred.

11. Prairiewood National Bank (PNB) sells a piece of real estate. PNB would prefer to use the full accrual method to account for the sale, but first it must determine if it meets all four of the necessary qualifications. Under which of the following circumstances, would PNB have met one of the qualifications for use of the full accrual method?

   a. The property deed has not been transferred.
   b. PNB will have a small amount of continuing involvement with the property.
   c. PNB has the second lien on the property for sale.
   d. The buyer’s down payment and continuing payments are adequate.

12. PNB needs to assess the initial investment on a real estate sale to determine the accounting method to be used for gain recognition. There has been no recent loan or commitment on the property. The real estate sold is raw land, but the land is scheduled for development two years after the sale takes place. What percentage of the land’s sales value is required for the buyer to meet the minimum initial investment?

   a. 5%.
   b. 10%.
   c. 20%.
   d. 25%.
13. The Bank of Harristown sells a piece of real estate. The buyer’s investments are considered adequate under FASB ASC 360-20-40; however, the bank determines as of the sales date that collectability of the sales value is uncertain. Can the bank still consider the continuing investment test to be met?

a. Yes.

b. No.

14. Mabel, an auditor, is engaged to audit a financial institution. As part of her audit, she will audit the institution’s real estate sales. One of the real estate transactions Mabel selects to audit is large and complex, so Mabel decides to use the detailed approach instead of the shortcut approach. Which of the following steps would Mabel perform for this transaction that is unique to the detailed approach?

a. Reviewing the closing statement.

b. Reviewing the mortgage note.

c. Vouching funds received at or before closing.

d. Determining that the correct accounting method was used.

15. As part of her audit of the sale described in the previous question (for which she uses the detailed approach), Mabel verifies the sales value and the cost of property sold. What would these audit procedures test?

a. The institution’s gain or loss calculation.

b. The institution’s previously deferred gains.

c. The rights and obligations of the institution.

d. Whether the piece of real estate is impaired.
SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. (References are in parentheses.)

9. Heartland National Bank (HNB) sells a piece of real estate and must calculate the gain. If the following amounts apply to the sale, what would be HNB’s sales value? (Page 305)

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contract sales price:</td>
<td>$350,000</td>
</tr>
<tr>
<td>Additional sales proceeds:</td>
<td>$10,000</td>
</tr>
<tr>
<td>Discount to reduce the seller’s receivable to present value:</td>
<td>$15,000</td>
</tr>
<tr>
<td>Present value of seller services to be performed without compensation or at less than prevailing rates:</td>
<td>$5,000</td>
</tr>
</tbody>
</table>

a. $320,000. [This answer is incorrect. To get this answer, HNB would have used the following calculation: $350,000 − $10,000 − $15,000 − $5,000 = $320,000. This calculation does not correctly handle the additional sales proceeds.]

b. $340,000. [This answer is correct. When accounting for real estate sales, financial institutions must follow FASB ASC 360-20 and 976. To determine the sales value, which is part of calculating the gain on a sale of real estate, a financial institution must take the contract sales price, add any additional sales proceeds, and subtract both any discount to reduce the seller’s receivable to present value and any present value of seller services to be performed without compensation or at less than prevailing rates. Therefore, based on the information in this scenario, HNB should perform the following calculation: $350,000 + $10,000 − $15,000 − $5,000 = $340,000.]

c. $350,000. [This answer is incorrect. The contract sales price is the sale price specified in the contract. The contract sales price typically consists of cash, assumption of existing debt, notes payable to the seller, or some combination of the three. However, a series of calculations must be performed to the contract price to determine the sales value.]

d. $380,000. [This answer is incorrect. To get this answer, HNB would have used the following calculation: $350,000 + $10,000 + $15,000 + $5,000 = $380,000. This calculation does not correctly handle either the discount to reduce the seller’s receivable to present value or the present value of seller services to be performed without compensation or at less than prevailing rates.]

10. HNB uses the full accrual method to account for a sale of real estate. How would it recognize any gain from the sale? (Page 305)

a. HNB would recognize the entire gain on the sale on the date the property was sold. [This answer is correct. FASB 360-20 and 976 provides accounting methods financial institutions can use for recognizing gains on sales of real estate, including the full accrual method. Under the full accrual method, the entire gain on the sale is recognized at the date of the sale.]

b. HNB would recognize the gain proportionally as the sales value is collected. [This answer is incorrect. FASB 360-20 and 976 provide guidance on accounting methods. This type of gain recognition applies if the installment method is used to account for the sale.]

c. HNB would account for the transaction as if no sale occurred. [This answer is incorrect. FASB 360-20 and 976 should be consulted for guidance on accounting methods used for real estate sales. When the deposit method is used, the seller accounts for the transaction as if no sale had occurred. Therefore, some steps that would apply include no gain being recognized and the seller not recording a receivable from the buyer.]
11. Prairiewood National Bank (PNB) sells a piece of real estate. PNB would prefer to use the full accrual method to account for the sale, but first it must determine if it meets all four of the necessary qualifications. Under which of the following circumstances, would PNB have met one of the qualifications for use of the full accrual method? (Page 310)

a. The property deed has not been transferred. [This answer is incorrect. One of the criteria for determining if a sale has been consummated is that all consideration, such as cash, notes, and deeds, must be exchanged. Under FASB ASC 360-20, the full accrual method cannot be used unless the sale has been consummated; however, there are other criteria that must be met before a completed sale can be determined.]

b. PNB will have a small amount of continuing involvement with the property. [This answer is incorrect. Under FASB ASC 360-20, to use the full accrual method, the sale must transfer the risks and rewards of ownership to the buyer, and the seller must be free from continuing involvement with the property. If the circumstances described in this answer choice exist, PNB cannot use the full accrual method.]

c. PNB has the second lien on the property for sale. [This answer is incorrect. Under FASB ASC 360-20, to use the full accrual method, the seller’s lien on the property must be superior to all other liens on the property, except for an existing loan at the date of sale or any future loan that is provided for in the sales agreement (if the proceeds of that debt will be applied first to pay the seller’s receivable). Because PNB has a second lien behind other loans, except those listed previously, PNB does not meet this qualification for using the full accrual method.]

d. The buyer’s down payment and continuing payments are adequate. [This answer is correct. The buyer’s investments (both initial and continuing investments) must meet the minimum guidelines established by FASB ASC 360-20-40-9 through 40-24. In this case, PNB meets one of the four primary conditions for using the full accrual method.]

12. PNB needs to assess the initial investment on a real estate sale to determine the accounting method to be used for gain recognition. There has been no recent loan or commitment on the property. The real estate sold is raw land, but the land is scheduled for development two years after the sale takes place. What percentage of the land’s sales value is required for the buyer to meet the minimum initial investment? (Page 314)

a. 5%. [This answer is incorrect. According to the FASB guidance, 5% of sales value would be the minimum initial investment if the property were a single family home, condominium unit, townhome, or 1 to 4 family residence (though not those purchased with FHA or VA financing) and if the property were the buyer’s primary residence.]

b. 10%. [This answer is incorrect. Under the authoritative guidance, an example of the type of property for which 10% of sales value would be the minimum initial investment is a primary residence on a multi-family residential property for which current cash flow is adequate to cover all debt payments.]

c. 20%. [This answer is correct. The minimum initial investment required under FASB ASC 360-20-55-1 and 55-2 depends on whether there has been a recent permanent loan or loan commitment placed by an independent institution for the maximum amount of financing available on that type of property. If there has been no recent loan or commitment, the minimum required investment is a specified percentage of the sales value. The minimum initial investment for land of this type is 20% of the sales value.]

d. 25%. [This answer is incorrect. According to FASB ASC 360-20-55-1 and 55-2, if the land sold was scheduled to be developed more than two years after the sale date, the minimum initial investment would be 25% of the sales value.]
13. The Bank of Harristown sells a piece of real estate. The buyer’s investments are considered adequate under FASB ASC 360-20-40; however, the bank determines as of the sales date that collectability of the sales value is uncertain. Can the bank still consider the continuing investment test to be met? (Page 318)

a. Yes. [This answer is incorrect. Though, normally, the continuing investment test would be presumed met under the authoritative guidance if the investments are adequate, in this case, the information about collectability must be factored into the assessment.]

b. No. [This answer is correct. Even if the buyer’s investments are adequate under FASB ASC 360-20-40, that only suggests that the buyer is obligated to pay the entire sales value. It does not necessarily indicate that the buyer is able to make the required payments. If collectability of the sales value is uncertain as of the sale date, the continuing investment test is not considered to be met. That evaluation should be based on the facts and circumstances of the transaction.]

14. Mabel, an auditor, is engaged to audit a financial institution. As part of her audit, she will audit the institution’s real estate sales. One of the real estate transactions Mabel selects to audit is large and complex, so Mabel decides to use the detailed approach instead of the shortcut approach. Which of the following steps would Mabel perform for this transaction that is unique to the detailed approach? (Page 320)

a. Reviewing the closing statement. [This answer is incorrect. The closing statement normally documents that the sale has been consummated, as required by FASB ASC 360-20-40-7. A review of the closing statement would be performed in both the detailed and shortcut approach; however, the review would be brief if the shortcut approach was used.]

b. Reviewing the mortgage note. [This answer is incorrect. The mortgage note would be reviewed under both the detailed and the shortcut approaches as part of the review of loan documentation. However, under the detailed approach, the auditor would also review the loan agreement. Under both approaches the auditor would also review the deed of trust.]

c. Vouching funds received at or before closing. [This answer is incorrect. These funds constitute the buyer’s initial investment, and they should be vouched when either the detailed or the shortcut approach is used.]

d. Determining that the correct accounting method was used. [This answer is correct. The detailed approach consists of a detailed document review, and then the auditor considers whether the sale was accounted for properly. As part of this second consideration, Mabel would determine whether the institution used the correct accounting method for the sale and if the method was correctly applied. This would not be done if the shortcut approach was used.]

15. As part of her audit of the sale described in the previous question (for which she uses the detailed approach), Mabel verifies the sales value and the cost of property sold. What would these audit procedures test? (Page 320)

a. The institution’s gain or loss calculation. [This answer is correct. When considering whether the sale was accounted for properly, Mabel must test the institution’s calculation to determine that the gain or loss was appropriately computed. This generally involves verifying both of the items listed above. She would perform this step as part of the detailed approach.]

b. The institution’s previously deferred gains. [This answer is incorrect. In addition to testing current year sales, the auditor also typically tests previously deferred gains that are recognized during the year. This can normally be accomplished by selecting larger gains based on a dollar cutoff and recomputing the gains that should be recognized under the applicable accounting method. This would be done regardless of whether Mabel used the detailed or the shortcut approach. It is not affected by the procedures Mabel performs in this scenario.]
c. The rights and obligations of the institution. [This answer is incorrect. The rights and obligations of the buyer and the seller (the institution) are outlined in the sales contract. Reviewing the sales contract is a part of the detailed documentation review that Mabel will perform as part of the detailed approach.]

d. Whether the piece of real estate is impaired. [This answer is incorrect. The impairment of real estate investments is a separate consideration from real estate sales and requires different accounting treatment. Mabel would not perform audit procedure related to impairment during her audit of a real estate sale.]
ACCOUNTING FOR THE IMPAIRMENT OF REAL ESTATE INVESTMENTS

FASB ASC 360-10 (formerly SFAS No. 144, *Accounting for the Impairment or Disposal of Long-lived Assets*) provides guidance on identifying and accounting for impairment of real estate investments. The guidance addresses the following questions:

- When should impairment be recognized?
- How should impairment losses be measured?

Exhibit 1-8 is a decision tree that outlines the guidance in FASB ASC 360-10 (formerly SFAS No. 144).

**Exhibit 1-8**

*Accounting for Impaired Real Estate*

1. **Type of real estate?**
   - To be held and used
   - To be disposed of

2. **Is disposal by sale?**
   - Yes
   - No

3. **Does carrying amount exceed fair value less selling costs?**
   - Yes
   - No

4. **Does carrying amount exceed total future net cash flows?**
   - Yes
   - No

- **No impairment**
- **Recognize impairment loss**
Notes:

a. If the property is to be disposed of by means other than a sale, FASB ASC 360-10-45-15 (formerly SFAS No. 144) requires the property to be classified as *held and used*, subject to impairment procedures for property to be held and used, until disposal.

b. FASB ASC 310-40-30-2 (formerly FASB Staff Position No. FAS 144-1) clarifies that any valuation allowance for a loan collateralized by a long-lived asset should not be carried over as a separate element of the cost basis for purposes of accounting for the long-lived asset subsequent to foreclosure.

c. Although no impairment loss is indicated, it may be necessary to reconsider the depreciation policies or add disclosures.

* * *

FASB ASC 360-10 (formerly SFAS No. 144) requires the following:

- Real estate projects that are substantially complete and ready for sale should be accounted for as assets to be disposed of by sale according to the requirements of FASB ASC 360-10 (formerly SFAS No. 144). See further discussion earlier in this lesson.

- Real estate that is to be held and used, including property for which development has begun or will begin in the future and property that is substantially completed, should be accounted for according to the provisions of FASB ASC 360-10-35-16 through 35-36 (formerly SFAS No. 144) for assets to be held and used. See further discussion earlier in this lesson.

Treatment of Asset Groups

If a long-lived asset is part of a group of assets that may include other assets and liabilities not covered by FASB ASC 360-10 (formerly SFAS No. 144), FASB ASC 360-10 (formerly SFAS No. 144) applies to the group. An asset group is the lowest level for which identifiable cash flows are largely independent of the cash flows of other groups of assets and liabilities. The guidance in the following paragraphs applies to either an individual asset or to the asset group.

Real Estate to Be Disposed of by Sale

Criteria for Classification. Real estate to be sold may include property previously held and used or newly acquired property, such as property acquired in a business combination that the institution does not plan to keep. As previously discussed, FASB ASC 360-10-45-9 (formerly SFAS No. 144) states that a property or disposal group to be sold should be classified as held for sale in the period in which all of the following criteria are met:

a. Management, having the appropriate approval authority, commits to a plan to sell the property or disposal group.

b. The property or disposal group is available for immediate sale in its present condition subject only to usual and customary sales terms for such properties.

c. The institution has initiated an active program to locate a buyer and other actions required to complete the plan to sell the property or disposal group.

d. The sale of the property or disposal group is probable, and transfer of the property or disposal group is expected to qualify for recognition as a completed sale within one year. Exceptions to this criterion are discussed later in this lesson.

e. The property or disposal group is being actively marketed for sale at a price that is reasonable relative to its current fair value.
f. Actions required to complete the plan indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn.

If at any time the criteria above are no longer met (except as discussed in the next paragraph), the institution should reclassify property classified as held for sale to property held and used.

Although it is generally required that a sale be probable within one year for a property to be classified as held for sale (see item d. above), there are events and circumstances beyond the institution’s control that may extend the period required to complete the sale beyond one year. An exception to the one-year requirement is permitted in the following situations—

a. At the date an institution commits to a plan to sell a property—
   (1) the institution reasonably expects that conditions on the asset transfer that will be imposed by parties other than the buyer will extend the period required to complete the sale,
   (2) responses to those conditions cannot begin until after a firm purchase commitment is obtained, and
   (3) a firm purchase commitment is probable within one year.

b. An institution obtains a firm purchase commitment and, as a result—
   (1) a buyer or others unexpectedly impose conditions on the transfer of the property classified as held for sale that will extend the period necessary to complete the sale,
   (2) actions necessary to respond to the conditions have begun or will begin on a timely basis, and
   (3) delaying factors are expected to be resolved favorably.

c. During the initial one-year period, circumstances arise that previously were considered unlikely and, as a result—
   (1) property that was previously classified as held for sale is not sold by the end of that period,
   (2) during the initial one-year period, actions necessary to respond to the change in circumstances have been initiated,
   (3) the institution is actively marketing the property at a reasonable price given the change in circumstances, and
   (4) the criteria in the “Criteria for Classification” paragraph are met.

If the criteria for classification as held for sale are met after the date of the balance sheet but before issuance of the financial statements, property should continue to be classified as held and used in the financial statements when issued.

**Reporting.** FASB ASC 360-10-35-43 (formerly SFAS No. 144) requires property to be disposed of by sale to be reported at the lower of its carrying amount or fair value less costs to sell. Fair value and selling costs should be determined as follows:

a. **Fair Value.** Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value is further discussed in *PPC’s Guide to Real Estate*.

b. **Costs to Sell.** According to FASB ASC 360-10-35-38 (formerly SFAS No. 144, Paragraph 35), costs to sell should include only the incremental direct costs of selling the property, such as sales commissions, legal and title transfer fees, and other closing costs. Costs not directly related to the sale (for example, insurance
and property taxes incurred while the property is being sold and other holding costs) should not be considered in this calculation. If the sale is expected to occur beyond one year, costs to sell should be discounted.

Assets classified as held for sale should not be depreciated, and expected future losses associated with operations of long-lived assets to be sold should not be accrued. Assets classified as held for sale should be presented separately in the balance sheet. For asset groups, both assets and liabilities should be presented separately; they should not be offset and presented as a single amount.

**Assessing Impairment.** If the carrying amount of the property exceeds its fair value less selling costs, an impairment loss should be recognized for the excess and the carrying amount reduced accordingly. After that, the carrying amount of the property should be adjusted (either up or down) for subsequent changes in fair value. However, it should never be adjusted above the property’s carrying amount before the impairment loss.

This guidance seems to imply that an impairment loss should be recognized by a direct writedown of the property. However, since property cannot be written up beyond its carrying amount before the impairment loss, one opinion is to use a valuation allowance rather than direct writedown for bookkeeping purposes.

**Example 1-8: An Impairment Calculation**

Assume an institution has land for sale with a book value of $500,000, a fair value of $400,000, and estimated selling costs of $50,000. The institution should record an impairment loss of $150,000 for the excess of the land’s book value over its fair value less selling costs, as follows:

<table>
<thead>
<tr>
<th>DR</th>
<th>CR</th>
</tr>
</thead>
<tbody>
<tr>
<td>Impairment loss on real estate</td>
<td>$150,000</td>
</tr>
<tr>
<td>Allowance for impairment of real estate</td>
<td>$150,000</td>
</tr>
</tbody>
</table>

This example assumes the institution uses an impairment valuation allowance for bookkeeping purposes, as discussed above.

Assume the fair value of the impaired land subsequently increased to $500,000 and estimated selling costs remained at $50,000. The carrying amount of the property should be increased to $450,000 (fair value less selling costs). The entire $100,000 increase should be recorded because the property’s new carrying amount will not exceed its original carrying amount, $500,000. The journal entry to record the increase in the land’s fair value is—

<table>
<thead>
<tr>
<th>DR</th>
<th>CR</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allowance for impairment of real estate</td>
<td>$100,000</td>
</tr>
<tr>
<td>Impairment loss on real estate (or Recovery of impairment loss)</td>
<td>$100,000</td>
</tr>
</tbody>
</table>

Now assume the property’s fair value increased again to $600,000 and estimated selling costs remained at $50,000. In that case, only $50,000 of the $100,000 increase in fair value should be recorded because the property’s new carrying amount cannot exceed its original amount, $500,000. The increase should be recorded as follows:

<table>
<thead>
<tr>
<th>DR</th>
<th>CR</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allowance for impairment of real estate</td>
<td>$50,000</td>
</tr>
<tr>
<td>Impairment loss on real estate (or Recovery of impairment loss)</td>
<td>$50,000</td>
</tr>
</tbody>
</table>

If an allowance account had not been used in the preceding examples, it would have been more difficult to ensure that the property’s adjusted carrying amount did not exceed its original carrying amount.
**Frequency of Assessment.** Neither FASB ASC 970 (formerly SFAS No. 67) nor FASB ASC 360-20 (formerly SFAS No. 144) specify how often impairment should be assessed for property to be disposed of. One method is to make this assessment at the end of each financial reporting period.

**Depreciation of Real Estate to Be Disposed of by Sale.** FASB ASC 360-10-35-43 (formerly Paragraph 34 of SFAS No. 144) states that assets to be disposed of by sale should not be depreciated.

**Reclassification.** If property held for sale is reclassified as held and used, the reclassified property should be measured at the lower of (a) its carrying amount before being classified as held for sale, adjusted for depreciation expense that subsequently would have been taken or (b) its fair value when reclassified.

**Real Estate to Be Disposed of Other Than by Sale**

Occasionally, property may be abandoned, exchanged in a transaction measured based on the recorded amount of the nonmonetary asset relinquished for similar productive assets, or distributed to owners in a spin-off. Such property should be classified as held and used until disposed of and assessed for impairment. An impairment loss should be recognized when the property is disposed of, if its carrying amount exceeds its fair value at that date. Real estate to be abandoned should be depreciated to its estimated salvage value over the expected period to abandonment.

**Real Estate to Be Held and Used**

**Signs of Possible Impairment.** Property to be held and used should be assessed for impairment if events or changes in circumstances indicate its carrying amount may not be fully recoverable. FASB ASC 360-10-35-21 (formerly Paragraphs 8 and C31c. of SFAS No. 144) cites the following conditions that may indicate the property is impaired:

- Significant decrease in the property’s market price.
- Significant adverse change in the property’s use or in its physical condition.
- Significant adverse changes in legal factors or business climate, including an adverse action or assessment by a regulator.
- Costs to acquire or construct property that significantly exceed original expectations.
- Current-period operating or cash flow loss combined with a history of operating or cash flow losses or a projection or forecast showing continuing losses associated with a property.
- A current expectation that it is more likely than not (greater than 50% likelihood) that a property will be sold or disposed of significantly before the end of its previously estimated useful life.

The following conditions may also indicate that a real estate project should be assessed for impairment:

- Cash flows from operating the property are less than debt service on the property.
- Current occupancy rates indicate that future cash inflows are less than the amounts needed to fully recover the property’s carrying amount.
- Major tenants are experiencing (or have experienced) financial difficulties.
- A significant portion of leases will expire in the near term.
- Lessors are making significant concessions to rent the property.
- The local market area has an oversupply of comparable properties.
• Selling periods for comparable properties are unusually long, or sales of comparable properties have occurred only at discounted prices.

• Other investors have quit providing support or reduced their financial commitment to the project.

• Rental demand for a project under construction is not meeting projections.

• Auditors’ reports on investee properties are modified for a GAAP departure due to improper valuation of assets.

The preceding lists are not all-inclusive. Other factors might raise doubts about the recoverability of a property, and, if they do, the auditor should assess the asset for impairment.

Assessing Impairment. As previously noted, if conditions indicate that a property’s carrying amount may not be fully recoverable, the property should be assessed for impairment. To make that assessment, the carrying amount of the property should be compared to the total net future cash flows, undiscounted and without interest, expected to be received from the property. Additional information on estimating future cash flows is provided earlier in this lesson.

If total net future cash flows exceed the property’s carrying amount, the asset is not considered impaired. However, it may be appropriate to review depreciation policies (including the depreciation method and estimated useful life and salvage values of the property). Also, FASB ASC 275-10 and 450-20 (formerly SOP 94-6) may require disclosures because, according to the guidance, the events or changes in circumstances listed previously regarding impairment may indicate an estimate associated with the property’s carrying amount may be particularly sensitive to change in the near term.

If total net cash flows are less than the property’s carrying amount, the property is impaired, and an impairment loss may need to be recognized. The following paragraphs discuss accounting for impaired assets.

Recognizing and Measuring Impairment. If real estate to be held and used is impaired, a loss should be recognized for any excess of the property’s carrying amount over its fair value. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. PPC’s Guide to Real Estate provides additional guidance on how to determine fair value.

Impairment loss should be recognized by a direct writedown of the property’s carrying amount. This reduced carrying amount then becomes the property’s new cost basis, which should be depreciated over the property’s remaining useful life. The carrying amount should not be increased for subsequent increases in fair value.

Example 19: Impairment accounting

Assume an office building has a book value of $750,000 (cost of $900,000 less accumulated depreciation of $150,000) and a fair value of $500,000. Also assume the total net future cash flows from the building are $600,000. The excess of the building’s book value over its total cash flows indicates the building is impaired. The impairment loss to be recorded is $250,000, which is the excess of the building’s $750,000 book value over its $500,000 fair value. The entry to record the impairment loss is:

<table>
<thead>
<tr>
<th>DR</th>
<th>CR</th>
</tr>
</thead>
<tbody>
<tr>
<td>Impairment loss on real estate</td>
<td>$250,000</td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td>150,000</td>
</tr>
<tr>
<td>Office building</td>
<td>$400,000</td>
</tr>
</tbody>
</table>

Depreciation. As previously noted, after an impairment loss has been recognized, the property’s reduced carrying amount becomes its new cost basis. Depreciable property should then be depreciated over its estimated remaining life.
SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

16. Cumberland Mutual has a real estate project that is substantially complete and ready for sale. How should it be accounted for?
   a. Using the provisions of FASB ASC 360-10-35-16 through 35-36.
   b. As an asset to be disposed of by sale.
   c. As an asset group.

17. Cumberland Mutual has a piece of real estate that it would like to classify has held for sale. For the institution to use this classification, certain criteria must be met. Which of the following is one of those criteria?
   a. The property will be ready for sale in the next reporting period.
   b. Management plans to sell the property and is waiting for approval.
   c. The institution is actively trying to locate a buyer.
   d. The property’s marketed sale price is greater than fair value.

18. Assume the same details as in the previous question. Cumberland Mutual determines that the property in question meets all the qualifications to be classified as held for sale. Therefore, it makes that classification. A month later, it is determined that that sale of the property is no longer probable and will not likely happen within one year. The property does not qualify for any of the relevant exceptions. Does Cumberland Mutual have to reclassify this property as held and used?
   a. Yes
   b. No.

19. Seaside National Bank abandons a piece of real estate, which it owns indirectly through a subsidiary. Which of the following best describes how this property should be treated?
   a. It should be reclassified as held for sale.
   b. When the property is disposed of, an impairment loss should be recognized.
   c. The subsidiary cannot depreciate the property because it was abandoned.

20. All of the following financial institutions own a piece of real estate that is classified as held and used. Which property has a characteristic that indicates it is impaired?
   a. Alpha Institution’s cash flows from operating the property are less than the property’s debt service.
   b. Beta Institution’s property houses a major tenant that is experiencing financial difficulties.
   c. Gamma Institution’s property has a significant number of leases will expire in the near term.
   d. Delta Institution’s property suffers a significant decrease in its market price.
SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. (References are in parentheses.)

16. Cumberland Mutual has a real estate project that is substantially complete and ready for sale. How should it be accounted for? (Page 328)

   a. Using the provisions of FASB ASC 360-10-35-16 through 35-36. [This answer is incorrect. Real estate that is to be held and used, including property for which development has begun or will begin in the future and property that is substantially completed, should be accounted for according to the provisions listed here. Since Cumberland Mutual’s asset will be sold, this treatment is not appropriate.]

   b. As an asset to be disposed of by sale. [This answer is correct. Real estate projects that are substantially complete and ready for sale should be accounted for as assets to be disposed of by sale according to the requirements of FASB ASC 360-10.]

   c. As an asset group. [This answer is incorrect. If a long-lived asset is part of a group of assets that may include other assets and liabilities not covered by FASB ASC 360-10, FASB ASC 360-10 applies to the group. However, because the asset described above is not part of a group, this treatment would not apply.]

17. Cumberland Mutual has a piece of real estate that it would like to classify has held for sale. For the institution to use this classification, certain criteria must be met. Which of the following is one of those criteria? (Page 328)

   a. The property will be ready for sale in the next reporting period. [This answer is incorrect. Under FASB ASC 360-10-45-9, one of the criteria that must be met for this classification is that the property or disposal group is available for immediate sale in its present condition subject only to usual and customary sales terms for such properties.]

   b. Management plans to sell the property and is waiting for approval. [This answer is incorrect. Under FASB 360-10-45-9, one of the criteria that must be met for this classification is that management, having the appropriate approval authority, commits to a plan to sell the property or disposal group.]

   c. The institution is actively trying to locate a buyer. [This answer is correct. FASB ASC 360-10-45-9 states that a property or disposal group to be sold should be classified as held for sale in the period in which all of the applicable criteria are met. One of these criteria is that the institution has initiated an active program to locate a buyer and other actions required to complete the plan to sell the property or disposal group.]

   d. The property’s marketed sale price is greater than fair value. [This answer is incorrect. According to FASB ASC 360-10-45-9, one of the criteria that must be met for the institution to use this classification is that the property or disposal group is being actively marketed for sale at a price that is reasonable relative to its current fair value.]

18. Assume the same details as in the previous question. Cumberland Mutual determines that the property in question meets all the qualifications to be classified as held for sale. Therefore, it makes that classification. A month later, it is determined that that sale of the property is no longer probable and will not likely happen within one year. The property does not qualify for any of the relevant exceptions. Does Cumberland Mutual have to reclassify this property as held and used? (Page 329)

   a. Yes. [This answer is correct. FASB ASC 360-10-45-9 governs this classification and it states that all the criteria must be met. If at any time the criteria are no longer met the institution should reclassify property classified as held for sale to property held and used.]

   b. No. [This answer is incorrect. Because none of the exceptions to the one-year-sale criteria were not met in the scenario above, Cumberland Mutual will have to reclassify the property under FASB ASC 360-10-45-9.]
19. Seaside National Bank abandons a piece of real estate, which it owns indirectly through a subsidiary. Which of the following best describes how this property should be treated? (Page 331)

a. It should be reclassified as held for sale. [This answer is incorrect. This type of property should be classified as held and used until disposed of and assessed for impairment.]

b. When the property is disposed of, an impairment loss should be recognized. [This answer is correct. An impairment loss should be recognized when the property is disposed of, if its carrying amount exceeds its fair value at that date.]

c. The subsidiary cannot depreciate the property because it was abandoned. [This answer is incorrect. Real estate to be abandoned should be depreciated to its estimated salvage value over the expected period to abandonment.]

20. All of the following financial institutions own a piece of real estate that is classified as held and used. Which property has a characteristic that indicates it is impaired? (Page 331)

a. Alpha Institution’s cash flows from operating the property are less than the property’s debt service. [This answer is incorrect. Under FASB ASC 360-10-35-21, this is a condition that indicates the real estate project should be assessed for impairment, not that it is impaired.]

b. Beta Institution’s property houses a major tenant that is experiencing financial difficulties. [This answer is incorrect. According to the authoritative FASB guidance, this is an indication that the real estate project should be assessed for impairment, but that does not necessarily mean that it is impaired.]

c. Gamma Institution’s property has a significant number of leases will expire in the near term. [This answer is incorrect. Based on the FASB guidance, this is an indicator that the real estate project should be assessed for impairment. However, even if the institution assesses for impairment, that does not mean the property will actually turn out to be impaired.]

d. Delta Institution’s property suffers a significant decrease in its market price. [This answer is correct. Property to be held and used should be assessed for impairment if events or changes in circumstances indicate its carrying amount may not be fully recoverable. FASB ASC 360-10-35-21 cites conditions that may indicate the property is impaired. One such condition is a significant decrease in the property’s market price.]
EXAMINATION FOR CPE CREDIT

Lesson 1 (AFITG103)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. Grayson, an auditor, is engaged to audit a financial institution. What piece of authoritative literature can he consult for guidance on auditing foreclosed assets and real estate transactions and balances?
   a. FASB ASC 360-10, Property, Plant, and Equipment—Overall.
   b. FASB ASC 360-20, Property, Plant, and Equipment—Real Estate Sales.
   c. FASB ASC 835-20, Interest—Capitalization of Interest.
   d. The AICPA Audit and Accounting Guide, Depository and Lending Institutions: Banks and Savings Institutions, Credit Unions, Finance Companies and Mortgage Companies (DEP).

2. Grayson might use the following relevant assertion for what audit area when auditing the institution’s foreclosed assets and real estate investments?
   Gains and losses on sales of foreclosed assets and real estate investments reported in the institution’s statement of income represent valid transactions that took place during the period and pertain to the institution.
   a. Existence or occurrence.
   b. Completeness.
   c. Cutoff.
   d. Accuracy or classification.

3. Hannah, an auditor, is engaged to audit a financial institution. The institution has foreclosed assets on its books. Which of the following would be one of Hannah’s primary concerns when performing audit procedures on these assets?
   a. That assets from both voluntary and involuntary settlements were accounted for as foreclosed assets.
   b. That all accounting procedures related to foreclosed assets have been performed correctly.
   c. That foreclosed assets were correctly recorded on the institution’s books before the foreclosure.
   d. That any initial foreclosures were correctly recorded by the institution.

4. Which of the following actions should Hannah perform when auditing the financial institution’s initial foreclosures?
   a. She should test all foreclosures on the institution’s books during the period in question.
   b. She should obtain independent appraisals of the value of the property in all new foreclosures.
   c. She should examine the support for ownership for new foreclosed assets selected based on a dollar cutoff.
   d. She should test the value of all new foreclosed assets based on sales of similar properties.
5. Which of the following auditors has correctly followed FASB ASC 360-10-35-29’s guidelines for estimating the future cash inflows of a foreclosed asset to assess impairment during the course of the audit of a financial institution?

a. Alison incorporates her assumptions about how her financial institution client will use the assets into the estimate of future cash flows.

b. Bryant includes all relevant discounts and interest charges in his estimate of his financial institution client’s future cash flows.

c. Caroline uses a probability-weighted approach to assess the range of possible future cash flows that is estimated for her financial institution client.

d. Doug’s client has an asset that is under development. He bases the estimate used to test the asset’s recoverability on the asset’s existing service potential.

6. Second National Bank incurs preacquisition costs consisting of payments to third parties in connection with the purchase of real estate. The costs meet the “clearly associated” condition under FASB ASC 970-360-25-2. If the bank already owned the property, these costs would be capitalized. The bank is actively seeking to acquire this property, and it has the ability to obtain any necessary financing. However, the owner of the property has recently indicated that the property is no longer for sale. Can the bank capitalize these costs?

a. Yes, all costs that meet the “clearly associated” condition can be capitalized.

b. No, the costs fail the “directly identifiable” test.

c. Yes, all the appropriate conditions have been met under authoritative guidance.

d. No, it is not probable that the property will be acquired.

7. Second National Bank incurs costs related to the development of a real estate asset. Which of the following costs incurred by the bank would be considered direct costs and which would be considered indirect costs?

i. Land clearing

ii. Cost accounting

iii. Insurance costs

iv. Utility connections

v. Physical construction on the building

vi. Field office administration costs

vii. Interest costs

viii. Taxes

ix. Land grading


8. A hierarchy of allocation methods used to allocate acquisition, development, and construction costs to each component of a real estate project is established by FASB ASC 970-360-30-1. Match the following cost allocation methods with the appropriate description.

<table>
<thead>
<tr>
<th>Allocation Method</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Specific identification method</td>
<td>i. The cost of the land and other common costs incurred by the institution before construction are allocated based on the relative fair value of each parcel of land before construction. Construction costs are allocated based on the relative sales value of each component. This method should be considered first if the preferred method in the hierarchy cannot be used.</td>
</tr>
<tr>
<td>2. Relative value method</td>
<td>ii. If all components have the same characteristics, are approximately the same size, and will be sold for approximately the same price, costs can be allocated equally to each of them. This method is ranked in the third level of the hierarchy.</td>
</tr>
<tr>
<td>3. Equal allocation method.</td>
<td>iii. This method involves recording each cost directly to the component of the project to which it belongs. This method should be used whenever practical.</td>
</tr>
<tr>
<td>4. Square footage method.</td>
<td>iv. This method may be used if components with greater frontage are expected to have a higher selling price. This method is ranked in the third level of the hierarchy.</td>
</tr>
<tr>
<td>5. Frontage size.</td>
<td>v. This method should be used when, except for size, all of the components have the same characteristics and will be sold for approximately the same price per square foot. This method is ranked in the third level of the hierarchy.</td>
</tr>
</tbody>
</table>

a. 1., ii.; 2., v.; 3., iv.; 4., i.; 5., iii.
b. 1., iii.; 2., i.; 3., ii.; 4., v.; 5., iv.
c. 1., iv.; 2., iii.; 3., v.; 4., ii.; 5., i.
d. 1., v.; 2., iv.; 3., i.; 4., iii.; 5., ii.

9. FASB ASC 360-20 and 976 provide accounting methods to be used for recognizing gains from real estate sales. What are the three most commonly used methods?

a. Full accrual, installment, and deposit.
b. Full accrual, installment, and cost recovery.
c. Deposit, cost recovery, and reduced profit.
d. Installment, reduced profit, and percentage-of-completion.
10. The Commonwealth Credit Union (CCU) sells a piece of real estate. CCU provides some of the financing for the sale, and the buyer does not make a sufficient down payment. What accounting method should CCU use to account for this sale?

a. The full accrual method.
b. The installment method.
c. The deposit method.
d. The financing, leasing, or profit-sharing method.

11. Third National Bank (TNB) sells a piece of real estate. However, the buyer does not meet the minimum initial investment that was required by FASB ASC 360-20-55-1 and 55-2. Despite failing the initial investment test, it is reasonably assured that TNB will recover its investment in the property. What accounting method should TNB use to account for this sale?

a. The full accrual method.
b. The cost recovery method.
c. The installment method.
d. The deposit method.

12. Which of the following financial institutions has correctly dealt with an issue related to the continuing investment test when choosing the right method to account for real estate sales?

a. Bank A sells land. The buyer’s continuing investment is equal to the annual principal and interest payment needed to amortize the total debt over a 20-year period.
b. Bank B only applies the initial investment and continuing investment tests on a cumulative basis to its real estate sale.
c. Bank C relies on GAAP guidance to determine the interest rate to use to determine the annual interest payments needed for the continuing investment test.
d. Bank D excludes its buyer’s excess initial investment from consideration as part of the buyer’s continuing investment.

13. Bridgestone Mutual sells a piece of real estate. The sale meets the initial investment test, but it does not meet the continuing investment test. Annual payments by the buyer will cover (1) the interest and principle on the maximum first mortgage loan that could be obtained from an independent financial institution and (2) market rate interest on the excess of the total debt on the property over such maximum first mortgage loan. What accounting should the financial institution use for this sale?

a. The reduced profit method.
b. The installment method.
c. The cost recovery method.
d. The deposit method.
14. Bridgestone Mutual sells another piece of real estate. The sale does not meet all the conditions for using the full accrual method, so the installment method is used. After the sale date, the sale finally meets all the qualifications for the full accrual method. Once all those conditions are met, what should Bridgestone Mutual do?

   a. It should recognize any remaining deferred gain under the full accrual method at that time
   b. The use of accounting method is irrevocable, so it should not change how it accounts for the sale.
   c. Do not select this answer choice.
   d. Do not select this answer choice.

15. Jane, an auditor, is engaged to audit a financial institution. As part of her audit, she audits the institution’s real estate sales. Which of the following statements best describes this portion of Jane’s audit?

   a. Jane’s primary purpose for this part of the audit is to determine if the correct accounting method was used for each sale.
   b. Scanning entries to the institution’s general ledger account will help her identify individually significant items to test as part of her audit procedures.
   c. Once Jane establishes a cutoff amount for identifying individually significant items, it cannot be changed.
   d. Jane should use the detailed approach for both simple and complex real estate transactions.

16. Gateway Savings has a piece of real estate to be disposed of. It plans to dispose of the property by sale, but the carrying amount exceeds the property’s fair value (minus selling costs). According to the guidance in FASB ASC 360-10, how should this property be accounted for?

   a. Gateway should recognize an impairment loss
   b. There is no impairment for Gateway to recognize.
   c. There would only be an impairment loss if the property was to be held and used.
   d. There would only be an impairment loss if the property was to be disposed of other than by sale.

17. Which of the following properties can be classified as held for sale under an exception to the one-year requirement?

   a. At the date the Blue Institution commits to a plan to sell a piece of property, it reasonably expects that conditions imposed by the buyer will extend the period required to complete the sale, responses to the conditions can begin after a firm purchase commitment is obtained, and a firm purchase commitment is probable within one year.
   b. The Red Institution obtains a firm purchase commitment. As a result, a third party unexpectedly imposes conditions on the transfer of property that will extend the time period needed for the sale, actions needed to respond to the conditions will begin on a timely basis, and the delaying factors are expected to be favorably resolved.
   c. During the one-year period, circumstances arise that the Green Institution thought were not likely. As a result, the property in question was not sold, actions needed to respond to the changed circumstances are planned, and the institution plans to market the property at a revised price.
   d. Do not select this answer choice.
18. Market Savings sells a piece of real estate. The sale occurs within a one-year time period. Given the following information and ignoring impairment, at what amount should Market Savings report the sale?

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value</td>
<td>$250,000</td>
</tr>
<tr>
<td>Sales commissions</td>
<td>$25,000</td>
</tr>
<tr>
<td>Other closing costs</td>
<td>$5,000</td>
</tr>
<tr>
<td>Property taxes incurred while the property was being sold</td>
<td>$10,000</td>
</tr>
<tr>
<td>Carrying amount</td>
<td>$240,000</td>
</tr>
</tbody>
</table>

a. $210,000.
b. $220,000.
c. $240,000.
d. $250,000.

19. Assume the same details as in the previous question, except consider impairment. Should Market Savings recognize an impairment loss? If so, how much?

a. No, Market Savings would not recognize an impairment loss in this scenario.
b. Yes, Market Savings would recognize an impairment loss of $10,000.
c. Yes, Market Savings would recognize an impairment loss of $20,000.
d. Yes, Market Savings would recognize an impairment loss of $10,000.

20. Double Ring Bank assesses a piece of real estate for impairment. Under which of the following circumstances would the property be considered impaired?

a. Total net future cash flows exceed the carrying amount.
b. Total net future cash flows are less than the carrying amount.
c. Total net future cash flows exceed the total depreciation over the estimated useful life.
d. Total net future cash flows are less than total depreciation over the estimated useful life.
Lesson 2: Cash, Other Assets, and Liabilities

INTRODUCTION

Lesson 1 discusses one of the larger, more complex assets held by financial institutions. There are several other assets and liabilities of financial institutions that require special audit attention or involve unique audit considerations. Examples of such assets and liabilities include the following:

- Cash, due from banks, and interest-bearing deposits.
- Federal funds purchased and sold.
- Premises and equipment.
- Intangible assets.
- Deposit accounts.
- Borrowings.
- Official checks.
- Accounts payable and accrued expenses.

Audit Procedures for Obtaining Audit Evidence

The third standard of fieldwork states:

> The auditor must obtain sufficient appropriate audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit. (AU 150.02)

SAS No. 106 (AU 326), *Audit Evidence*, states that those audit procedures consist of the following:

- Risk assessment procedures.
- Tests of controls.
- Substantive procedures.

Risk assessment procedures and tests of controls contribute to the formation of the auditor’s opinion, but do not, by themselves, provide sufficient appropriate audit evidence. SAS No. 110 (AU 318), *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, states that regardless of the assessed risk of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure. Substantive procedures consist of (a) tests of details of classes of transactions, account balances, and disclosures, and (b) substantive analytical procedures.

The relevant audit assertions and substantive procedures for cash, other assets, and liabilities are discussed in this lesson. *PPC’s Guide to Audits of Financial Institutions* discusses the auditor’s considerations when responding to assessed risks of material misstatement at the relevant assertion level and the PPC core audit programs—which include basic, extended and other audit procedures. That guide also discusses considerations when choosing substantive procedures, including substantive analytical procedures and tests of details. Auditors should be familiar with those concepts when designing the nature, timing, and extent of substantive audit procedures for cash, other assets, and liabilities.
What This Lesson Covers

This lesson generally discusses cash and other assets and liability accounts. The specific topics discussed in this lesson are as follows:

Topics Covered

- Cash, due from banks, and interest-bearing deposits
- Federal funds purchased and sold
- Premises and equipment
- Intangible and other assets
- Deposit accounts
- Audit procedures for obtaining audit evidence relating to liabilities other than deposit accounts
- Borrowings
- Official checks, accounts payable, and accrued expenses

Learning Objectives:

Completion of this lesson will enable you to:

- Compare and contrast the different types of accounts an institution may have related to cash, due from banks, and interest-bearing deposits, summarize the process of clearing checks, and identify audit procedures related to cash that would apply in the audit of a financial institution.
- Assess issues related to auditing other types of assets (e.g., federal funds, premises and equipment, and intangible and other assets) that might occur in the audit of a financial institution.
- Compare and contrast the different types of deposit accounts, and identify related audit procedures related to deposit accounts that would apply in the audit of a financial institution.
- Compare and contrast the different types of borrowings, and summarize audit procedures used during audits of financial institutions to obtain audit evidence related to liabilities other than deposit accounts (e.g., borrowings, official checks, accounts payable, and accrued expenses).

Presentation of Assets and Liabilities

Although financial information normally is presented based on costs incurred, there are a number of situations in which other, more current information is either required or useful to the users of the presentation. Recent accounting literature indicates a gradual move to providing more fair value information, and some nonpublic entities find that fair value information is useful to the primary readers of their financial statements. Under generally accepted accounting principles, fair values can be used for only specific items in the financial statements or, in some cases, as a comprehensive basis for all items in the financial statements. In addition, GAAP requires fair value disclosures in several areas, principally for financial instruments. This lesson includes discussion on fair value accounting, when appropriate under GAAP, for cash, other assets, and liabilities.

Fair Value Measurements. FASB ASC 820-10 (formerly SFAS No. 157, Fair Value Measurements), provides a common definition of fair value, establishes a framework to measure fair value within GAAP, and expands the disclosures about fair value measurements. It generally applies under existing accounting pronouncements that require or permit fair value measurements, such as measuring fair value of investments, but it does not expand the use of fair value in any new circumstances.

FASB ASC 820-10-35-55A (formerly FASB Staff Position (FSP) No. FAS 157-3, Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active) clarifies the application of fair value measurements in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. FASB ASC 820-10-35-51A through 35-55H (formerly FASB Staff Position (FSP) No. FAS 157-4, Determining Fair Value When the Volume and Level of Activity for
The Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly] provides additional details on determining fair value when there has been a significant decrease in the volume or level of activity for an asset or liability. The guidance includes several factors to evaluate when assessing the significance of the decrease.

In August 2009, the FASB issued Accounting Standards Update (ASU) No. 2009-5, Measuring Liabilities at Fair Value, to provide guidance on the fair value measurement of liabilities since liabilities are rarely transferred in the marketplace. However, some liabilities are traded in the marketplace as assets, and price of the related asset may be used to measure the fair value of the liability. The guidance in this ASU is effective for the first reporting period, including interim periods, beginning after issuance.

The Fair Value Option. FASB ASC 825-10 (formerly SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities) permits entities to choose to measure prescribed financial instruments at fair value. Such elections (a) are made on an instrument-by-instrument basis, (b) are irrevocable, and (c) require changes in fair value to be recognized in earnings. This option was to provide entities the chance to reduce earnings volatility caused by measuring related assets and liabilities differently, such as measuring the liability at fair value but measuring the asset at historical cost. Generally, the Statement permits the fair value option for all financial assets and financial liabilities except the following, which are specifically excluded:

a. An investment in a subsidiary that is required to be consolidated by the entity.

b. A variable interest in a variable interest entity that is required to be consolidated by the entity.

c. Obligations for pension and other postretirement and postemployment benefits, share-based payments, compensated absences, and costs associated with exit or disposal activities.

d. Amounts recognized under FASB ASC 840 (formerly SFAS No. 13 Accounting for Leases).

e. Deposit and similar liabilities of financial institutions.

f. Financial instruments classified by the issuer as a component of equity.

Generally, a financial asset is defined as a financial instrument that conveys a right to the entity, and a financial liability is defined as a contract that imposes an obligation on the entity. For example, an entity could elect the fair value option for an investment that would otherwise be accounted for using the cost or equity method. Similarly, an entity could elect the fair value option for a fixed-rate long-term note.

The disclosure requirements of the Statement only apply if an entity has elected the fair value option. Those requirements generally look at how the election affects the measurement of those assets and liabilities. For example, the Statement requires disclosure of the reason for electing the fair value option and information about differences between the fair values and contractual cash flows. In addition, the measurement and disclosure requirements of FASB ASC 820-10 (formerly SFAS No. 157) apply to those assets and liabilities.

CASH TRANSACTIONS AND AUDITING CASH ACCOUNTS

Processing cash transactions is an integral part of a financial institution’s operations. Financial institutions have unique terminology and accounting practices for their cash accounts. Auditors must be able to understand an institution’s terminology and practices to effectively and efficiently audit cash accounts. The following paragraphs discuss cash transactions and how to audit cash accounts.

Types of Accounts

Financial institutions have a variety of accounts that may be considered part of cash. The following are some common types of cash accounts:

a. Cash on hand.
b. Cash items and collections.

c. Clearings and exchanges.

d. Balances due from banks and other financial institutions.

e. Interest-bearing deposits.

The following paragraphs discuss each of those accounts.

**Cash on Hand.** Cash on hand consists of cash in teller drawers and the vault. Teller funds are balanced and counted daily. In most institutions, each teller prepares a summary sheet showing a rollforward of his or her fund for that day and the total cash on hand at the end of the day. If the rollforward balance and the cash on hand differ at the end of the day, the rollforward balance is adjusted, with the difference going to a cash over/short account. Then the related general ledger balances are updated accordingly.

**Cash Items and Collections.** Cash items are items other than coin or currency that are held for conversion to cash. The following are examples of collections and cash items:

- **Food Stamps.** Food stamps may be received in deposits by retail customers. Those items are then redeemed with the appropriate government agencies.

- **Maturing Bond Coupons.** Bond coupons are received when an institution agrees to collect the bond payments for a customer.

- **Insufficient Funds Checks (Also Known as NSF Checks).** NSF checks may be received in various ways. One common situation is when a customer deposits a check drawn on another institution. If the amount of the check exceeds the check writer’s account balance, it is returned by the other institution. Then the institution may either charge back the customer’s account or return it to the customer for cash.

Cash items may be temporarily included in a teller’s cash fund during the day. However, those items should be segregated into a separate general ledger account at the end of the day.

**Clearings and Exchanges.** Clearings and exchanges primarily consist of checks drawn on other financial institutions. These items are generally received with customers’ deposits, and they are processed as discussed later in this lesson. (Some institutions use the term clearings to refer to checks drawn on local institutions and the term transit items for checks drawn on institutions in other areas. For simplicity, this course uses clearings and exchanges to refer to any checks drawn on another institution.)

**Balances Due from Banks and Other Financial Institutions.** A due from account is basically a checking account maintained with another financial institution. Due from accounts are used primarily in the check clearing process, as discussed later in this lesson. Due from accounts can also be used for other purposes, such as securities purchases and wire transfers. (The term due from account is used more often by banks. Savings institutions, credit unions, and some banks may use other terms for the account. This course uses the term due from account to represent deposits in other financial institutions.)

Some financial institutions also have a due to account, which is a deposit account. Due from accounts should be presented net of due to accounts on the institution’s balance sheet.

**Interest-bearing Deposits.** Interest-bearing deposits are normally certificates of deposit or other interest-bearing accounts maintained in other financial institutions. Some institutions consider these to be another type of due from account.

**Overview of the Process of Clearing Checks through Other Institutions**

To understand how to audit due from accounts, it is important for the auditor to understand the check clearing process. The following paragraphs discuss the process of clearing a check drawn on another financial institution. Exhibit 2-1 is a diagram of that process.
Exhibit 2-1
Illustration of Check Clearing Process

INSTITUTION A

BANK B
(Correspondent Bank)

Teller receives deposit and forwards checks and deposit ticket to proof and transit department.

Proof and transit department compares checks to deposit ticket, sorts checks for processing, prepares outgoing cash letters, and sends checks or digital substitute checks to correspondent banks.

Correspondent bank credits other institution for incoming cash letter, processes checks, and charges customers’ accounts for cleared checks.

Receipt of Checks. Checks drawn on other financial institutions are generally received through customer deposits. For example,

Example 2-1: Receipt of checks.

Assume a customer makes a $600 deposit to his or her checking account with Third National Bank. Also, assume that the deposit is composed of $100 in currency and a $500 check drawn on another financial institution, ABC Bank. The teller will generally count the currency and compare it to the deposit slip, give the customer a receipt for the deposit, and forward the deposit ticket and checks to the proof and transit department. The journal entry to record the transaction is as follows:

\[
\begin{align*}
\text{DR} & \quad \text{CR} \\
\text{Cash} & \quad $100 \\
\text{Clearings and exchanges} & \quad 500 \\
\text{Deposit account} & \quad $600
\end{align*}
\]

Proof and Transit Department. The proof and transit department takes checks deposited to customer accounts and proves the amounts deposited by comparing the checks and cash total to the total amount shown on the customer’s deposit slip. Adjustments are made for any customer errors. The dollar amount of each check is then encoded at the bottom of the check. Next, the checks are mechanically endorsed on the back and sorted by institution. Checks written on checking accounts of the institution’s own customers (sometimes referred to as on-us checks) are charged to the appropriate customers’ accounts. The remaining checks (sometimes called foreign checks) are written on checking accounts of other institutions and must be sent to those institutions for clearing.
Transmittal letters called *cash letters* are sent with each batch of checks or electronic check data to the appropriate institutions.

**Clearing Checks through Other Institutions.** After cash letters are prepared, the checks or electronic check data and cash letters are transmitted to the respective institutions for clearing. This may be accomplished through one or more of the following:

- **Other Institution.** The institution may send the checks or electronic check data directly to the other institution on which the checks are drawn. This is more likely to occur between institutions in the same community.

- **Local Clearinghouse.** A clearinghouse is an association of local financial institutions that is used for clearing checks drawn on the member institutions. A member institution may send checks or electronic check data drawn on other members to the clearinghouse.

- **Federal Reserve Bank (FRB) or Federal Home Loan Bank (FHLB).** The regional FRBs and FHLBs provide check clearing and collection services for their members. If the institution is a member, it may send some or all of the checks or electronic check data drawn on other institutions to the FRB or FHLB in that region for clearing and collection. Corporate credit unions, which are organized and owned by credit unions, provide similar check clearing and other functions for credit unions.

- **Correspondent Bank.** An institution may establish a correspondent relationship through one of the larger banks in the area rather than use the FRB or FHLB. Then, the correspondent would provide the check clearing and collection services for the institution.

- **Corporate Credit Unions.** There are a number of corporate credit unions throughout the country whose only customers are other credit unions. These corporate credit unions perform a variety of services to their credit union customers, including correspondent banking relationships. This service allows small credit unions to perform more functions at a reduced cost.

The financial institution establishes a due from account with each of the institutions used to clear checks. The institution accounts for the shipment of checks or electronic check data to the other institutions by debiting the due from accounts with those institutions.

**Example 2-2:** Clearing checks through other institutions.

Assume the same facts as in Example 2-1. Third National Bank’s proof and transit department proves the $600 deposit and prepares a cash letter for the $500 check. The check and cash letter are then sent to ABC Bank. Third National Bank records the shipment of the check for clearing by making the following journal entry:

\[
\begin{align*}
\text{DR} & \quad \text{CR} \\
\text{Due from ABC Bank} & \quad \text{Clearings and exchanges} \\
& \quad \$ 500 \quad \$ 500
\end{align*}
\]

A similar entry would be made if the check was cleared with the FRB or another institution.

**Clearing Checks Drawn on the Institution**

A financial institution will also receive cash letters for checks drawn on its customers’ accounts. The process of clearing those checks is the reverse of that previously discussed. The other institution ships checks or transmits electronic check data that are credited to the due from account (or a due to account, as previously discussed). Then, the checks are processed and debited to the respective customers’ accounts.

**Example 2-3:** Clearing checks drawn on the institution

Assume ABC Bank sends checks or transmits electronic check data totaling $400 that are drawn on Third National Bank’s customer accounts. Those checks are debited to the customers’ checking accounts, and Third National Bank records those transactions as follows:
Audit Procedures for Obtaining Audit Evidence Relating to Cash

Relevant Assertions for Cash. Relevant assertions for a particular audit area are assertions that have a meaningful bearing on whether the related account balances, transaction classes, or disclosures are fairly stated. The relevant assertions for cash generally are as follows:

- **Existence or Occurrence (E/O)**—Cash in teller and vault funds reflected in the financial statements exists and is physically on hand. Amounts due from banks and other financial institutions reflected in the financial statements exist. Cash transactions occurred and pertain to the institution.

- **Completeness (C)**—All cash transactions have been recorded. Cash and due from account balances reflect all cash and cash items on hand, in transit, or on deposit with third parties. Related disclosures are complete.

- **Rights or Obligations (R/O)**—Cash and due from account balances are owned by the institution, and any restrictions on the availability of funds are identified and properly disclosed.

- **Valuation or Allocation (V)**—Due from account balances are stated at realizable amounts.

- **Cutoff (CO)**—Cash and due from account balances reflect a proper cutoff of receipts and disbursements.

- **Accuracy or Classification (A/CL)**—Cash transactions have been properly recorded as to account and amount. Cash and due from account balances are properly classified in the balance sheet, and the information about cash required by GAAP is disclosed fairly at appropriate amounts.

The auditor uses relevant assertions in assessing the risks of material misstatements by considering the different types of potential misstatements that may occur (that is, what could go wrong in the financial statements), and then designing audit procedures that are responsive to the assessed risks. For each relevant assertion within an account balance, class of transactions, or disclosure, the auditor assesses the risks of material misstatement and, based on that assessment, determines the nature, timing, and extent of the substantive procedures necessary to obtain sufficient appropriate audit evidence.

The following paragraphs discuss substantive procedures for each type of cash account.

**Cash and Cash Items.** Cash and cash items are often not material at financial institutions. Audit procedures for those accounts can normally be limited to reviewing internal cash counts made by internal auditors or bank management, tellers’ daily cash summaries, and the list of cash items for unusual items, and agreeing the amounts to the general ledger balances.

**Clearings and Exchanges.** Clearings and exchanges can generally be tested like deposits in transit; that is, by tracing significant clearing items to the next day’s deposit in the bank statements for the due from accounts. Some auditors confirm clearing amounts, but confirmation generally is not necessary.

**Due from Accounts.** Due from accounts are reconciled at least monthly, but the reconciliations are different from the standard bank reconciliations used by commercial businesses. Exhibit 2-2 shows an example of a reconciliation form for a due from account. The following paragraphs explain the components of the reconciliation.
## Exhibit 2-2

### Example of a Due from Reconciliation Form

Financial Institution: ________________________________  
Date: ________________________________  
Statement account number: __________________  
General ledger account number: __________________  

<table>
<thead>
<tr>
<th>We debit/They do not credit</th>
<th>We credit/They do not debit</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Our date</strong></td>
<td><strong>Description</strong></td>
</tr>
<tr>
<td>__________</td>
<td>__________</td>
</tr>
<tr>
<td>__________</td>
<td>__________</td>
</tr>
<tr>
<td>__________</td>
<td>__________</td>
</tr>
<tr>
<td>__________</td>
<td>__________</td>
</tr>
<tr>
<td>__________</td>
<td>__________</td>
</tr>
<tr>
<td>__________</td>
<td>__________</td>
</tr>
<tr>
<td>__________</td>
<td>__________</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>They debit/We do not credit</th>
<th>They credit/We do not debit</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Their date</strong></td>
<td><strong>Description</strong></td>
</tr>
<tr>
<td>__________</td>
<td>__________</td>
</tr>
<tr>
<td>__________</td>
<td>__________</td>
</tr>
<tr>
<td>__________</td>
<td>__________</td>
</tr>
<tr>
<td>__________</td>
<td>__________</td>
</tr>
<tr>
<td>__________</td>
<td>__________</td>
</tr>
</tbody>
</table>

**TOTAL**  $__________  **TOTAL**  $__________

* * *
The left side of the reconciliation begins with the statement balance maintained by the correspondent bank or other institution. It is normally shown as a positive number. Then the following reconciling items are added to the statement balance to determine the reconciled balance:

- **We Debit/They Do Not Credit.** These are generally outgoing cash letters or other items that have been sent to the correspondent but that have not yet been recorded by the correspondent. They are analogous to deposits in transit in a commercial business bank reconciliation.

- **They Debit/We Do Not Credit.** These are generally incoming cash letters or other items charged to the account by the correspondent that have not yet been recorded by the client. If those items are valid, they should generally be recorded and the due from account balance reduced appropriately.

The right side of the reconciliation begins with the client’s general ledger balance. Like the left side, the balance is normally shown as a positive number. Then the following reconciling items are added to the general ledger balance to determine the reconciled balance:

- **We Credit/They Do Not Debit.** These are outstanding drafts or other items written on the account that the correspondent has not recorded. They are analogous to outstanding checks in a commercial bank reconciliation. They should be added to the general ledger balance to determine the reconciled balance.

- **They Credit/We Do Not Debit.** These are generally deposits or credits to the account that have not been recorded by the client. If those items are valid, they should generally be recorded and the due from balance increased appropriately.

Due from accounts should generally be tested like bank accounts of commercial businesses. Accordingly, the net balance should be confirmed with the correspondent bank or other institution. The **We Debit/They Do Not Credit** and **We Credit/They Do Not Debit** balances can generally be tested by comparing them to the subsequent period’s account statement from the correspondent. The remaining items should be vouched and audit adjustments proposed to book any unrecorded transactions.

The auditor should also assess the recoverability of any uninsured due from account balances. This can normally be accomplished by assessing the creditworthiness of the client’s correspondent bank and any other institution with which the client has large uninsured balances. For example, if the client uses the Federal Reserve Bank as its primary correspondent bank and has no uninsured deposits with other institutions, then its due from account balances would be considered recoverable.

**Interest-bearing Deposits.** As previously noted, interest-bearing deposits generally consist of certificates of deposit in other financial institutions. They can normally be tested through confirmation of significant deposits. The auditor should also assess the recoverability of any uninsured balances, as discussed in the preceding paragraph. Auditors should be aware that additional procedures may be necessary when material investments are held by brokers or other third parties.

**Surprise Entry Procedures**

Some auditors perform surprise entry procedures to test cash accounts on an unannounced basis. Those procedures generally involve entering a financial institution or branch on a surprise basis before the institution opens and physically counting and verifying the following:

- Cash funds.
- Cash items.
- Clearings and exchange items.
- Traveler’s checks.
- Official checks.
• Securities on hand.

Surprise entry procedures may not normally be necessary to address the relevant assertions relating to cash accounts. Surprise entry procedures may be performed if the procedures are deemed necessary based on the auditor’s assessment of the risk of material misstatement including those caused by fraud, or if the procedures are performed at the request of the board of directors.
SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

21. Green Leaf Mutual (GLM) agrees to collect bond payments for a customer. What type of cash account is this?
   a. Cash on hand.
   b. Cash items and collections.
   c. Clearings and exchanges.
   d. Interest-bearing deposits.

22. A customer of GLM deposits a check into her account. Which of the following steps would come first in GLM’s check clearing process?
   a. The proof and transit department proves the deposit amount.
   b. Correspondent banks charge the customer’s account.
   c. Checks are endorsed and sorted.
   d. A teller will forward the deposit to the proof and transit department.

23. Jason, an auditor, is engaged to audit a financial institution. When auditing the institution’s cash, he uses the following relevant assertion:

   Due from account balances are stated using realizable amounts.

This relevant assertion falls into what audit area?
   a. Completeness.
   b. Rights or obligations.
   c. Valuation or allocation.
   d. Accuracy or classification.
SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. (References are in parentheses.)

21. Green Leaf Mutual (GLM) agrees to collect bond payments for a customer. What type of cash account is this? (Page 346)

a. Cash on hand. [This answer is incorrect. Cash on hand consists of cash in teller drawers and the vault.]

b. Cash items and collections. [This answer is correct. Cash items are items other than coin or currency that are held for conversion to cash. Maturing bond coupons are an example of collections and cash items.]

c. Clearings and exchanges. [This answer is incorrect. Clearings and exchanges primarily consist of checks drawn on other financial institutions.]

d. Interest-bearing deposits. [This answer is incorrect. Interest-bearing deposits are normally certificates of deposit or other interest-bearing accounts maintained in other financial institutions.]

22. A customer of GLM deposits a check into her account. Which of the following steps would come first in GLM’s check clearing process? (Page 347)

a. The proof and transit department proves the deposit amount. [This answer is incorrect. This is the second step in the check clearing process. The proof and transit department, among other things, will take checks deposited to customer accounts and prove the amounts deposited by comparing the checks and cash total to the total amount shown on the customer’s deposit slip.]

b. Correspondent banks charge the customer’s account. [This answer is incorrect. This would be one of the final steps in the check clearing process. Once GLM has completed all of its steps in the process, checks written on checking accounts of other institutions are sent to those institutions for clearing along with cash letters. The correspondent bank will then credit the other institution for the incoming cash letter, process the checks, and charge customers’ accounts for cleared checks.]

c. Checks are endorsed and sorted. [This answer is incorrect. This step cannot occur until other steps in the check clearing process have already taken place. It would not be the first step in the process. After other steps have occurred, the dollar amount of each check is encoded at the bottom of the check, and then the checks are mechanically endorsed on the back and sorted by institution.]

d. A teller will forward the deposit to the proof and transit department. [This answer is correct. When a customer makes a deposit, the teller will receive that deposit and then forward the checks and the deposit ticket to the proof and transit department. As the person who interacts with the customer, the teller is the first stop in an institution’s check clearing process.]

23. Jason, an auditor, is engaged to audit a financial institution. When auditing the institution’s cash, he uses the following relevant assertion:

Due from account balances are stated using realizable amounts.

This relevant assertion falls into what audit area? (Page 349)

a. Completeness. [This answer is incorrect. The relevant assertions for completeness would be as follows: All cash transactions have been recorded. Cash and due from account balances reflect all cash and cash items on hand, in transit, or on deposit with third parties. Related disclosures are complete.]

b. Rights or obligations. [This answer is incorrect. The relevant assertion for rights or obligations would be as follows: Cash and due from account balances are owned by the institution, and any restrictions on the availability of funds are identified and properly disclosed.]
c. Valuation or allocation. [This answer is correct. Relevant assertions for a particular audit area are assertions that have a meaningful bearing on whether the related account balances, transaction classes, or disclosures are fairly stated. The relevant assertion for cash related to valuation or allocation is generally as written above.]

d. Accuracy or classification. [This answer is incorrect. The relevant assertions for accuracy or classification would be as follows: Cash transactions have been properly recorded as to account and amount. Cash and due from account balances are properly classified in the balance sheet, and the information about cash required by GAAP is disclosed fairly at appropriate amounts.]
FEDERAL FUNDS

What Are Federal Funds?

Federal funds (fed funds) are funds banks deposit in Federal Reserve Banks. Banks that are members of the Federal Reserve System must maintain specified levels of vault cash and deposits at Federal Reserve Banks. The federal funds market was originally designed to allow banks with excess levels of reserves to lend those funds to banks that need additional reserves. The loans are made by selling federal funds to other institutions. Thus, federal funds sold represent funds lent to other institutions, and federal funds purchased represent borrowings from other institutions. Interest rates are technically set by the selling banks, but rates tend to be relatively consistent around the country. This rate is generally referred to as the fed funds rate.

Federal funds transactions may be secured or unsecured. Unsecured transactions generally have short maturities, such as one day. Secured transactions may have longer maturities, such as several weeks. The collateral for a secured transaction, generally U.S. government securities, is placed in a custodial account for the benefit of the seller until the funds are repaid.

The federal funds market has now expanded beyond its original purpose and scope. Financial institutions that are not members of the Federal Reserve System can now participate in the federal funds market through correspondent banks that are members. Consequently, the total amount of federal funds purchased and sold is often greater than the total amount of excess reserves at member banks.

Substantive Audit Procedures

Federal funds purchased and sold should be tested through confirmation of significant balances with the other party to the transaction. Since most federal funds loans have short maturities, it is usually most efficient to confirm the balances at year end to avoid any updating procedures.

AUDIT PROCEDURES FOR PREMISES AND EQUIPMENT

Audit Procedures for Obtaining Audit Evidence Relating to Premises and Equipment

Relevant Assertions for Premises and Equipment. Relevant assertions for a particular audit area are assertions that have a meaningful bearing on whether the related account balances, transaction classes, or disclosures are fairly stated. The relevant assertions for premises and equipment generally are as follows:

- **Existence or Occurrence (E/O)**—Premises and equipment reflected in the accounts exists and is physically on hand. The costs and related depreciation applicable to all sold, abandoned, damaged, or obsolete property have been properly removed from the accounts. Premises and equipment transactions occurred and pertain to the entity.

- **Completeness (C)**—All premises and equipment transactions have been recorded. Premises and equipment reflected in the accounts represent a complete listing of the capitalizable cost of assets purchased, constructed, or leased by the entity and related disclosures are complete.

- **Rights or Obligations (R/O)**—Premises and equipment are owned by the entity.

- **Valuation or Allocation (V)**—Premises and equipment are valued in accordance with GAAP. The balances in the depreciation allowance accounts are reasonable, considering the expected useful lives of the premises and equipment units and estimated salvage value, and depreciation charged to income during the period is adequate but not excessive and has been computed on an acceptable basis consistent with that used in prior years. Accordingly, the net carrying values of premises and equipment presented in the financial statements are expected to be recoverable in the ordinary course of business.

- **Cutoff (CO)**—Premises and equipment are recorded in the proper accounting period.
• **Accuracy or Classification (A/CL)—**Premises and equipment are properly classified in the balance sheet; noncapitalizable costs are properly expensed, and capitalizable costs are excluded from maintenance or other expense accounts. Liens, significant fully depreciated assets, idle property, and property held for investment are identified and properly disclosed. The financial statements also include disclosure of information about premises and equipment required by GAAP.

The auditor uses relevant assertions in assessing the risks of material misstatement by considering the different types of potential misstatements that may occur (that is, what could go wrong in the financial statements), and then designing audit procedures that are responsive to the assessed risks. For each relevant assertion within an account balance, class of transactions, or disclosure, the auditor assesses the risks of material misstatement and, based on that assessment, determines the nature, timing, and extent of the substantive procedures necessary to obtain sufficient appropriate audit evidence.

Substantive audit procedures for premises and equipment sometimes include:

- Reviewing the changes in the premises and equipment accounts during the period.
- Assessing the reasonableness of depreciation expense.
- Assessing the value of property held for sale.

Those procedures are discussed in the following paragraphs.

**Reviewing Changes in Premises and Equipment Accounts**

Normally, the premises and equipment accounts have been audited in prior periods. Thus, current period audit procedures should be designed only to identify the additions or dispositions occurring in the current period. The auditor should obtain or prepare a schedule of changes in the premises and equipment accounts, including related depreciation. Then, the auditor should review the schedule for significant acquisitions and dispositions. Detailed vouching is usually needed only for significant acquisitions and dispositions.

**Assessing the Reasonableness of Depreciation Expense**

The auditor can normally assess depreciation expense by performing analytical procedures. One such procedure is to compute depreciation expense as a percentage of the net carrying amount for each category of depreciable asset and compare the current year’s percentage to the prior year’s or other expectation. Any significant differences should be investigated. A detailed recalculation of depreciation is usually needed only if there are significant unexplained differences.

**Assessing the Valuation of Premises and Equipment**

Normally, premises and equipment are carried at their depreciated cost, unless an asset becomes impaired. While performing substantive audit procedures, the auditor should be alert for signs that any significant assets may be impaired. The following conditions may indicate that an asset has been impaired:

- A significant decrease in the market price of the asset. (This applies particularly to assets that are held for sale or expected to be sold in the foreseeable future.)
- A significant adverse change in the extent or manner of the asset’s use, such as a significant decline in the use of certain equipment.
- A significant adverse physical change in an asset (for example, physical damage).
- A significant adverse change in legal factors or in the business climate that affects the value of the asset, or an adverse action or assessment by a regulator. For example, computer equipment or software may become obsolete, or changes in environmental regulations may significantly restrict the use of a particular facility.
Significant cost overruns beyond the amount originally expected to be needed to acquire or build the asset.

Current period operating or cash flow losses combined with a history of losses, or budgets or prospective financial information showing continuing losses associated with an asset, such as a branch that is expected to generate significant operating losses for the foreseeable future.

It is more likely than not that an asset will be sold or disposed of significantly before the end of its estimated useful life.

In those situations, the auditor should consider whether the asset is impaired and the carrying amount of the asset should be written down. FASB ASC 360-10-35-17 (formerly SFAS No. 144) requires that, if the sum of the cash flows expected to result from the use of the asset (undiscounted and without interest charges) is less than the carrying amount of the asset, an impairment loss should be recognized. Otherwise, an impairment loss is not recognized. PPC’s Guide to Preparing Financial Statements provides additional guidance regarding measuring impairment losses for various types of assets.

Another important consideration for valuation of premises and equipment is whether the institution plans to dispose of any significant assets. Sometimes, regulatory restrictions may require an institution to sell some of its premises and equipment. The following are examples of those regulatory restrictions:

- **National Banks.** Federal law (12 USC 371d) states that a national bank cannot invest in bank premises without OCC approval if that investment will cause the bank’s total direct and indirect investment in premises to exceed the amount of its capital stock. Also, OCC regulations (12 CFR 34.84) indicate that land acquired for expansion must generally be used within five years.

- **Federal Savings Institutions.** OTS regulations (12 CFR 560.37) limit a federal savings institution’s total investment in premises to the amount of its total regulatory capital.

- **Federal Credit Unions.** NCUA regulations (12 CFR 701.36) indicate that a federal credit union with assets of $1 million or more cannot invest in premises and equipment without NCUA approval if that investment will cause total premises and equipment to exceed 5% of the sum of share accounts and retained earnings. The definition of premises and equipment includes an institution’s main office, branch office, service organization, parking lot, other facilities, real estate, furniture, fixtures, equipment, software, computer hardware, ATM’s, heating and cooling equipment, leasehold improvements, and the aggregate of all capital and operating lease payments under lease agreements for fixed assets. In addition, there are other requirements for credit unions to occupy the space they have acquired within certain time frames or the NCUA could require the sale of the property. Credit unions also have restrictions on transactions with related parties.

Many state regulatory agencies have similar restrictions for state-chartered institutions. State member banks have the same statutory restrictions as national banks, except they must seek permission from the Federal Reserve Board.

While auditing premises and equipment, the auditor should consider whether regulatory or other limitations require the institution to dispose of any of those assets. If an institution’s investment in premises and equipment exceeds its regulatory limits, the institution may be required to dispose of some of those assets. If any assets are held for sale or required to be sold, the auditor should determine whether the asset is subject to FASB ASC 360-10 (formerly SFAS No. 144), if applicable. An asset that management plans to dispose of should be recorded at the lower of its carrying amount or fair value less cost to sell. The costs to sell are direct costs such as broker commissions, title transfer and legal fees, and closing costs incurred before legal title can be transferred.
AUDIT PROCEDURES FOR INTANGIBLE AND OTHER ASSETS

Audit Procedures for Obtaining Audit Evidence Relating to Intangible and Other Assets

Relevant Assertions for Intangible and Other Assets. Relevant assertions for a particular audit area are assertions that have a meaningful bearing on whether the related account balances, transaction classes, or disclosures are fairly stated. The relevant assertions for intangible and other assets generally are as follows:

- **Existence or Occurrence (E/O)**—Intangible and other assets reflected in the accounts exist.
- **Completeness (C)**—Intangible and other assets reflected in the accounts represent a complete listing of the institution’s costs that are allocable to future periods. Disclosures required by GAAP have been made.
- **Rights or Obligations (R/O)**—Intangible and other assets reflected in the accounts are the assets of the institution.
- **Valuation or Allocation (V)**—Intangible and other assets can reasonably be expected to be realized through future operations and are properly amortized or written off on an acceptable basis consistent with methods used in prior periods; impairment of balances is recognized by write-downs.
- **Cutoff (CO)**—Intangible and other assets and any related amortization or write-downs are recorded in the proper accounting period.
- **Accuracy or Classification (A/CL)**—Intangible and other assets and any related amortization or write-downs are properly described and classified. Intangible and other assets and any related amortization or write-downs are recorded in the proper accounts at appropriate amounts. Information about intangible and other assets, including restrictions, pledges, or liens against other assets, is disclosed fairly at appropriate amounts.

The auditor uses relevant assertions in assessing the risks of material misstatement by considering the different types of potential misstatements that may occur (that is, what could go wrong in the financial statements), and then designing audit procedures that are responsive to the assessed risks. For each relevant assertion within an account balance, class of transactions, or disclosure, the auditor assesses the risks of material misstatement and, based on that assessment, determines the nature, timing, and extent of the substantive procedures necessary to obtain sufficient appropriate audit evidence.

**Intangible Assets**

Intangible assets of financial institutions generally arise in one of two ways—

- Acquisition of a financial institution or branch.
- Purchase or origination of loan servicing rights.

The following paragraphs discuss accounting and auditing considerations for each situation.

**Intangibles Relating to Acquisition of Another Institution or Branch**

**Recording Goodwill and Other Intangible Assets.** FASB ASC 805 [formerly SFAS No. 141(R), Business Combinations] and FASB ASC 350 (formerly SFAS No. 142, Goodwill and Other Intangible Assets) contain accounting and reporting requirements for goodwill and other intangible assets. Under the purchase method, the acquisition is basically accounted for as a purchase of assets and liabilities. Identifiable assets and liabilities acquired are recorded at their fair values. Intangible assets, such as the following, may also be recorded:

- Goodwill.
- Core deposits.
In addition to core deposits, other identifiable intangible assets that may result from financial institution acquisitions include purchased credit-card relationships, favorable leaseholds, and trust servicing.

FASB ASC 350 (formerly SFAS No. 142) addresses intangible assets acquired individually or with a group of other assets (excluding those acquired in a business combination) at acquisition. In addition, it provides guidance for goodwill and other intangible assets subsequent to acquisition. Under the purchase method, the excess of the purchase price paid to acquire an institution over the fair value of the identifiable assets and liabilities acquired is recorded as goodwill.

**Amortization of Goodwill.** FASB ASC 350-20-35-1 (formerly SFAS No. 142) prohibits the amortization of goodwill. Instead, FASB ASC 350-20-35-1 (formerly SFAS No. 142) requires that goodwill be tested for impairment at least annually.

**Assessing the Impairment of Goodwill.** FASB ASC 350 (formerly SFAS No. 142) requires that goodwill be tested for impairment at least annually rather than be amortized. Impairment is to be assessed at the reporting unit level, which is defined as an operating segment or a component one level below an operating segment. A component is considered a reporting unit if it is a business with discrete financial information and operating results that are regularly reviewed by segment management. Two or more components should be combined into a single reporting unit if they have similar economic characteristics. FASB ASC 280-10 (formerly SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*) should be used to identify the reporting units of an institution.

Testing goodwill for impairment is a two-step process. The first step is to determine whether impairment exists. That is accomplished by comparing the fair value and the carrying value (including goodwill) of a reporting unit. Impairment exists if the carrying value exceeds the fair value of the reporting unit. Conversely, if the fair value exceeds the carrying value, the goodwill is not considered impaired and the second step of the impairment process is not applicable.

The second step of the impairment process is to measure of the amount of the impairment loss. The loss is calculated by comparing the carrying value of the goodwill to its implied fair value. The loss is the amount by which the carrying value exceeds the implied fair value. However, the loss cannot exceed the carrying value of the goodwill, and recognized impairment losses may not be subsequently reversed. The implied fair value of goodwill can be estimated similarly to the methodology used to measure the amount of goodwill resulting from a business combination accounted for by the purchase method. The following steps are required:

- Determine the fair value of a reporting unit.
- Allocate that fair value to all of the assets and liabilities of that reporting unit. Amounts should also be allocated to unrecognized intangible assets, if any.
- Compare the fair value of the reporting unit to the amounts assigned to its assets and liabilities. Any excess of fair value is considered the implied fair value of the goodwill.
- Compare the implied fair value of the goodwill to its carrying value. The impairment loss is the amount by which the carrying value exceeds the implied fair value.

**Frequency of Testing Goodwill for Impairment.** GAAP requires that goodwill be tested for impairment at least once a year. Impairment testing may need to be performed more frequently if events or circumstances change such that it is more likely than not that the fair value of a reporting unit has been reduced below its carrying value. Such circumstances may include the allocation of goodwill to a branch to be disposed of, significant adverse changes in an entity’s business or legal environment, regulatory actions or assessments, impairment testing of a significant group of assets within a reporting unit, or the assessment of a goodwill impairment loss in a subsidiary that is a component of a reporting unit. Furthermore, institutions should test goodwill for impairment at the same time every year. However, all reporting units are not required to test for impairment at the same time as the others.
An entity is not required to make a detailed determination of the fair value of a reporting unit each year. A prior year’s valuation may be carried forward to a subsequent year if the following conditions are met in their entirety:

- The reporting unit’s assets and liabilities have not changed significantly since the prior fair value determination was made.
- The fair value of the reporting unit substantially exceeded the carrying amount at the time the prior fair value determination was made.
- The entity can conclude, based on an analysis of recent events and circumstances, that the likelihood is remote that a revised fair value calculation would produce an amount lower than the current carrying value of the reporting unit.

**Amortization of Intangible Assets.** Intangible assets that have an indefinite useful life should not be amortized, but rather they should be subject to an impairment test similar to that performed for goodwill. Intangible assets that have a finite useful life should be amortized over the asset’s estimated useful life, which may include extended terms under renewal or extension provisions. FASB ASC 350-30-35-1 through 35-13 (formerly SFAS No. 142) provides guidance for estimating the useful life of an intangible asset. Amortization should be calculated using the straight-line method unless another method better reflects the pattern of consumption of the economic benefits of the intangible asset.

**Assessing the Impairment of Intangible Assets.** Intangible assets that have an indefinite useful life should be tested for impairment by comparing the fair value to the carrying amount of the intangible asset. If the assessment indicates that the carrying amount exceeds the fair value of the intangible asset, the excess should be recognized as an impairment loss. If the fair value exceeds the carrying amount, impairment is deemed not to exist. Impairment should be tested at least annually and more frequently if certain circumstances indicate that the asset may be impaired. Such circumstances may include a significant decrease in the market value of the asset, significant adverse changes in an entity’s business or legal environment, regulatory actions or assessments, or other factors that could adversely impact the value of the intangible asset. Once an impairment loss has been recognized, GAAP prohibits the subsequent reversal of that loss.

**Core Deposits.** Core deposits are deposit accounts that tend to remain in the institution regardless of changes in interest rates. Core deposits are a dependable, long-term source of funds for the institution and, thus, are considered to have a value that is separate from the institution’s other assets. The core deposit intangible is an identifiable asset, and it should be recorded before determining the amount of goodwill. Consequently, the greater the core deposit intangible, the smaller the amount of goodwill recorded.

A core deposit study by a valuation specialist is generally required to determine the value of the intangible to be recorded. The asset should be amortized over the estimated life of the depositor relationships, which is normally indicated in the core deposit study.

**Servicing Rights**

An institution may buy or originate loans and sell the loans but retain the right to service them in return for a fee. The rights to service loans are frequently purchased and sold because servicing fees often exceed the cost of performing servicing functions. The servicing fee, usually based on a percentage of the outstanding principal balance of the loan, is received for performing loan administration functions, such as collecting loan and escrow payments and maintaining loan payment records.

An institution should recognize a servicing asset or liability for a servicing contract in either of the following situations [FASB ASC 860-50-25-1 and 25-3 (formerly SFAS 140, paragraphs 13 and 63, as amended by SFAS 166, paragraph 4)]:

- A servicer’s transfer of financial assets that meets the requirements for a sale.
- An acquisition or assumption of a servicing obligation unrelated to financial assets of the servicer or its consolidated affiliates.
The contract to service financial assets should be accounted for separately from the financial assets. However, FASB ASC 860-50-25-4 (formerly SFAS No. 140, paragraph 13, as amended by SFAS No. 166, paragraph 4) indicates if an entity transfers financial assets to an unconsolidated entity in a transfer accounted for as a sale and obtains the resulting securities, which are classified as debt held-to-maturity, it can separately recognize the servicing assets or liabilities or report them together with the serviced asset.


a. Servicing assets should be presented separately from servicing liabilities in the balance sheet.

b. Both servicing assets and servicing liabilities should initially be measured at fair value, if practical.

c. Rights to future interest income from serviced assets in excess of contractually specified servicing fees should be accounted for separately from servicing assets. (Those rights should be accounted for like interest-only strips.)

d. Classes of servicing assets and servicing liabilities should be identified based on the availability of market inputs used in determining the fair value of servicing assets and servicing liabilities, an institution’s method for managing the risks of its servicing assets and servicing liabilities, or both.

e. Servicing assets and servicing liabilities determined on a class-by-class basis should subsequently be measured using either the amortization method or the fair value measurement method. (These methods are described in the following paragraphs.) Different measurement methods may be used for different classes of servicing assets and servicing liabilities. FASB ASC 860-50-35-3 (formerly SFAS No. 140, paragraph 63) indicates that once a servicing asset or a servicing liability is reported in a class of servicing assets and servicing liabilities that an entity elects to subsequently measure at fair value, that servicing asset or servicing liability shall not be placed in a class of servicing assets and servicing liabilities that is subsequently measured using the amortization method. An entity may make an irrevocable decision to subsequently measure a class of servicing assets and servicing liabilities at fair value at the beginning of any fiscal year.

f. Each class of servicing assets that is subsequently measured using the amortization method noted in subparagraph e should be evaluated for impairment.

g. For servicing liabilities subsequently measured using the amortization method noted in subparagraph e, if subsequent events (such as higher servicing expenses than originally estimated) result in an increase in the fair value of the servicing liability, the increased liability should be charged to earnings.

**Amortization Method.** Using the amortization method, servicing assets or servicing liabilities are amortized over the period of and in proportion to estimated net servicing income (loss). Net servicing income (loss) is the excess of servicing revenues over servicing costs (the excess of servicing costs over servicing revenues). At each reporting date, servicing assets or servicing liabilities should be assessed for impairment or increased obligation based on fair value.

**Fair Value Measurement Method.** Using the fair value measurement method, servicing assets or servicing liabilities are measured at fair value at each reporting date and changes in fair value of the assets and liabilities are reported in earnings in the period in which the changes occur.

**Impairment.** Impairment of servicing assets should be evaluated and measured as follows:

a. Servicing assets should be stratified based on one or more predominant risk characteristics, which may include financial asset type, size, interest rate, origination date, term, and geographic location.

b. Impairment should be recognized through a valuation allowance for each stratum in which the carrying amount of the servicing asset exceeds fair value. (For this purpose, the fair value of any unrecorded servicing rights should be excluded.)
c. The valuation allowance should be adjusted for subsequent changes in fair value. (However, the servicing assets should not be adjusted above their carrying amount before impairment was recognized.)

**Reporting.** Servicing assets and servicing liabilities measured at fair value are required to be reported separately from those measured using the amortization method. FASB ASC 860-50-50 provides guidance for financial statement presentation and additional required disclosures.

**Audit Considerations**

In auditing an intangible asset or servicing liability, the auditor is concerned primarily with the following:

a. *Whether the Asset or Liability Was Originally Recorded Correctly.* This is really a consideration only for the period in which the related institution servicing asset or servicing liability is acquired. The auditor should review appropriate documentation of the purchase price and estimated values of the assets acquired to determine whether the intangible asset or liability was recorded correctly.

b. *Whether the Asset or Liability Is Being Measured Properly.* The auditor should use inquiry, observation, and analytical procedures as necessary to determine whether the asset or liability is measured properly, as discussed in the preceding paragraphs.

c. *Whether Amortizable Assets Are Recoverable.* The auditor should assess whether the net book values of amortized assets are recoverable. Factors to consider include the following:

   (1) **Goodwill.** If the institution qualifies as a *going concern,* its goodwill is usually considered to be recoverable. As previously discussed, goodwill is subject to impairment testing.

   (2) **Core Deposits.** Core deposits are also usually recoverable for a going concern. However, if the institution has experienced a significant decline in its core deposit base, the intangible may be impaired.

   (3) **Servicing Rights.** Servicing assets and servicing liabilities measured using the amortization method must be evaluated for impairment based on their fair values. See the list of rules provided earlier in this lesson.

   If there is substantial doubt about the institution’s ability to continue as a going concern, the recoverability of intangible assets would generally also be considered in doubt.

**FDIC Deposit Insurance Fund (DIF)**

The FDIC requires insured institutions to pay a quarterly risk-based assessment to fund the Deposit Insurance Fund (DIF). With the worsening economic crisis and the number of bank and thrift failures rising significantly in 2008 and 2009, the liquid assets of the DIF have been used to protect depositors and converted to less liquid claims against the assets of the failed institutions. In 2009, the FDIC imposed a five-basis point special assessment to prevent the DIF balance from falling to a level close to or below zero. The DIF has a statutory mandated minimum ratio of 1.15 percent.

**DIF Restoration Plan.** In November 2009, the FDIC adopted a final rule requiring insured institutions to prepay the estimated quarterly risk-based assessments for the fourth quarter of 2009 and all of 2010, 2011, and 2012. With this final rule, the FDIC increased the annual assessment rates uniformly by three basis points beginning on January 1, 2011. The prepaid assessments were collected on December 30, 2009. The final rule for the Restoration Plan also allowed the DIF eight years to return the DIF reserve ratio back to 1.15 percent.

An institution would recognize the prepaid assessments as a prepaid expense. The institution’s quarterly risk-based deposit insurance assessment would be expensed with an offset to the prepaid expense until the prepaid expense account is exhausted or until June 30, 2013. Any remaining prepaid amount at June 30, 2013 is to be returned to the institution.
National Credit Union Share Insurance Fund (NCUSIF) Deposit

Credit unions have their own internal financial system—the Corporate Credit Union Network, consisting of the U.S. Central Federal Credit Union (USC) and its member corporate credit unions. These state or regional corporate credit unions make available a wide range of investment and correspondent financial services for credit unions, and the USC serves as a financial intermediary for corporate credit unions. Credit unions that are insured by the NCUSIF are required to maintain a deposit with the insurance fund equal to 1% of their total insured deposits. The NCUSIF deposit should be shown as a separate report line item as long as it is fully refundable. Generally, a deposit is considered to be refundable if both the credit union and the NCUSIF are solvent.

The amount of the NCUSIF deposit is periodically adjusted to reflect changes in the balance of a credit union’s insured shares. In addition, a credit union is required to pay an additional annual insurance premium equal to one-twelfth of 1% of its insured shares.

Credit Union Insurance Stabilization Act. The Credit Union Insurance Stabilization Act (Stabilization Act) became law on May 20, 2009 and incorporated several provisions of the NCUA’s strategy to promote stability in the credit union industry. The Stabilization Act:

- Created a temporary corporate credit union stabilization fund to mitigate stabilization costs.
- Extended the $250,000 insurance ceiling for share and deposit accounts through 2013.
- Provided the NCUSIF the authority to assess premiums over eight years to rebuild the equity ratio in the fund.
- Increased the NCUA regular and emergency borrowing authority levels.

In mid-June 2009, the NCUA took several actions that released the NCUSIF from its corporate stabilization obligations. As a result of these actions, each federally insured credit union was to record a special assessment of .30 percent of insured shares (with a $100,000 per account limit) and an impairment of their NCUSIF deposit of approximately 69 percent.

Later in June 2009, the NCUA announced in its Letter to Credit Unions No. 09-CU-14, Corporate Stabilization Fund Implementation, for credit unions to consider additional information provided in the letter for regulatory reports as of June 30, 2009. After the implementation of the corporate credit union stabilization fund, the NCUA adjusted the special assessment for credit unions to .15 percent of insured shares (with a $250,000 per account limit), which required a revision of the special assessment originally recorded. The special assessment was invoiced and collected in September 2009. Additionally with the implementation of the credit union stabilization fund and the full restoration of the NCUSIF, an amount equal to 69 percent of each insured credit union’s insured shares was passed back and credited to each insured credit union’s NCUSIF deposit account as a recaptured NCUSIF deposit. As noted in in the previous paragraph, credit unions should have recorded an impairment charge for the insured shares and should now reflect a fully refundable one percent of insured shares deposit asset as of June 30, 2009. The recovery through passing back funds and simultaneously recapitalizing their deposit without an additional cash payment should be considered income. The previous impairment should not be reversed and the recapitalization should be recorded as nonoperating income that is offset by an increase to the NCUSIF deposit (bringing the balance back to what it was prior to the impairment recognition).

Contributions Received by Credit Unions

Many credit unions receive assets or services from their sponsors or members at no cost. For example, a credit union might receive free office space, telephone services, and data processing from its sponsor without charge. The receipt of such contributions has raised the question as to the applicability of FASB ASC 958 (formerly SFAS No. 116, Accounting for Contributions Received and Contributions Made).

FASB ASC 958 (formerly SFAS No. 116) applies to all entities, not only traditional not-for-profit organizations. Accordingly, credit unions that receive donated materials, facilities, or services should account for them in accor-
dance with FASB ASC 958 (formerly SFAS No. 116). The following is a summary of the GAAP rules for donated materials, facilities, and services:

a. Materials. Donated materials should be recorded at fair value in the period received.

b. Office Facilities. Donations of office facilities should be measured using fair value lease rates for the donated space. If the facilities are donated for an unspecified period, contribution revenue and rent expense should be recognized for the same amount each period the space is occupied. If an unconditional promise of office facilities for a specified number of years is received, a receivable and contribution revenue should be recognized for the present value of the office space, discounted at a rate commensurate with the risk involved. Thereafter, the receivable is increased each period by the applicable amount of interest, which is recognized as additional contribution revenue, and reduced by the full fair value of donated space, which is recorded as lease expense.

c. Services. Donated services are recognized only if they either (1) create or enhance a nonfinancial asset or (2) are specialized skills, provided by entities or persons possessing those skills, that would be purchased if they were not donated. Donated services meeting one or both criteria should be recorded at fair value. The donated services should be credited to contribution revenue when provided and charged to a nonfinancial asset (such as a building) or expense (such as accounting or data processing expense).

For a more detailed discussion, see PPC’s Guide to Preparing Nonprofit Financial Statements.
SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

24. Jeanie, an auditor, is engaged to audit a financial institution that is part of the Federal Reserve System. Which of the following procedures would apply to this portion of her audit?
   a. Confirming federal funds with the other party at year-end.
   b. Ensuring that all federal funds transactions are secured.
   c. Ensuring that institutions in federal funds transactions with her client are members of the system.
   d. Responsibility for federal funds rests with the Federal Reserve System, so Jeanie will not need to perform any federal funds procedures during her audit.

25. Jeanie must also audit the premises and equipment of her financial institution client. Which of the following statements best describes this portion of her audit?
   a. She should perform a detailed recalculation of all depreciation.
   b. She should be alert for signs that any of her client’s assets have been impaired.
   c. There are no regulatory restrictions related to premises and equipment, so she does not need to consider them as part of the audit.

26. Carl, an auditor, is hired to audit a financial institution that has intangible and other assets. When Carl assesses the risk of material misstatement in the completeness audit area, which of the following relevant assertions would apply?
   a. The institution has properly described and classified intangible and other assets and any related amortization or write-downs.
   b. The intangible and other assets reflected in the institution’s accounts exist.
   c. Intangible and other assets reflected in the institution’s accounts make up a complete list of the institution’s costs allocable to future periods.
   d. The institution recorded intangible and other assets and related amortization or write-downs in the proper accounting period.

27. Collinstown National Bank (CNB) acquires a new branch. As part of the acquisition, CNB receives goodwill. How should the goodwill be treated?
   a. It should be amortized.
   b. It should be tested for impairment.

28. Which of the following financial institutions has correctly dealt with goodwill?
   a. Alpha Bank tests its goodwill for impairment once every two years.
   b. Beta Bank determines that its goodwill is impaired because its fair value exceeds its carrying value.
   c. Gamma Bank determines that the impairment loss for its goodwill exceeds the carrying value.
   d. Delta bank carries the previous detailed valuation of its reporting unit forward to a subsequent year.
29. Which of the following financial institutions has correctly followed the accounting rules for servicing rights?

a. Echo Institution combines servicing liabilities and servicing assets on its balance sheet.

b. Foxtrot Institution identifies classes of servicing assets and liabilities based on the availability of market inputs used to determine the fair value of such assets and liabilities.

c. Sierra Institution initially measures its servicing assets at their carrying value and its servicing liabilities at fair value.

d. Tango Institution accounts for servicing assets and rights to any future interest income from serviced assets in excess of contractually specified servicing fees together.

30. Midtown Credit Union (MCU) is a federally insured credit union. Which of the following will affect MCU under the Credit Union Insurance Stabilization Act (Stabilization Act)?


b. Recording a special assessment of .30 percent of insured shares.

c. Extension of the $250,000 insurance ceiling for share and deposit accounts.

d. Incorporating additional information into regulatory reports.
SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. (References are in parentheses.)

24. Jeanie, an auditor, is engaged to audit a financial institution that is part of the Federal Reserve System. Which of the following procedures would apply to this portion of her audit? (Page 356)

   a. Confirming federal funds with the other party at year-end. [This answer is correct. Federal funds purchased and sold should be tested through confirmation of significant balances with the other party to the transaction. Since most federal funds loans have short maturities, it is usually most efficient to confirm the balances at year end to avoid any updating procedures.]

   b. Ensuring that all federal funds transactions are secured. [This answer is incorrect. Federal funds transactions may be secured or unsecured. Unsecured transactions generally have short maturities, such as one day. Secured transactions may have longer maturities, such as several weeks.]

   c. Ensuring that institutions in federal funds transactions with her client are members of the system. [This answer is incorrect. The federal funds market has now expanded beyond its original purpose and scope. Financial institutions that are not members of the Federal Reserve System can now participate in the federal funds market through correspondent banks that are members.]

   d. Responsibility for federal funds rests with the Federal Reserve System, so Jeanie will not need to perform any federal funds procedures during her audit. [This answer is incorrect. Jeanie should perform certain audit procedures with regards to her client’s federal funds transactions. Not performing any audit procedures related to federal funds would result in Jeanie missing out on knowledge that could be relevant to her audit opinion.]

25. Jeanie must also audit the premises and equipment of her financial institution client. Which of the following statements best describes this portion of her audit? (Page 357)

   a. She should perform a detailed recalculation of all depreciation. [This answer is incorrect. The auditor can normally assess depreciation expense by performing analytical procedures. One such procedure is to compute depreciation expense as a percentage of the net carrying amount for each category of depreciable asset and compare the current year’s percentage to the prior year’s or other expectation. Any significant differences should be investigated. A detailed recalculation of depreciation is usually needed only if there are significant unexplained differences.]

   b. She should be alert for signs that any of her client’s assets have been impaired. [This answer is correct. Normally, premises and equipment are carried at their depreciated cost, unless an asset becomes impaired. While performing substantive audit procedures, the auditor should be alert for signs that any significant assets may be impaired. An example of such a sign would be if there was a significant decrease in the market price of the asset.]

   c. There are no regulatory restrictions related to premises and equipment, so she does not need to consider them as part of the audit. [This answer is incorrect. Depending on the type of financial institution Jeanie has for a client, federal law, OTS regulations, or NCUA regulations should be considered. Sometimes, regulatory restrictions may require an institution to sell some of its premises and equipment, which Jeanie should consider. Plans by the institution to dispose of any significant assets could affect her valuation of premises and equipment.]
26. Carl, an auditor, is hired to audit a financial institution that has intangible and other assets. When Carl assesses the risk of material misstatement in the completeness audit area, which of the following relevant assertions would apply? (Page 359)

a. The institution has properly described and classified intangible and other assets and any related amortization or write-downs. [This answer is incorrect. This relevant assertion applies to the accuracy or classification audit area.]

b. The intangible and other assets reflected in the institution’s accounts exist. [This answer is incorrect. This relevant assertion applies to the existence or occurrence audit area.]

c. Intangible and other assets reflected in the institution’s accounts make up a complete list of the institution’s costs allocable to future periods. [This answer is correct. This relevant assertion applies to the audit area of completeness. Another related relevant assertion would be that disclosures required by GAAP have been made. Relevant assertions for a particular audit area are assertions that have a meaningful bearing on whether the related account balances, transaction classes, or disclosures are fairly stated.]

d. The institution recorded intangible and other assets and related amortization or write-downs in the proper accounting period. [This answer is incorrect. This relevant assertion applies to the cutoff audit area.]

27. Collinstown National Bank (CNB) acquires a new branch. As part of the acquisition, CNB receives goodwill. How should the goodwill be treated? (Page 360)

a. It should be amortized. [This answer is incorrect. FASB ASC 350-20-35-1 prohibits the amortization of goodwill, so CNB should not treat the acquired goodwill in this way.]

b. It should be tested for impairment. [This answer is correct. FASB ASC 350-20-35-1 requires that goodwill be tested for impairment on a regular basis. Therefore, this would be an appropriate action for CNB to take.]

28. Which of the following financial institutions has correctly dealt with goodwill? (Page 361)

a. Alpha Bank tests its goodwill for impairment once every two years. [This answer is incorrect. FASB ASC 350 requires that goodwill be tested for impairment at least annually. Impairment is to be assessed at the reporting unit level.]

b. Beta Bank determines that its goodwill is impaired because its fair value exceeds its carrying value. [This answer is incorrect. Testing goodwill for impairment is a two-step process. The first step is to determine whether impairment exists. This is accomplished by comparing the fair value and the carrying amount (including goodwill) of a reporting unit. Impairment exists if the carrying value exceeds the fair value of the reporting unit. Conversely, if the fair value exceeds the carrying value, the goodwill is not considered impaired and the second step of the process is not applicable.]

c. Gamma Bank determines that the impairment loss for its goodwill exceeds the carrying value. [This answer is incorrect. The second step of the impairment process is to measure the amount of the impairment loss. The loss is the amount by which the carrying value exceeds the implied fair value. The loss is calculated by comparing the carrying value of the goodwill to its implied fair value. The loss cannot exceed the carrying value of the goodwill, and recognized impairment losses may not be subsequently reversed.]

d. Delta bank carries the previous detailed valuation of its reporting unit forward to a subsequent year. [This answer is correct. An entity is not required to make a detailed determination of the fair value of a reporting unit each year. A prior year’s valuation may be carried forward to a subsequent year if certain conditions are met.]
29. Which of the following financial institutions has correctly followed the accounting rules for servicing rights? (Page 361)

a. Echo Institution combines servicing liabilities and servicing assets on its balance sheet. [This answer is incorrect. Under FASB ASC 860, servicing assets should be presented separately from servicing liabilities in the balance sheet.]

b. Foxtrot Institution identifies classes of servicing assets and liabilities based on the availability of market inputs used to determine the fair value of such assets and liabilities. [This answer is correct. Classes of servicing assets and servicing liabilities should be identified based on the availability of market inputs used in determining the fair value of servicing assets and servicing liabilities, and institution’s method for managing the risks of its servicing assets and servicing liabilities, or both. FASB ASC 860 discusses accounting for servicing assets and servicing liabilities.]

c. Sierra Institution initially measures its servicing assets at their carrying value and its servicing liabilities at fair value. [This answer is incorrect. According to FASB ASC 860, both servicing assets and servicing liabilities should initially be measured at fair value, if practical.]

d. Tango Institution accounts for servicing assets and rights to any future interest income from serviced assets in excess of contractually specified servicing fees together. [This answer is incorrect. Under FASB ASC 860, rights to future interest income from serviced assets in excess of contractually specified servicing fees should be accounted for separately from servicing assets. Those rights should be accounted for like interest-only strips.]

30. Midtown Credit Union (MCU) is a federally insured credit union. Which of the following will affect MCU under the Credit Union Insurance Stabilization Act (Stabilization Act)? (Page 364)

a. Prepaying estimated quarterly risk-based assessments for 2010. [This answer is incorrect. In November 2009, the FDIC adopted a final rule requiring insured institutions to prepay the estimated quarterly risk-based assessments for the fourth quarter of 2009 and all of 2010, 2011, and 2012. However, because MCU is a credit union, this FDIC rule would not apply. Credit unions have their own internal financial system—the Corporate Credit Union Network.]

b. Recording a special assessment of .30 percent of insured shares. [This answer is incorrect. In mid-June 2009, the NCUA took several actions that release the NCUSIF from its corporate stabilization obligations. As a result of these actions, each federally insured credit union was to record a special assessment of .30 percent of insured shares (with a $100,000 per account limit) and an impairment of their NCUSIF deposit of approximately 69 percent. This assessment will affect MCU; however, it is not part of the Stabilization Act.]

c. Extension of the $250,000 insurance ceiling for share and deposit accounts. [This answer is correct. The Stabilization Act became law on May 20, 2009, and incorporated several provisions of the NCUA’s strategy to promote stability in the credit union industry. It’s provisions will affect MCU. One of the provisions of this act is that it extended the $250,000 insurance ceiling for share and deposit accounts through 2013.]

d. Incorporating additional information into regulatory reports. [This answer is incorrect. In June 2009, the NCUA announced in its Letter to Credit Unions No. 09-CU-14, Corporate Stabilization Fund Implementation, for credit unions to consider additional information provided in the letter for regulatory reports as of June 30, 2009. This consideration would affect MCU; however, it was not part of the Stabilization Act.]
TYPES OF DEPOSIT ACCOUNTS

Types of Accounts

Deposit accounts are typically the largest liabilities of financial institutions. The following are types of deposit accounts commonly offered by financial institutions.

a. Checking accounts.

b. Savings accounts.

c. Certificates of deposit.

Credit union depositors are members of the institution, and their deposit accounts are referred to as share accounts, share drafts, and share certificates. The interest payments on these types of accounts are referred to as dividends by the NCUA accounting manual. Before the Credit Union Membership Access Act (CUMAA) was passed in 1998, credit union regulatory accounting practices classified members’ shares as equity. Due to the modifications made by CUMAA, credit unions with total assets of $10 million or greater must now follow GAAP for reporting on Call Reports. Therefore, the NCUA has moved members’ shares and related accounts from equity to liabilities in the Call Report. Under GAAP, deposit accounts should be classified as liabilities. The following paragraphs discuss each type of deposit account.

Checking Accounts. Checking accounts generally generate the largest transaction volume of all deposit accounts. Funds in checking accounts are available on demand to customers, and, thus, checking accounts are sometimes referred to as demand deposit accounts (DDAs). There are two primary types of checking accounts:

a. Noninterest-bearing Checking. This is the checking account traditionally offered by commercial banks. It is less common in savings institutions and credit unions.

b. Interest-bearing Checking. This is probably the primary type of checking account offered by savings institutions and credit unions, and it is becoming increasingly popular in commercial banks. Savings institutions often refer to interest-bearing checking accounts as negotiable order of withdrawal (NOW) accounts, and credit unions often call them share draft accounts. There are two primary types of interest-bearing checking accounts:

(1) Regular. The conventional interest-bearing checking account is similar to the noninterest-bearing checking account, except that it pays interest to the customer. Interest rates on these accounts are generally the lowest of all the interest-bearing accounts. In many cases, interest-bearing checking accounts have minimum balance requirements and higher fees for services than noninterest-bearing accounts.

(2) Money Market Accounts. Money market deposit accounts (MMDAs) carry higher interest rates than the conventional accounts, but they generally have higher minimum balance requirements and impose limits on the number of checks and withdrawals that can be made during a month. Fees are generally charged (or lower interest rates are paid) when minimum balance or transaction requirements are not met.

Most checking account transactions originate outside the institution. Withdrawals are usually originated through checks given to third parties, automated teller machines (ATMs), point-of-sale (POS) terminals, electronic fund transfers (EFTs), or preauthorized payment transactions and received by the institution, either through the clearing process (as discussed earlier in this lesson) or through a deposit to another customer’s account. Deposits are usually originated through checks received from third parties, direct deposit (instead of a payroll check), or EFTs that are made online, at ATMs, or at teller windows. Most transactions are posted on either the day they are received or the following business day. Any rejected items (such as missorted items, checks lacking proper endorsements, insufficient funds checks, and checks subject to stop payment orders) are generally processed on the next business day.
The Check Clearing for the 21st Century Act (Check 21 Act) increased the volume of checks processed electronically by allowing financial institutions to exchange digital copies of checks rather than the actual check. Under the Check 21 Act, the digital substitute check clears the exchange process quickly, typically being posted the following business day.

**Savings Accounts.** Savings accounts are interest-bearing accounts that allow depositors to withdraw funds on demand, but checks cannot be written on these accounts. Generally, savings account deposits and withdrawals must be transacted directly between the depositor and the institution. For some accounts (referred to as passbook accounts), the depositor receives a passbook in which the teller records all the transactions and updates the account balance for the customer. Savings accounts generally offer higher interest rates than interest-bearing checking accounts.

**Certificates of Deposit.** A certificate of deposit (CD), also known as a time deposit, generally requires the customer to keep the deposit account for a minimum period of time, which generally ranges from one month to five years or more. CDs may be redeemed before maturity, but the institution usually assesses a penalty based on the amount of interest earned. Matured CDs are due on demand, but many institutions automatically renew the certificates unless they are notified by the depositor within a specified period. Interest on CDs may be paid by check, deposited into the customer’s checking or savings account, or rolled into the new certificate balance at renewal.

Certificates of deposit tend to have larger balances and pay higher interest rates than other deposit accounts. They also tend to be more volatile because CD holders are more likely to transfer their accounts to the institutions paying the highest rates. Jumbo certificates of deposit (CDs of $100,000 or more) are generally the most volatile deposit accounts, especially if they were obtained through deposit brokers, which are discussed later in this lesson.

**Other Deposit Accounts.** The preceding paragraphs discuss the most common types of deposit accounts. A financial institution may also have one or more of the following types of accounts:

- **Demand Certificates of Deposit.** Demand certificates of deposit do not have a fixed maturity date. They are redeemable upon the holder’s demand. Demand CDs differ from checking accounts because they do not require signature cards or resolutions. These CDs are sometimes used as security for loans. Also, interest due on a matured time deposit may be classified as a demand CD until it is remitted or rolled into a new time deposit.

- **Individual Retirement Accounts (IRAs).** IRAs are tax-deferred investment accounts designed to be used to save for retirement. An IRA may be maintained as a CD or as a separate form of time deposit.

- **Keogh Plan Accounts.** Keogh plans are retirement plans for self-employed people. A Keogh plan account may be maintained as a CD or as a separate form of time deposit.

- **Club Accounts.** Club accounts (sometimes called open accounts) are deposit accounts for which the depositor makes regular weekly or monthly deposits. These accounts have specific maturities and fixed interest rates. A Christmas Club account is probably the most common example of a club account.

**Audit Procedures for Obtaining Audit Evidence Relating to Deposits**

Audit procedures consist of risk assessment procedures, tests of controls, and substantive procedures. Risk assessment procedures and tests of controls contribute to the formation of the auditor’s opinion, but do not, by themselves, provide sufficient appropriate audit evidence. Risk assessment procedures and tests of controls for deposits are discussed in PPC’s Guide to Audits of Financial Institutions. Substantive procedures are discussed later in this lesson.

**Relevant Assertions for Deposit Accounts.** Relevant assertions for a particular audit area are assertions that have a meaningful bearing on whether the related account balances, transaction classes, or disclosures are fairly stated. The relevant assertions for deposit accounts generally are as follows:

- **Existence or Occurrence (E/O)—**Deposit accounts reflected in the financial statements exist.
Completeness (C)—All deposit accounts transactions have been recorded. Deposit accounts reflected in the accounts represent a complete presentation of the customer accounts held by the entity. Disclosures required by GAAP have been made.

Rights or Obligations (R/O)—Deposit accounts reflected in the accounts are the obligations of the entity. Securities or other assets pledged on deposit accounts are properly disclosed.

Valuation or Allocation (V)—Deposit accounts are valued in accordance with GAAP. Valuation allowances are provided for uncollectible overdrafts.

Cutoff (CO)—Deposit accounts are recorded in the proper accounting period.

Accuracy or Classification (A/CL)—Deposit accounts are properly classified in the balance sheet and required disclosures have been made. Overdrafts are properly classified as loans receivable when significant.

The auditor uses relevant assertions in assessing the risks of material misstatement by considering the different types of potential misstatements that may occur (that is, what could go wrong in the financial statements), and then designing audit procedures that are responsive to the assessed risks. For each relevant assertion within an account balance, class of transaction, or disclosure, the auditor assesses the risks of material misstatement and, based on that assessment, determines the nature, timing, and extent of the substantive procedures necessary to obtain sufficient appropriate audit evidence.

Substantive Audit Procedures. In many cases, deposit accounts are tested through confirmation. In addition, the auditor should test the reconciliation of the deposit accounts trial balance to the general ledger control account as of the balance sheet date and the confirmation date, if deposits were confirmed at an interim date. The following paragraphs discuss other procedures and issues relating to auditing deposit accounts.

Analytical procedures, together with other audit procedures, can provide evidence about deposit account completeness. Examples of analytical procedures that might be used include:

- Comparing average deposit account balances during the year with prior years or other expectation.
- Comparing the percentage of deposit growth during the year with historical percentages or other expectation.
- Comparing the ratio of average deposit account balances to total average assets during the year with prior years or other expectation.
- Comparing the relative composition of year-end deposits to the prior year end or other expectation.
- Comparing the amount and ratio of dormant accounts to total deposits for the current year to prior years or other expectation.
- Comparing deposit interest rates with those prevailing in the institution’s marketing area during the year or other expectation.

If deposits are confirmed at interim, the auditor should consider performing these procedures as of the interim date and year end.

Brokered Deposits. Financial institutions sometimes obtain certificates of deposit through deposit brokers. Those brokers obtain funds from large depositors, pool the money into certificates of deposit that are within the deposit insurance limit, and place those funds with institutions paying the highest rates. FDIC regulations (12 CFR 337.6) indicate that brokered deposits can be obtained only by institutions that are well capitalized or, with FDIC approval, adequately capitalized.

Brokered deposits are generally audited the same way as other deposit accounts. However, because of the regulatory restrictions on and volatility of brokered deposits, the auditor should assess the potential effect of the
loss of those deposits on the institution’s liquidity, as well as the likelihood of that loss. For example, if the institution does not meet the conditions for classification as well capitalized or adequately capitalized, the institution will probably be unable to retain its brokered deposits and need to obtain alternative funds.

Fees paid by institutions to deposit brokers should be recorded as a discount to the related deposit accounts and amortized into interest expense over the lives of the related deposits.

Dormant Accounts. Deposit accounts are classified as dormant when there has been no activity in the account for a specified period of time. Each institution generally establishes its own criteria for classifying dormant accounts, and the criteria may vary depending on the type of deposit account involved. Access to dormant accounts should generally be restricted, and the signature cards for those accounts should generally be maintained by someone independent of the teller and accounting functions. Most states have laws requiring that funds in dormant accounts be remitted to the state after a statutorily determined period. Remitting those funds to the state is known as escheating.

Generally, dormant accounts should be subjected to the same audit procedures as other accounts. However, the auditor should also consider specifically reviewing the dormant accounts to determine whether the accounts are being properly controlled.

Overdrafts. Overdrafts are basically unsecured loans made to depositors. Many financial institutions have controls that require specific authorization for payment of checks that will result in overdrafts of depositors’ accounts. Those controls tend to reduce the number of overdrafts incurred by the institution. However, most overdrafts expose the institution to credit risk, that is, the risk that the depositors will fail to make additional deposits to cover (repay) the overdrafts.

There are two primary audit and accounting issues related to overdrafts—

- **Collectibility.** The auditor should assess the collectibility of the overdrafts. Individually significant overdrafts should be reviewed to determine whether the overdrafts will be covered through either other deposit accounts or other resources of the borrower. In the latter case, the auditor should assess the borrowers’ ability and willingness to repay loans. Loss allowances should be provided as needed for specific overdrafts for which collection is doubtful. The auditor should also consider providing a general allowance if the total amount of overdrafts is significant.

- **Balance Sheet Presentation.** If the total amount of overdrafts is significant, the overdrafts should be reclassified to loans receivable.

Some institutions offer “courtesy pay” programs. These programs consist of two main types: contractual and non-contractual. The accounting for the programs can be substantially different. Contractual programs are generally underwritten and fall under lending rules and regulations. As such, these types of programs should be reclassified as loans on the financial statements and an allowance account should be considered. Non-contractual programs might be treated as overdrafts or could be treated as contractual programs. Auditors should consider the materiality of these programs and the presentation and valuation issues related to the programs.

Interest Expense and Accrued Interest Payable. The following analytical procedures are commonly used to test interest expense and accrued interest payable on deposit accounts:

- **Monthly Yield Analysis.** A monthly yield analysis test, which calculates the yield by month for each type of deposit account, can be used to test the reasonableness of interest expense on deposit accounts. This test can also highlight significant variations in expense that may reveal misstatement of the accrued interest balance.

- **Accrued Interest Percentage.** The reasonableness of the accrued interest payable balance can normally be tested by dividing the accrued interest on each interest-bearing account by the related deposit account balance, and comparing those percentages to the prior year’s percentages or other expectation.

Significant differences noted in the preceding analytical procedures should be investigated.
DEP, Paragraph 13.65, states that it may be difficult to develop precise estimates of expected yields on deposit accounts. Unless precise estimates can be made, analytical procedures should be supplemented with other tests, such as recalculation of interest on a sample of deposit accounts.
SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

31. Fourth National Bank (FNB) offers its customers the option of money market accounts. Money market accounts would be classified as what type of deposit account by this type of institution?
   a. Checking account.
   b. Savings account.
   c. Certificate of deposit.
   d. Share draft.

32. If offered by FNB, which of the following interest-bearing account types would be considered the most volatile?
   a. Regular interest bearing checking accounts.
   b. Money market accounts.
   c. Savings accounts.
   d. Certificates of deposit.

33. George, an auditor, is engaged to audit a financial institution. To gather audit evidence about his client’s deposit accounts, George wants to perform substantive audit procedures. Which of the following procedures should George perform?
   a. Testing deposit accounts through confirmation.
   b. Comparing average account balances with prior years.
   c. Comparing the current year’s amount of dormant accounts with the prior year.
   d. Comparing deposit interest rates with those in the area during the year.

34. As part of his audit, George must assess issues related to overdrafts. Which of the following would be one of his primary audit concerns related to overdrafts?
   a. Courtesy pay programs.
   b. Collectibility.
SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. (References are in parentheses.)

31. Fourth National Bank (FNB) offers its customers the option of money market accounts. Money market accounts would be classified as what type of deposit account by this type of institution? (Page 372)

a. Checking account. [This answer is correct. There are two primary types of checking accounts: noninterest-bearing checking and interest-bearing checking. There are also two types of interest-bearing checking accounts: regular and money market accounts. Money market accounts carry higher interest rates than the conventional accounts, but they generally have higher minimum balance requirements and impose limits on the number of checks and withdrawals that can be made during a month.]

b. Savings account. [This answer is incorrect. Savings accounts are interest-bearing accounts, which is a similarity that this type of deposit account has with money market accounts. However, savings accounts are a single type of deposit account. As there are no other subtypes of savings accounts, money market accounts would not be classified under this account type.]

c. Certificate of deposit. [This answer is incorrect. Certificates of deposit (CDs) are also known as time deposits. However, CDs are a single type of deposit account. There are no other types of CDs, so money market accounts would not fall under this account type.]

d. Share draft. [This answer is incorrect. Credit union depositors are members of the institution, and their deposit accounts are referred to as share accounts, share drafts, and share certificates. FNB is a bank, not a credit union; therefore, credit union terminology would not apply to the types of deposit accounts FNB offers to its customers.]

32. If offered by FNB, which of the following interest-bearing account types would be considered the most volatile? (Page 373)

a. Regular interest bearing checking accounts. [This answer is incorrect. The conventional interest-bearing checking account is similar to the noninterest-bearing checking account, except that it pays interest to the customer. Interest rates on these accounts are generally the lowest of all the interest-bearing accounts. Based on the likelihood of customers to switch banks, there is a different type of interest-bearing account that would be considered the most volatile.]

b. Money market accounts. [This answer is incorrect. In regards to having higher interest rates, money market accounts would generally fall between regular interest-bearing checking accounts and savings accounts. However, the volatility of an account type is based on the likelihood of the customer to switch banks, and there is another type of account with a greater likelihood of that than money market accounts.]

c. Savings accounts. [This answer is incorrect. Savings accounts are interest-bearing accounts that allow depositors to withdraw funds on demand, but checks cannot be written on these accounts. Savings accounts generally offer higher interest rates than interest-bearing checking accounts. However, there is another type of account that would be considered more volatile based on the likelihood of customers to switch banks.]

d. Certificates of deposit. [This answer is correct. CDs tend to have larger balances and pay higher interest rates than other deposit accounts. They also tend to be more volatile because CD holders are more likely to transfer their accounts to the institutions paying the highest rates. Jumbo CDs ($100,000 or more) are generally the most volatile deposit accounts, especially if they were obtained through deposit brokers.]
33. George, an auditor, is engaged to audit a financial institution. To gather audit evidence about his client’s deposit accounts, George wants to perform substantive audit procedures. Which of the following procedures should George perform? (Page 374)

   a. Testing deposit accounts through confirmation. [This answer is correct. To perform this type of confirmation, George would send letters to confirm the amounts in various deposit accounts. This would be considered a substantive audit procedure. Another example of a substantive procedure George could perform is testing the reconciliation of the deposit accounts trial balance to the general ledger control account as of the balance sheet date and the confirmation date, if deposits were confirmed at an interim date.]

   b. Comparing average account balances with prior years. [This answer is incorrect. This is an example of an analytical procedure, not a substantive procedure. As an analytical procedure, George could compare average deposit account balances during the year with prior years or with another expectation.]

   c. Comparing the current year’s amount of dormant accounts with the prior year. [This answer is incorrect. As part of his audit, George could compare the amount and ratio of dormant accounts to total deposits for the current year to prior years or other expectation. However, this would be considered an analytical procedure, not a substantive procedure.]

   d. Comparing deposit interest rates with those in the area during the year. [This answer is incorrect. As part of his audit, George can compare the deposit interest rates with those prevailing in the institution’s marketing area during the year or other expectation. However, this would be considered an analytical procedures, not a substantive procedure.]

34. As part of his audit, George must assess issues related to overdrafts. Which of the following would be one of his primary audit concerns related to overdrafts? (Page 375)

   a. Courtesy pay programs. [This answer is incorrect. Some institutions offer “courtesy pay” programs. These programs consist of two main types: contractual and non-contractual. The accounting for these programs can be substantially different. Auditors should consider the materiality of these programs and the presentation and valuation issues related to the programs. However, this type of program is not listed as one of the two main concerns related to overdrafts.]

   b. Collectibility. [This answer is correct. There are two primary audit and accounting issues related to overdrafts: collectibility and balance sheet presentation. The auditor should assess the collectibility of the overdrafts. Individually significant overdrafts should be reviewed to determine whether the overdrafts will be covered through either other deposit accounts or other resources of the borrower. In the latter case, the auditor should assess the borrowers’ ability and willingness to repay loans.]
## AUDIT PROCEDURES RELATED TO LIABILITIES OTHER THAN DEPOSIT ACCOUNTS

### Relevant Assertions for Liabilities Other Than Deposit Accounts

Relevant assertions for a particular audit area are assertions that have a meaningful bearing on whether the related account balances, transaction classes, or disclosures are fairly stated. The relevant assertions for liabilities other than deposit accounts (which were discussed earlier in this lesson) generally are as follows:

<table>
<thead>
<tr>
<th>Assertions</th>
<th>Borrowings</th>
<th>Federal Funds Purchased</th>
<th>Treasury, Tax, and Loan (TT&amp;L) Accounts</th>
<th>Accounts Payable</th>
<th>Accrued Expenses and Other Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Existence or Occurrence (E/O)</td>
<td>Borrowings reflected in the financial statements exist.</td>
<td>Federal funds purchased reflected in the financial statements exist.</td>
<td>TT&amp;L accounts reflected in the financial statements exist.</td>
<td>Accounts payable reflected in the financial statements exist.</td>
<td>Accrued expenses and other liabilities reflected in the financial statements exist.</td>
</tr>
<tr>
<td>Completeness (C)</td>
<td>Borrowings reflected in the accounts represent a complete presentation of authorized debt.</td>
<td>Federal funds purchased reflected in the accounts represent a complete presentation of authorized obligations.</td>
<td>TT&amp;L accounts reflected in the accounts represent a complete presentation of authorized obligations.</td>
<td>Accounts payable reflected in the accounts represent a complete presentation of authorized current obligations that arose from the purchase of goods and services.</td>
<td>Accrued expenses and other liabilities reflected in the accounts represent a complete presentation of unpaid costs and expenses for which the benefit has been received in the current period.</td>
</tr>
<tr>
<td>Rights or Obligations (R/O)</td>
<td>Borrowings reflected in the accounts are the obligations of the entity.</td>
<td>Federal funds purchased reflected in the accounts are the obligations of the entity.</td>
<td>TT&amp;L accounts reflected in the accounts are the obligations of the entity.</td>
<td>Accounts payable reflected in the accounts are the obligations of the entity.</td>
<td>Accrued expenses and other liabilities reflected in the accounts are the obligations of the entity.</td>
</tr>
<tr>
<td>Valuation or Allocation (V)</td>
<td>Borrowings are valued in accordance with GAAP.</td>
<td>Federal funds purchased are valued in accordance with GAAP.</td>
<td>TT&amp;L accounts are valued in accordance with GAAP.</td>
<td>Accounts payable are valued in accordance with GAAP.</td>
<td>Accrued expenses and other liabilities are valued in accordance with GAAP.</td>
</tr>
</tbody>
</table>
The auditor uses relevant assertions in assessing the risks of material misstatement by considering the different types of potential misstatements that may occur (that is, what could go wrong in the financial statements), and then designing audit procedures that are responsive to the assessed risks. For each relevant assertion within an account balance, class of transactions, or disclosure, the auditor assesses the risks of material misstatement and, based on that assessment, determines the nature, timing, and extent of the substantive procedures necessary to obtain sufficient appropriate audit evidence.

The remainder of this lesson discusses the audit considerations for various liabilities.

**AUDIT CONSIDERATIONS FOR BORROWINGS**

**Types of Borrowings**

Although deposit accounts are their largest source of funds, financial institutions may also borrow funds from various sources. The following are examples of types of borrowings of financial institutions:

- Government-sponsored entity advances.
- Correspondent bank borrowing.
- Agent loans (to credit unions).
- Treasury, Tax, and Loan (TT&L) notes.
- Loans from corporate credit unions.
- Other sources, such as mortgage debt, debentures, and collateralized mortgage obligations.

The following paragraphs discuss each type of borrowing. Obligations relating to securities sold under agreements to repurchase are discussed in PPC’s *Guide to Audits of Financial Institutions*. 
Government-sponsored Entity Advances. Different types of financial institutions can borrow funds from related government-sponsored entities. The following are examples of those borrowings:

a. Federal Reserve Bank (FRB). Banks and other financial institutions that are members of the Federal Reserve System and nonmember institutions can borrow from the discount window of the FRB in their region, subject to certain conditions. The borrowings are primarily designed to provide short-term liquidity rather than long-term financing. There are two types of FRB borrowings:

(1) Discounting (or Rediscounting). Under this arrangement, the bank borrows against a specified list of eligible loans receivable that are pledged as collateral. This type of borrowing is available only to member institutions.

(2) Advance. Under an advance arrangement, the institution signs a promissory note for the amount borrowed and pledges qualifying government securities as collateral. This type of borrowing is available to member and nonmember institutions. Advances are much more common than discounting.

Maturities on the borrowings are normally 15 days or less but may range up to 90 days. The interest charged on the borrowings is known as a discount. The interest rate (discount rate) charged is set biweekly by the FRBs, subject to the review of the Board of Governors of the Federal Reserve System.

b. Federal Home Loan Bank (FHLB). Savings institutions and other financial institutions can borrow from the FHLB in their region. The advances are generally secured by the institution’s investment in FHLB stock, cash and interest-bearing deposits in FHLBs, qualifying mortgage loans, or other collateral (as discussed later in this lesson). FHLB advances may be short-term or long-term, and they may have either fixed or floating interest rates.

c. Central Liquidity Facility (CLF). Credit unions that are members of the CLF can borrow directly from the CLF. Other credit unions may borrow indirectly through agent loans, as discussed later in this lesson. CLF loans generally have short maturities and are intended to provide short-term liquidity. The loans are secured by all of the assets of the borrower. In many cases, the interest rate (commonly referred to as the penalty rate) on the advances is higher than prevailing market rates.

Correspondent Bank Borrowing. Institutions that use correspondent banks for check clearing services (as previously discussed) may also borrow from their correspondent banks. The borrowings are generally structured as lines of credit. Interest rates, repayment terms, and collateral requirements vary based on the institutions involved.

Agent Loans. Credit unions that are not members of the CLF (as discussed in item c. above) can borrow indirectly from the CLF using agent loans. Under an agent loan arrangement, a CLF member (an agent member) borrows from the CLF and then loans the funds in an agent loan to the nonmember. The loan to the agent member is secured by the agent loan, and the agent loan is secured by all of the assets of the credit union borrower. Like other CLF advances, agent loans are short-term loans used for liquidity purposes.

Treasury, Tax, and Loan Notes. Many financial institutions receive payroll tax deposits on behalf of the U.S. Treasury. Those funds are deposited into a demand deposit account known as a Treasury, Tax, and Loan (TT&L) account. According to U.S. Treasury regulations (31 CFR 203), institutions have two options for handling TT&L deposits—

a. Remittance Option. Under the remittance option, the institution notifies the U.S. Treasury that funds have been received by forwarding the deposit advices received. The Treasury withdraws the funds immediately upon notification.

b. Note Option. Under the note option, the institution transfers funds to a note account on the day after the deposit is made. The borrowing is formalized as an open-ended note maintained at the regional Federal Reserve Bank, which acts as an agent for the U.S. Treasury. The institution can establish a maximum limit on its note but cannot set a minimum balance. The note is payable on demand. Interest on the note is
payable monthly at the rate of ¼% below the federal funds rate (defined earlier in this lesson). Principal and interest payments are made through a charge to the reserve account maintained with the FRB. (If the institution is not a member of the Federal Reserve System, payment is made to the reserve account of the institution’s correspondent member bank, which then charges the institution’s due from account.) The notes are secured by a pledge of certain qualifying investment securities or insured student loans.

For financial reporting purposes, the demand deposit account under the remittance option should be classified as a deposit account, and the account balance under the note option should be classified as a borrowing.

**Loans from Corporate Credit Unions.** Each state generally has one corporate credit union, and its membership consists of the credit unions incorporated in that state. One of the primary functions of a corporate credit union is to provide financing to its members. A loan from a corporate credit union is generally structured as a line of credit. The loan is secured by the credit union’s assets, and the borrowing limit is based on the credit union’s total assets. The interest rate on the loan is usually below prevailing market rates.

**Other Borrowings.** Some institutions use forms of borrowings other than those discussed in the preceding paragraphs. Examples of those other forms of debt include the following:

- **Mortgage Debt.** Mortgage debt is sometimes used as a source of long-term financing, especially financing of expansion into new facilities. The debt is typically secured by specific real estate facilities of the institution. Interest rates may be fixed or variable.

- **Collateralized Mortgage Obligations (CMOs).** CMOs are issued by special purpose entities that are sponsored by the financial institution. The financial institution transfers mortgage loans to the special purpose entity that then issues debt or equity securities that are collateralized by the mortgage loans. FASB ASC 860 (formerly SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities*, as amended) provides the criteria for determining whether the sponsoring institution should account for CMOs as a sale or borrowing. CMOs are more likely to be sponsored by larger financial institutions.

- **Debentures.** Debentures are unsecured, long-term debt obligations. Maturities generally range from seven to 40 years. Debentures are sometimes subordinated to other liabilities of the institution, and they are sometimes convertible into stock. Debentures have historically been used to increase an institution’s regulatory capital. However, under the current capital rules, debentures are not included in Tier 1 capital, and only certain debentures qualify as Tier 2 capital.

**Substantive Audit Procedures**

The auditor should obtain an understanding of each significant borrowing by reviewing the related legal documentation. The balance of each significant obligation, along with other pertinent information, should be confirmed with the lender (or the Federal Reserve Bank for TT&L notes). The specific information to be confirmed varies depending on the type of borrowing. Confirmation letters can be used to confirm borrowings.

For any borrowings in which the client has made loan covenants, the auditor should also determine whether the client is in compliance with those covenants. If the client is not in compliance, the auditor should ask the client to obtain a written waiver of the applicable covenants from the lender. If a waiver cannot be obtained, the covenant violation should be disclosed in the financial statements. The auditor should also consider the effect of that violation on the institution’s ability to hold certain assets, such as investment securities held-to-maturity, and its ability to continue as a going concern.

The auditor should also test the interest expense and accrued interest payable on borrowings. Analytical procedures such as those used for testing interest on deposit accounts can often be used for testing interest on borrowings. If borrowings are material, some auditors recompute the accrued interest on individual borrowings that are expected to have large accrued balances.

**Special Collateral Verification Procedures for Federal Home Loan Bank Advances**

As previously discussed, savings institutions and other financial institutions may obtain advances from FHLBs for short-term or long-term needs. Under Federal Housing Finance Board regulations (12 CFR 950.9), each FHLB must
establish procedures for verifying the collateral securing its advances. Generally, this is accomplished by requiring each borrower to provide a report on the collateral securing its advances. Although each FHLB determines its own reporting requirements, some FHLBs require the borrowing institutions to furnish annual reports containing the following:

a. A schedule comparing the required level of collateral to the fair (or stipulated) value of the collateral.

b. Note disclosures, including a description of the collateral requirement under the loan agreement with the FHLB and disclosure of the methods and assumptions used to determine the value of collateral.

Some FHLBs require institutions to engage CPAs to perform services relating to the annual reports. These services vary from agreed-upon procedure engagements to audits. The auditor should call the applicable district FHLB to determine the types of procedures to be performed for the institution. If an audit is required, the audit procedures to be performed normally include the following:

a. Identifying the collateral securing the FHLB advances.

b. Testing the existence of the collateral.

c. Determining whether the collateral is eligible to secure the advances.

d. Assessing the value of the collateral.

e. Reading the collateral verification report.

The following paragraphs discuss each of those audit procedures.

**Identifying the Collateral Securing the FHLB Advances.** FHLB advances may be collateralized in either of the following ways:

a. *Blanket Floating Lien.* Under a blanket floating lien agreement, the borrowing institution gives a blanket pledge of first mortgage loans or other eligible collateral.

b. *Delivery Agreement.* Under a delivery agreement, the borrowing institution pledges specific first mortgage loans or other eligible collateral.

The auditor should determine the type of collateral arrangement the client has with the FHLB. When the client has a delivery agreement, the FHLB generally sends the auditor a listing of the collateral securing the advances sometime after the balance sheet date. If the auditor does not receive that information in advance, it should be requested from the FHLB. When the client has a blanket agreement, the auditor should determine the types of assets that are pledged.

**Testing the Existence of the Collateral.** If the client has pledged specific collateral for FHLB advances, the auditor should compare the list of collateral obtained from the FHLB (as discussed in the preceding paragraph) to the client’s records. If the list of pledged assets is very long, the auditor can test it by tracing selected assets from the list obtained from the FHLB to the client’s records and vice versa. These procedures do not apply to a blanket agreement because there is no specific list of pledged assets.

Regardless of the type of collateral agreement, the pledged assets are normally subject to confirmation or vouching procedures to test their existence. In those situations, no further procedures are generally needed to test the existence of the pledged assets. However, if the pledged assets were not previously subject to confirmation or vouching procedures, these procedures should be applied as necessary.
Determining the Eligibility of the Collateral. FHLB advances are generally secured by a combination of the following types of collateral:

a. *Single-family Residential Loans.* Permanent first mortgage loans on single-family residential property, excluding the following loans:

   (1) Participations or other fractional interests in loans.
   (2) Loans over 90 days past due.
   (3) Loans classified as substandard, doubtful, or loss.
   (4) Loans to directors, officers, attorneys, or agents of the institution or the FHLB, unless formally approved by the board of directors of the FHLB and endorsed by the Federal Housing Finance Board.

b. *FHLB Stock.* The institution’s investment in the stock of the FHLB.

c. *Cash or Interest-bearing Deposits.* Cash or interest-bearing deposits in the FHLB.

d. *U.S. Government or Agency Securities.* Any securities issued or guaranteed by the U.S. government or a related agency, including mortgage-backed securities issued or guaranteed by the Federal Home Loan Mortgage Corporation, Federal National Mortgage Association, or Government National Mortgage Association.

e. *Multi-family Residential Loans.* Permanent multi-family residential loans. The exclusions for single-family residential loans listed above also apply to multi-family residential loans.

f. *Other Real Estate-related Collateral.* Real estate loans other than single-family and multifamily residential loans, as well as other real estate-related collateral, provided the value of the loans or collateral is readily determinable and the FHLB can perfect a security interest in it. Examples include:

   (1) Second mortgage loans, including home equity loans.
   (2) Commercial real estate loans.
   (3) Mortgage loan participations.

   Borrowings secured by those loans or other collateral cannot exceed 30% of the institution’s GAAP capital at the date the funds are borrowed.

g. *Privately Issued Mortgage-backed Securities.* Privately issued mortgage-backed securities. However, the following securities can be included only if they meet the conditions and limitations discussed in item f.:

   (1) *Interest Only or Principal Only Securities.* Securities that represent a share of only the interest or the principal payments from the underlying mortgage loans.
   (2) *Subordinate Interests.* Securities that represent a subordinate interest in the payments from the underlying mortgage loans.
   (3) *Residual Payments.* Securities that represent an interest in any residual payments from the underlying mortgage loans.
   (4) *High-risk Securities.* Any other securities that the Federal Housing Finance Board may designate as high risk.

If the client has a blanket floating lien agreement, the auditor should identify the specific assets subject to the blanket assignment that are not eligible to secure the FHLB advances. If the client has a delivery agreement, the
auditor should determine whether the list of pledged assets contains any that are not eligible to secure the pledged assets. This can normally be accomplished through the following:

a. Inquiring of the client regarding whether they are aware of any pledged assets that are ineligible.

b. Reviewing the list of pledged assets to determine whether they are the types of assets discussed in the preceding paragraph.

c. Reviewing the past due loan reports and lists of classified loans. As noted in the previous paragraph, classified loans and loans over 90 days past due are not eligible to secure advances.

d. Reviewing lists of loans to related parties (officers, directors, and others as discussed in the previous paragraph). Related party loans are not eligible to secure advances.

e. Reviewing pledged assets other than mortgage loans (such as securities) to determine whether they meet the conditions discussed in the previous paragraph.

Any ineligible assets should not be included in the fair value of pledged assets as disclosed in the collateral verification report.

Normally, the reliability of the delinquent loan report and loan classifications will be tested in connection with loan review procedures. The accuracy of the client’s related party loan list should also be tested. This may be accomplished by selecting loans from both the related party lists and the loan trial balance and determining whether they are flagged as related party loans when applicable. Alternatively, the auditor can review the controls related to the preparation and maintenance of the related party lists.

Assessing the Value of the Collateral. Each FHLB establishes its own procedures for valuation of collateral. The FHLB valuation rules for loans vary with the type of loan and its interest rate. For example, the value of the fixed-rate, single-family residential loans may be stipulated as 75% of their unpaid principal balance.

The auditor should determine whether the client has appropriately applied the FHLB’s rules in determining the collateral value. The actual procedures that may be used will vary depending on the assets involved and the applicable FHLB rules. If the assets are based on a specific formula, the auditor can merely test the client’s calculations. If a more subjective assessment is required, the auditor should assess the reasonableness of the methods and assumptions used in the valuation. If appropriate, the auditor should also consider comparing subjective value estimates to the estimated fair values determined for the financial statement disclosures required under FASB ASC 825-10-50 (formerly SFAS No. 107).

Reviewing the Client’s Report. After testing the pledged assets as described in the preceding paragraphs, the auditor should review the client’s collateral verification report to assess whether the schedules and related disclosures are appropriate. Factors to consider in reviewing the report include whether:

- Ineligible assets are appropriately excluded.
- Collateral values are appropriately determined.
- The disclosures in the report are sufficient.
AUDIT CONSIDERATIONS FOR OFFICIAL CHECKS, ACCOUNTS PAYABLE, AND ACCRUED EXPENSES

Official checks are liabilities that are unique to financial institutions, and they involve unique considerations. The relevant audit assertions regarding accounts payable and other liabilities are generally the same for financial institutions and commercial businesses, but the nature and extent of substantive audit procedures often differ. The following paragraphs discuss audit procedures that are commonly used to test official checks, accounts payable, and accrued expenses. Escrow accounts, dealers reserves, income taxes, and commitments and contingencies are discussed in PPC’s Guide to Audits of Financial Institutions.

Official Checks

What Are Official Checks? Official checks are checks that the institution writes on its own accounts. Examples of official checks that may be written by a financial institution include—

- Cashier’s checks.
- Loan disbursement checks.
- Expense checks.

Accounting for Official Checks

To facilitate check processing, an institution normally sets up a separate checking account (deposit account) for each type of official check, but each account maintains a zero balance. The actual transactions in the accounts are reflected in the cash (due from) and official checks outstanding (liability) accounts. When an institution writes an official check, the check is initially credited to the official checks outstanding account. The check is ultimately paid through the clearing process (as discussed earlier in this lesson), and the payment is recorded as a reduction of the related due from account and the official checks outstanding account. Consequently, the balance in the liability account for official checks consists solely of the outstanding checks at that date. Those outstanding checks should be recorded and maintained in a check register for each type of check. Alternatively, a numerical file of check copies may be maintained, with cleared checks matched to the copies as they are received. In either case, the total of outstanding checks for each account should be reconciled to its general ledger control account.

Example 2-4: Accounting when official checks are issued.

Assume an institution writes a cashier’s check for $500 on behalf of a depositor and the depositor’s account is charged for the transaction. The entry to record the transaction (assuming there are no fees charged to the depositor) are as follows:

<table>
<thead>
<tr>
<th>DR</th>
<th>CR</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deposit accounts</td>
<td>$500</td>
</tr>
<tr>
<td>Official checks outstanding—cashier’s check</td>
<td>$500</td>
</tr>
</tbody>
</table>

At this point, the balance in the official checks outstanding account on the general ledger is equal to $500, which is the amount of the outstanding check (assuming there are no other outstanding checks). A similar entry would be recorded for loan disbursement checks and expense checks, except that loans receivable or accounts payable (or the appropriate expense account) would be debited rather than deposit accounts.

To show how official checks are cleared, assume the cashier’s check is cleared by the institution’s correspondent bank, ABC Bank, and is included in the incoming cash letter. The institution records the clearing of the official check as follows:
Auditing Official Checks

If determined necessary based on the assessed risk of material misstatement, the existence of official checks can be substantiated by obtaining and testing the list of outstanding checks for each account as of the balance sheet date. However, the relevant audit assertion for official checks is the completeness of the list. Evidence supporting this assertion can normally be obtained by reviewing the official check’s checking account statement for the period following the balance sheet date for any checks written before the balance sheet date and tracing those checks back to the list of outstanding checks. If significant unrecorded transactions are noted, an audit adjustment should be proposed. For unrecorded loan and deposit transactions, the auditor should also assess the validity of those transactions, for example, by reviewing loan documentation or confirming the transaction with the borrowers or depositors.

Accounts Payable

As previously noted, the relevant audit assertions regarding accounts payable and other liabilities are generally the same for financial institutions and commercial businesses. However, accounts payable is generally a less significant audit area in financial institution audits because there are no inventory-related purchases. Consequently, the nature and extent of audit procedures for accounts payable may be less than that for small business audits.

The existence of accounts payable can generally be verified by comparing the total balance in the detailed accounts payable records to the general ledger control account and testing the accounts payable records to the extent necessary. However, the primary audit assertion relating to accounts payable is completeness. Completeness is normally assessed through the search for unrecorded liabilities, that is, by reviewing disbursements made after the balance sheet date to determine whether they represent unrecorded liabilities. The procedures are basically the same as in commercial business audits.

Accrued Expenses

Accrued expenses can normally be tested effectively through analytical procedures. One common procedure that can be used is to divide the accrued balance by the related expense account and comparing it to the comparable percentage in the prior year or other expectation. Significant differences should be investigated. In addition, significant debits should be vouched to supporting documentation.

In 2009, the FDIC revised the rules for depository insurance assessments to collect depository insurance assessments through 2012 that is prepaid on December 30, 2009. The prepayment of the FDIC Deposit Insurance Fund was discussed earlier in this lesson. With this change, financial institutions will not have a related accrued expense account at least until the prepaid assessments are exhausted or returned.

Official checks outstanding—
cashier’s checks
Due from ABC Bank

<table>
<thead>
<tr>
<th>DR</th>
<th>CR</th>
</tr>
</thead>
<tbody>
<tr>
<td>$ 500</td>
<td>$ 500</td>
</tr>
</tbody>
</table>
SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

35. Sue, an auditor, is engaged to audit a financial institution. She uses relevant assertions as part of her audit, and as part of her audit she must obtain audit evidence for liabilities other than deposit accounts. Which of the following is a relevant assertion for the valuation or allocation area related to this type of liability?
   a. Borrowings reflected in the institution’s financial statements exist.
   b. Federal funds purchased reflected in the institution’s accounts are the obligations of the entity.
   c. The institution recorded accounts payable in the proper accounting period.
   d. Treasury, tax, and loan (TT&L) accounts are valued in accordance with GAAP.

36. Farmer’s National Bank needs to borrow funds for 15 days. Assuming it meets all the necessary qualifications, what type of borrowing would best suit the institution’s needs?
   a. A borrowing from the Federal Home Loan Bank (FHLB).
   b. A discounting arrangement under the Federal Reserve Bank (FRB).
   c. A debenture.
   d. A loan from a corporate credit union.

37. Based on the description given, which of the following institutions is eligible to borrow funds from a correspondent bank?
   a. Avon National Bank utilizes the check clearing services of a correspondent bank.
   b. Partnership Credit Union is not a member of the Central Liquidity Facility (CLF).
   c. Bulwark National Bank receives payroll deposits on behalf of the U.S. Treasury.
   d. Monarch Savings plans to expand into new facilities.

38. Cameron Gap National Bank (CGNB) obtains advances from the FHLB for its short-term financing needs. Which of the following will apply?
   a. CGNB must furnish a schedule comparing the required collateral level to the fair value of the collateral.
   b. CGNB should engage a CPA to perform services, such as identifying the collateral securing FHLB advances.
   c. CGNB collateralized its FHLB advance using a blanket floating lien agreement or a delivery agreement.

39. Bethany, an auditor, is engaged to audit a financial institution. The institution has an FHLB advance which is secured by a delivery agreement. Which of the following audit procedures would assist Bethany in determining if her client’s list of pledged assets are all eligible?
   a. Inquiring of the FHLB whether they are aware of any pledged assets that are ineligible.
   b. Reviewing lists of classified loans and past due loan reports.
   c. Comparing a list of collateral from the FHLB to the client’s records.
   d. Determining whether the client applied the FHLB’s rules for determining collateral value correctly.
40. As part of her audit, Bethany will also need to perform procedures on her financial institution client’s accounts payable. How will her procedures compare with those she would perform on accounts payable for a small business audit?

   a. She will need to perform more procedures for a financial institution.

   b. The nature and extent of her procedures will be less for a financial institution.
SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. (*References are in parentheses.*)

35. Sue, an auditor, is engaged to audit a financial institution. She uses relevant assertions as part of her audit, and as part of her audit she must obtain audit evidence for liabilities other than deposit accounts. Which of the following is a relevant assertion for the valuation or allocation area related to this type of liability? *(Page 380)*

a. Borrowings reflected in the institution’s financial statements exist. [This answer is incorrect. This relevant assertion relates to the existence or occurrence audit area.]

b. Federal funds purchased reflected in the institution’s accounts are the obligations of the entity. [This answer is incorrect. This relevant assertion relates to the rights or obligations audit area.]

c. The institution recorded accounts payable in the proper accounting period. [This answer is incorrect. This relevant assertion relates to the cutoff audit area.]

d. Treasury, tax, and loan (TT&L) accounts are valued in accordance with GAAP. [This answer is correct. Relevant assertions for a particular audit area are assertions that have a meaningful bearing on whether the related account balances, transaction classes, or disclosures are fairly stated. This relevant assertion applies to the valuation or allocation of TT&L accounts. Similar relevant assertions would be used for this audit area related to borrowings, federal funds purchased, accounts payable, and accrued expenses and other liabilities.]

36. Farmer’s National Bank needs to borrow funds for 15 days. Assuming it meets all the necessary qualifications, what type of borrowing would best suit the institution’s needs? *(Page 382)*

a. A borrowing from the Federal Home Loan Bank (FHLB). [This answer is incorrect. FHLB advances may be short-term or long-term. It would be possible for Farmer’s Mutual to seek this type of borrowing, but another choice is better suited to that institution’s needs.]

b. A discounting arrangement under the Federal Reserve Bank (FRB). [This answer is correct. Borrowings from the FRB are primarily designed to provide short-term liquidity rather than long-term financing. Maturities on the borrowings are normally 15 days or less but may range up to 90 days.]

c. A debenture. [This answer is incorrect. Debentures are unsecured, long-term debt obligations. That would make them a bad choice to fulfill the very short-term needs of Farmer’s Mutual in this scenario.]

d. A loan from a corporate credit union. [This answer is incorrect. Each state generally has one corporate credit union, and is membership consists of the credit unions incorporated in that state. One of the primary functions of a corporate credit union is to provide financing to its members. Because Farmer’s Mutual is a bank and not a credit union, it should not seek to borrow funds from a corporate credit union.]

37. Based on the description given, which of the following institutions is eligible to borrow funds from a correspondent bank? *(Page 382)*

a. Avon National Bank utilizes the check clearing services of a correspondent bank. [This answer is correct. Institutions that use correspondent banks for check clearing services may also borrow from their correspondent banks. The borrowings are generally structured as lines of credit.]

b. Partnership Credit Union is not a member of the Central Liquidity Facility (CLF). [This answer is incorrect. Credit unions that are not members of the CLF can borrow indirectly from the CLF using agent loans. An agent loan is not the same type of borrowing as correspondent bank borrowing. CLF membership is not a requirement for correspondent bank borrowing.]
c. Bulwark National Bank receives payroll deposits on behalf of the U.S. Treasury. [This answer is incorrect. The bank will deposit these funds into a demand deposit account known as a TT&L account. If the bank chooses to use the note option for dealing with these funds, the borrowing will be formalized as an open-ended note maintained at the regional Federal Reserve Bank, which acts as an agent for the U.S. Treasury. TT&L notes are not the same type of borrowing as correspondent borrowing. Payroll deposits are not needed for correspondent bank borrowing.]

d. Monarch Savings plans to expand into new facilities. [This answer is incorrect. Mortgage debt is sometimes used as a source of long-term financing, especially financing of expansion into new facilities. The debt is typically secured by specific real estate facilities of the institution. Mortgage debt is a different type of borrowing than correspondent borrowing. Expansion of facilities and real estate are not qualifications for correspondent bank borrowing.]

38. Cameron Gap National Bank (CGNB) obtains advances from the FHLB for its short-term financing needs. Which of the following will apply? (Page 384)

a. CGNB must furnish a schedule comparing the required collateral level to the fair value of the collateral. [This answer is incorrect. Each FHLB determines its own reporting requirements, but some FHLBs require the borrowing institutions to furnish annual reports containing (1) a schedule comparing the required level of collateral to the fair (or stipulated) value of the collateral and (2) note disclosures. CGNB should consult with its FHLB for the specific requirements that apply, not just provide such a schedule automatically.]

b. CGNB should engage a CPA to perform services, such as identifying the collateral securing FHLB advances. [This answer is incorrect. Some FHLBs require institutions to engaged CPAs to perform services relating to the annual reports. These services vary from agreed-upon procedure engagements to audits. The auditor should call the applicable district FHLB to determine the types of procedures to be performed for the institution. If an audit is required, the audit procedures performed could include the one described here; however, CGNB should determine the requirements of its FHLB before engaging the CPA’s services.]

c. CGNB collateralized its FHLB advance using a blanket floating lien agreement or a delivery agreement. [This answer is correct. FHLB advances may be collateralized in one of two ways: a blanket floating lien agreement or a delivery agreement. If an audit is required by a FHLB, the auditor will perform procedures to determine what collateral secures the FHLB advances.]

39. Bethany, an auditor, is engaged to audit a financial institution. The institution has an FHLB advance which is secured by a delivery agreement. Which of the following audit procedures would assist Bethany in determining if her client’s list of pledged assets are all eligible? (Page 385)

a. Inquiring of the FHLB whether they are aware of any pledged assets that are ineligible. [This answer is incorrect. Bethany should make her inquiries of her client, the financial institution, not the FHLB.]

b. Reviewing lists of classified loans and past due loan reports. [This answer is correct. Classified loans over 90 days past due are not eligible to secure advances; therefore, Bethany should perform this procedure to make sure no such loans are on the list of pledged assets.]

c. Comparing a list of collateral from the FHLB to the client’s records. [This answer is incorrect. This audit procedure would allow Bethany to test the existence of the collateral. It would not help her determine if all the pledged assets on the list are eligible.]

d. Determining whether the client applied the FHLB’s rules for determining collateral value correctly. [This answer is incorrect. This would allow Bethany to assess the value of the collateral. It would not help her determine if all the pledged assets her client included on the list are eligible to be collateral.]
40. As part of her audit, Bethany will also need to perform procedures on her financial institution client’s accounts payable. How will her procedures compare with those she would perform on accounts payable for a small business audit? (Page 388)

   a. She will need to perform more procedures for a financial institution. [This answer is incorrect. The relevant audit assertions regarding accounts payable and other liabilities are generally the same for financial institutions and commercial businesses. However, accounts payable is generally a less significant audit area in financial institution audits because there are no inventory-related purchases.]

   b. The nature and extent of her procedures will be less for a financial institution. [This answer is correct. Because financial institutions generally do not have inventory-related purchases, their accounts payable is typically a less significant audit area. Consequently, the nature and extent of audit procedures for accounts payable may be less than that for small business audits.]
EXAMINATION FOR CPE CREDIT
Lesson 2 (AFITG103)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

21. Township National Bank has a due from account. This is an example of what type of cash account?
   a. Interest-bearing deposit.
   b. Clearings and exchanges.
   c. Cash items and collections.
   d. Balances due from banks and other financial institutions.

22. Township National Bank has a proof and transit department that participates in its check clearing process. Which of the following steps in the check clearing process would be performed by this department?
   a. Receiving customer deposits.
   b. Making adjustment for customer errors on deposit slips.
   c. Clearing checks that are drawn on member institutions.
   d. Establishing due from accounts with other institutions.

23. Lola, an auditor, is engaged to audit a financial institution. As part of her audit, she must test clearings and exchanges. Which of the following procedures would apply to that part of Lola’s audit?
   a. Reviewing the internal cash counts that were made by bank management.
   b. Tracing significant clearing items to the next day’s deposit.
   c. Arriving on a surprise basis and physically counting all cash funds.
   d. Confirming significant deposits.

24. Beacon National Bank (BNB) has excess funds in its reserves. BNB lends these reserves to other institutions through the Federal Reserve System. Which of the following statements best describes this process?
   a. BNB sells federal funds.
   b. BNB purchases federal funds.
   c. BNB secures federal funds.
   d. BNB lends federal funds.

25. Harvey, an auditor, is engaged to audit a financial institution. As part of the engagement, Harvey will audit his client’s premises and equipment. Which of the following relevant assertions could Harvey use to help him assess the accuracy or classification audit area related to premises and equipment?
   a. The institution has recorded all premises and equipment transactions.
   b. The premises and equipment in question are owned by the institution.
   c. The institution has recorded premises and equipment in the proper accounting period.
   d. The institution has properly classified all premises and equipment in the balance sheet.
26. Assume the same details as in the scenario above. Additionally, this is the third consecutive time Harvey has audited this particular financial institution client. When auditing premises and equipment, will Harvey have to perform detailed vouching on all assets?
   a. Yes, detailed vouching is a required audit procedure for every audit of premises and equipment.
   b. No, detailed vouching should only be needed for significant acquisitions and dispositions.
   c. Do not select this answer choice.
   d. Do not select this answer choice.

27. Bakersfield Mutual makes an acquisition and acquires goodwill. Bakersfield Mutual uses the purchase method. Which of the following would be considered goodwill in this scenario?
   a. The excess of the purchase price the institution paid for the acquisition over the fair value of identifiable assets and liabilities acquired.
   b. The excess of the fair value of identifiable assets and liabilities acquired over the purchase price the institution paid for the acquisition.
   c. The fair value of core deposits, credit-card relationships, favorable leaseholds, and trust servicing acquired as part of the acquisition.
   d. Do not select this answer choice.

28. Small Bank has a large amount of core deposits. Mega Bank acquires Small Bank. How would Small Bank’s core deposits relate to any goodwill that Mega Bank might acquire in this transaction?
   a. A large amount of core deposits means a large amount of recorded goodwill.
   b. A large amount of core deposits means a smaller amount of recorded goodwill.
   c. The amount of core deposits should be combined with the amount of goodwill and then recorded.
   d. The amount of goodwill will be determined by a core deposit study.

29. Juliet, an auditor, was engaged to audit a financial institution. Her client has intangible assets and servicing liabilities. Which of the following related to these assets and liabilities would she be concerned with during her audit?
   a. If the asset or liability was recorded correctly in subsequent periods.
   b. If the asset or liability was measured properly.
   c. If the institution has goodwill and core deposits.
   d. Do not select this answer choice.

30. Bloomville Credit Union (BCU) receives free office space from its members. BCU occasionally also receives donated materials from members. Does FASB ASC 958 apply?
   a. Yes, this guidance applies to all entities that receive donations.
   b. No, the guidance does not apply because BCU is not a nonprofit organization.
   c. Do not select this answer choice.
   d. Do not select this answer choice.
31. Greenbrier National Bank (GNB) offers its customers the usual types of deposit accounts for a typical financial institution that is not a credit union. What type of deposit account should generate the largest transaction volume for GNB?
   a. Checking accounts.
   b. Savings accounts.
   c. Certificates of deposits.
   d. Share accounts.

32. Match the following types of deposit accounts with the correct description.

<table>
<thead>
<tr>
<th>Deposit accounts</th>
<th>Descriptions</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Demand certificates of</td>
<td>i. Retirement plans used by self-employed individuals. They can be CDs or a separate form of time deposit.</td>
</tr>
<tr>
<td>2. Individual retirement</td>
<td>ii. Deposit accounts into which a depositor makes regular weekly or monthly deposits. They have specific maturities and fixed interest rates.</td>
</tr>
<tr>
<td>3. Keogh plan accounts</td>
<td>iii. Tax-deferred investment accounts allowing users to save for retirement. They can be CDs or a separate form of time deposit.</td>
</tr>
<tr>
<td>4. Club accounts</td>
<td>iv. CDs without a fixed maturity date.</td>
</tr>
</tbody>
</table>

   a. 1., i.; 2., ii.; 3., iii.; 4., iv.
   b. 1., ii.; 2., i.; 3., iv; 4., iii.
   c. 1., iii.; 2., iv; 3., ii.; 4., i.
   d. 1., iv.; 2., iii.; 3., i.; and 4., ii.

33. Juan, an auditor, is engaged to audit a financial institution. Which of the following relevant assertions would have a bearing on Juan’s audit of the cutoff of his client’s deposit accounts?
   a. The institution’s deposit accounts are recorded in the correct accounting period.
   b. The deposit accounts that are reflected in the institution’s financial statements exist.
   c. The institution’s deposit accounts are classified properly in the balance sheet and all required disclosures have been made.
   d. The deposit accounts reflected in the institution’s accounts are the obligation of the entity.

34. In which of the scenarios below would Juan be considered to have performed a portion of his financial institution audit incorrectly?
   a. He assesses the affect that brokered deposits have on his client’s liquidity.
   b. Because they are no longer active, he does not address dormant accounts in his audit.
   c. He compares the percentage of deposit growth over the year with historical percentages.
   d. He performs a monthly yield analysis to test interest expense on deposit accounts.
35. Uptown Credit Union (UCU) needs a loan to provide short-term liquidity. UCU would like to borrow these funds from a government-sponsored entity. Which of the following entities would be the most appropriate choice?
   a. The Federal Reserve Bank (FRB).
   b. The Federal Home Loan Bank (FHLB).
   c. The Central Liquidity Facility (CLF).
   d. Do not select this answer choice.

36. Pendleton Savings, a large financial institution, sponsors a special purpose entity called Funding Unlimited. Pendleton Savings transfers mortgage loans to Funding Unlimited. Then Funding Unlimited issues debt or equity securities that are collateralized by the mortgage loans. What is the correct term for this type of borrowing?
   a. A collateralized mortgage obligation.
   b. A debenture.
   c. An advance arrangement.
   d. An agent loan.

37. Molly, an auditor, is engaged to audit a financial institution. As part of her audit, she obtains an understanding of the institution’s significant borrowings. While obtaining this understanding, Molly discovers that her client is in violation of a loan covenant. What should Molly’s next step be?
   a. She should ask her client to obtain a written waiver of the covenant from the lender.
   b. She should make sure that the covenant violation is disclosed in her client’s financial statements.
   c. She should consider the violation’s effect on her client’s ability to continue as a going concern.
   d. She should test accrued interest payable and interest expense on her client’s borrowings.

38. Molly’s client has an FHLB advance. As part of her audit, Molly must examine the collateral related to this borrowing. All of the following collateral types would be eligible for this type of borrowing, except:
   a. Interest-bearing or cash deposits in the FHLB.
   b. Securities that were issued or guaranteed by the U.S. government.
   c. Commercial real estate loans.
   d. Participations in single-family residential loans.

39. The First Bank of Bridgewater uses official checks. Which of the following statements best describes an accounting or auditing concern related to this type of check?
   a. All official checks should be processed using the same deposit account.
   b. The relevant assertion for this type of check is that the list is complete.
   c. Payment of an official check is recorded as a reduction in cash on hand.
   d. It is acceptable for the institution to have significant, unrecorded official checks.
40. Gary, an auditor, is engaged to audit a financial institution. Does Gary need to audit the institution’s accrued expenses?

   a. Yes, he must perform a detailed evaluation of accrued expenses as part of his audit.
   b. Yes, he must consider accrued expenses, but he usually does not need to perform detailed procedures.
   c. No, analytical procedures are not needed to test accrued expenses.
   d. Do not select this answer choice.
GLOSSARY

**Acquisition costs:** Costs incurred in connection with the purchase of real estate either on or near the purchase date.

**Asset group:** The lowest level for which identifiable cash flows are largely independent of the cash flows of other groups of assets and liabilities.

**Average accumulated expenditures:** The average net balance of capitalized costs of all components of the real estate project that are undergoing development or construction during the period.

**Cash items and collections:** Items other than coin or currency that are held for conversion to cash, such as food stamps, maturing bond coupons, or insufficient funds checks.

**Cash on hand:** The cash in teller drawers and the vault.

**Certificates of deposit (CD):** A type of deposit account also known as a time deposit. CDs generally require the customer to keep the deposit account for a minimum period of time, which generally ranges from one month to five years or more.

**Checking accounts:** A type of deposit account that allows funds to be available to customers on demand. The two primary types are noninterest-bearing checking and interest-bearing checking.

**Clearings and exchanges:** These primarily consist of checks drawn on other financial institutions. They are generally received with customer’s deposits and then processed.

**Core deposits:** Deposit accounts that tend to remain in the institution regardless of changes in interest rates. They are a dependable, long-term source of funds for the institution and, thus, are considered to have a value that is separate from the institution’s other assets.

**Costs to sell:** These costs include only the incremental direct costs of selling the property, such as sales commissions, legal and title transfer fees, and other closing costs.

**Development and construction costs:** The direct and indirect costs involved in developing land, constructing buildings, or making other physical improvements.

**Disposal group:** Properties to be disposed of as a group in a single transaction and liabilities directly associated with those properties that will be transferred in the transaction.

**Dormant accounts:** Accounts receive this classification when there has been no activity in the account for a specified period of time. Each institution generally establishes its own criteria for classifying dormant accounts, and the criteria may vary depending on the type of deposit account involved.

**Due from account:** Basically a checking account maintained with another financial institution. They are used primarily during the check clearing process. They can also be used for other purposes, such as securities purchases and wire transfers.

**Due to account:** Some financial institutions have this kind of account, which is a deposit account.

**Fair value:** The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

**Federal funds:** Funds banks deposit in Federal Reserve Banks (also called fed funds).

**Foreclosed assets:** Assets obtained through foreclosure and assets voluntarily transferred by the borrower in settlement of a loan, such as a deed in lieu of foreclosure.

**Foreclosure:** An involuntary settlement in which a financial institution receives assets from a borrower in settlement of a loan.
Future cash flows: The future cash inflows to be generated from using and disposing of a foreclosed asset, less the future outflows necessary to obtain those inflows.

Goodwill: Under the purchase method, the excess of the purchase price paid to acquire an institution over the fair value of the identifiable assets and liabilities acquired is recorded as goodwill.

Interest-bearing deposits: Normally, these are certificates of deposit or other interest-bearing accounts maintained in other financial institutions. Some institutions consider these to be another type of due from account.

Official checks: Checks that the institution writes on its own accounts (e.g., cashier’s checks, loan disbursement checks, and expense checks).

Overdrafts: These are basically unsecured loans made to depositors. Many financial institutions have controls that require specific authorization for payment of checks that will result in overdrafts of depositor’s accounts. Most overdrafts expose the institution to credit risk.

Preacquisition costs: Costs incurred in connection with the purchase of real estate before the purchase.

Savings accounts: A type of deposit account that is interest-bearing and that allows depositors to withdraw funds on demand. However, checks cannot be written on these accounts.
INDEX

ACCOUNTING PRINCIPLES BOARD OPINIONS
- APB Opinion No. 16 .................................................. 359
- APB Opinion No. 17 .................................................. 360
- APB Opinion No. 18 .................................................. 282
- APB Opinion No. 20 .................................................. 296

ACCOUNTS PAYABLE
- Relevant assertions .................................................. 380

ACCRUED EXPENSES ................................................. 383, 388
- Relevant assertions .................................................. 380

AICPA STATEMENTS OF POSITION
- SOP 78-9 ............................................................... 282

BANKS
- Foreclosed assets, terminology .................................... 281
- Premises and equipment, regulatory restrictions .............. 357
- Real estate investments, regulatory restrictions ............ 281

BORROWINGS
- Agent loans ................................................................ 382
- Audit procedures ...................................................... 383
- Central Liquidity Facility, borrowings from ............... 382
- Collateralized mortgage obligations ......................... 383
- Confirmations ........................................................ 383
- Correspondent bank, borrowing from ..................... 382
- Debentures ................................................................ 383
- Federal home loan bank advances ......................... 383
  - Collateral verification procedures ......................... 383
  - Description ...................................................... 382, 384
- Federal Reserve Bank borrowings ......................... 382
- Mortgage debt ....................................................... 383
- Relevant assertions ................................................ 380
- Treasury, Tax, and Loan notes ............................. 382
- Types of borrowings ............................................. 381

CASH
- Audit procedures ...................................................... 349
- Cash items
  - Audit procedures ............................................. 349, 351
  - Defined .......................................................... 346
- Cash letter ........................................................... 347
- Cash on hand
  - Audit procedures ............................................. 349, 351
  - Described ..................................................... 346
- Check clearing process ....................................... 346
- Clearinghouse ....................................................... 348
- Clearings and exchanges
  - Audit procedures ............................................. 349, 351
  - Defined ........................................................ 346
  - Use of in check clearing process ....................... 347
- Correspondent bank .............................................. 348
- Due from accounts
  - Audit procedures ............................................. 349
  - Check clearing process .................................... 348
  - Defined ........................................................ 346
  - Reconciliations ................................................ 349
- Federal Home Loan Bank .................................... 348
- Federal Reserve Bank .......................................... 348
- Interest-bearing deposits
  - Audit procedures ............................................. 351
  - Defined ........................................................ 346
  - Proof and transit department ............................. 347
  - Relevant assertions .......................................... 349
  - Surprise entry procedures ............................... 351

CONFIRMATION PROCEDURES
- Clearings and exchanges ........................................ 349
- Due from accounts ............................................... 351
- Federal funds purchased ..................................... 356
- Federal funds sold ............................................... 351
- Interest-bearing deposits ..................................... 351

CREDIT UNIONS
- Agent loans ........................................................... 382
- Central Liquidity Facility, borrowings from .............. 382
- Contributions of assets and services received .......... 364
- Corporate credit unions ....................................... 383
- National Credit Union Share Insurance
  - Fund deposit .................................................... 364
- Premises and equipment, regulatory restrictions ...... 357
- Regulatory accounting principles ....................... 372

DEPOSIT ACCOUNTS
- Accrued interest payable ........................................ 375
- Audit procedures .................................................. 374
- Brokered deposits ............................................... 374
- Certificates of deposit ......................................... 373
- Checking accounts .............................................. 372
- Club accounts .................................................... 373
- Demand certificates of deposit ............................ 373
- Demand deposit accounts .................................... 372
- Dormant accounts ............................................... 375
- Interest expense ................................................... 375
- IRAs ..................................................................... 373
- Keogh plan accounts .......................................... 373
- NOW accounts ................................................... 372
- Overdrafts ........................................................... 375
- Relevant assertions ............................................. 373
- Savings accounts ................................................ 373
- Time deposits ..................................................... 373
- Treasury, Tax, and Loan account ....................... 382
- Types of accounts ............................................... 372

EMERGING ISSUES TASK FORCE ISSUES
- Issue No. 88-24 ..................................................... 306

FAIR VALUE
- Measurements ....................................................... 344
- Options ............................................................... 345

FDIC
- FDIC Deposit Insurance Fund .................................. 363

FEDERAL FUNDS PURCHASED
- Audit procedures .................................................. 356
- Confirmation ......................................................... 356
- Defined ............................................................. 356
- Relevant assertions ............................................. 380

FEDERAL FUNDS SOLD
- Audit procedures .................................................. 356
- Confirmation ......................................................... 356
- Definition .......................................................... 356

FEDERAL HOME LOAN BANKS
- Advances from
  - Collateral verification procedures ....................... 383
  - Described ..................................................... 382, 384

401
**FEDERAL RESERVE BANKS**
- Borrowings from ........................................ 382
- Check clearing services ............................... 348

**FORECLOSED ASSETS**
- Accounting
  - After foreclosure .................................... 288
  - At foreclosure ........................................ 287
  - Allowances ............................................ 288, 289
  - Audit procedures .................................... 283, 288, 289
- Authoritative literature ............................... 281
- Depreciation .......................................... 289
- Relevant assertions ................................... 284
- Repairs and improvements ............................ 288
- Second liens ........................................... 287
- Terminology ............................................ 281

**INTANGIBLE AND OTHER ASSETS**
- Acquisitions of other institutions or branches ..... 359
- Audit procedures ....................................... 363
- Core deposits .......................................... 361, 363
- FDIC Deposit Insurance Fund ......................... 363
- Goodwill .................................................. 360, 363
  - Amortization ......................................... 360
  - Impairment ............................................ 360
- National Credit Union Share Insurance Fund Deposit ........................................ 364
- Other than goodwill .................................... 360
  - Amortization ......................................... 361
  - Impairment ............................................ 361
- Relevant assertions ................................... 359
- Servicing assets ....................................... 361
- Servicing rights requirements ....................... 361
- Types of .................................................. 359

**OFFICIAL CHECKS**
- Accounting for ......................................... 387
- Audit procedures ....................................... 388
- Defined .................................................... 387

**PREMISES AND EQUIPMENT**
- Depreciation expense .................................. 357
  - Regulatory restrictions ............................... 357
  - Relevant assertions ................................... 356
- Transactions, procedures regarding ................ 357
  - Valuation, assessment of ............................ 357

**REAL ESTATE DEVELOPMENT AND CONSTRUCTION COSTS**
- Acquisition costs
  - Accounting ............................................. 292
  - Defined ................................................ 292
- Allocation of project costs
  - Equal allocation method ............................. 297
  - Frontage size allocation method .................. 297
  - Selecting allocation methods ....................... 296
  - Specific identification method ..................... 296
  - Square footage allocation method ................ 297
- Components of project, cost capitalization on .... 293
  - Construction costs
    - Accounting ............................................ 293
    - Defined ............................................. 293
  - Cost capitalization, general ....................... 291
- Development costs
  - Accounting ............................................ 293
  - Defined ............................................. 293
- Interruptions, effect on cost capitalization ........ 294

- Preacquisition costs
  - Accounting ............................................. 292
  - Defined ............................................. 292
  - Recoverability, effect on cost capitalization .... 296
  - Taxes, property ...................................... 295

**REAL ESTATE INVESTMENTS**
- Audit procedures ....................................... 283
- Authoritative literature ................................ 281
- Impairment
  - Estimating future cash flows ....................... 290
  - Extent of testing .................................... 319
  - Gains and losses .................................... 289
  - Objective .......................................... 319
  - Previously deferred gains ......................... 320
  - Shortcut approach .................................. 319, 320
- Buyer’s investments ................................... 312
- Consummation of sale ................................ 311
- Continuing investment
  - Adequacy, assessment of ............................. 316
  - Collectibility, effect on ............................ 318
  - Inadequacy, effect on accounting ................ 318
  - Continuing seller involvement ..................... 311
  - Cost recovery method ................................. 315, 318
  - Deposit method
    - Conditions for use ................................. 308, 311, 318
    - Gain recognition .................................. 308
  - Full accrual method
    - Conditions for use ................................. 305, 310
    - Gain recognition under ......................... 305
  - Gain calculation ..................................... 304
  - Initial investment
    - Adequacy, assessment of ............................ 313
    - Composition ....................................... 312
    - Inadequacy, effect on accounting ................ 315
  - Installment method
    - Conditions for use ................................. 305, 315, 318
    - Gain recognition .................................. 305
  - Lien superiority ..................................... 311
  - Reduced profit method ................................ 318
  - Sales value .......................................... 304

**SAVINGS INSTITUTIONS**
- Foreclosed assets, terminology ....................... 281
- Real estate investments, regulatory restrictions ... 281
- Regulatory restrictions, premises, and equipment ... 357

**SERVICING LIABILITIES**
- Audit procedures ....................................... 363

**STATEMENTS OF FINANCIAL ACCOUNTING STANDARDS**
- SFAS No. 15 ............................................. 360
- SFAS No. 34 ............................................. 287
- SFAS No. 66 ............................................. 281, 287, 304, 305, 306, 308, 310, 315, 316, 317, 318
- SFAS No. 67 ............................................. 281, 288, 291, 292, 295, 296, 298, 328
- SFAS No. 116 ............................................ 364
- SFAS No. 122 ............................................ 361
- SFAS No. 140 ............................................ 381, 383
• SFAS No. 144 ........ 281, 287, 288, 289, 308, 327, 328, 357, 358
• SFAS No. 156 ................................................. 361

STATEMENTS ON AUDITING STANDARDS STANDARDS
• SAS No. 106 ....................................................... 283
• SAS No. 110 ....................................................... 283

T

TREASURY, TAX, AND LOAN ACCOUNT ......................... 382
• Relevant assertions .............................................. 380
TESTING INSTRUCTIONS FOR EXAMINATION FOR CPE CREDIT

Companion to PPC’s Guide to Audits of Financial Institutions—Course 1—Loans Receivable and the Loan Loss Allowance (AFITG101)

1. Following these instructions is information regarding the location of the CPE CREDIT EXAMINATION QUESTIONS and an EXAMINATION FOR CPE CREDIT ANSWER SHEET. You may use the answer sheet to complete the examination consisting of multiple choice questions.

ONLINE GRADING. Log onto our Online Grading Center at OnlineGrading.Thomson.com to receive instant CPE credit. Click the purchase link and a list of exams will appear. Search for an exam using wildcards. Payment for the exam is accepted over a secure site using your credit card. Once you purchase an exam, you may take the exam three times. On the third unsuccessful attempt, the system will request another payment. Once you successfully score 70% on an exam, you may print your completion certificate from the site. The site will retain your exam completion history. If you lose your certificate, you may return to the site and reprint your certificate.

PRINT GRADING. If you prefer, you may mail or fax your completed answer sheet to the address or number below. In the print product, the answer sheets are bound with the course materials. Answer sheets may be printed from electronic products. The answer sheets are identified with the course acronym. Please ensure you use the correct answer sheet. Indicate the best answer to the exam questions by completely filling in the circle for the correct answer. The bubbled answer should correspond with the correct answer letter at the top of the circle's column and with the question number.

Send your completed Examination for CPE Credit Answer Sheet, Course Evaluation, and payment to:

Thomson Reuters
Tax & Accounting—R&G
AFITG101 Self-study CPE
36786 Treasury Center
Chicago, IL  60694-6700

You may fax your completed Examination for CPE Credit Answer Sheet and Course Evaluation to the Tax & Accounting business of Thomson Reuters at (817) 252-4021, along with your credit card information.

Please allow a minimum of three weeks for grading.

Note: The answer sheet has four bubbles for each question. However, not every examination question has four valid answer choices. If there are only two or three valid answer choices, “Do not select this answer choice” will appear next to the invalid answer choices on the examination.

2. If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.

3. Copies of the answer sheet are acceptable. However, each answer sheet must be accompanied by a payment of $79. Discounts apply for 3 or more courses submitted for grading at the same time by a single participant. If you complete three courses, the price for grading all three is $225 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is $284 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is $336 (a 15% discount on all five courses or more).

4. To receive CPE credit, completed answer sheets must be postmarked by June 30, 2011. CPE credit will be given for examination scores of 70% or higher. An express grading service is available for an additional $24.95 per examination. Course results will be faxed to you by 5 p.m. CST of the business day following receipt of your examination for CPE Credit Answer Sheet.

5. Only the Examination for CPE Credit Answer Sheet should be submitted for grading. DO NOT SEND YOUR SELF-STUDY COURSE MATERIALS. Be sure to keep a completed copy for your records.

6. Please direct any questions or comments to our Customer Service department at (800) 431-9025.
EXAMINATION FOR CPE CREDIT

To enhance your learning experience, examination questions are located immediately following each lesson. Each set of examination questions can be located on the page numbers listed below. The course is designed so the participant reads the course materials, answers a series of self-study questions, and evaluates progress by comparing answers to both the correct and incorrect answers and the reasons for each. At the end of each lesson, the participant then answers the examination questions and records answers to the examination questions on either the printed EXAMINATION FOR CPE CREDIT ANSWER SHEET or by logging onto the Online Grading System. The EXAMINATION FOR CPE CREDIT ANSWER SHEET and SELF-STUDY COURSE EVALUATION FORM for each course are located at the end of all course materials.

<table>
<thead>
<tr>
<th>Examination Questions</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>CPE Examination Questions (Lesson 1)</td>
<td>37</td>
</tr>
<tr>
<td>CPE Examination Questions (Lesson 2)</td>
<td>100</td>
</tr>
<tr>
<td>CPE Examination Questions (Lesson 3)</td>
<td>136</td>
</tr>
</tbody>
</table>
EXAMINATION FOR CPE CREDIT ANSWER SHEET
Companion to PPC’s Guide to Audits of Financial Institutions—Course 1—Loans Receivable and the Loan Loss Allowance (AFITG101)

Price $79

First Name: ________________________________
Last Name: ________________________________
Firm Name: ________________________________
Firm Address: ____________________________________________
City: __________________ State /ZIP: __________________
Firm Phone: ____________________________________________
Firm Fax No.: ____________________________________________
Firm Email: ____________________________________________
Express Grading Requested: □ Add $24.95

Signature: ____________________________________________
Credit Card Number: ____________________________ Expiration Date: ________________
Birth Month: __________________ Licensing State: ____________________________

ANSWERS:
Please indicate your answer by filling in the appropriate circle as shown: Fill in like this ○ not like this □ ✔ ✗.

1. ○ ○ ○ ○ 11. ○ ○ ○ ○ 21. ○ ○ ○ ○ 31. ○ ○ ○ ○
2. ○ ○ ○ ○ 12. ○ ○ ○ ○ 22. ○ ○ ○ ○ 32. ○ ○ ○ ○
3. ○ ○ ○ ○ 13. ○ ○ ○ ○ 23. ○ ○ ○ ○ 33. ○ ○ ○ ○
4. ○ ○ ○ ○ 14. ○ ○ ○ ○ 24. ○ ○ ○ ○ 34. ○ ○ ○ ○
5. ○ ○ ○ ○ 15. ○ ○ ○ ○ 25. ○ ○ ○ ○ 35. ○ ○ ○ ○
6. ○ ○ ○ ○ 16. ○ ○ ○ ○ 26. ○ ○ ○ ○ 36. ○ ○ ○ ○
7. ○ ○ ○ ○ 17. ○ ○ ○ ○ 27. ○ ○ ○ ○ 37. ○ ○ ○ ○
8. ○ ○ ○ ○ 18. ○ ○ ○ ○ 28. ○ ○ ○ ○ 38. ○ ○ ○ ○
10. ○ ○ ○ ○ 20. ○ ○ ○ ○ 30. ○ ○ ○ ○ 40. ○ ○ ○ ○

You may complete the exam online by logging onto our online grading system at OnlineGrading.Thomson.com, or you may fax completed Examination for CPE Credit Answer Sheet and Course Evaluation to Thomson Reuters at (817) 252-4021, along with your credit card information.

Expiration Date: June 30, 2011
# Self-study Course Evaluation

Course Title: Companion to PPC’s Guide to Audits of Financial Institutions—Course 1—Loans Receivable and the Loan Loss Allowance

Course Acronym: AFITG101

Your Name (optional): ___________________________ Date: ___________________________

Email: __________________________________________________________________________

---

Please indicate your answers by filling in the appropriate circle as shown:

Fill in like this ☐ not like this ☒ ☐ ☐.

### Satisfaction Level:

<table>
<thead>
<tr>
<th>1. Rate the appropriateness of the materials for your experience level:</th>
<th>Low (1) . . . to . . . High (10)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2. How would you rate the examination related to the course material?</td>
<td>1 2 3 4 5 6 7 8 9 10</td>
</tr>
<tr>
<td>3. Does the examination consist of clear and unambiguous questions and statements?</td>
<td>1 2 3 4 5 6 7 8 9 10</td>
</tr>
<tr>
<td>4. Were the stated learning objectives met?</td>
<td>1 2 3 4 5 6 7 8 9 10</td>
</tr>
<tr>
<td>5. Were the course materials accurate and useful?</td>
<td>1 2 3 4 5 6 7 8 9 10</td>
</tr>
<tr>
<td>6. Were the course materials relevant and did they contribute to the achievement of the learning objectives?</td>
<td>1 2 3 4 5 6 7 8 9 10</td>
</tr>
<tr>
<td>7. Was the time allotted to the learning activity appropriate?</td>
<td>1 2 3 4 5 6 7 8 9 10</td>
</tr>
<tr>
<td>8. If applicable, was the technological equipment appropriate?</td>
<td>1 2 3 4 5 6 7 8 9 10</td>
</tr>
<tr>
<td>9. If applicable, were handout or advance preparation materials and prerequisites satisfactory?</td>
<td>1 2 3 4 5 6 7 8 9 10</td>
</tr>
<tr>
<td>10. If applicable, how well did the audio/visuals contribute to the program?</td>
<td>1 2 3 4 5 6 7 8 9 10</td>
</tr>
</tbody>
</table>

Please provide any constructive criticism you may have about the course materials, such as particularly difficult parts, hard to understand areas, unclear instructions, appropriateness of subjects, educational value, and ways to make it more fun. Please be as specific as you can.

(Please print legibly):

**Additional Comments:**

1. What did you find **most** helpful?  
2. What did you find **least** helpful?

3. What other courses or subject areas would you like for us to offer?

4. Do you work in a Corporate (C), Professional Accounting (PA), Legal (L), or Government (G) setting? _________

5. How many employees are in your company? _________

6. May we contact you for survey purposes (Y/N)? If yes, please fill out contact info at the top of the page. Yes/No ☐ ☐

For more information on our CPE & Training solutions, visit trainingcpe.thomson.com. Comments may be quoted or paraphrased for marketing purposes, including first initial, last name, and city/state, if provided. If you prefer we do not publish your name, write in “no” and initial here _________
TESTING INSTRUCTIONS FOR EXAMINATION FOR CPE CREDIT

Companion to PPC’s Guide to Audits of Financial Institutions—Course 2—An Introduction to Audits of Financial Institutions and Related Pre-engagement Activities (AFITG102)

1. Following these instructions is information regarding the location of the CPE CREDIT EXAMINATION QUESTIONS and an EXAMINATION FOR CPE CREDIT ANSWER SHEET. You may use the answer sheet to complete the examination consisting of multiple choice questions.

ONLINE GRADING. Log onto our Online Grading Center at OnlineGrading.Thomson.com to receive instant CPE credit. Click the purchase link and a list of exams will appear. Search for an exam using wildcards. Payment for the exam is accepted over a secure site using your credit card. Once you purchase an exam, you may take the exam three times. On the third unsuccessful attempt, the system will request another payment. Once you successfully score 70% on an exam, you may print your completion certificate from the site. The site will retain your exam completion history. If you lose your certificate, you may return to the site and reprint your certificate.

PRINT GRADING. If you prefer, you may mail or fax your completed answer sheet to the address or number below. In the print product, the answer sheets are bound with the course materials. Answer sheets may be printed from electronic products. The answer sheets are identified with the course acronym. Please ensure you use the correct answer sheet. Indicate the best answer to the exam questions by completely filling in the circle for the correct answer. The bubbled answer should correspond with the correct answer letter at the top of the circle’s column and with the question number.

Send your completed Examination for CPE Credit Answer Sheet, Course Evaluation, and payment to:

Thomson Reuters
Tax & Accounting—R&G
AFITG102 Self-study CPE
36786 Treasury Center
Chicago, IL  60694-6700

You may fax your completed Examination for CPE Credit Answer Sheet and Course Evaluation to the Tax & Accounting business of Thomson Reuters at (817) 252-4021, along with your credit card information.

Please allow a minimum of three weeks for grading.

Note: The answer sheet has four bubbles for each question. However, not every examination question has four valid answer choices. If there are only two or three valid answer choices, “Do not select this answer choice” will appear next to the invalid answer choices on the examination.

2. If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.

3. Copies of the answer sheet are acceptable. However, each answer sheet must be accompanied by a payment of $79. Discounts apply for 3 or more courses submitted for grading at the same time by a single participant. If you complete three courses, the price for grading all three is $225 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is $284 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is $336 (a 15% discount on all five courses or more).

4. To receive CPE credit, completed answer sheets must be postmarked by June 30, 2011. CPE credit will be given for examination scores of 70% or higher. An express grading service is available for an additional $24.95 per examination. Course results will be faxed to you by 5 p.m. CST of the business day following receipt of your examination for CPE Credit Answer Sheet.

5. Only the Examination for CPE Credit Answer Sheet should be submitted for grading. DO NOT SEND YOUR SELF-STUDY COURSE MATERIALS. Be sure to keep a completed copy for your records.

6. Please direct any questions or comments to our Customer Service department at (800) 431-9025.
EXAMINATION FOR CPE CREDIT

To enhance your learning experience, examination questions are located immediately following each lesson. Each set of examination questions can be located on the page numbers listed below. The course is designed so the participant reads the course materials, answers a series of self-study questions, and evaluates progress by comparing answers to both the correct and incorrect answers and the reasons for each. At the end of each lesson, the participant then answers the examination questions and records answers to the examination questions on either the printed EXAMINATION FOR CPE CREDIT ANSWER SHEET or by logging onto the Online Grading System. The EXAMINATION FOR CPE CREDIT ANSWER SHEET and SELF-STUDY COURSE EVALUATION FORM for each course are located at the end of all course materials.

CPE Examination Questions (Lesson 1) ................................................................. 191
CPE Examination Questions (Lesson 2) ................................................................. 265
EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC’s Guide to Audits of Financial Institutions—Course 2—An Introduction to Audits of Financial Institutions and Related Pre-engagement Activities (AFITG102)

Price $79

First Name: ________________________________
Last Name: ________________________________
Firm Name: ________________________________
Firm Address: ________________________________
City: ___________________ State /ZIP: ________________
Firm Phone: ________________________________
Firm Fax No.: ________________________________
Firm Email: ________________________________
Express Grading Requested:  □ Add $24.95
Signature: __________________________________
Credit Card Number: ___________________________ Expiration Date: ___________________________
Birth Month: ___________________ Licensing State: ___________________________

ANSWERS:

Please indicate your answer by filling in the appropriate circle as shown: Fill in like this ● not like this ✗ ✅.

a b c d a b c d a b c d a b c d
1. ● ● ● ● 11. ● ● ● ● 21. ● ● ● ● 31. ● ● ● ●
2. ● ● ● ● 12. ● ● ● ● 22. ● ● ● ● 32. ● ● ● ●
3. ● ● ● ● 13. ● ● ● ● 23. ● ● ● ● 33. ● ● ● ●
4. ● ● ● ● 14. ● ● ● ● 24. ● ● ● ● 34. ● ● ● ●
5. ● ● ● ● 15. ● ● ● ● 25. ● ● ● ● 35. ● ● ● ●
6. ● ● ● ● 16. ● ● ● ● 26. ● ● ● ● 36. ● ● ● ●
7. ● ● ● ● 17. ● ● ● ● 27. ● ● ● ● 37. ● ● ● ●
8. ● ● ● ● 18. ● ● ● ● 28. ● ● ● ● 38. ● ● ● ●
10. ● ● ● ● 20. ● ● ● ● 30. ● ● ● ● 40. ● ● ● ●

You may complete the exam online by logging onto our online grading system at OnlineGrading.Thomson.com, or you may fax completed Examination for CPE Credit Answer Sheet and Course Evaluation to Thomson Reuters at (817) 252-4021, along with your credit card information.

Expiration Date:  June 30, 2011
Self-study Course Evaluation

Course Title: Companion to PPC’s Guide to Audits of Financial Institutions—Course 2
—An Introduction to Audits of Financial Institutions and Related Pre-engagement Activities

Course Acronym: AFITG102

Your Name (optional): _____________________________ Date: _____________________________

Email: _____________________________

Please indicate your answers by filling in the appropriate circle as shown:

Fill in like this ● not like this × √.

Satisfaction Level:

1. Rate the appropriateness of the materials for your experience level:

2. How would you rate the examination related to the course material?

3. Does the examination consist of clear and unambiguous questions and statements?

4. Were the stated learning objectives met?

5. Were the course materials accurate and useful?

6. Were the course materials relevant and did they contribute to the achievement of the learning objectives?

7. Was the time allotted to the learning activity appropriate?

8. If applicable, was the technological equipment appropriate?

9. If applicable, were handout or advance preparation materials and prerequisites satisfactory?

10. If applicable, how well did the audio/visuals contribute to the program?

Low (1) . . . to . . . High (10)

1 2 3 4 5 6 7 8 9 10

Please provide any constructive criticism you may have about the course materials, such as particularly difficult parts, hard to understand areas, unclear instructions, appropriateness of subjects, educational value, and ways to make it more fun. Please be as specific as you can.

(Please print legibly):

Additional Comments:

1. What did you find most helpful? 2. What did you find least helpful?

3. What other courses or subject areas would you like for us to offer?

4. Do you work in a Corporate (C), Professional Accounting (PA), Legal (L), or Government (G) setting? _________

5. How many employees are in your company? _________

6. May we contact you for survey purposes (Y/N)? If yes, please fill out contact info at the top of the page. Yes/No ☑ ☐

For more information on our CPE & Training solutions, visit trainingcpe.thomson.com. Comments may be quoted or paraphrased for marketing purposes, including first initial, last name, and city/state, if provided. If you prefer we do not publish your name, write in “no” and initial here __________.
TESTING INSTRUCTIONS FOR EXAMINATION FOR CPE CREDIT

Companion to PPC’s Guide to Audits of Financial Institutions—Course 3—Foreclosed Assets, Real Estate Investments, Cash, Other Assets, and Liabilities (AFITG103)

1. Following these instructions is information regarding the location of the CPE CREDIT EXAMINATION QUESTIONS and an EXAMINATION FOR CPE CREDIT ANSWER SHEET. You may use the answer sheet to complete the examination consisting of multiple choice questions.

ONLINE GRADING. Log onto our Online Grading Center at OnlineGrading.Thomson.com to receive instant CPE credit. Click the purchase link and a list of exams will appear. Search for an exam using wildcards. Payment for the exam is accepted over a secure site using your credit card. Once you purchase an exam, you may take the exam three times. On the third unsuccessful attempt, the system will request another payment. Once you successfully score 70% on an exam, you may print your completion certificate from the site. The site will retain your exam completion history. If you lose your certificate, you may return to the site and reprint your certificate.

PRINT GRADING. If you prefer, you may mail or fax your completed answer sheet to the address or number below. In the print product, the answer sheets are bound with the course materials. Answer sheets may be printed from electronic products. The answer sheets are identified with the course acronym. Please ensure you use the correct answer sheet. Indicate the best answer to the exam questions by completely filling in the circle for the correct answer. The bubbled answer should correspond with the correct answer letter at the top of the circle’s column and with the question number.

Send your completed Examination for CPE Credit Answer Sheet, Course Evaluation, and payment to:

Thomson Reuters
Tax & Accounting—R&G
AFITG103 Self-study CPE
36786 Treasury Center
Chicago, IL  60694-6700

You may fax your completed Examination for CPE Credit Answer Sheet and Course Evaluation to the Tax & Accounting business of Thomson Reuters at (817) 252-4021, along with your credit card information.

Please allow a minimum of three weeks for grading.

Note: The answer sheet has four bubbles for each question. However, not every examination question has four valid answer choices. If there are only two or three valid answer choices, “Do not select this answer choice” will appear next to the invalid answer choices on the examination.

2. If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.

3. Copies of the answer sheet are acceptable. However, each answer sheet must be accompanied by a payment of $79. Discounts apply for 3 or more courses submitted for grading at the same time by a single participant. If you complete three courses, the price for grading all three is $225 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is $284 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is $336 (a 15% discount on all five courses or more).

4. To receive CPE credit, completed answer sheets must be postmarked by June 30, 2011. CPE credit will be given for examination scores of 70% or higher. An express grading service is available for an additional $24.95 per examination. Course results will be faxed to you by 5 p.m. CST of the business day following receipt of your examination for CPE Credit Answer Sheet.

5. Only the Examination for CPE Credit Answer Sheet should be submitted for grading. DO NOT SEND YOUR SELF-STUDY COURSE MATERIALS. Be sure to keep a completed copy for your records.

6. Please direct any questions or comments to our Customer Service department at (800) 431-9025.
EXAMINATION FOR CPE CREDIT

To enhance your learning experience, examination questions are located immediately following each lesson. Each set of examination questions can be located on the page numbers listed below. The course is designed so the participant reads the course materials, answers a series of self-study questions, and evaluates progress by comparing answers to both the correct and incorrect answers and the reasons for each. At the end of each lesson, the participant then answers the examination questions and records answers to the examination questions on either the printed EXAMINATION FOR CPE CREDIT ANSWER SHEET or by logging onto the Online Grading System. The EXAMINATION FOR CPE CREDIT ANSWER SHEET and SELF-STUDY COURSE EVALUATION FORM for each course are located at the end of all course materials.

Page

<table>
<thead>
<tr>
<th>Examination Questions (Lesson 1)</th>
<th>336</th>
</tr>
</thead>
<tbody>
<tr>
<td>CPE Examination Questions (Lesson 2)</td>
<td>394</td>
</tr>
</tbody>
</table>
EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC’s Guide to Audits of Financial Institutions—Course 3—Foreclosed Assets, Real Estate Investments, Cash, Other Assets, and Liabilities (AFITG103)

Price $79

First Name: ________________________________
Last Name: ________________________________
Firm Name: ________________________________
Firm Address: ____________________________________________
City: __________________ State /ZIP: __________________________
Firm Phone: __________________
Fax No.: __________________
Firm Email: __________________
Express Grading Requested: □ Add $24.95
Signature: ________________________________
Credit Card Number: ________________________ Expiration Date: ____________
Birth Month: __________________ Licensing State: __________________

ANSWERS:
Please indicate your answer by filling in the appropriate circle as shown: Fill in like this • not like this ☒ ☐.

1. ○ ○ ○ ○ 11. ○ ○ ○ ○ 21. ○ ○ ○ ○ 31. ○ ○ ○ ○
2. ○ ○ ○ ○ 12. ○ ○ ○ ○ 22. ○ ○ ○ ○ 32. ○ ○ ○ ○
3. ○ ○ ○ ○ 13. ○ ○ ○ ○ 23. ○ ○ ○ ○ 33. ○ ○ ○ ○
4. ○ ○ ○ ○ 14. ○ ○ ○ ○ 24. ○ ○ ○ ○ 34. ○ ○ ○ ○
5. ○ ○ ○ ○ 15. ○ ○ ○ ○ 25. ○ ○ ○ ○ 35. ○ ○ ○ ○
6. ○ ○ ○ ○ 16. ○ ○ ○ ○ 26. ○ ○ ○ ○ 36. ○ ○ ○ ○
7. ○ ○ ○ ○ 17. ○ ○ ○ ○ 27. ○ ○ ○ ○ 37. ○ ○ ○ ○
8. ○ ○ ○ ○ 18. ○ ○ ○ ○ 28. ○ ○ ○ ○ 38. ○ ○ ○ ○
10. ○ ○ ○ ○ 20. ○ ○ ○ ○ 30. ○ ○ ○ ○ 40. ○ ○ ○ ○

You may complete the exam online by logging onto our online grading system at OnlineGrading.Thomson.com, or you may fax completed Examination for CPE Credit Answer Sheet and Course Evaluation to Thomson Reuters at (817) 252-4021, along with your credit card information.

Expiration Date: June 30, 2011
Self-study Course Evaluation

Course Title: Companion to PPC’s Guide to Audits of Financial Institutions—Course 3—Foreclosed Assets, Real Estate Investments, Cash, Other Assets, and Liabilities
Course Acronym: AFITG103

Your Name (optional): __________________________ Date: __________________________

Email: __________________________

Please indicate your answers by filling in the appropriate circle as shown:
Fill in like this ☐ not like this ☒ ☑ ☔.

<table>
<thead>
<tr>
<th>Satisfaction Level:</th>
<th>Low (1) . . . to . . . High (10)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Rate the appropriateness of the materials for your experience level:</td>
<td>☐ ☐ ☐ ☐ ☐ ☐ ☐ ☐ ☐ ☐</td>
</tr>
<tr>
<td>2. How would you rate the examination related to the course material?</td>
<td>☐ ☐ ☐ ☐ ☐ ☐ ☐ ☐ ☐ ☐</td>
</tr>
<tr>
<td>3. Does the examination consist of clear and unambiguous questions and statements?</td>
<td>☐ ☐ ☐ ☐ ☐ ☐ ☐ ☐ ☐ ☐</td>
</tr>
<tr>
<td>4. Were the stated learning objectives met?</td>
<td>☐ ☐ ☐ ☐ ☐ ☐ ☐ ☐ ☐ ☐</td>
</tr>
<tr>
<td>5. Were the course materials accurate and useful?</td>
<td>☐ ☐ ☐ ☐ ☐ ☐ ☐ ☐ ☐ ☐</td>
</tr>
<tr>
<td>6. Were the course materials relevant and did they contribute to the achievement of the learning objectives?</td>
<td>☐ ☐ ☐ ☐ ☐ ☐ ☐ ☐ ☐ ☐</td>
</tr>
<tr>
<td>7. Was the time allotted to the learning activity appropriate?</td>
<td>☐ ☐ ☐ ☐ ☐ ☐ ☐ ☐ ☐ ☐</td>
</tr>
<tr>
<td>8. If applicable, was the technological equipment appropriate?</td>
<td>☐ ☐ ☐ ☐ ☐ ☐ ☐ ☐ ☐ ☐</td>
</tr>
<tr>
<td>9. If applicable, were handout or advance preparation materials and prerequisites satisfactory?</td>
<td>☐ ☐ ☐ ☐ ☐ ☐ ☐ ☐ ☐ ☐</td>
</tr>
<tr>
<td>10. If applicable, how well did the audio/visuals contribute to the program?</td>
<td>☐ ☐ ☐ ☐ ☐ ☐ ☐ ☐ ☐ ☐</td>
</tr>
</tbody>
</table>

Please provide any constructive criticism you may have about the course materials, such as particularly difficult parts, hard to understand areas, unclear instructions, appropriateness of subjects, educational value, and ways to make it more fun. Please be as specific as you can.
(Please print legibly):

Additional Comments:
1. What did you find most helpful? 2. What did you find least helpful?
3. What other courses or subject areas would you like for us to offer?
4. Do you work in a Corporate (C), Professional Accounting (PA), Legal (L), or Government (G) setting? _________
5. How many employees are in your company? _________
6. May we contact you for survey purposes (Y/N)? If yes, please fill out contact info at the top of the page. Yes/No ☐ ☐

For more information on our CPE & Training solutions, visit trainingcpe.thomson.com. Comments may be quoted or paraphrased for marketing purposes, including first initial, last name, and city/state, if provided. If you prefer we do not publish your name, write in “no” and initial here _________