OFHEO

Examination Guidance

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Subject: Examination for Accounting Practices

To: OFHEO Director of Supervision
OFHEO Office of Director and Associate Directors
Chief Executive Officers of Freddie Mac and Fannie Mae

I. PURPOSE AND SCOPE.

This Guidance sets forth examination guidance and standards relating to the accounting practices of the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation (collectively, the Enterprises) consistent with the safety and soundness responsibilities of the Office of Federal Housing Enterprise Oversight (OFHEO) under the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 and the OFHEO corporate governance regulation, 12 CFR Part 1710.

II. REFERENCES.

a. Federal Housing Enterprises Financial Safety and Soundness Act of 1992.
b. Corporate Governance Regulation, 12 CFR Part 1710.
c. Stipulation and Consent to the Issuance of a Consent Order, between OFHEO and Freddie Mac, December 9, 2003.
e. Stipulation and Consent to the Issuance of a Consent Order, between OFHEO and Fannie Mae, May 23, 2006.
f. OFHEO Examination Guidance PG- 06-001, Examination for Corporate Governance (Nov. 8, 2006).
g. OFHEO Examination Guidance PG-06-002, Examination for Compensation Practices (Nov. 8, 2006).
h. New York Stock Exchange, Listed Company Manual, Corporate Governance Rules, as modified Nov. 3, 2004, Section 303A of the NYSE Listed Company Manual, as modified from time to time (NYSE rules).
i. Sarbanes-Oxley Act of 2002 (SOX).
j. Securities and Exchange Commission (SEC) Staff Accounting Bulletin 99 – Materiality
k. Securities and Exchange Commission Rule 13a-15, Controls and Procedures

l. Securities Exchange Act of 1934 Rule 10A-3, Standards Relating To Listed Company Audit Committees.

m. Securities and Exchange Commission Rule 2-01 of Regulation S-X, Qualifications of Accountants.

n. Public Company Accounting Oversight Board (PCAOB) Release No. 2003-006 Establishment of Interim Professional Auditing Standards.

III. DEFINITIONS.

For purposes of this Guidance:

a. Chief Accountant; OCA.

Chief Accountant means OFHEO's Chief Accountant or designee(s) of the Chief Accountant; OCA means the OFHEO Office of Chief Accountant.

b. Item of Regulatory Concern (IRC).

An Item of Regulatory Concern (IRC) is an item that may affect accounting policies and procedures, systems, controls, or reporting of an Enterprise, such as a new Financial Accounting Standards Board (FASB) standard or deficiencies in existing policies and procedures, systems, controls or reporting.

c. Item of Significant or Critical Regulatory Concern (ISCRC).

An Item of Significant or Critical Regulatory Concern (ISCRC) is an item that affects accounting policies and procedures, systems, controls or reporting of an Enterprise. The designation of significant or critical is made by OFHEO and signifies the degree of importance and the need for and timing of the item being addressed by the Enterprise, including any necessary remediation.

d. Material; materiality.

OFHEO recognizes that for public disclosures filed with the SEC, the materiality guidelines of the SEC should be employed.[1] OFHEO is informed by the SEC definitions and may consider them or employ them as part of its ongoing review of Enterprise accounting. A determination that an accounting matter is material or presents a materiality issue may be a factor in OFHEO oversight of an Enterprise. An item not being "material" or not having "materiality," however, does not supplant OFHEO's regulatory concerns that are defined in paragraphs III.b. and c.

[1] SEC Staff Accounting Bulletin 99 – Materiality.

IV. GUIDANCE.

a. Office of Chief Accountant.

1. General.

OCA advises the Director and OFHEO staff on all accounting matters related to the Enterprises. OCA develops policies regarding accounting and financial reporting and monitors accounting standards that affect the Enterprises and works with the Enterprises at a policy level on emerging issues. OCA develops and interprets examination guidance concerning Enterprise accounting policy and procedures, systems, reporting, and disclosure. OCA supports and coordinates accounting resources within OFHEO to assure the best and most efficient use of those resources. OCA supports other offices in providing consistent accounting policy interpretation across OFHEO and works with external constituencies on accounting issues; 12 CFR § 1700.2 (d)(8). Finally, OCA oversees Enterprise efforts to address accounting and accounting related issues such as those identified as an IRC or ISCRC.

2. Designation of staff member to receive notification or reports.

In designating an OFHEO staff member to receive notification or reports, the Chief Accountant may designate a staff member under his or her supervision or a staff member of another office within OFHEO, such as the Office of Examination or Office of General Counsel.

3. Additional accounting guidance.

Beyond the provisions of this Guidance, OCA will develop additional guidance, as needed, including but not limited to guidance to assure consistent application of Generally Accepted Accounting Principles (GAAP) by the Enterprises, where applicable and where the accounting change would be to a preferable method; and to provide additional examination guidance concerning Enterprise accounting policies, practices, procedures, and disclosures.

b. Enterprise accounting policies and procedures.

1. Development of policies and procedures.

Each Enterprise must establish a formal written procedure for development of accounting policy and create a system for full disclosure to the Audit Committee of the board of directors (Board Audit Committee) of these policies and the Enterprise's compliance with regulatory and GAAP requirements.

2. Policies and procedures to reflect GAAP.

Each Enterprise must establish and maintain accounting policies and procedures that properly reflect GAAP.

3. Establishment of accounting guide.

Each Enterprise should establish and maintain a complete and current accounting guide that lists all of the Enterprise's accounting policies and procedures, including a procedure for documenting the business purpose of all significant transactions. The accounting guide should be provided to the Chief Accountant within 90 days of the effective date of this Guidance and notification of any subsequent revisions, when undertaken, should be submitted to the Chief Accountant on a monthly basis or, in either case, at such later time as determined by the Chief Accountant.

4. Enforcement of Enterprise policies and procedures.

Each Enterprise is responsible for designing and maintaining internal control over financial reporting.[2] Each should ensure that controls exist for internal control over financial reporting including activities of the internal audit function, the audit committee and self-assessment programs. Furthermore, each Enterprise should require that employees and consultants comply with the policies and procedures established by the Enterprise.

5. Periodic review.

Each Enterprise should have a system in place to assure that accounting policies and procedures are continuously reviewed and updated to reflect current GAAP requirements, and should have proper procedures and processes in place to assure compliance.

6. Board Audit Committee oversight.

The Board Audit Committee is responsible for overseeing that Enterprise management establishes, implements, and maintains accounting policies and procedures that are in compliance with applicable law, regulation, guidance, and industry standards, including GAAP and other applicable reporting and disclosure standards.

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[2] SEC Rule 13a-15 (f) defines the term "internal control over financial reporting":

> as a process designed by, or under the supervision of, the issuer's principal executive and principal financial officers, or persons performing similar functions, and effected by the issuer's board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:
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> (1) Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the issuer;
>
> (2) Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the issuer are being made only in accordance with authorizations of management and directors of the issuer; and
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> (3) Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the issuer's assets that could have a material effect on the financial statements.

c. Board Audit Committee.

1. Establishment of the Board Audit Committee**.**

The board of directors of each Enterprise shall establish the Board Audit Committee. The Board Audit Committee shall be in compliance with the charter, independence, composition, expertise, duties, responsibilities, and other requirements set forth in section 301 of the SOX[3] and the NYSE rules;[4] 12 C.F.R 1710.12 (c).

2. Charter of the Board Audit Committee.

The charter of the Board Audit Committee shall**,** at a minimum, address the purpose of the Committee and the duties and responsibilities of the Committee as set forth in paragraphs IV.c.2.A. and B. below, and in compliance with the NSYE rules.

A. Purpose of the Board Audit Committee. The purpose of the Board Audit Committee, at a minimum, must be to:

i. Assist the board of director's oversight of the integrity of the financial statements, compliance with legal and regulatory requirements, the external auditor's qualifications, and performance of the internal audit function.

ii. Prepare a Board Audit Committee report as required by the SEC to be included in the annual proxy statement.

B. Duties and Responsibilities of the Board Audit Committee. The duties and responsibilities of the Board Audit Committee, shall, at a minimum, include:

i. Duties and responsibilities relating to annual review of internal quality control procedures of the external auditor; discussion of annual audited financial statements, earnings releases, and policies with respect to risk assessment and risk management; periodic meetings with management and external auditors; and setting clear hiring policies for employees or former employees of the external auditor.

ii. Responsibilities set forth in the Securities Exchange Act Rule 10A-3(b) relating to audit

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[3] Section 301 of SOX provides that each member of the audit committee shall be a member of the board of directors, and shall be independent. To be considered "independent", the member of the audit committee may not receive, other than for service on the board, any consulting, advisory, or other compensatory fee from the issuer (in this case the Enterprise), and may not be an affiliated person of the issuer (Enterprise). The audit committee shall be directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by the issuer (Enterprise). The audit committee shall establish procedures for the "receipt, retention, and treatment of complaints" regarding accounting, internal controls, and auditing. The audit committee has the authority to engage independent counsel and other advisors, and to provide for appropriate funding for payment to those advisors.

[4] The NYSE rules require that the audit committee have at least three members and satisfy Rule 10A-3 of the Securities Exchange Act of 1934.

committees, including establishing procedures for the receipt, retention, and treatment of complaints received by the Enterprise regarding accounting, internal accounting controls, or auditing matters; and confidential, anonymous submission by Enterprise staff members of concerns regarding questionable accounting or auditing matters.[5]

iii. Selecting, evaluating, and replacing the external auditor. The external auditor is ultimately accountable to the Board Audit Committee.

iv. Assuring that the external auditor submits a formal written statement regarding relationships and services which may adversely affect independence and for discussing with the external auditor any disclosed relationships that may impact objectivity and independence.

v. Overseeing internal audit activities, including decisions regarding the appointment or replacement of the chief audit executive who reports directly to the Board Audit Committee.

vi. Receiving, reviewing, and discussing reports from the external auditor on critical accounting policies and practices used, all alternative treatments of financial information within GAAP related to material items that have been discussed with management, ramifications of the use of such alternative treatments, and the treatment preferred by the external auditors.[6] The Board Audit Committee must review with the external auditor any difficulties the auditor encountered and management's response.

vii. Meeting periodically with management, internal auditors, and the external auditor.

viii. Providing for an annual evaluation of the Board Audit Committee.

C. Additional Responsibilities of the Board Audit Committee. The Board Audit Committee plays a critical role and, at a minimum, should:

i. Assure the development of policies and procedures for its approval and for notice to OFHEO of any accounting treatments or policies identified as having significant legal, reputation, or safety and soundness risk with a focus on accounting treatments or policies that do not employ GAAP or preferred methods.

ii. Approve and evaluate the staffing, budget, and audit plan of the internal audit function.

iii. Assure that management provides it with adequate information and reports to carry out its duties and responsibilities.

iv. Annually review the adequacy of its charter.

[5] Compliance with SEC Rule 10A-3(b)(2), (3), (4), and (5) relating to audit committee responsibilities is a requirement set forth in the Sec. 303A.07 of the NYSE rules.

[6] The term “material” is used here as defined in the SEC guidance referenced in footnote 1, above.

d. Independent internal audit function.

1. Establishment of Enterprise internal audit function.

A. General. An Enterprise shall maintain an internal audit function that is independent and objective in performing its activities. The internal audit function should have a charter approved by the Board Audit Committee. Performance of the internal audit function should be evaluated not less than annually.

B. Compensation. Compensation for the internal auditor should comport with OFHEO Examination Guidance PG-006-02, Examination for Compensation Practices (Nov. 8, 2006).

C. Reporting. The head of the internal audit function should report directly to the Board Audit Committee and administratively to executive management.

D. Access to Records. The internal audit function should have independent access to all internal records and systems, including the general ledger, of the Enterprise.

2. Reporting by the internal audit function.

The board of directors should assure that the internal audit function maintains open and direct communication with management and the Board Audit Committee. The head of the internal audit function should report periodically to the Board Audit Committee and senior management on internal audit's activities and performance. Reporting should include internal audit's assessment of significant risk exposures and control issues, corporate governance issues, and other matters needed or requested by the Board Audit Committee and senior management.

3. Internal audit staff.

A. Qualifications and Training. Each Enterprise should have policies and procedures in place to assure that technically competent internal audit staff members are hired and appropriate training and professional development is provided to such staff members so that they remain professionally competent and current with professional standards. OFHEO shall review such training and professional development and may provide additional guidance.

B. Understanding of Duties. Each Enterprise should have policies and procedures to assure that internal audit staff members clearly understand their duties. Those duties should include that they report where noted non-compliance of GAAP to appropriate management and the Board Audit Committee.

C. Quality Control. Each Enterprise shall develop and implement internal control procedures to assure that internal audit staff members follow internal policies and procedures.

e. Enterprise accounting staff.

1. Qualifications and training.

Each Enterprise should have policies and procedures in place to assure that technically competent accounting staff members are hired and that they are provided appropriate training and development so that they remain professionally competent and current in professional standards.

2. Understanding of duties.

Each Enterprise should have policies and procedures to assure that accounting members clearly understand their duties. Those duties should include reporting non-compliance of GAAP to appropriate management.

3. Quality control.

Each Enterprise should develop and implement internal control procedures to assure that accounting staff members follow internal accounting policies and procedures.

f. Financial statements.

[reserved]

g. Security of accounting information.

[reserved]

h. External auditor.

1. Board Audit Committee responsibilities with respect to the external auditor.

The Board Audit committee is responsible for assuring that adequate policies and procedures are in place so that the Board Audit Committee may assess the expertise and capacity of the external auditor to fulfill its duties and obligations; selecting, evaluating, and replacing the external auditor; and assuring that the external auditor submits a formal written statement regarding its relationships and services which may affect objectivity and independence.

2. Audit partner engagement.

An Enterprise may not accept audit services from an external auditor if the lead or concurring/coordinating audit partner who has primary responsibility for the external audit of the Enterprise, or if the audit partner who has responsibility for reviewing the external audit, has performed auditing services for the Enterprise in each of the five previous fiscal years; 12 CFR § 1710.18.

3. Auditing firm engagement.

A. Auditing Firm Change. Each Enterprise should change its external auditing firm no less frequently than every ten years to assure safe and sound operations of the Enterprise. The Director of OFHEO, or his or her designee, may waive or otherwise modify this requirement if he or she determines that the auditing firm change would be detrimental to safe and sound operations of the Enterprise.

B. Other Auditing Firm Change. Should an auditing firm change occur or be planned for other than the purposes of paragraph IV.h.3.A., the Enterprise should provide prompt notice to the Chief Accountant.

C. Auditing Firm Transition Plan. No later than one year prior to each auditing firm change required in paragraph IV.h.3.A., an Enterprise should submit to the Chief Accountant an accounting firm transition plan that addresses bidding and related processes, time schedules, operational problems, and other relevant facts, as may be requested by the Chief Accountant.

D. External Auditor Review. The Board Audit Committee should review the external auditor's engagement and other commitments of the auditing firm to the Enterprise to understand fully the work performed by the external auditor.

E. Communication with External Auditor. An Enterprise's audit engagement letter with the external auditor should provide that:

i. The external auditor may, upon the Chief Accountant's request, provide the Chief Accountant with access to senior audit partners on the engagement and any other personnel whom such partners deem necessary. The Chief Accountant also may have access to the external auditor's working papers prepared in the course of performing the services set forth in the engagement letter and the Chief Accountant may have such access to the external auditor without Enterprise personnel in attendance.

ii. The engagement letter should provide that the external auditor, without the approval of the Enterprise, may meet with the Chief Accountant with such frequency and about such matters as determined by the Chief Accountant, and may provide reports or other communications arising from the audit engagement directly to the Chief Accountant.

iii. The audit engagement letter should not contain provisions characterized as unsafe and unsound in the "Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions in External Audit Engagement Letter," 71 F.R. 6847 (February 9, 2006).

F. Matters covered by Reports or Communications. The matters covered by external auditor reports or communications referenced above in paragraph IV.h.3.E.ii. may include, but are not limited to:

i. Fraud involving senior management, and fraud (whether caused by senior management or other employees) that causes a material misstatement of the financial statements.

ii. Illegal acts that come to the external auditor's attention and has a significant impact on the financial statements or the external auditor's opinion on the financial statements.

iii. Adjustments arising from the audit that have a significant effect on the financial statements, identified by either the external auditor or management.

iv. Major issues that were discussed with management in connection with the initial or recurring retention of the external auditor including, and discussions regarding the application of accounting principles and auditing standards.

v. Disagreements with management over the application of accounting principles to the Enterprise's specific transactions and events that could be significant to the Enterprise's financial statements or the auditor's report.

vi. Processes used by management in formulating particularly sensitive accounting estimates and the basis for the auditor's conclusions regarding the reasonableness of those estimates.

vii. Initial selection of and changes in accounting polices, including critical accounting policies, alternative treatments within generally accepted accounting principles and the auditor's judgment about the quality of the Enterprise's accounting policies.

viii. Consultation by management with other accountants about auditing and accounting matters.

ix. External auditor's responsibility under GAAP for matters of interest in internal control and degree of assurance obtained about the financial statements.

x. Any serious difficulties encountered by the external auditor in dealing with management relating to the performance of the audit. Such difficulties may include significant matters involving, among other things, unreasonable delays by management in permitting the commencement of the audit or in providing needed information, whether the timetable set by management is unreasonable under the circumstances, unavailability of client personnel, and the failure of client personnel to complete schedules on a timely basis.

xi. A report by the external auditor describing in detail the auditing firm's internal quality-control procedures; any issues raised by the most recent internal quality-control review, peer review, or PCAOB inspection of the firm and any steps taken to deal with any such issues, including the auditing firm's letters of response to the peer review and PCAOB inspection reports. The Chief Accountant may meet with senior partners or representatives of the auditing firm to discuss the report by the independent auditor, peer review report, or PCAOB inspection report and various letters of response in understanding the firm's quality control procedures.

G. Independence of External Auditor. In oversight of an Enterprise's efforts to assure independence and fitness for service of external auditors, the Chief Accountant will consider carefully regulatory and professional independence requirements, including relevant facts and circumstances of specific conduct as well as factors of reputation risk, appearance of a lack of independence or impropriety, and the ability to perform responsibilities.[7]

H. Conflicts of Interest.

i. With respect to the auditing firm and in oversight of an Enterprise's efforts to assure fitness for service of external auditors, the Chief Accountant will consider carefully the responsibility and actions of a firm of external auditors to adopt and apply a system of quality control in conducting an audit practice consisting of policies, procedures, and code of conduct to address matters including, but not limited to outside employment, business relationships, confidentiality requirements, exchange of gifts and entertainment, contributions to charitable activities, community service, and state board licensing requirements addressing violations of professional standards of conduct, disciplinary action, or conviction of any felony and/or misdemeanor charge(s).

ii. With respect to the lead engagement team partner and concurring/coordinating partner, the Chief Accountant will consider and evaluate situations involving possible conflicts of interest with the Enterprise relative to professional and firm standards including, but not limited to outside employment, business relationships, exchange of gifts and entertainment, contributions to charitable activities and community service, and state board licensing requirements addressing violations of professional standards of conduct, disciplinary action, or conviction of any felony and/or misdemeanor charge(s).

i. Review of audit and accounting functions.

1. <u>Annual review by Board Audit Committee</u>**.**

At least annually, the Board Audit Committee should review, with appropriate professional assistance, the requirements of laws, rules, regulations and guidelines that are applicable to its activities and duties. The Board Audit Committee should provide the Chief Accountant with the materials and procedures employed in such review and should keep the Chief Accountant apprised of the progress of such review.

2. <u>General review</u>.

No less frequently than every five years, the Board Audit Committee should cause management to conduct an assessment of the Enterprise's accounting functions, including, but not limited to lines of reporting, independence of functions, segregation of duties, alignment of functions, roles and responsibilities, staff training and qualifications, key person dependencies, and adequacy of resources. Also, the Board Audit Committee should engage an external auditor to attest to and report on management's assessment. The external auditor should report its findings to the board of directors, senior management, and the Chief Accountant. The Chief

[7] The external auditor must meet the requirements of independence set forth by the PCAOB Release No. 2003-006 and in SEC Rule 2-01 of Regulation S-X.

Accountant shall review the appointment of the firm, the work plan for the engagement, and should have access to the external auditor during the engagement.

3. Targeted independent review.

No less frequently than every two years, the Board Audit Committee should cause an independent consultant or accounting firm to conduct a targeted evaluation of one or more accounting policy areas, such as, but not limited to derivatives, securitizations, amortization of premium and discount, and report its findings to the board of directors, senior management, and the Chief Accountant. The Chief Accountant shall review the appointment of the firm, the work plan for the engagement, and shall have access to the firm during the engagement.

V. ADDITIONAL MATTERS.

a. Guidance compliance report.

In addition to annual reports and other specific reports required by this Guidance, the board of directors should cause to be submitted a summary description of the Enterprise’s compliance with this Guidance (Guidance compliance report) to the Chief Accountant within 150 days of the publication date of the Guidance. The board of directors should assure that the Guidance compliance report includes a summary of the plans, policies, procedures, and organizational structure the Enterprise has developed and all other actions taken to comply with the provisions of this Guidance. The board should cause to be submitted annual updates to the initial report to the Chief Accountant.

b. Safety and soundness.

Any failure of the Enterprise to meet the terms of this Guidance, the OFHEO corporate governance regulation, or the NYSE rules may raise safety and soundness concerns and may be determined to constitute an unsafe and unsound practice.

c. Preservation of existing authority.

Nothing in this Guidance in any way limits the authority of OFHEO to otherwise address unsafe or unsound conditions or practices or violations of applicable law, regulation or supervisory order. OFHEO has the ability to act in the case of a poorly performing external auditor of an Enterprise at any time, not just at the time of a planned change. Action referencing the Guidance may be taken separate from, in conjunction with or in addition to any other enforcement action available to OFHEO. Compliance with the Guidance in general would not preclude a finding by the agency that an Enterprise is otherwise engaged in a specific unsafe or unsound practice or is in an unsafe or unsound condition, or requiring corrective or remedial action with regard to such practice or condition. That is, supervisory action is not precluded against an Enterprise that has not been cited for a deficiency under the Guidance. Conversely, an Enterprise's failure to comply with one of the supervisory requirements set forth in the Guidance may not warrant a formal supervisory response from OFHEO, if OFHEO determines the matter may be otherwise addressed in a satisfactory manner. For example, OFHEO may require the submission of a plan to achieve compliance with the particular requirement or standard.