Current Audit and Accounting Issues

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The GAAP Hierarchy

- FASB - Statements of Financial Accounting Standards (Level A)
- AcSEC - Statements of Position (Level B)
- EITF - Consensus (Level C)

Allowance for Loan and Lease Losses: The Saga Continues…..

- New Accounting Standards Executive Committee (AcSEC) Statements of Position (SOP) to be finalized in July 2002

- Objective: Provide additional guidance on accounting for, documentation of and disclosures relating to the ALLL that results in improvement in practice

Allowance for Loan and Lease Losses (Continued)

- Primary basis: SFAS 5 and 114
- Scope: All creditors
- Emphasis: Incurred loss is probable and estimable

AcSEC Conclusions

- The allowance should consist only of (a) a component for individual loan impairment (SFAS 114) and (b) components for collective loan impairment (SFAS 5)

Example:	Individually impaired (SFAS 114)	$ 50
	Collective Impairment (SFAS 5):	
	Commercial	404
	Consumer	211
	Other components (SFAS 5)	
	Consumer bankruptcy	32
	Industry exposure	56
	Total Allowance	$ 753

AcSEC Conclusions

- There may not be a distinct, single event
- Components should be measures using PV of expected future cash flows
- Loss emergence period is one technique for measuring incurred losses

AcSEC Conclusions (Continued)

- Observable data and directionally consistent notion
- Start with creditor’s own historical loss experience
- Use of peer data only if no experience of their own

AcSEC Conclusions (Continued)

- Unallocated not prohibited but <u>must have observable data</u>

- The amount of disclosures will definitely increase

- Effective for fiscal years beginning after December 15, 2003

SEC

- "…while the staff (SEC) understands the judgmental nature of allowances, the staff will challenge those that appear to be too low or too excessive, or appear inconsistent with the disclosures in the filing."

  1998 National Conference on

  Current SEC Developments

- Look for directional inconsistency

SEC

- Moving from concept of:

  "Allowance is sufficient to absorb losses"

- To:

  "Allowance is appropriate based on estimated losses"

SEC MD&A Comments

- Discuss changes in the provision for credit losses and how changes in risks in the portfolio during each period relate to the ALLL

- Quantify and explain how changes in loan concentrations, quality, and terms during the period are reflected in the ALLL

SEC MD&A Comments (Continued)

- Quantify and explain how changes in estimation methods and assumptions affected the allowance
- Quantify and explain why reallocations of the ALLL among different parts of the portfolio or different elements of the allowance occurred

SEC MD&A Comments (Continued)

- Quantify and explain how actual changes and expected trends in nonperforming loans affected the allowance
- Quantify and explain how the level of your ALLL compares with historical net loss experience
- Explain how you determine each element of the allowance

SEC MD&A Comments (Continued)

- Explain which loans are evaluated individually and which loans are evaluated as a group
- Explain how you determine the allocation of the allowance for loan losses
- Explain how you determine the loss factors applied to any graded loans

SEC MD&A Comments (Continued)

- Explain what self correcting mechanism is used to reduce differences between estimated and observed losses

Other ALLL Issue

- Probable and estimable losses for unfunded loan commitments are not to be included in the ALLL but in a separate liability account.

Changes Called for in the Wake of Enron

- Independent oversight of the accounting profession

- Banning the practice of the same firm providing both audit and non-audit services

- Improved quality of financial disclosure

Changes Called for in the Wake of Enron

- More timely disclosure
- Making corporate officers accountable
- Expansion of fraud guidance for U.S. auditors to follow in their effects to detect material misstatements due to fraud

Exposure Draft - Consideration of Fraud in a Financial Statement Audit

- Auditing Standards Board of AICPA expands fraud guidance for U.S. auditors to follow to detect material misstatements due to fraud

- Research demonstrates that the recording of fictitious entries through the override of management controls is a major source of fraud

Exposure Draft - Consideration of Fraud in a Financial Statement Audit (Continued)

- Research also confirms that material frauds often involve the manipulation of revenue

- The new standard requires
  - Expanded questioning of management and others
  - Review of how the audit committee exercises its oversight
  - Review audit procedures for detecting fraud

Internal Audit - The Key

- In the best position to detect fraud
- Independence and empowerment
- Comprehensive audit program
- Comment on the use of metrics

FASB 94 and ARB 51

- The legal entity is to be consolidated by the party that has a controlling financial interest in the entity.

- In some cases control is not clear as the legal documents establishing the SPE significantly limit its activities.

Two Types of SPEs

- Qualifying SPE (QSPE)
- Nonqualifying SPE (Non-SPE)

Qualifying SPE

- FASB 140 (successor to FASB 125)
- Can hold only financial assets transferred to it
- Demonstratively distinct from sponsor (at least 10% of the fair value of its beneficial interests is held by third parties

Qualifying SPE (Continued)

- Activities are limited to those contained in the SPE’s legal documents
- There are restrictions on the disposition of financial assets

Qualifying SPE (Continued)

- Although the sponsor “controls” an SPE by ownership of its residual interest, it need not consolidate if the SPE is a QSPE

  – Used mainly in securitizations where the QSPE serves to isolate the financial assets from the sponsor

Qualifying SPE (Continued)

- Follows the predefined list of activities allowed it, such as collects cash/remits it to investors and sponsors

- Is otherwise “brain dead”

Nonqualifying SPE

- SPEs that are not QSPEs
  - Hold title to physical assets
  - Make buy or sell decisions on financial assets
  - Own mortgaged property and lease to sponsor (synthetic leasing)

Nonqualifying SPE (Continued)

- To avoid consolidation, sponsor must meet three criteria (EITF Topic D-14)
  - An independent third party must have:
    - substantive capital (equity) ownership (at least 3% of total assets
    - Control of the SPE (more than 50% of the voting rights), and
    - Substantive risk and rewards of assets ownership

Nonqualifying SPE (Continued)

- A sponsor should consolidate a Non-QSPE, if (EITF Topic D-14)
  - The majority owner has only made a nominal investment
  - Activities of the SPE are virtually all for the sponsor, and
  - Substantive risks & rewards of assets and debts rest directly or indirectly with the sponsor or transferor

Future Accounting Guidance

- An SPE should be consolidated by its **Primary Beneficiary (PB)** when it lacks sufficient independent economic substance
  - An SPE is an entity that supports the PB's activities
  - A PB is the entity that retains or obtains the principal economic risks and benefits that arise from the SPE's activities

Future Accounting Guidance Continued)

- An SPE has sufficient independent economic substance if, at all times during its life, it has the ability to fund or finance its operations without assistance from the PB.

- An SPE has that ability if its owner(s) is an independent third party who has:

Future Accounting Guidance Continued)

– Substantive equity at risk (at least 10% capitalization)

– Substantive risks and rewards of ownership

– The ability to make decisions/manage the SPE

FASB 142 - Goodwill and Other Intangible Assets

- No amortization for:
  - Goodwill
  - Intangibles which have an indefinite useful life
- Annual impairment tests required
  - Can be more frequent if events or circumstances warrant

FASB 142 - Goodwill and Other Intangible Assets (Continued)

- Tested for impairment annually at the reporting unit level
- Necessary adjustments recorded where goodwill resides
- Impairment done at the same time every year but doesn’t have to be at year-end

FASB 142 - Goodwill and Other Intangible Assets (Continued)

- Two-step process
  - Compare the reporting unit's fair value with its carrying value
  - If the reporting unit's fair value exceeds its carrying amount, goodwill is not considered to be impaired and test is completed

FASB 142 - Goodwill and Other Intangible Assets (Continued)

- Step Two
  - Compare the implied fair value of the reporting unit goodwill with the carrying value of the goodwill
  - If less than the carrying value, record the difference as impairment
  - **Note: An impairment loss is never reversed in subsequent years**

FASB 142 - Goodwill and Other Intangible Assets (Continued)

- Subsequent year short-cut method
- Carry forward the fair value determination of a reporting unit to the next year if <u>**all**</u> criteria are met:
  - The unit's assets and liabilities have not changed significantly,

FASB 142 - Goodwill and Other Intangible Assets (Continued)

  - Fair value exceeded the carrying amount by a substantial margin, and

  - It is remote that an updated fair value would be less than the carrying amount of the reporting unit

- Documentation must be updated by management reflecting the above conclusions

FASB 72

- "Accounting for Certain Acquisitions of Banking or Thrift Institutions" 9/30/82
- Results in "unidentifiable intangible assets" which was scoped out of FASB 142
- FASB 72 goodwill amortization

FASB 72 (Continued)

- Over a period no greater than the estimated remaining life of the long-term interest bearing assets acquired

or

- Over the estimated remaining life of the existing customer deposit base acquired

FASB 72 (Continued)

- FASB 72 goodwill treatment conflicts with the goodwill treatment in FASB 142
- FASB agreed to reconsider guidance in paragraphs 5-7 of FASB 72 in another project
- On February 20, 2002, FASB removed stockholder-owned FIs from FASB 72 (paragraphs 5-7) for deals going forward

FASB 72 (Continued)

- FASB 141 and 142 will apply for all stockholder-owned FI combinations whether liabilities exceed assets or assets exceed liabilities

Regulatory Capital Treatment of Tax-Deductible Goodwill

- FASB 142 causes a difference in goodwill treatment for book versus tax
- No longer amortized for book purposes
- Still deductible for tax purposes

Regulatory Capital Treatment of Tax-Deductible Goodwill (Continued)

- Deferred tax liabilities created
- Goodwill still deducted (in its entirety) from Tier 1 capital
- FDIC, FRB, OCC, OTS have determined that trade group comments have merit and the agencies are looking closer at “net of tax” treatment