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Fact Sheet for the Chairman of the Subcommittee on Commerce, Consumer and Monetary Affairs, Committee on Government Operations, House of Representatives

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BANK REGULATION

Information on Independent Public Accountant Audits of Financial Institutions

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GENERAL GOVERNMENT
DIVISION

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The Honorable Doug Barnard, Jr.
Chairman, Subcommittee on Commerce,
Consumer and Monetary Affairs
Committee on Government Operations
House of Representatives

Dear Mr. Chairman:

This document responds to your February 8, 1985, request that we provide you with information to aid your subcommittee's assessment of the role played by public accounting firms in certifying financial statements and performing audits of financial institutions. One major objective of your request was for us to conduct an empirical study of six failed and open financial institutions that have undergone independent audits to determine if a workable methodology can be devised for analyzing the audit work done at a statistically valid sample of financial institutions. Your request envisioned that this pilot project would include reviews of audit products, such as audit reports and management letters, and of auditors' actual work papers.

As you know, we encountered difficulty in gaining access to auditors' work papers, which took several months of negotiation, and, in the case of two failed banks, access was denied (see table on page 7). You will recall that we do not have a legal right to access to auditors' work papers. We have briefed your staff several times on the status of our efforts to gain access to auditors' work papers, as well as on our progress in obtaining information from other sources. At one such briefing we mutually agreed that, given the access difficulties coupled with the probable inconclusive nature of anticipated results from pursuing the empirical study if we did gain access, a change in approach was warranted. We have worked with your staff to develop alternative work steps for gaining the type of information which will aid your subcommittee and have, in fact, developed much information. In this regard, the Staff Director for your subcommittee has asked that we provide you a written summary of our work results.

We have included in this fact sheet a table which provides detailed information on the responsibilities, policies, and procedures of four federal financial regulatory agencies concerning independent audits of the financial institutions they regulate (see p. 35). Other tables in the package show (1) the results of preliminary investigations, performed by an audit firm under contract with the Federal Deposit Insurance Corporation (FDIC), on the quality of audit work at failed banks (see pp. 45-49), (2) the status of FDIC's efforts to pursue monetary claims against independent accounting firms in cases where FDIC has provided monetary assistance to federally insured banks and believes that the accounting firms were negligent in work that they performed prior to the banks' needing assistance (see pp. 39-44), and (3) a description of monetary claims initiated by the Federal Home Loan Bank Board against audit firms for negligent work at thrift institutions (see p. 37). We have also included information which responds to your interest in accounting methods that the federal regulators prescribe in which regulatory accounting principles (RAP) are used rather than generally accepted accounting principles (GAAP). We have identified 21 such accounting issues and detailed how accounting treatment differs for those issues under RAP and GAAP (see pp. 8-34). Our package also contains additional tables that we believe will be useful to your subcommittee.

Our work was performed at 5 federal regulatory agencies--the FDIC, the Office of the Comptroller of the Currency, the Federal Reserve System, the Federal Home Loan Bank Board, and the Securities and Exchange Commission--as well as at a public accounting firm which performs, under contract with FDIC, investigations into the validity of accounting work that had been performed at banks which subsequently failed. We derived information concerning the federal regulatory agencies from (1) discussions with officials of the agencies, (2) examinations of the agencies' regulations and policy and procedure manuals, and (3) reviews of examination and related files at the agencies.

We obtained information on the accounting treatment prescribed by generally accepted accounting principles from Industry Audit Guides published by the American Institute of Certified Public Accountants and through discussions with members of the accounting profession.

We provided a draft of this fact sheet to officials of the FDIC, FRS, FHLBB, and OCC for comment. Each agency generally agreed with the facts we presented. We received written comments from the FDIC and the FHLBB (see app. I). In addition, each of the four agencies provided technical comments orally. We made changes to incorporate the agencies' comments where appropriate.

As arranged with your office, copies of this document are being provided to the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Home Loan Bank Board, and the Securities and Exchange Commission. Copies will also be available to other interested parties who request them. If you have any questions regarding the attached information, I can be reached on 275-8678.

Sincerely yours,

Craig A. Simmons
Associate Director

Contents

ABBREVIATIONS

AICPA	American Institute of Certified Public Accountants
APB	Accounting Principles Board
ARB	Accounting Research Bulletin
FASB	Financial Accounting Standards Board
FDIC	Federal Deposit Insurance Corporation

FHLBB	Federal Home Loan Bank Board
FRS	Federal Reserve System
FSLIC	Federal Savings and Loan Insurance Corporation
GAAP	Generally Accepted Accounting Principles
GAO	General Accounting Office
OCC	Office of the Comptroller of the Currency
RAP	Regulatory Accounting Principles
SEC	Securities and Exchange Commission
SFAS	Statement of Financial Accounting Standards
S&L	Savings and Loan Association

REGULATORY ACCOUNTING PRINCIPLES (RAP) THAT DIFFER FROM OR ARE EXTENSIONS OF GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (GAAP)

In order for financial information about a bank or any other economic entity to be useful, the information must be collected, aggregated, and reported according to a set of rules that is consistently applied and accessible to users of the financial information. To this end, the accounting profession recognizes "generally accepted accounting principles" (GAAP). GAAP incorporate the consensus within the accounting profession at a particular time on the appropriate recording of financial transactions and the proper external reporting of financial information.

Some users of financial information, such as federal regulatory agencies, however, have needs which they feel are met best through financial statements which may not conform entirely with GAAP. Such users often require that special purpose financial statements be prepared. The four federal regulatory agencies that regulate banks and thrift institutions--the Federal Home Loan Bank Board (FHLBB), the Federal Deposit Insurance Corporation (FDIC), the Federal Reserve System (FRS), and the Office of the Comptroller of the Currency (OCC)--do require special purpose financial statements from the financial institutions they regulate. Each of the four agencies, while requiring that regulated entities generally follow GAAP, has set forth a small number of reporting rules and regulations which depart from GAAP. The reporting rules and regulations which depart from GAAP are sometimes referred to as regulatory accounting procedures or regulatory accounting principles (RAP).

The regulatory agencies may promulgate RAP because they feel the financial services industry must deal with a specific type of accounting issue not fully covered by GAAP, or in order to obtain more consistent or comparable financial information for oversight purposes. For these and other reasons, regulatory officials believe that specific, limited departures from GAAP are sometimes necessary to adequately monitor and evaluate the safety and soundness of financial institutions.

A regulatory accounting principle may deviate from its GAAP counterpart in either of two ways. As we have defined them, differences from GAAP occur when RAP specify accounting methods--some of which are mandatory and some of which are optional--that are contrary to GAAP. Extensions of GAAP exist when GAAP allow flexibility in the accounting treatment of a particular transaction but RAP limit or restrict the accounting treatment to one or more particular GAAP methods. The "differences" cited in the former example produce financial information which does not conform with GAAP, while the "extensions" cited in the latter example result in financial information which does conform with GAAP.

PROFILE OF PILOT PROJECT SAMPLE

	Federal regulatory agency	Owned by holding company	Audit firm engaged to certify financial statements: Most recent	Prior	Date cooperation with GAO granted (G) or denied (D) by: Financial institution	Most recent audit firm	Prior audit firm
Failed S&L	FHLBB	No	Big 8	Non-Big 8	a	(G) 08-06-85	(G) 09-26-85[b]
Failed S&L[c]	FHLBB	No	Big 8	None	a	(G) 08-02-85	N/A
Failed Bank	OCC	Yes	Big 8	Big 8	a	(D) 08-19-85	08-09-85[d]
Failed Bank[e]	FDIC	No	Big 8	None	a	(D) 10-03-85	N/A
Problem Bank	OCC	Yes	Big 8	None	(G) f	(G) 08-19-85[g]	N/A
Problem Bank	FRS	No	Big 8	None	(G) 08-14-85	(G) 08-23-85	N/A
Non-Problem Bank	FDIC	Yes	Big 8	None	(G) 08-08-85	(G) 09-25-85	N/A
Open S&L[h]	FHLBB	Yes	Big 8	Non-Big 8	(G) 08-30-85	(G) 09-25-85	(G) 09-09-85

[a]No financial institution officials were contacted by GAO in the cases of financial institutions which failed or were forced to merge.

[b]This audit firm expressed a willingness to cooperate on August 16, 1985, but requested guidance from the AICPA's Ethics Division. The firm, acting on the AICPA's advice, contacted the successor Savings and Loan (S&L) and obtained the successor's concurrence before providing final consent.

[c]This failed S&L was added to the original sample of four banks and two S&Ls at the request of the Subcommittee because the FHLBB officials had refused to provide documents to GAO in cases where the FHLBB is pursuing, or is likely to pursue, a negligence claim against the audit firm. Neither failed S&L in the pilot project sample involves an FHLBB negligence claim against an audit firm.

[d]The prior audit firm for this failed bank said that it is willing to cooperate but that it cannot do so voluntarily without written consents from the FDIC and from the successors-in-interest to the failed bank. Because the most recent audit firm in this case has refused to cooperate, this matter was not further pursued with the prior audit firm.

[e]This failed bank was added to the original sample of four banks and two S&Ls because the most recent audit firm of the failed bank already in the sample had refused to cooperate with GAO.

[f]This bank has agreed to cooperate with GAO, but has made its cooperation contingent upon the acceptance of a set of procedures for protecting the identity and proprietary information of the bank which is to be formulated by the bank's external legal counsel. The procedures are to be contained in a two-party agreement. Tentative agreement has been reached on the content of the document, but it has not yet been formally executed.

[g]The most recent audit firm for this bank has agreed to cooperate with GAO, but its cooperation is contingent upon the bank's agreeing to cooperate.

[h]The FHLBB does not maintain a problem list. This S&L is considered to be a non-problem financial institution for purposes of meeting the guidelines provided in the Subcommittee's request letter concerning the makeup of the pilot project sample.

This document presents on pages 8 through 32 the accounting treatment prescribed by GAAP and RAP for 21 separate accounting issues where one or more of the financial institution federal regulators require or allow RAP treatment in place of GAAP treatment. The chart on page 8 summarizes the accounting treatment for all 21 issues, while pages 9 through 32 deal with each of the 21 issues individually. Excerpts representing GAAP are either taken directly from the source indicated or are summarized from that source material. Officials of the financial institution regulatory agencies provided the information concerning RAP and the reasons for requiring RAP. To the best of those officials' knowledge, the 21 accounting issues discussed in this document represent a complete listing for their respective agencies.

ACCOUNTING TREATMENT REQUIRED BY REGULATORY AGENCIES FOR ACCOUNTING ISSUES WHERE AT LEAST ONE FEDERAL REGULATOR REQUIRES RAP BE FOLLOWED

Accounting issue	Accounting treatment[a] prescribed for regulatory reports submitted to			
	FHLBB	FRS	FDIC	OCC
Basis of Accounting - Cash versus Accrual	RAP-D[b]	GAAP	GAAP	GAAP
Intangibles - Goodwill	RAP-X	RAP-X	RAP-X	RAP-X
Sale of Receivables with Recourse	GAAP	RAP-D	RAP-D	RAP-D
Securities Transactions - Trading Account	GAAP	RAP-D	RAP-D	RAP-D
Subordinated Debt Securities	RAP-D	GAAP	GAAP	GAAP
Sale and Leaseback	GAAP	RAP-D	RAP-D	RAP-X
Futures Contracts	RAP-D	RAP-D	RAP-D	RAP-D
Gains/Losses on Sales of Loans and Certain Securities	RAP-D[c]	GAAP	GAAP	GAAP
Acquisition, Development, and Construction Loan Transactions	RAP-D	GAAP	GAAP	GAAP
Appraised Equity Capital	RAP-D[d]	GAAP	GAAP	GAAP
Loan Origination Charges and Credits	RAP-D	GAAP	GAAP	GAAP
Premium/Discount on Purchase of Mortgage Loans	RAP-D	GAAP	GAAP	GAAP
Loan Commitment Fees	RAP-D	GAAP	GAAP	GAAP
Convertible Debt Securities	RAP-D[e]	GAAP	GAAP	RAP-D[e]
Recordation of Loss Reserves	RAP-D	GAAP	GAAP	GAAP
Sales of Real Estate Developed by the Association	RAP-D	GAAP	GAAP	GAAP
Wash Sales	RAP-D	GAAP	GAAP	GAAP
Net Worth Certificates	RAP D	N/A	RAP-D	N/A
Participations in Bankers Acceptances	N/A[f]	RAP-D[f]	RAP-D[f]	RAP-D[f]
In-Substance Defeasance	GAAP	RAP-D	RAP-D	RAP-D
Net Deferred Tax Charges	GAAP	GAAP	RAP-X	RAP-X

[a]GAAP indicates a generally accepted accounting principle for that accounting issue.

RAP-D indicates a regulatory accounting principle which differs from its GAAP counterpart for that accounting issue. For some issues, use of the principle is optional, for other issues, use of the principle is mandatory.

RAP-X indicates a regulatory accounting principle which is an extension of its GAAP counterpart for that accounting issue.

N/A indicates not applicable. Financial institutions reporting to that federal regulatory agency do not encounter that particular accounting issue.

[b]Thrifts with total assets of more than $10 million are required to follow GAAP.

[c]The FHLBB recently issued a rule change which requires that gains and losses realized from the sale of mortgages, mortgage-related securities, and debt securities acquired after 10/28/84 must be accounted for in accordance with GAAP.

[d]The FHLBB permits thrift institutions to record, one time only, any appreciation in the value of their office land, buildings, and improvements; however, they must do so before January 1, 1987.

[e]RAP applies only to federally chartered institutions. State-chartered thrifts follow GAAP.

[f]There is no official GAAP pronouncement regarding this issue.

BASIS OF ACCOUNTING - CASH VERSUS ACCRUAL (FHLBB)

GAAP

--The pervasive measurement principles establish the basis for implementing accrual accounting. [Accounting Principles Board (APB) Statement No. 4, "Basic Concepts and Accounting Principles," par. 144.]

RAP

--Insured institutions with total assets of $10 million or less are not required to use the accrual basis of reporting. [Federal Home Loan Bank Board (FHLBB) Annotated Manual of Statutes and Regulations, 5th Ed., sec. 563c.10.]

REASON

--A change to accrual accounting would be too costly and would require accounting expertise that small institutions cannot afford. (Note: only two institutions presently use cash basis accounting.)

INTANGIBLES - GOODWILL (FDIC, FRS, OCC, FHLBB)

GAAP

--A company should record as assets the cost of intangible assets acquired from others including goodwill acquired in a business combination. (APB Opinion No. 17, "Intangible Assets," par. 9.)

--Amortize intangible assets by systematic charges to income over the period estimated to be benefited, but the period of amortization should not exceed 40 years. (APB Opinion No. 17, "Intangible Assets," par. 9.)

--If, in such a [business] combination, the fair value of liabilities assumed exceeds the fair value of tangible and identified intangible assets acquired, that excess constitutes an unidentifiable, intangible asset. That asset shall be amortized to expense over a period no greater than the estimated remaining life of the long-term, interest-bearing assets acquired. However, if the assets acquired in such a combination do not include a significant amount of long-term, interest-bearing assets, the unidentifiable intangible asset (goodwill in this case) shall be amortized over a period not exceeding the estimated average remaining life of the existing customer (deposit) base acquired. Notwithstanding the other provisions of this paragraph, the period of amortization shall not exceed 40 years. [Statement of Financial Accounting Standards (SFAS) No. 72, "Accounting for Certain Acquisitions of Banking or Thrift Institutions," par. 5.]

--In a business combination under the purchase method, goodwill is generally amortized under the straight-line method. (APB Opinion No. 17, "Intangible Assets," par. 30; and Financial Accounting Standards Board (FASB) Interpretation No. 9, "Applying APB Opinions No. 16 and 17 'When a Savings and Loan Association or a Similar Institution Is Acquired in a Business Combination Accounted for by the Purchase Method,'" par. 9.)

RAP

--Requires the intangible asset to be amortized over a period not in excess of 15 years or the estimated useful life of the asset, whichever is less (FDIC, FRS, OCC).

--Allows bank holding companies to write off goodwill over a period of up to 25 years (FRS).

--On a case-by-case basis, allows amortization of goodwill on a straight-line basis, generally over a period of 25 years (FHLBB).

REASON

--Due to the current, volatile nature of the banking industry, the banking agencies believe that using a time period shorter than the 40 years allowed by GAAP better approximates the time period related to a customer base.

SALE OF RECEIVABLES WITH RECOURSE (FDIC, FRS, OCC)

GAAP

--A transfer of receivables with recourse shall be recognized as a sale if all of the following conditions are met:

a. The transferor surrenders control of the future economic benefits embodied in the receivables. Control has not been surrendered if the transferor has an option to repurchase the receivables at a later date.

b. The transferor's obligation under the recourse provisions can be reasonably estimated. Lack of experience with receivables with characteristics similar to those being transferred or other factors that affect a determination at the transfer date of the collectibility of the receivables may impair the ability to make a reasonable estimate of the probable bad debt losses and related costs of collections and repossessions. A transfer of receivables shall not be recognized as a sale if collectibility of the receivables and related costs of collection and repossession are not subject to reasonable estimation.

c. The transferee cannot require the transferor to repurchase the receivables except pursuant to the recourse provisions.

(SFAS No. 77, "Reporting by Transferors for Transfers of Receivables with Recourse," par. 5.)

RAP

--The transaction is considered to be a collateralized borrowing. Accordingly, the bank records the proceeds from the "sale" as a liability for borrowed money and continues to report the receivables "sold" as part of its assets (FDIC).

--Because of the recourse, it is not a sale but a financing (liability) (OCC).

--Because of the recourse, it is not a sale but a borrowing (liability) (FRS).

REASON

--The regulatory agencies look at the transaction in terms of risk--the seller retains a measure of liability as long as the recourse provision is outstanding; therefore, they require that the liability be disclosed.

SECURITIES TRANSACTIONS - TRADING ACCOUNT (FDIC, FRS, OCC)

GAAP

--Trading securities should be accounted for at current market value. (AICPA Industry Audit Guide--Audits of Banks, 1984 Ed., ch. 6, "Trading Securities," pp. 40-41.)

RAP

--The bank supervisory agencies permit banks to carry trading securities either at market value or at the lower of cost or market (FDIC, FRS, OCC).

REASON

--The supervisory agencies permit this option since use of the lower of cost or market results in more conservative valuations. It should be noted, however, that although institutions have the option of carrying trading securities at market value or at the lower of cost or market, the majority comply with GAAP because they perceive little or no benefit in using the lower of cost or market.

SUBORDINATED DEBT SECURITIES (FHLBB)

GAAP

--Federal regulations now permit the issuance of subordinated debt securities for terms of not less than 7 years. Subordinated debt securities issued by savings and loan associations should be classified as debt on the associations' statements of financial condition. Even though the securities may be wholly or partially considered as "net worth" for certain regulatory purposes, they are debt instruments that require repayment. (AICPA Audit and Accounting Guide - Savings and Loan Associations, 1985 Ed., ch. 3, "Accounting Principles and Auditing Procedures," p. 62.)

RAP

--The FHLBB allows subordinated debt securities to be recorded as a part of net worth for regulatory purposes. (FHLBB Annotated Manual of Statutes and Regulations, 5th Ed., sec. 561.13.)

REASON

--The claims of holders of subordinated debt securities are subordinate to the claims of the FSLIC. Therefore, the FHLBB, in evaluating the risk to the FSLIC, considers the subordinate nature and long term of the securities and regards them as part of net worth for regulatory purposes. (Note: Debt subordinated to a subsidiary is accounted for as debt.)

SALE AND LEASEBACK (FDIC, FRS, OCC)

GAAP

--If the seller-lessee retains, through a leaseback, substantially all of the benefits and risks incident to the ownership of the property sold, the sale-leaseback transaction is merely a financing. Therefore, the seller-lessee should not recognize any profit if the related leaseback of the entire property sold meets one of the following criteria for classification as a capital lease:

a. The lease transfers ownership of the property to the lessee by the end of the lease term.

b. The lease contains a bargain purchase option.

c. The lease term is equal to 75 percent or more of the estimated economic life of the leased property. However, if the beginning of the lease term falls within the last 25 percent of the total estimated economic life of the leased property, including earlier years of use, this criterion shall not be used for purposes of classifying the lease.

d. The present value at the beginning of the lease term of the minimum lease payments, excluding that portion of the payments representing executory costs to be paid by the lessor, including any profit thereon, equals or exceeds 90 percent of the excess of the fair value of the lease property to the lessor at the inception of the lease over any related investment tax credit retained by the lessor and expected to be realized by him. However, if the beginning of the lease term falls within the last 25 percent of the total estimated economic life of the leased property, including earlier years of use, this criterion shall not be used for purposes of classifying the lease. A lessee shall compute the present value of the minimum lease payments using his/her incremental borrowing rate, unless (i) it is practicable for him/her to learn the implicit rate computed by the lessor and (ii) the implicit rate computed by the lessor is less than the lessee's incremental borrowing rate. If both of those conditions are met, the lessee shall use the implicit rate.

(SFAS No. 13, "Accounting for Leases," par. 7; and SFAS No. 28, "Accounting for Sales with Leasebacks," par. 17.)

RAP

--Some "sales" between related or quasi-related parties are being questioned by regulatory agencies and modifications to RAP treatment have been initiated. If the substance of the transaction indicates it is not a sale:

- FDIC and FRS require gain to be deferred and amortized over a period of not less than 10 years.
- OCC requires gain to be deferred and amortized over the remaining life of the asset.

REASON

--The RAP requirements are intended to reflect the substance of a transaction and to prevent abuse. Without such requirements, gain on a short-term sale/leaseback could be recognized in as short a period as a year.

FUTURES CONTRACTS (FDIC, FHLBB, OCC, FRS)

GAAP

--In August 1984, SFAS No. 80 was issued to provide guidance on the accounting for futures transactions. This document starts with the premise that a futures transaction is speculative and requires that two tests be met in order for a company to be able to use hedge (or deferral) accounting:

a. The item to be hedged exposes the entity to interest-rate risk.

b. The futures contract reduces the exposure and is designated as a hedge.

The accounting for changes in the value of futures contracts is as follows:

a. A change in the market value of a futures contract that qualifies as a hedge of an existing asset or liability shall be recognized as an adjustment of the carrying amount of the hedged item.

b. If the hedged item is carried at fair value, gains and losses are recognized in the period that the change occurs.

(SFAS No. 80, "Accounting for Futures Contracts," pars. 4, 5, and 6.)

RAP

--Regulations permit the deferral of any gain or loss arising from a futures transaction if the transaction was designed to reduce the institution's exposure to interest-rate risk. (FHLBB Annotated Manual of Statutes and Regulations, 5th Ed., sec. 563.17-4.)

--"Futures" should be valued consistently at either market value or the lower of cost or market. Gains and losses should generally be recognized in the period that the change occurs and be reported as other noninterest income or expense. Hedge accounting is not permitted (FDIC, OCC, FRS).

REASON

--At the time these regulatory accounting principles were instituted, SFAS No. 80 had not been formally issued, so the regulators adopted policies they felt were most appropriate in the circumstances. (Note: This policy is presently being studied by FDIC, FHLBB, FRS, and OCC, and new regulations are expected that conform more closely to GAAP.)

GAINS OR LOSSES ON SALES OF LOANS AND CERTAIN SECURITIES (FHLBB)

GAAP

--Profits on the sales of assets are recognized when the transactions are complete and realization of the profit is reasonably assured. (Accounting Research Bulletin No. 43, ch. 1A, "Rules Adopted by Membership," par. 1.)

--Losses on the sales of assets must be recognized immediately. (APB Statement No. 4, "Basic Concepts and Accounting Principles," par. 160.)

RAP

--If an election has been made by the board of directors, all gains and losses from the sales of loans and certain securities during a fiscal year may be deferred. The minimum annual amortization of the gain or loss to income may be determined by using the straight-line or interest method of amortization over a period no longer than the average remaining contractual lives of the disposed assets. If long term (contractual maturity of 10 years or more), deep discount (discount greater than 10 percent) loans or securities are acquired during a period 6 months prior or subsequent to the date of disposition from which a gain or loss is deferred, the discount associated with such purchases (to the extent of investment of the proceeds of the disposition) must be amortized to income over an approved period and by an approved method which are the same as those used for the deferred gains or losses arising during the 12-month period. Unamortized deferred amounts arising in any fiscal year may be included in current income if an association's board of directors revokes any prior election(s) to defer and amortize gains and losses. (Note: The FHLBB recently ruled that gains and losses realized from the sale of mortgages, mortgage-related securities, and debt securities acquired after 10-28-84 must be accounted for in accordance with GAAP.)

(FHLBB Annotated Manual of Statutes and Regulations, 5th Ed., sec. 563c.14, and Memo R 57.)

REASON

--Originally, the regulation was adopted to permit institutions wishing to restructure their portfolios by selling old, low-yielding mortgages to stretch out the resulting losses, rather than recognize the losses at the time of the sale. The FHLBB's recent change, however, was in response to some institutions having used the technique to artificially enhance earnings.

ACQUISITION, DEVELOPMENT, AND CONSTRUCTION LOAN TRANSACTIONS (FHLBB)

GAAP

--Use net realizable value when assessing the recoverability of the asset. Net realizable value is the expected amount of net cash or other net equivalent to be received from the sale of the asset in the regular course of business. ("Notices to Practitioners," Feb. 1986.)

RAP

--Use "as is" market value when assessing the recoverability of the asset. Market value represents a normal consideration, in cash or its equivalent, for the property sold, unaffected by special financing amounts, fees, costs, or credits incurred in the transaction. (FHLBB Annotated Manual of Statutes and Regulations, 5th Ed., Memo R 41b.)

REASON

--The FHLBB believes that use of market value provides for more conservative financial ratios than use of net realizable value.

APPRAISED EQUITY CAPITAL (FHLBB)

GAAP

--Plant and equipment should not be written up by an entity to reflect appraised, market, or current values which are above cost to the entity. (APB Opinion No. 6, "Status of Accounting Research Bulletins," par. 17.)

RAP

--The FHLBB permits thrift institutions to record, one time only, any appreciation in the value of their office land, buildings, and improvements; but the recording of this appreciation as both a fixed asset and an increase in capital has to be done before January 1, 1987 (FHLBB).

REASON

--Appraised equity capital is the amount by which the fair market value of an institution's office properties exceed the related aggregate book value. The FHLBB permits institutions to record the asset appreciation in order to increase the institutions' regulatory net worth.

LOAN ORIGINATION CHARGES AND CREDITS (FHLBB)

GAAP

--Generally, loan origination and acquisition charges are to be expensed, and origination and acquisition credits not in excess of underwriting costs should be recognized as income at the time the loans are made. Any fees in excess of that amount should be accounted for as an adjustment of the yield. Unamortized credits remaining after the loan is funded should be amortized to income over the loan period by application of the interest method. (AICPA Audit and Accounting Guide - Savings and Loan Associations, 1985 Ed., ch. 3, "Accounting Principles and Auditing Procedures," pp. 74-75; and SFAS No. 65, "Accounting for Certain Mortgage Banking Activities," pars. 14 and 21.)[a]

RAP

--Loan origination and acquisition charges are to be expensed. Credits of up to 2 percent of the loan amount plus $400 (or 2.5 percent plus $400 for construction loans) may be recognized as income in the current period, credits in excess of those amounts are to be deferred and amortized to income over not less than 10 years (or such shorter term if the contract term of the loan, including mandatory renewals, is less than 10 years). Amortization of deferred credits must be taken to income when the related loan is sold and may optionally be taken to income when a loan is paid off prior to maturity. (FHLBB Annotated Manual of Statutes and Regulations, 5th Ed., sec. 563.23-1.)

REASON

Underwriting costs include a variety of administrative and overhead expenses and as such would require savings and loans to maintain detailed cost accounting procedures in order to conform to GAAP. The FHLBB does not believe that the benefits derived from calculating the underwriting costs justify the additional time and expense of maintaining the cost accounting procedures.

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[a]The FASB has issued for public comment a December 31, 1985, exposure draft of a proposed Statement of Financial Accounting Standards entitled "Accounting for Nonrefundable Fees and Costs Associated with Originating and Acquiring Loans" (file reference no. 014), which, if adopted as drafted, would affect the GAAP-prescribed treatment of this issue. It would not, however, eliminate differences between GAAP treatment and RAP treatment of this issue, according to an FHLBB official.

PREMIUM OR DISCOUNT ON PURCHASE OF MORTGAGE LOANS (FHLBB)

GAAP

--Premiums and discounts are to be amortized over the estimated remaining lives of the loans using the interest method. However, purchase discounts shall not be amortized as interest revenue during the period the loans are held for sale. (SFAS No. 65, "Accounting for Certain Mortgage Banking Activities," pars. 5 and 6.)[a]

RAP

--Premiums paid relative to the purchase of loans may be charged off when paid or deferred over not more than 10 years. Discounts from such purchases are to be amortized over not less than 10 years. For both premiums and discounts, amortization over shorter periods is permissible if the related loans have shorter lives. Amortization must be by the interest method. (FHLBB Annotated Manual of Statutes and Regulations, 5th Ed., sec. 563.23-1.)

REASON

--The FHLBB believes the above amortization requirements best approximate the life of outstanding mortgage loan portfolios. The FHLBB cited a recent study conducted by the Federal Home Loan Mortgage Corporation and the Government National Mortgage Association which concluded that mortgage loans remain outstanding an average of 12 years.

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[a]The FASB has issued for public comment a December 31, 1985, exposure draft of a proposed Statement of Financial Accounting Standards entitled "Accounting for Nonrefundable Fees and Costs Associated with Originating and Acquiring Loans" (file reference no. 014), which, if adopted as drafted, would affect the GAAP-prescribed treatment of this issue. It would not, however, eliminate differences between GAAP treatment and RAP treatment of this issue, according to an FHLBB official.

LOAN COMMITMENT FEES (FHLBB)

GAAP

--The accounting for recognition of income from commitment fees should be based on the nature and substance of the transactions. Amounts equal to direct underwriting costs should be recognized as income at the time the commitment fee becomes a contractual obligation. The balance of any fees received is to be deferred and amortized to income.

a. A floating rate commitment is defined as a commitment to provide financing at the market interest rate to be determined at the time the loan is drawn down or the purchase transaction is to be settled. A floating rate commitment fee, in excess of direct underwriting costs, should be deferred and amortized over the commitment period using the straight-line method of amortization.

b. A fixed rate commitment is defined as a commitment to provide financing at an interest rate determined at the time the commitment is made. Such a fee, in excess of direct underwriting costs, should be deferred and amortized over the combined commitment and loan period (the average loan life expectancy for a particular category of loans). The straight-line method of amortization should be used during the commitment period. When the loan is drawn down or the purchase transaction settled, the current market interest rate should be compared with the contract interest rate on the loan. If the current market interest rate is the same as or lower than the contract interest rate on the loan, the remaining unamortized fixed rate commitment fee should be recognized as income. If the current market interest rate at the time the loan is drawn down or the purchase transaction is settled is higher than the contract interest rate on the loan, the remaining unamortized fixed rate commitment fee should be deferred and amortized over the loan period using the interest method.

GAAP (Continued)

c. Unamortized commitment fees should be recognized as income at the end of the commitment period if the loan is not funded.

(AICPA Audit and Accounting Guide - Savings and Loan Associations, 1985 Ed., ch. 3, "Accounting Principles and Auditing Procedures," pp. 70-73.)[a]

RAP

--Commitment fees can be recognized as income as follows.

Commitment Period	Maximum Income
6 to 12 months	1% of the loan commitment
12 to 18 months	1.5% of the loan commitment
over 18 months	2% of the loan commitment

Any excess fees received are to be deferred and considered as additional origination and acquisition credits using the interest method. (FHLBB Annotated Manual of Statutes and Regulations, 5th Ed., sec. 563.23-1.)

REASON

--Underwriting costs include a variety of administrative and overhead expenses and as such would require savings and loans to maintain detailed cost accounting procedures in order to conform to GAAP. The FHLBB does not believe the benefits to be derived from calculating the underwriting costs justify the additional time and expense of maintaining the cost accounting procedures.

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[a]The FASB has issued for public comment a December 31, 1985, exposure draft of a proposed Statement of Financial Accounting Standards entitled "Accounting for Nonrefundable Fees and Costs Associated with Originating and Acquiring Loans" (file reference no. 014), which, if adopted as drafted, would affect the GAAP-prescribed treatment of this issue. It would not, however, eliminate differences between GAAP treatment and RAP treatment of this issue, according to an FHLBB official.

CONVERTIBLE DEBT SECURITIES (FHLBB, OCC)

GAAP

--Assets acquired in exchanges are measured at the exchange price, that is, at acquisition cost. (APB Statement No. 4, "Basic Concepts and Accounting Principles," par. 181, M-1A.)

--If the market price of marketable securities classified as current assets is less than cost and it is evident that the decline is not due to a temporary condition, a loss is recorded when the price declines. (APB Statement No. 4, "Basic Concepts and Accounting Principles," par. 183, S-5B.)

RAP

--Federally chartered institutions are required to carry convertible debt securities at an amount not in excess of "the amount which represents the investment value of the security considered independently of the conversion feature." The amount in excess of the investment feature, that is, the amount which represents the conversion feature in the transaction, is to be charged to expense upon acquisition of the convertible debt security. (FHLBB Annotated Manual of Statutes and Regulations, 5th Ed., sec. 545.75(b)(4).)

REASON

--RAP provides a more conservative approach to recording historical cost because the value of the conversion feature cannot be considered as part of the convertible debt securities' cost. Although federally chartered institutions are permitted to invest in and hold corporate debt securities which are convertible into stock, the institutions are prohibited from (1) purchasing such securities if the conversion into stock is at the option of the issuer, and (2) exercising such a conversion feature, themselves, on securities which they hold.

RECORDATION OF LOSS RESERVES (FHLBB)

GAAP

--The following two conditions must be met for a loss contingency to be accrued as a charge to income as of the date of the financial statements:

a. it is probable that an asset has been impaired or a liability incurred--it is implicit in this condition that it must be "probable" that one or more future events will occur to confirm the loss, and

b. the amount of the loss can be reasonably estimated.

(SFAS No. 5, "Accounting for Contingencies," par. 8.)

RAP

--Examiners or supervisory agents may order appraisals on assets held by an institution (or its service corporation). If the appraisal discloses that the asset is over-valued (except for over-valuations that result from changes in interest rates), the institution, at the direction of the supervisory agent, must make an adjustment to the book value of the asset. The adjustment may be made by either a charge against earnings or a charge against surplus, undivided profits, or reserves established solely for absorbing losses. (FHLBB Annotated Manual of Statutes and Regulations, 5th Ed., sec. 561.16c and sec. 563.17-2.)

REASON

--The FHLBB adopted the regulatory accounting principle to assure that thrift institutions provide a conservative financial picture in their regulatory reports.

GAAP

--Detailed guidelines are set forth in the Statement of Financial Accounting Standards No. 66, "Accounting for Sales of Real Estate." Transactions must generally meet the following tests for profit recognition:

a. a sale is consummated (as defined in the document);

b. minimum down payment is made by the purchaser;

c. there is a continuing investment in the property by the purchaser;

d. the seller's receivable is not subject to future subordination; and

e. the seller has transferred to the buyer the usual risks and rewards of ownership in a transaction that is in substance a sale, and the seller does not have a substantial continuing involvement with the property.

(SFAS No. 66, "Accounting for Sales of Real Estate," par. 5.)

--The buyer's initial investment shall be adequate to demonstrate the buyer's commitment to pay for the property and shall indicate a reasonable likelihood that the seller will collect the receivable. Lending practices of independent established lending institutions provide a reasonable basis for assessing the collectibility of receivables from buyers of real estate. Therefore, to qualify, the initial investment shall be equal to at least a major part of the difference between usual loan limits and the sales value of the property. (SFAS No. 66, "Accounting for Sales of Real Estate," par. 11.)

RAP

--If the sale results in a profit and the institution has not made, acquired, or committed to make or acquire a loan, for any purpose to the purchaser, the profit may be recognized as income during the accounting period in which the sale occurs, just as GAAP allows.

--If the sale results in a profit and the institution has made, acquired, or committed to make or acquire a loan, the sole purpose of which is to finance the purchase of the real estate, the profit may be recognized during the accounting period in which the sale occurs only if:

a. the institution has not made, acquired, or committed to make or acquire any other loan to the purchaser of the real estate that is unsecured or that is secured by that real estate; and

b. the loan is secured by a first lien on the real estate and conforms to the FHLBB's regulations as to maturity, loan-to-value ratio, and other restrictions. Generally the FHLBB limits the allowable loan-to-value ratio to 90 percent; however, in conformance with the Garn-St Germain Act, it will sometimes allow ratios up to 100 percent, which does not conform to GAAP minimum down payment criteria for profit recognition.

(FHLBB Annotated Manual of Statutes and Regulations, 5th Ed., sec. 563.23-1.)

REASON

--The Garn-St Germain Act permits savings and loans, generally, to carry up to 100 percent loan-to-value ratios.

WASH SALES (FHLBB)

GAAP

--When a bank sells a security and concurrently reinvests the proceeds from the sale in the same or substantially the same security, no sale should be recognized, since the effect of the sale and repurchase transaction leaves the bank in essentially the same position as before, notwithstanding the fact that the bank has incurred brokerage fees and taxes. (AICPA Industry Audit Guide - Audits of Banks, 1984 Ed., ch. 5, "Investment Securities," p. 33.)

RAP

--Gains and losses from wash sales should be recognized currently. (FHLBB Annotated Manual of Statutes and Regulations, 5th Ed., Memo T 59-8.)

REASON

--The FHLBB views wash sales as completed transactions and therefore requires current accounting recognition of any gains or losses.

NET WORTH CERTIFICATES (FDIC, FHLBB)

GAAP

--The Financial Accounting Standards Board tentatively concluded that the FHLBB's promissory note does not meet the profession's definition of an asset and that the FHLBB's net worth certificate should, therefore, not increase an institution's net worth. Similarly, the American Institute of Certified Public Accountants (AICPA) concluded that the FDIC's promissory note did not meet the definition of an asset. The AICPA concluded that the exchange of FDIC's promissory note for a bank's net worth certificate under FDIC's program does not involve the payment of any consideration and that the note is realizable only if the bank is liquidated. [FASB, "Announcements of Board Actions and Forthcoming Meetings," No. 83-46, Nov. 23, 1983; and GAO report, Net Worth Certificate Assistance Programs: Their Design, Major Differences, and Early Implementation (GAO/GGD-85-8, Nov. 5, 1984).]

RAP

--As required by the Garn-St Germain Depository Institutions Act of 1982 (Public Law 97-320), savings banks record net worth certificates as part of their capital accounts. (Commercial banks have not issued net worth certificates.) (FDIC).

--The promissory note is recorded as an asset, and the net worth certificate is included as net worth (FHLBB).

REASON

--Statutory provisions require that net worth certificates be considered net worth for regulatory purposes.

PARTICIPATIONS IN BANKERS ACCEPTANCES (FRS, FDIC, OCC)

GAAP

--No official GAAP pronouncement in this area.

RAP

--Bankers acceptances are recorded on the books at the full amount regardless of any participations sold (FRS, FDIC, OCC).

REASON

--The three bank regulatory agencies do not allow institutions to reduce the acceptances by the amount of any participations sold because the lead bank remains legally responsible for paying the acceptance at maturity.

IN-SUBSTANCE DEFEASANCE (OCC, FRS, FDIC)

GAAP

--A debtor shall consider debt to be extinguished for financial reporting purposes if the debtor irrevocably places cash or other assets in a trust to be used solely for satisfying scheduled payments of both interest and principal of a specific obligation and if the possibility that the debtor will be required to make future payments with respect to that debt is remote. In this circumstance, debt is extinguished even though the debtor is not legally released from being the primary obligor under the debt obligation. (SFAS No. 76, "Extinguishment of Debt," par. 3.)

RAP

--The debt continues to be recorded as a liability (OCC).

--The debt is reported as a liability of the bank, and the assets held in trust are reported as assets of the bank (FDIC).

--Bank holding companies as well as state member banks record the debt as a liability (FRS).

REASON

--The three bank regulatory agencies require the debt to be recorded as a liability because the debtor has not been released as the primary obligor of the debt.

NET DEFERRED TAX CHARGES (FDIC, OCC)

GAAP

--The deferred method of allocation is a procedure whereby the tax effects of current timing differences between tax and financial accounting are deferred and allocated to income tax expense of future periods when the timing differences reverse. The deferred method emphasizes the tax effects of timing differences on income of the period in which the differences originate. The deferred taxes are determined on the basis of the tax rates in effect at the time the timing differences originate and are not adjusted for subsequent changes in tax rates or to reflect the imposition of new taxes. The tax effects of transactions that reduce taxes currently payable (or create a refund of taxes because of a loss carryback) are treated as deferred tax credits; the tax effects of transactions that increase taxes currently payable (or reduce the amount of a refund of taxes because of a loss carryback) are treated as deferred tax charges. Such deferred credits and charges are amortized to income tax expense in future years as the original timing differences reverse and enter into the determination of pretax accounting income. (FASB Accounting Standards, Current Text, General Standards as of June 1, 1985, sec. I24 entitled, "Income Taxes: Deferred Taxes and Tax Allocation," par. I24.502.)

RAP

--The OCC and the FDIC have limited the extent to which a bank is permitted to carry net deferred tax charges as assets on its reports of condition. Such assets may not exceed taxes previously paid by the bank which are potentially available through carryback of net operating losses. (Comptroller of the Currency Banking Circular BC-202 entitled "Accounting for Net Deferred Tax Charges," and FDIC Bank Letter BL-36-85 on "Accounting for Net Deferred Tax Charges.")

REASON

--Due to changes in the tax law and in the economic environment, an increasing number of banks have been taking bad debt deductions on their tax returns which are less than the loan loss provisions reflected in their financial statements. This results in the banks' (1) reporting higher net income to the taxing authorities than is reflected in their Reports of Income filed with the regulatory agencies and (2) carrying net deferred tax charges as an asset on their reports of condition. Supervisory concerns have arisen since this accounting treatment may have the effect of overstating the level of a bank's capital when the realizability of this asset is in question.

SUMMARY OF FEDERAL FINANCIAL REGULATORY AGENCIES' STATUTORY OBLIGATIONS, POLICIES, AND PROCEDURES REGARDING INDEPENDENT AUDITS OF CONSTITUENT FINANCIAL INSTITUTIONS

Federal agency	Statutory obligations of agency	Requirement for independent audits	Guidance provided on proper scope of audits	Monitoring/ supervision of audits	Review of audits upon completion	Review of audits during supervisory examinations	Use/reliance on audit reports by examiners	Administrative actions against audit firms for deficient work	Investigation of audit work when financial institution fails
FDIC	None	No requirements but encourages all supervised banks to have annual audits	None	None	None	None as to adequacy of audit work; examiner notes in examination report whether bank has acted on audit recommendations made	Examiner may consider auditor comments in planning scope and identifying weaknesses	None	If FDIC-insured, preliminary investigation to consider adequacy of audit work, and, where warranted, in-depth investigation follows, which may result in claim against audit firm
OCC	None	Requires annual audits for some problem, and generally all new, national banks	Should be of sufficient scope for auditor to express an opinion on financial statements	None	None	Review of adequacy of audit work to determine amount of reliance to place on it during exam	Examiner may rely to some extent on audit work and may use auditor comments to help identify weaknesses	None	No investigation by OCC, but OCC may provide information to FDIC for its investigation
FRS	None	Has annual requirement for bank holding companies with consolidated assets of $150 million or more, encourages all supervised banks and bank holding companies to have annual audits	None	None	None	Review of adequacy to determine reliance; examiner also notes if bank acted on audit recommendations and if bank changed auditors and bank's reason for change	Examiner may consider auditor comments in planning scope and identifying weaknesses	None	No investigation by FRS, but FRS may provide information to FDIC for its investigation
FHLBB	None	Requires all FSLIC-insured thrifts to be audited annually by external or internal auditors who must be independent	Sets some standards	None	Review of all audit reports and management letters by District Directors	None as to adequacy of audit work; examiner notes the name of the independent auditor and the date of the last audit	Examiner may consider auditor comments in planning scope and identifying weaknesses	Some administrative actions taken, including rejection of audit reports and disqualification of audit firms	District Director reviews audit work, makes recommendation regarding negligence to Chief Accountant at Headquarters, who then reviews case and determines if claim should be undertaken

Source: Federal banking and securities laws were reviewed and officials of the four federal regulatory agencies were consulted concerning statutory obligations of the agencies. Policies and procedures are contained in the agencies' examination and policy manuals.

NUMBER OF FEDERALLY INSURED THRIFTS WHICH CLOSED OR WERE FORCED TO MERGE AND REQUIRED FINANCIAL ASSISTANCE FROM THE FSLIC, BY CALENDAR YEAR, FOR THE YEARS 1980 THROUGH 1985

Year thrifts closed or were merged	Number of thrifts
1980	11
1981	28
1982	76
1983	54
1984	27
1985	33
TOTAL	229

Source: The FSLIC's Analysis and Evaluation Division provided the information from which this table was derived.

FHLBB CLAIMS BASED ON ACCOUNTANTS' LIABILITY IN CASES WHERE THRIFTS HAVE FAILED OR HAVE MERGED WITH FSLIC ASSISTANCE DURING THE PERIOD FROM 1/1/80 THROUGH 12/31/85, INCLUSIVE

Year thrift failed or was merged	Audit deficiencies on which claim is based	Audit work done at thrift[a]	Size of audit firm[b]	Status of FSLIC claim
1981	Failure to discover unauthorized trading	Opinion audit	Big 8	Settled for approximately $2 million
1982	Failure to follow generally accepted auditing standards, particularly with regard to internal control and confirmation of share loans	Opinion audit	Large	Complaint filed in federal district court[c]
1984	Inadequate loan review, resulting in overvaluation of assets and failure to detect fraud	Opinion audit	Mid-size	Complaint filed in federal district court[d]

Source: The FHLBB's Office of General Counsel

[a]Opinion audit refers to the audit firm's having been engaged to perform sufficient audit work that would enable it, under generally accepted auditing standards, to provide a formal "opinion" on the thrift's financial statements.

[b]Denotations of the size of the audit firms were made by the agency official who provided this information.

[c]Federal Savings and Loan Insurance Corporation v. Laventhol & Horwath, No. CV-84-0129 (M.D. Pa. filed January 27, 1984). In this case the FSLIC was acting as assignee of First Federal Savings & Loan Association of Pittston, Pennsylvania.

[d]Federal Savings and Loan Insurance Corporation v. McGladrey Hendrickson & Co., No. 85-2975 (WMB) (C.D. Cal. filed May 3, 1985). In this case the FSLIC was acting as receiver for San Marino Savings and Loan Association, San Marino, California.

NUMBER OF FEDERALLY INSURED BANKS REQUIRING DISBURSEMENTS BY THE FDIC, BY CALENDAR YEAR, FOR THE YEARS 1980 THROUGH 1985

Calendar year	National banks	State chartered FRS members	State chartered FDIC supervised	Total
1980	1	-	9	10
1981	1	2	7	10
1982	11	3	28	42
1983	9	3	36	48
1984	16	10	53	79
1985	30	11	79	120
TOTAL	68	29	212	309

Source: The information in this table regarding calendar years 1980 through 1984 was derived from tables in the FDIC's annual reports for those years. The FDIC's Division of Bank Supervision provided the information from which the 1985 figures were derived.

FDIC CLAIMS BASED ON ACCOUNTANTS' LIABILITY ARISING FROM FAILED BANKS AND THOSE WHICH HAVE MERGED WITH FDIC ASSISTANCE DURING THE PERIOD FROM 1/1/80 THROUGH 9/30/85, INCLUSIVE

FDIC case number	Year bank merged or failed	Alleged audit deficiencies on which FDIC based claim	Audit work done at bank[a]	Size of audit firm[b]	Status of FDIC claim
1	1980	Failure to reconcile correspondent bank accounts, thereby failing to detect embezzlements of funds	Directors' examination	Small	Claim settled for $190,000 without complaint being filed[c]
2	1980	Failure to review demand deposit accounts of bank's senior officers, thereby failing to detect embezzlements of funds	Directors' examination	Small	Claim settled for $350,000 without complaint being filed[c]
5	1980	A number of instances of failure to follow generally accepted auditing standards; FDIC had difficulty showing that damages resulted	Opinion audit	Small	Claim settled without complaint being filed[d]
9	1980	Failure to detect ongoing check kite--FDIC settled on return of audit fees because of problems showing causation	Opinion audit	Mid-size	Claim settled for $25,000 without complaint being filed[c]
11	1981	Failure to follow generally accepted auditing standards and to advise board of danger in frequent dividends to bank holding company while capital base eroded and loan loss reserves were inadequate	Opinion audit	Mid-size	Claim settled for $92,000 without complaint being filed[c]
15	1981	Failure to note problems at bank; FDIC having problems showing that damages resulted	Opinion audit	Small	Claim dropped
23	1982	Inadequate loan review, resulting in inadequate loan loss reserves and failure to detect fraud	Opinion audit	Small	FDIC engaged in settlement discussion; intends to settle or file suit soon
31	1982	Deficiencies with regard to confirmation of securities, thereby failing to detect fraud	Directors' examination	Small	Claim settled for $700,000 without complaint being filed[c]

FDIC CLAIMS BASED ON ACCOUNTANTS' LIABILITY ARISING FROM FAILED BANKS AND THOSE WHICH HAVE MERGED WITH FDIC ASSISTANCE DURING THE PERIOD FROM 1/1/80 THROUGH 9/30/85, INCLUSIVE

FDIC case number	Year bank merged or failed	Alleged audit deficiencies on which FDIC based claim	Audit work done at bank[a]	Size of audit firm[b]	Status of FDIC claim
39	1982	Inadequate loan review, resulting in failure to detect that numerous nominee name loans were being made to benefit control parties	Opinion audit	Small	Claim dropp because the auditor had insurance o ability to ;
42	1982	Inadequate loan review, resulting in inadequate loan loss reserves and failure to detect other loan-related problems	Opinion audit	Big 8	The FDIC ha filed suit i federal district court[c]
47	1982	Inadequate loan review, resulting in inadequate loan loss reserves and additional loans to problem borrowers	Opinion audit	Small	Claim settl for $2,000,(without complaint being filed (subject to approval of FI Board of Directors)[c]
53	1982	Inadequate loan review, resulting in additional loans to problem borrowers	Opinion audit	Small	The FDIC is preparing tc file a complaint
67	1983	Inadequate credit review; bank may have been insolvent at audit date	Opinion audit	Big 8	FDIC's inves tigation ne completion; will be meet ing with au firm soon
73	1983	Failure to detect off-book liabilities that were involved in ongoing employee dishonesty	Opinion audit	Mid-size	Claim settl for $450,00(without complaint bein filed[c]
75	1983	Inadequate credit review, resulting in failure to detect deteriorating condition of loan portfolio	Opinion audit	Small	Claim settl for $77,000 (complaint l been filed l bank prior closing)[c]

FDIC CLAIMS BASED ON ACCOUNTANTS' LIABILITY ARISING FROM FAILED BANKS AND THOSE WHICH HAVE MERGED WITH FDIC ASSISTANCE DURING THE PERIOD FROM 1/1/80 THROUGH 9/30/85, INCLUSIVE

FDIC case number	Year bank merged or failed	Alleged audit deficiencies on which FDIC based claim	Audit work done at bank[a]	Size of audit firm[b]	Status of FDIC claim
81	1983	Inadequate credit review and evaluation, resulting in inadequate loan loss reserves; insufficient review of related-party transactions	Opinion audit	Big 8	FDIC's investigation almost complete; will meet with audit firm soon to discuss claim and settlement
100	1983	Inadequate loan review, resulting in additional loans to problem borrowers	Opinion audit	Big 8	FDIC's investigation in early stages
109	1983	Inadequate loan review, resulting in inadequate loan loss reserves; inadequate review of related-party transactions, resulting in failure to detect violations of law	Opinion audit	Small	FDIC plans to file suit if not settled soon
142	1984	Auditor had audited both the bank and one of the bank's loan customers in separate audits and had failed to advise bank officials of the poor financial condition of the loan customer	Opinion audit	Small	FDIC has recently notified the audit firm of its claim

Note: In addition to the above, FDIC has determined that in 16 active liquidations presently under investigation, audit work was deficient, and FDIC is attempting to determine whether damages can be causally linked to those deficiencies. Details on those active liquidations are on pages 36 and 37. FDIC also has a substantial number of preliminary investigations continuing, in which no determination has yet been made as to whether there were deficiencies in the audit work.

Source: The FDIC's Office of General Counsel

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[a]Opinion audit, as used here, refers to the audit firm's having been engaged to perform sufficient audit work that would enable it, under generally accepted auditing standards, to provide a formal "opinion" on the bank's financial statements. Directors' examination, as used here, refers to special purpose audit work for which the audit firm was engaged and which did not result in the audit firm's expressing an opinion on the bank's financial statements.

Notes (continued)

[b]Denotations of the size of the audit firms were made by the agency official who provided this information.

[c]Amounts shown for settlements are approximate amounts.

[d]FDIC could not determine the amount that was paid by the audit firm in this case because the case involved claims against the bank's officers and directors, as well as against the audit firm, and FDIC obtained a package settlement.

[e]The Federal Deposit Insurance Corporation v. Peat Marwick Mitchell & Co., No. CIV-84-1612-SF (W.D. Okla. filed December 1984). In this case, the FDIC, acting as receiver of Penn Square Bank, N.A. Oklahoma City, Oklahoma, added the audit firm as an additional party defendant to an existing complaint, previously filed by FDIC.

FDIC CASES UNDER INVESTIGATION FOR POTENTIAL ACCOUNTANTS' LIABILITY CLAIMS ARISING FROM DEFICIENT AUDIT WORK AT FAILED BANKS AND THOSE WHICH HAVE MERGED WITH FDIC ASSISTANCE, AS OF 12/31/85

FDIC case number	Year bank merged or failed	Alleged audit deficiencies on which claim would be based	Audit work done at bank[a]	Size of audit firm[b]
80	1983	Inadequate loan loss reserve, and failure to detect a substantial shortage in an account	Opinion audit	Small
105	1984	Inadequate credit review which failed to disclose condition of loan portfolio	Opinion audit	Small
123	1984	Understated loan loss reserve, and failure to detect and disclose hazardous lending policies of certain insiders	Opinion audit	Big 8
125	1984	Understatement of loan loss reserve and inadequate credit file review	Opinion audit	Small
126	1984	Inadequate credit file review and understatement in loan loss reserve	Opinion audit	Small
128	1984	Material understatement in loan loss reserve	Opinion audit	Small
129	1984	Numerous problems in loan portfolio not evaluated for purposes of loan loss reserve nor disclosed to the board	Opinion audit	Big 8
132	1984	Inadequate credit review and material understatement in loan loss reserve; the FDIC is not yet sure whether it can prove damages resulted from deficiencies	Opinion audit	Large
134	1984	Inadequate loan loss reserve	Opinion audit	Big 8
148	1984	Understated loan loss reserve, and failure to detect and disclose hazardous lending policies of certain insiders	Opinion audit	Big 8
150	1984	Inadequate credit file review resulting in inadequate loan loss reserve and failure to detect fraud	Opinion audit	Big 8

FDIC CASES UNDER INVESTIGATION FOR POTENTIAL ACCOUNTANTS' LIABILITY CLAIMS ARISING FROM DEFICIENT AUDIT WORK AT FAILED BANKS AND THOSE WHICH HAVE MERGED WITH FDIC ASSISTANCE, AS OF 12/31/85

FDIC case number	Year bank merged or failed	Alleged audit deficiencies on which claim would be based	Audit work done at bank[a]	Size of audit firm[b]
158	1985	FDIC believes it will be able to prove auditors should have detected ongoing fraud; investigation not yet complete	Opinion audit	Big 8
159	1984[c]	Inadequate testing of internal controls; inadequate credit review and loan loss reserve	Opinion audit	Big 8
160	1985	Inadequate loan loss reserve	Opinion audit	Small
161	1984	Failure to detect fraud and to disclose disastrous lending policies of insiders	Opinion audit	Small
162	1984	Inadequate credit file review, inadequate loan loss reserve, and failure to disclose condition of loan portfolio	Opinion audit	Big 8

Source: The FDIC's Office of General Counsel

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[a] Opinion audit, as used here, refers to the audit firm's having been engaged to perform sufficient audit work that would enable it, under generally accepted auditing standards, to provide a formal "opinion" on the bank's financial statements. Directors' examination, as used here, refers to special purpose audit work for which the audit firm was engaged and which did not result in the audit firm's expressing an opinion on the bank's financial statements.

[b] Denotations of the size of the audit firms were made by the agency official who provided this information.

[c] The bank in this case did not fail or merge, but it did require FDIC financial assistance.

SUMMARY OF SELECTED REPORTS OF PRELIMINARY INVESTIGATION FOR DETERMINATION OF AUDITOR NEGLIGENCE FOR POTENTIAL AUDITOR LIABILITY CLAIMS BY FDIC[a]

Year bank failed	Number of cases	Audit firm prior to failure: Big 8	Audit firm prior to failure: Other	Audit work done[b]: Opinion audit	Audit work done[b]: Directors' examination	Preliminary Investigation Report — Reasons cited for bank's failure[c]: 1	2	3	4	5	6	7	Negligence: Yes[e]	Negligence: No[f]	Basis of negligence finding[d]: 1	2	3	4	5	6	7	8	9	10	11
1981	2	0	2	2	0	1	0	1	0	1	1	0	2	0	1	2	0	1	0	0	0	0	0	0	1
1982	23	6	17	14	9	6	7	7	7	4	7	2	10	13	4	6	1	4	4	2	1	1	0	0	7
1983	16	6	10	9	7	3	2	5	6	3	2	2	12	4	4	8	2	6	1	1	0	1	1	1	3
1984	34	9	25	22	12	12	5	7	24	10	2	0	14	20	1	12	1	1	1	0	0	0	0	1	1
Total	75	21	54	47	28	22	14	20	37	18	12	4	38	37	10	28	4	12	6	3	1	2	1	2	12

[a]A preliminary investigation, based on readily available information, is performed by an FDIC contractor in the case of each failed, FDIC-insured bank which had had audit work performed by an independent audit firm prior to failing, according to an FDIC official. The investigation report contains the contractor's conclusions on the adequacy of the work and reporting which was done by the bank's auditor prior to the bank's failure. The 75 preliminary investigation reports we reviewed were not selected on the basis of statistically significant characteristics, but rather on the basis of their availability at FDIC and at the premises of an FDIC contractor. Thus, while the 75 reports may not be a statistically representative sample, they include, according to an FDIC official, the vast majority of preliminary investigation reports completed at the time of our review.

[b]Opinion audit, as used here, refers to the audit firm's having been engaged to perform sufficient audit work that would enable it, under generally accepted auditing standards, to provide a formal "opinion" on the bank's financial statements. Directors' examination, as used here, refers to special purpose audit work for which the audit firm was engaged and which did not result in the audit firm's expressing an opinion on the bank's financial statements.

[c]See page 46 for a listing of the reasons cited in preliminary investigation reports as causes of banks' failures. The total of the frequencies of the reasons cited for the bank failures is greater than the total of failed banks because, in many reports, more than one reason was cited for the bank's failure.

[d]See page 47 for a listing of the audit deficiencies which were cited as the basis of negligence findings. The total of the frequencies for deficiencies cited as the basis of negligence findings is greater than the total of negligence findings because, in most reports containing a negligence finding, more than one audit deficiency was cited.

[e]According to an official in FDIC's Legal Division, if the preliminary investigation report concludes that the audit firm failed to conduct the audit in accordance with generally accepted auditing standards, the FDIC, primarily through the use of its own staff, determines whether there is a substantial likelihood that any of the bank's losses can be causally linked to such identified audit deficiencies. If so, FDIC staff, working in conjunction with the FDIC contractor, attempts to develop information to quantify the amount of the loss attributable to the audit deficiencies and to document the deficiencies. See page 48 for information on the status of these 38 cases.

[f]In most cases where the preliminary investigation resulted in a finding of no negligence on the part of the auditor, the finding was based on one or more of the following circumstances: Problems which caused the bank to fail (1) occurred after the audit work was completed, (2) occurred in areas of the bank's operations not included in the proper scope of work for which the auditor was engaged, and (3) were detected and properly reported by the auditor. See page 49 for further information on the bases for the conclusions of no negligence for these 37 cases.

REASONS CITED IN PRELIMINARY INVESTIGATION REPORTS AS CAUSES OF BANKS' FAILURES

Number of reason on table[a]	Description of reason as cited in preliminary investigation report	Number of reports citing reason
1	Insider loans and related-party transactions	22
2	Illegality, embezzlement, fraud, or other dishonest transactions by bank officials	14
3	Substantial loan losses and non-performing loans, without further elaboration	20
4	Substantial loan losses due to poor lending practices, ineffective loan administration, and inadequate supervision	37
5	Substantial loan losses related to economic difficulties experienced by a particular industry or geographic area	18
6	Other	12
7	Reason not cited in report	4

[a]See page 45 for a table summarizing selected reports of preliminary investigation for determination of auditor negligence.

AUDIT DEFICIENCIES CITED IN PRELIMINARY INVESTIGATION REPORTS AS BASES FOR FINDINGS OF AUDITOR NEGLIGENCE

Number of deficiency on table[a]	Description of alleged audit deficiency cited in preliminary investigation report	Number of reports citing this deficiency
1	Insufficient disclosure in financial statements	10
2	Inadequate provision for loan losses resulting in material misstatement of earnings	28
3	Failure to extend audit procedures when problems were detected	4
4	Failure to conduct a proper evaluation of the loan portfolio	12
5	Lack of independence	6
6	No proper review and evaluation of internal controls	3
7	Insufficient audit work to support an opinion on one or more of the financial statements	1
8	Audit not adequately planned; no work program in the workpapers	2
9	Failure to use due professional care in the conduct of the audit and preparation of the report	1
10	Unspecified audit deficiencies--failure to follow generally accepted auditing standards	2
11	Other	12

[a]See page 45 for a table summarizing selected reports of preliminary investigation for determination of auditor negligence.

STATUS OF ACTIONS TAKEN BY FDIC IN 38 CASES WHERE THE REPORT OF PRELIMINARY INVESTIGATION CONTAINED A CONCLUSION THAT THE AUDIT WORK WAS DEFICIENT[a]

Status of FDIC actions	Number of cases where status applies, by calendar year in which bank failed				
	1981	1982	1983	1984	Total
Investigation continuing, in order to link losses with audit deficiencies	0	0	2	12	14
No claim - damages could not be causally linked to audit deficiencies	0	4	5	2	11
Settlement discussions to begin soon with audit firm	0	0	2	0	2
Settlement discussions underway	0	1	1	0	2
Claim initiated, then dropped by FDIC	1	1	0	0	2
Claim settled pending FDIC Board of Directors' approval[b]	0	1	0	0	1
Claim settled - recoveries made[b]	1	1	2	0	4
FDIC will file formal complaint in near future	0	1	0	0	1
In litigation	0	1	0	0	1
TOTALS	2	10	12	14	38

Source: FDIC's Legal Division

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[a]See page 45 for further information on these 38 reports of preliminary investigation.

[b]The total amount of money paid by audit firms to FDIC, or presently in escrow, in connection with these 5 cases is about $3,319,000.

REASONS CITED IN 37 PRELIMINARY INVESTIGATION REPORTS AS BASES FOR CONCLUSIONS OF NO NEGLIGENCE[a]

Description of reason as cited in preliminary investigation report	Frequency of reasons cited in reports by calendar year in which bank failed				
	1981	1982	1983	1984	Total[b]
Problems which caused the bank to fail occurred after the audit work was completed	0	5	0	3	8
Problems which caused the bank to fail occurred in areas of the bank's operations not included in the proper scope of work for which the audit firm was engaged	0	7	3	11	21
Problems which caused the bank to fail were detected and properly reported by the audit firm	0	1	1	6	8
Problems which caused the bank to fail were not detected by the audit firm because the audit firm was a victim of well-covered-up fraud	0	1	0	0	1
Problems which caused the bank to fail became publicly known before the audit firm rendered an opinion on the financial statements or issued a management letter to the bank's board of directors	0	1	0	0	1
TOTALS[b]	0	15	4	20	39

[a]See page 45 for further information on these 37 reports of preliminary investigation.

[b]The total incidence of reasons cited is 39 because 2 of the 37 reports each noted that some problems which caused the bank's failure occurred after the audit work was completed, while other such problems were beyond the proper scope of the work for which the audit firm had been engaged.

AGENCIES' COMMENTS

NOTE: GAO's response appears at the end of this letter.

FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, D.C. 20429

OFFICE OF DIRECTOR - DIVISION OF BANK SUPERVISION

March 28, 1986

Mr. Craig A. Simmons
Associate Director
General Government Division
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Simmons:

We appreciate this opportunity to comment on the GAO draft fact sheet containing information on independent public accountant audits of financial institutions.

Our comments relate solely to the accuracy of the information contained in the fact sheet. They are as follows:

- In the describing the RAP accounting treatment of futures contracts on page 12 of the draft, the language used may incorrectly imply that "futures" are reported on the balance sheet. The draft also states erroneously that any gain/loss is amortized as interest income. The FDIC suggests the paragraph be changed to read as follows:

  Now on p. 18.

  Futures are not reflected on the balance sheet, but are treated as off-balance sheet items that must be valued consistently at either market value or the lower of cost or market. All gains and losses are generally recognized in the period that the change occurs and reported as other noninterest income or expense. Hedge accounting is not permitted (FDIC, OCC, FRS).

- In describing the status of the FDIC's claim in case number 39 on page 33, we suggest the addition of language explaining why the claim in that case was dropped, namely, because the auditor had no insurance or ability to pay.

  Now on p. 40.

- In describing the alleged audit deficiencies on which the FDIC based its claim in case number 109 on page 34, the word "inadequate" was apparently omitted before the words "loan loss reserves" in the second line of the description.

  Now on p. 41.

Sincerely,

Robert V. Shumway

Robert V. Shumway
Director

AGENCIES' COMMENTS

GAO's treatment of points raised in the FDIC's March 28, 1986, letter

1. The FDIC suggested some changes to our discussion of RAP treatment of Futures Contracts on page 18 to clarify the timing of gain/loss recognition and to remove any implication that futures contracts are reported on the balance sheet. We made most of the recommended changes which we feel do serve to clarify the discussion of RAP treatment.

2. The FDIC asked that we append to the status description of FDIC case number 39 on page 40 the reason for FDIC's dropping its pursuit of a claim. We agree that adding FDIC's reason provides the reader with useful information.

3. The FDIC pointed out that a word was inadvertently omitted by GAO from the description of the alleged audit deficiencies regarding FDIC's case number 109 on page 41. That word has since been inserted.

AGENCIES' COMMENTS

NOTE: GAO's response appears at the end of this letter.

Federal Home Loan Bank Board

EDWIN J. GRAY
CHAIRMAN

1700 G Street, N.W.
Washington, D.C. 20552
Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporation

April 1, 1986

Mr. Craig A. Simmons, Associate Director
United States General Accounting Office
General Government Division
Washington, D.C. 20548

Dear Mr. Simmons:

Thank you for giving us the opportunity to review and comment upon your draft fact sheet containing information on independent public accountant audits of financial institutions. The fact sheet is rather comprehensive and reflects a substantial amount of work by your staff.

We believe that most of the information in the fact sheet is indeed factual. However, there are some areas that we would offer some corrections or clarifications that we believe should be made in the final report. A listing of those corrections and clarifications is enclosed.

If you have any questions concerning our response, please contact Mr. Paul E. Gibbons, FHLBB Inspector General. He can be reached at 377-6190.

Sincerely,

Edwin J. Gray

Enclosure

cc: Mr. Paul E. Gibbons

AGENCIES' COMMENTS

1. The use of the term "regulatory accounting principles" (RAP) is somewhat misleading. In the case of the FHLBB, RAP is not a comprehensive basis of accounting and therefore should not be considered as "accounting principles". We maintain that certain of our regulations allow or in some instances dictate modifications of generally accepted accounting principles in determining capital requirements and in evaluating risk to the Federal Savings and Loan Insurance Corporation (FSLIC).

Now on p. 10.

2. The chart and footnotes on page 4 suggest RAP falls into only one of the two following areas:

   RAP-D - indicates financial institutions reports <u>must</u> follow a regulatory accounting principle which differs from its GAAP counterpart for that accounting issue.

   RAP-X - indicates financial institutions reports <u>must</u> follow a regulatory accounting principle which is an extension of its GAAP counterpart for that accounting issue.

   (Emphasis added)

   However, RAP with respect to the FHLBB can and often does fall into a third category. This category is: "regulatory treatment that <u>may</u> be followed instead of GAAP". This definition would better describe the following items on the list on pg. 4:

Now on p. 10.

   Basis of Accounting - Cash Versus Accrual
   Subordinated Debt
   Gains/Losses on Sales of Loans and Certain Securities
   Appraised Equity Capital
   Loan Origination Charges and Credits
   Loan Commitment Fees

Now on p. 14.

3. On page 8 - <u>Securities Transactions</u>.

   a. There is some divergence in the GAAP literature and in practice on this subject. The AICPA Audit and Accounting Guide for Savings and Loans would suggest that such securities should be recorded at the lower of cost or market after premium and discount related adjustments.

   b. As for the FHLBB, there is nothing in our regulations stating that there is a divergence from GAAP. However, our Examination Objectives and Procedures Manual would suggest that such securities should be reported using historical cost after premium and discount related adjustments.

AGENCIES' COMMENTS

-2-

Now on p. 15.

4. **Page 9 - Subordinated Debt. In the "Reason," section we would add that subordinated debt is subordinated to the claims of the FSLIC and therefore we include it as such in evaluating the risk to the FSLIC.**

Now on pp. 16-17.

5. **Page 10 & 11 - Sale and Leaseback. Our regulations do not make reference to a minimum five year amortization policy.**

Now on p. 21.

6. **Page 15 - Appraised Equity Capital. Board Resolution #85-949 dated October 24, 1985 extends the sunset provision on this regulation through December 31, 1986.**

Now on p. 27.

7. **Page 21 - Recordation of Loss Reserves. We would have you note that our regulation 561.16c "Classification of Assets" also addresses this subject. This regulation is used when appraisals are not currently available or use invalid assumptions.**

Now on p. 31.

8. **Page 25 - Net Worth Certificates - It is unclear to us what is meant in your "Reason" section.**

AGENCIES' COMMENTS

GAO's treatment of points raised in the FHLBB's April 1, 1986, letter

1. The FHLBB objects to GAO's use of the term "regulatory accounting principles" as being misleading. While we believe our use of the term in this fact sheet is appropriate, changes have been made on page 8 to indicate that (1) the four agencies discussed in the fact sheet require that regulated entities generally follow GAAP, (2) each of the four agencies has set forth a small number of reporting rules and regulations which depart from GAAP, and (3) the reporting rules and regulations which depart from GAAP are sometimes referred to as regulatory accounting procedures or regulatory accounting principles.

2. The FHLBB suggests that there should be three categories of RAP discussed instead of two. Rather than add a third category which we thought would tend to confuse matters we made other changes. An explanation has been added on page 8 which informs that some of the RAP that specify accounting methods that are contrary to GAAP are mandatory and some are optional. Also, the footnotes to the chart on page 10 note that for some accounting issues, use of the RAP is optional; for other issues, use of the principle is mandatory. Finally, the narratives for each of the six accounting issues for which RAP is not mandatory contain appropriate wording, such as "not required" and "may be deferred," which clearly shows the optional nature of the RAP.

3. The FHLBB points out that its regulations do not diverge from GAAP concerning the accounting treatment of trading account securities transactions. Because the FHLBB's regulations do not indicate otherwise, we now show the FHLBB as following GAAP for this issue on pages 10 and 14.

4. We have followed the FHLBB's suggestion and added to the reason section for subordinated debt securities on page 15.

5. The FHLBB points out a mischaracterization, contained in our draft, of its policy regarding sale and leaseback transactions. Consequently, reference to a minimum five-year amortization policy has been eliminated from pages 16 and 17.

AGENCIES' COMMENTS

6. The FHLBB points out that the date of the sunset provision of its appraised equity capital regulation has been extended. We have made appropriate changes to reflect Board Resolution 85-949 on page 21 and to the footnote on page 10.

7. The FHLBB has asked that we note that an additional FHLBB regulation is pertinent to RAP treatment regarding recordation of loss reserves. We have added FHLBB regulation 561.16C to the RAP citation on page 27.

8. The FHLBB questioned the clarity of the discussion in the "Reason" section of our draft regarding RAP treatment of net worth certificates. We have changed the "Reason" section on page 31 to increase clarity.

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