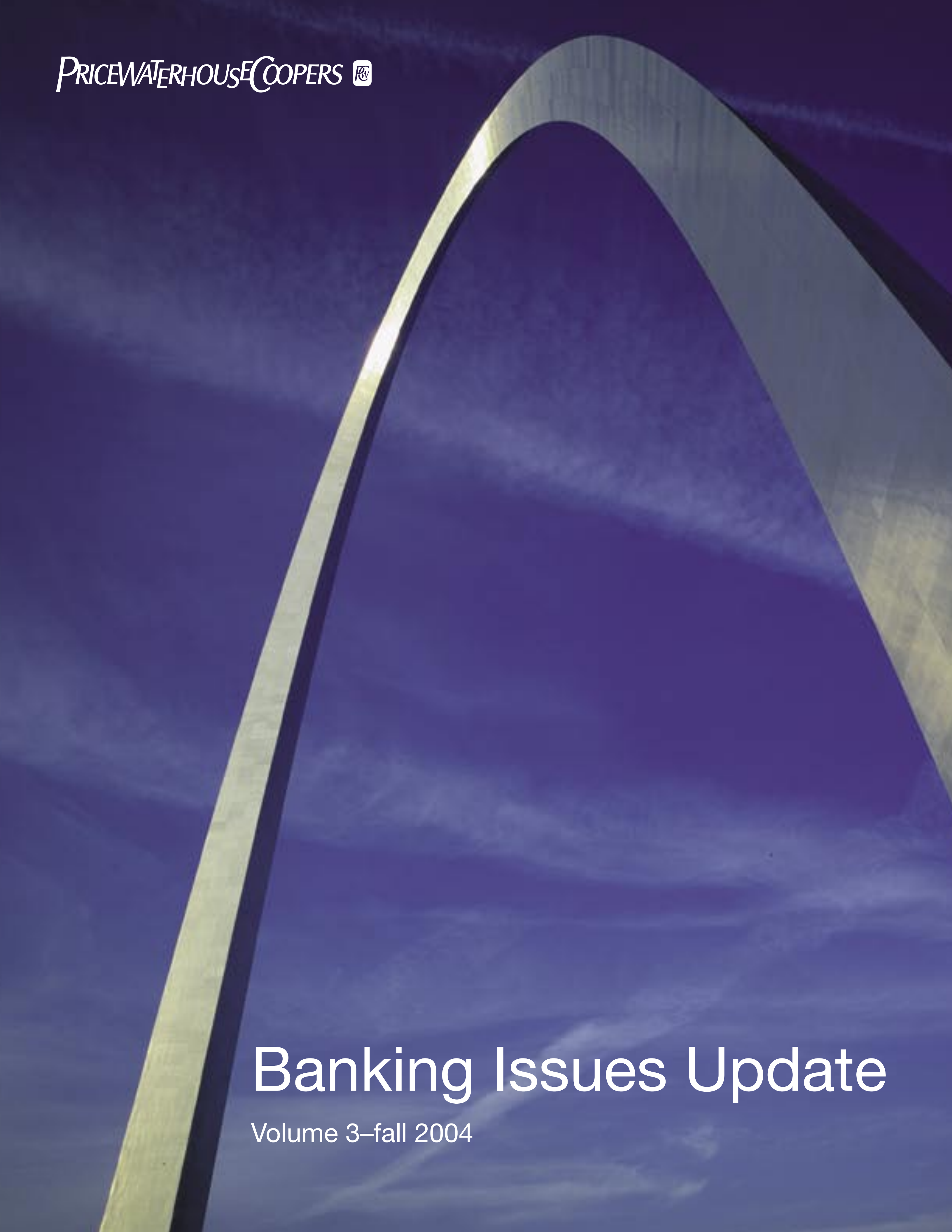

PRICEWATERHOUSECOOPERS

# Banking Issues Update

Volume 3–fall 2004

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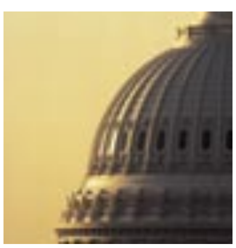
## 2 Accounting and Financial Reporting



## 3 Regulatory and Taxation





*The objective of our periodic publication is to provide insight on the business, financial reporting and regulatory challenges facing the banking industry. The PricewaterhouseCoopers Banking Practice is continuously responding to the dynamic changes in the industry, and we look forward to working with you to address these challenges.*

*To be included on our mailing list (email and/or hard copy), please contact Jennifer Bieber at jennifer.bieber@us.pwc.com or (646) 471-7723.*

# 1 Sarbanes-Oxley Section 404

# Sarbanes-Oxley 404 Survey Results

*by Gabe Kwentus*

## Overview

In December 2003 and February 2004 PricewaterhouseCoopers hosted roundtable sessions in New York to discuss Section 404 of the Sarbanes-Oxley Act of 2002. Attendees represented over 40 regulated financial institutions and specialty finance companies, with owned and managed assets ranging from $6 billion to $1 trillion.

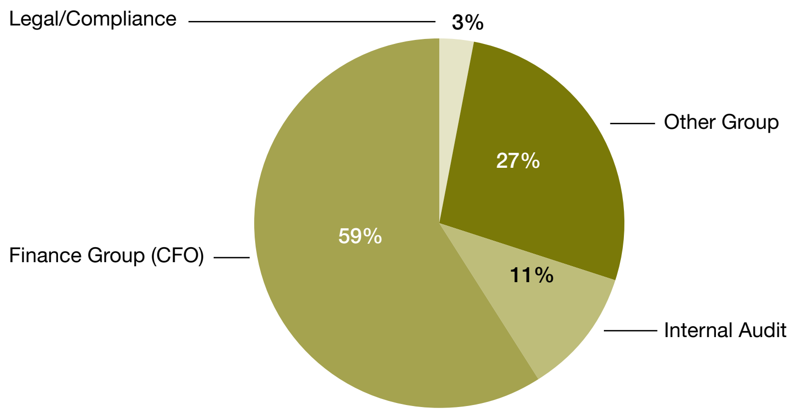
The roundtables included facilitated discussions on planning, documentation, operating effectiveness, management testing, reporting, and other related hot topics. These sessions were led by PricewaterhouseCoopers' Section 404 and financial institution industry professionals and client representatives.

The data that follows represents results from several key survey questions posed to the roundtable attendees and the combined average responses from those participants at a discrete point in time regarding the implementation status and views of this industry. Please note that at the time of the roundtable sessions and survey responses, the Public Company Accounting Oversight Board (PCAOB) had not yet issued *Release No. 2004-001: An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*, which was released on March 9, 2004.

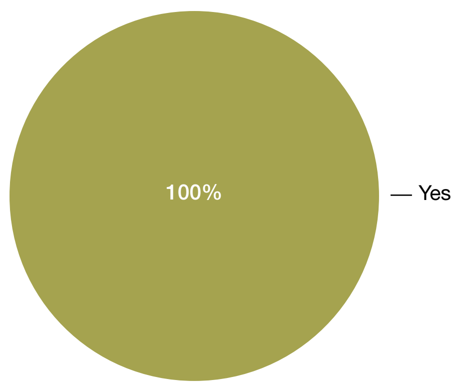
Please note that based on the timing of this survey, the focus was on the early stages of implementation. We anticipate further surveying in the coming quarters with an increased focus on the status of implementation plans, including testing plans, results and reporting.

# Planning

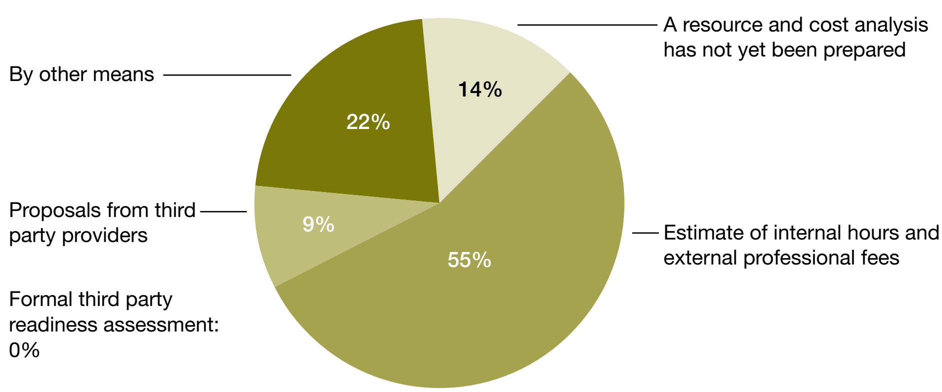
**1. Who officially owns the Section 404 compliance effort in your institution?**



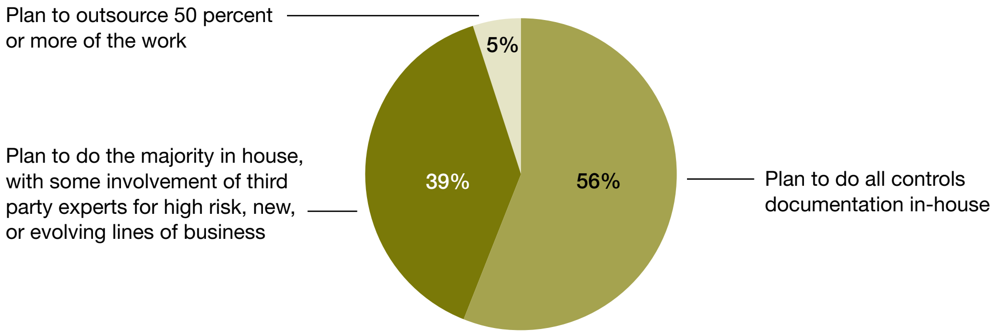

**2. Has your Company established a Sarbanes-Oxley Task Force or Project Management Office (PMO)?**



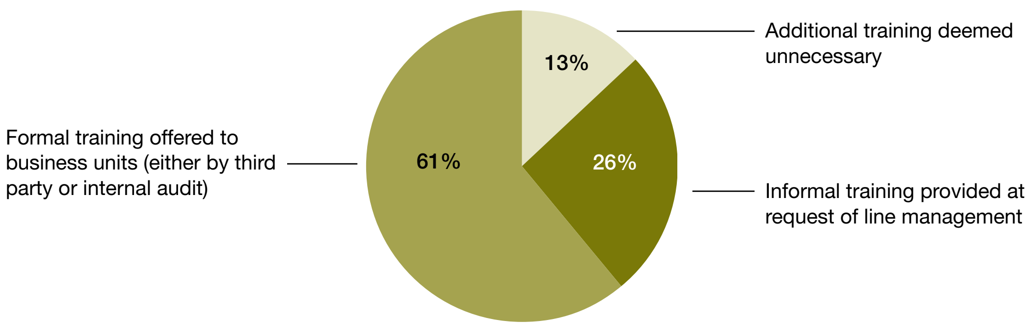

**3. How has your Company estimated the internal resource requirements for the Section 404 preparation and self-assessment, including the Project Management Office (PMO)?**



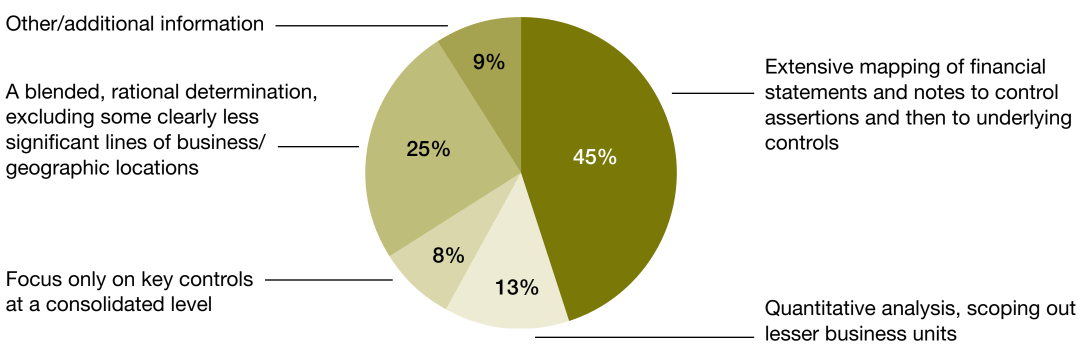
**4. Is your Company planning to do the Section 404 documentation in-house for all areas, or will topical experts be utilized?**



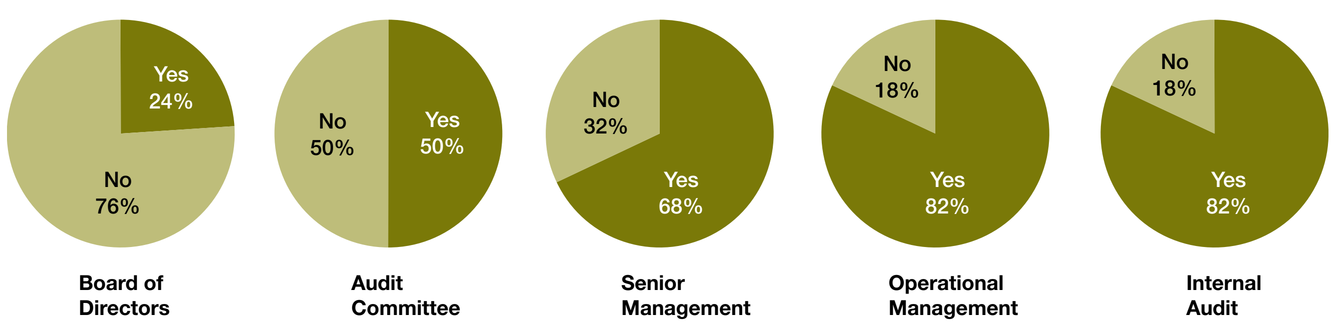

**5. To what extent has line management been provided “controls-specific” training?**



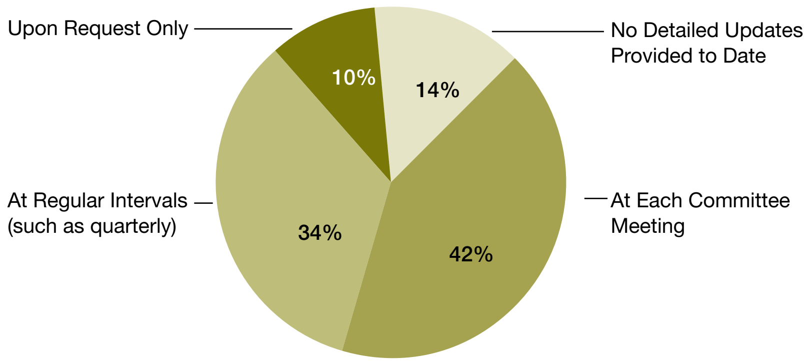

**6. How has the scope of the controls review been determined?**




**7. Has specific education taken place particularly for senior and operational management and for the board?**

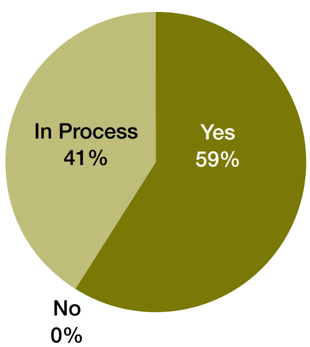


**8. How often is the Audit Committee updated as to status against plan?**

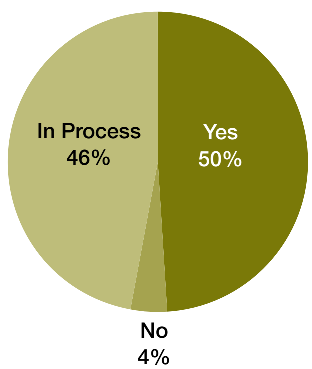



# Execution: *Documentation*

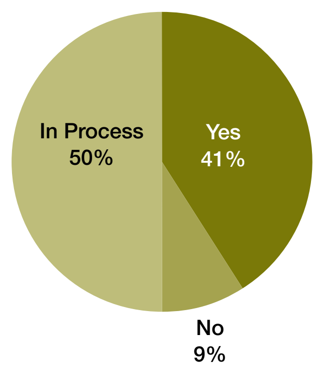
**1. Has your Company mapped individual financial statement accounts and disclosures to:**




**The underlying process**

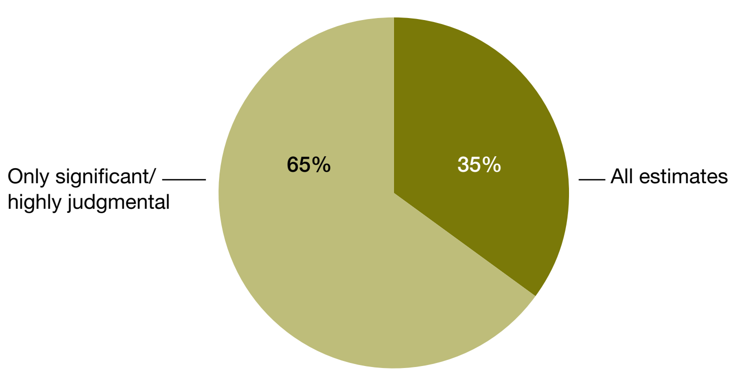



**The data source**

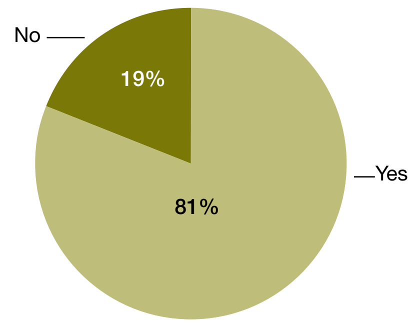



**The underlying key computer system(s)**

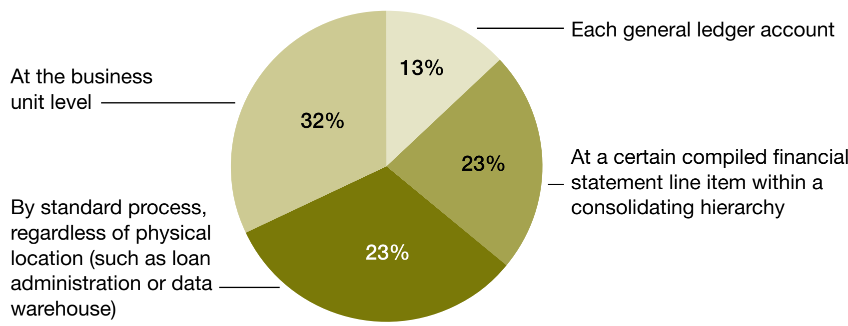
**2. Has your Company included all accounting estimates? Or are only significant or highly judgmental estimation processes documented?**



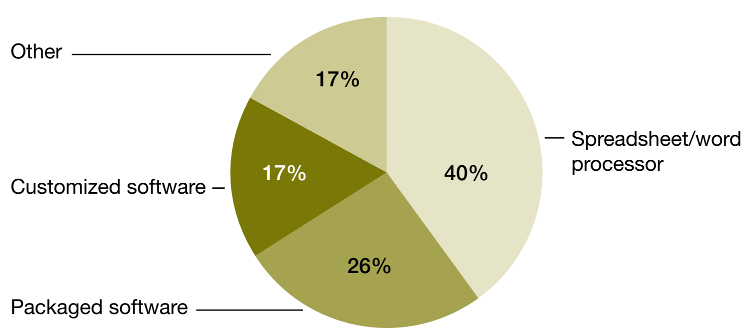
**3. Does the controls documentation follow/map directly to the Section 302 representation chain (i.e., assuming lower level business units provide representations to the CEO/CFO)?**



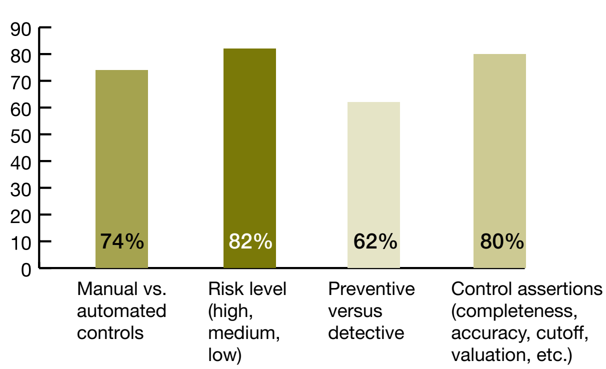

**4. What is the most detailed level of controls documentation required (i.e., how low within the process/organization will the controls documentation be required)?**




**5. What "tool" is your Company using to document risks and controls?**

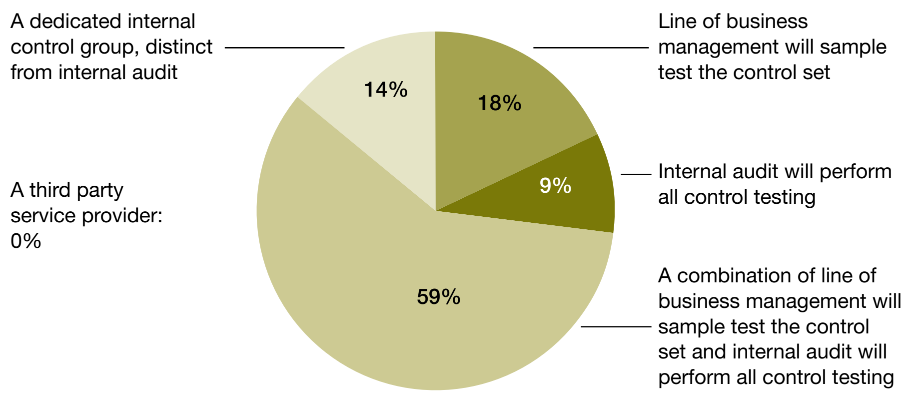



**6. Does the tool have sufficient detail so as to identify? (Please check all that apply):**

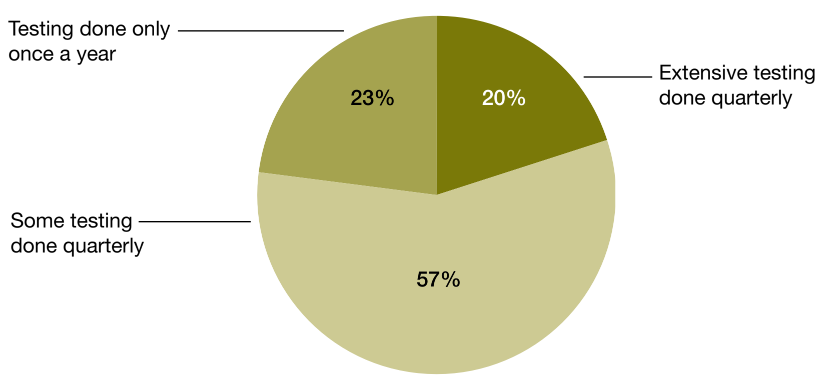


# Execution: *Operating Effectiveness and Management Testing*

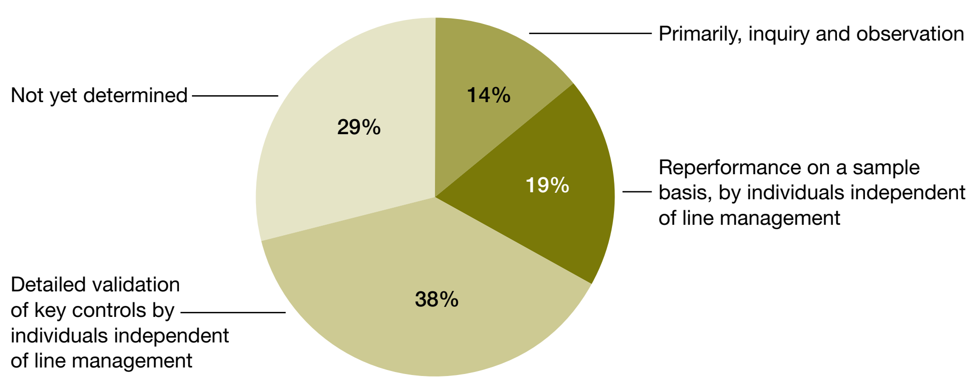
**1. How will your Company perform an evaluation of control effectiveness (e.g., management testing of controls)?**




**2. How often will the evaluation of control effectiveness occur?**

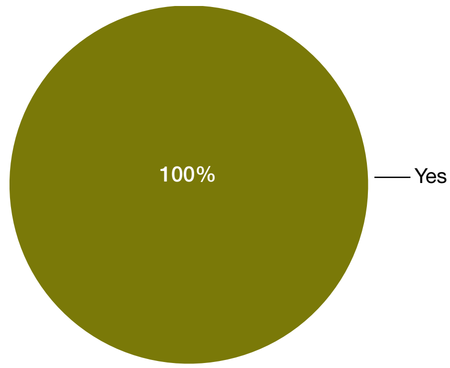



**3. What form will management's self-assessment/test of controls take?**

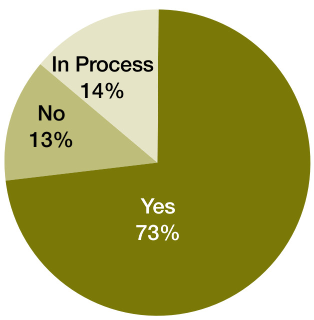


# Reporting

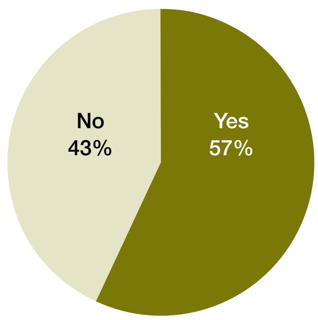
**1. Has your Company established a Disclosure Committee ("DC")?**



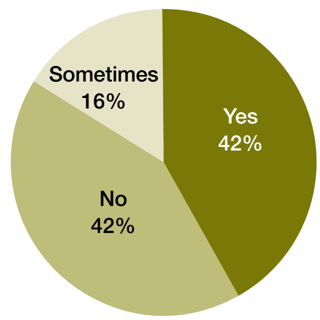

a. Is there a charter?




b. Does the DC present to the audit committee each quarter?

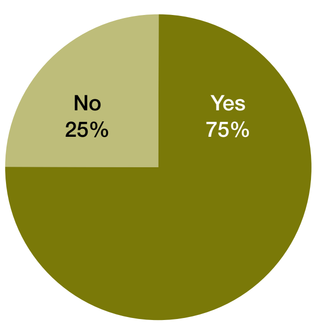



c. Is the external auditor present at the DC meetings?

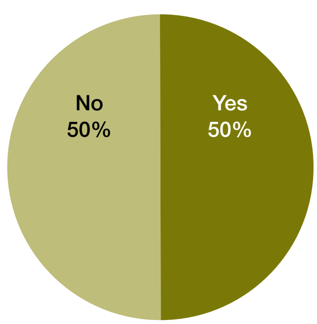



**2. Does the DC have the responsibility to gather and analyze *potential control deficiencies* for purposes of Section 302 or Section 404 reporting?**

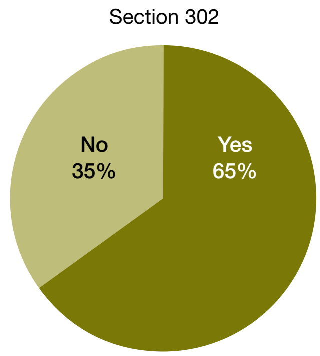
Section 302

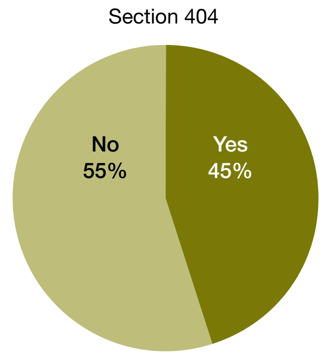



Section 404

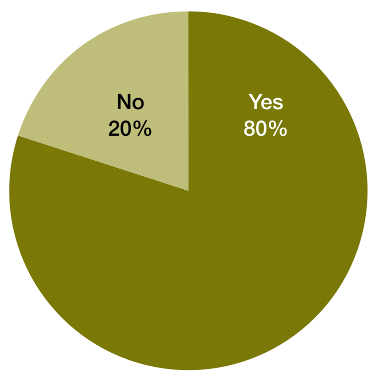


**3. Does the DC have the responsibility *to gather and analyze control changes* for purposes of Section 302 or Section 404 reporting?**

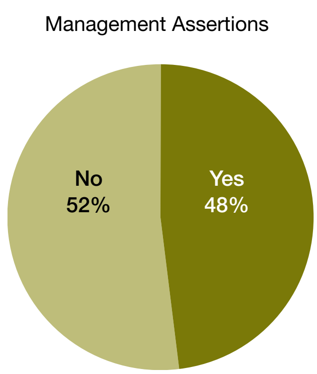


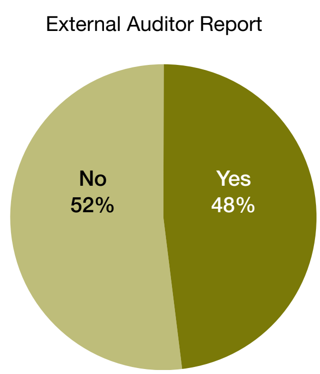




**4. Will the DC approve and present to executive management and the audit committee the form of Section 302, Section 404 and FDICIA management assertions?**




**5 . Does the Company expect that the management assertion date and the external opinion date will be later than the annual earnings release date?**




*For more information, please contact Gabe Kwentus in Dallas at (214) 999-2517 or gabe.kwentus@us.pwc.com.*

# Goodbye FDICIA, hello Sarbox—sort of

*by Westbrook Murphy*

## Overview

Effective in 1992, Section 112 of the FDIC Improvement Act (FDICIA) imposed new auditing and corporate reporting and governance reforms on each insured depository institution with assets exceeding $500 million (FDICIA reporting bank) and on its auditors.

A decade later these FDICIA requirements became a model for similar requirements imposed by the Sarbanes-Oxley Act of 2002 (Sarbox) on public companies, (i.e., companies with SEC-registered securities) including banks and bank holding companies.

This article highlights the overlap between FDICIA and Sarbox, and describes how the overlap will affect FDICIA reporting banks and their auditors. In general:

- Sarbox largely will replace FDICIA for banks and bank holding companies with public shareholders.
- FDICIA reporting banks that are not owned publicly either directly or indirectly through a holding company are awaiting FDIC guidance.
- The Sarbox-driven changes in the SEC's auditor independence standards apply to auditors for every FDICIA-reporting bank.

## Audit Committees

### FDICIA

As implemented in 1992 by the FDIC (see, 12 CFR, Part 363), FDICIA requires each FDICIA reporting bank to have an audit committee composed entirely of directors who are "independent of management." The audit committee's mandated duties include reviewing with management and the bank's independent auditor the bank's financial and internal control reports.

If the bank is larger than $3 billion, then FDICIA requires the audit committee to:

- Include one or more members with banking or related financial expertise,
- Have access to its own outside counsel, and
- Exclude from committee membership any "large customer."

The FDIC's regulation permits a bank to rely on the audit committee of its holding company if the holding company's committee meets the FDICIA requirements. (12 CFR §363.1(b)). A bank whose assets exceed $5 billion may rely on its holding company's audit committee only if the bank received a CAMELS rating of "1" or "2" in the bank's most recent report of examination.

### Sarbox

Sarbox requirements for audit committees apply only to a public company whose securities are listed on a national securities exchange. These requirements are implemented both by SEC regulations and by listing rules of the securities exchanges.

As implemented in 2003, Sarbox requires every listed company to have an audit committee composed entirely of independent directors, whose only compensation from the company is for service on the audit committee. Since the SEC and securities exchanges define independence more strictly than does the FDIC, any audit committee member who satisfies the SEC requirement for independence also should satisfy the FDICIA requirement.

The SEC's regulations also overlap FDICIA by requiring the audit committee to have authority to engage outside counsel or other advisors.

The SEC's regulations require each public company annually to disclose whether its audit committee includes one or more specifically identified "financial experts" with specified educational background and/or experience. New York Stock Exchange (NYSE) and NASDAQ listing rules additionally require each member of a listed company's audit committee to be financially literate. An audit committee whose members satisfy these qualifications also should satisfy the FDICIA requirements.

NYSE and NASDAQ listing rules approved last fall by the SEC require a listed company's audit committee to have a charter specifying a number of duties. These duties include discussing annual and quarterly financial statements (including MD&A disclosures) with the company's management and independent auditors, and reviewing with the auditors any audit problems or difficulties. Adhering to these and other audit committee charter requirements would more than satisfy the duties FDICIA imposes on audit committees with regard to financial statements and internal controls.

Thus, these Sarbox audit committee requirements should displace FDICIA requirements for any bank whose securities, or whose holding company's securities, are listed on a national stock exchange. Audit committees of banks whose securities are not listed on an exchange should continue to conform to FDICIA independence and qualification requirements unless advised differently by the FDIC.

## Management Responsibilities

### FDICIA

The FDIC's regulation implementing §112 of FDICIA requires each FDICIA reporting bank to:

- File with the bank's regulators annual audited financial statements of the bank or its holding company;
- File with the bank's regulators a report:
  - Acknowledging management's responsibility for preparing the bank's financial statements, maintaining adequate controls for financial reporting, and complying with laws relating to dividends and insider loans,
  - Evaluating the effectiveness as of year-end of the bank's financial reporting controls, and

– Assessing during the year the bank's compliance with laws relating to dividends and insider loans.

An independent auditor must attest to the report on the effectiveness of internal controls for financial reporting.

Management also must notify the bank's regulators within 15 days of the engagement, resignation, or dismissal of the bank's independent public accountant. This notice must state the reason for the resignation or dismissal. A publicly owned bank may satisfy this notice requirement by filing with its regulators a copy of the notice filed by the bank or by its holding company with the SEC, as required by the securities laws.

### Sarbox

Public companies already were required annually to file with the SEC audited financial statements. Sarbox added requirements annually to file with the SEC a management report:

- Acknowledging management's responsibility for preparing the company's financial statements and for maintaining adequate controls for financial reporting, and
- Evaluating the effectiveness as of year-end of the company's financial reporting controls.

For banks owned either directly or through a holding company by public shareholders, the FDIC undoubtedly will accept copies of these SEC reports to satisfy the FDICIA reporting requirements. But the FDICIA reporting requirements remain in place for FDICIA reporting banks that are not either directly or indirectly publicly owned. Additionally, all banks remain subject to the FDICIA requirement to report on compliance with laws governing dividends and insider loans. Changes in internal control reports are discussed in the next section.

## Internal Control Reports

### FDICIA

As already noted, the FDIC's regulation implementing FDICIA requires a FDICIA reporting bank to file with its regulators a report evaluating as of year end the effectiveness of the bank's internal controls for financial reporting.

The bank also must file a report of an independent auditor attesting to management's evaluation. FDIC's regulation requires the auditor's attestation to be made "in accordance with generally accepted standards for attestation engagements." Until April 2003, this standard was found in AT 501 promulgated by the Auditing Standards Board of the American Institute of Certified Public Accountants (AICPA).

The FDIC's regulation permits a bank to rely on an attested internal control report of its holding company. Because such a report would cover material aspects of all of the company's operations, both bank and non-bank, relatively few banks have chosen this option. A bank whose assets exceeded $5 billion may rely on its holding company's attested internal control report only if the bank received a CAMELS rating of "1" or "2" in the bank's most recent report of examination.

### Sarbox

In language strikingly similar to that of FDICIA §112, Sarbox §404 requires each public company to report as of its fiscal year end on the effectiveness of the company's internal control structure and procedures for financial reporting. Similar to FDICIA, the company's independent accountant must attest to management's evaluation. In addition—and unlike FDICIA—the independent accountant must attest not just to management's evaluation, but also directly on the controls' effectiveness. In another departure from FDICIA, the standard governing the attestation is promulgated by the Public Company Accounting Oversight Board (PCAOB).

On March 9, 2004, the PCAOB adopted Auditing Standard No. 2 to govern an independent accountant's attestation to a public company's report on internal controls for financial reporting. http://www.pcaobus.org/rules/Release-20040308-1.pdf.

PCAOB's Standard No. 2, which was approved by the SEC on June 18, 2004, will govern internal control reports required by Sarbox §404. The Standard affects not only accountants, but also the public companies that prepare and issue these internal control reports. Compared to the pre-existing AT 501, Standard No. 2 will require both the company and its auditor to perform significantly more work and to document far more extensively both the controls themselves and the testing and evaluation of those controls.

## Effects on particular banks

For most banks, the internal control reports required by Sarbox §404 will replace the similar reports that FDICIA reporting banks have filed each year since 1992. The PCAOB's Standard No. 2, however, is limited by its own terms to "the auditor's attestation of management's assessment of the effectiveness of internal control over financial reporting required by Section 404. . . ." Thus, the application of the new standard to any particular bank will vary depending on whether and when Sarbox §404 requires the bank or its holding company to file an internal control report.

The following examples assume that the FDICIA reporting bank's fiscal year is a calendar year:

- **Publicly held banks.** A bank that itself has public shareholders and whose securities are registered with a federal banking agency must comply with all applicable Sarbox provisions. See Federal Reserve Supervisory Release 02-20 (Oct. 29, 2002). Under the SEC's regulations:
  - For a bank with public float exceeding $75 million on June 30, 2004, the first §404 internal control report is due as of December 31, 2004.
  - For a bank with public float less than $75 million, the first §404 internal control report is due as of December 31, 2005. These banks may elect, however, to file for year end 2004 the attestation reports required by Sarbox §404 and governed by Auditing Standard No. 2.
- **Banks owned by publicly held holding companies.** A bank that is owned by a publicly held holding company, but historically has filed FDICIA internal control reports limited to the bank itself, probably will elect—as permitted by the FDIC—to satisfy its FDICIA reporting requirement by filing the Sarbox §404 internal control

report of its parent holding company. Since the holding company's report, covering both banks and non-banks, usually may be used to satisfy FDICIA, no regulatory need exists to prepare a separate report solely for the bank.

  – If the holding company's public float exceeds $75 million on June 30, 2004, the holding company's first §404 internal control report is due as of December 31, 2004.
  – If the holding company's public float is less than $75 million, the holding company's first §404 internal control report is due as of December 31, 2005. These holding companies may elect, however, to file for year end 2004 the attestation reports required by Sarbox §404 and governed by Auditing Standard No. 2.

- **Non-public banks.** A bank that is not publicly owned, either directly or through a holding company, must await FDIC guidance about the effect of PCAOB's attestation standard. While the PCAOB's standard by its own terms is limited to internal control reports for publicly held companies, the FDIC may decide to adopt the PCAOB's standard for FDICIA §112 internal control reports. For year-end 2004 only, this same uncertainty also exists for a bank:
  – With public float less than $75 million,
  – Owned by a holding company with public float less than $75 million, or
  – Owned by a non-government foreign company with securities registered in the U.S. (a foreign private issuer).

*According to FDICIA, the auditor's attestation to a bank's internal control report "shall meet or exceed the scope and procedures recognized by generally accepted auditing standards and other applicable standards recognized by the...[FDIC]."*

According to FDICIA, the auditor's attestation to a bank's internal control report "shall meet or exceed the scope and procedures recognized by generally accepted auditing standards and other applicable standards recognized by the. . . [FDIC]." 12 U.S.C. 1831m(f)(1). This statute clearly gives FDIC the option to apply the PCAOB's Auditing Standard No. 2 to every FDICIA reporting bank, whether or not it is publicly owned.

Thus, the FDIC soon must decide whether non-public banks filing FDICIA internal controls reports for year end 2004 (and later years) and their auditors will be governed by the existing AICPA standard (AT 501) or the new PCAOB Standard No. 2. Because the new PCAOB standard is much more demanding than the old AICPA standard, imposing it on non-public banks would increase significantly the time and expense associated with internal control reports. It also would require a bank's auditor who does not audit public companies and who is not registered with the PCAOB to use an otherwise unfamiliar standard.

But the FDIC nonetheless may choose to require every bank internal control report to conform to the new PCAOB Standard No. 2 because:

- The bank regulators have publicly criticized the pre-existing auditing standard (AT 501) as ineffective, and believe the new PCOAB standard to be a better one for evaluating the effectiveness of internal controls; and
- Confusion might result from attempting to maintain two different reporting and attestation standards for different FDICIA reporting banks.

The FDIC has not yet determined which auditing standard a non-public bank and its auditors should use for FDICIA internal control reports.

## Effects on Auditors

### FDICIA

The FDIC's regulation implementing FDICIA requires an independent auditor for a FDICIA reporting bank to:

- Be licensed by an appropriate state body,
- Agree to provide the bank's regulators access to the auditor's workpapers,
- Have peer review reports, and file those reports and any related comment letters with the FDIC,
- Conform to the independence requirements of both the AICPA and the SEC, and
- Notify the bank's regulators whether it agrees with the reasons stated by a former client for terminating the auditor's services. This requirement may be satisfied by filing with the bank's regulators a copy of any similar statement the auditor filed with the SEC regarding the former client.

### Sarbox

Under Sarbox, a public company's auditor must not only be licensed by an appropriate state body, but also registered with the PCAOB. The PCAOB also regularly inspects the auditing firm for adherence to:

- The provisions of the securities laws applicable to accountants,
- PCAOB rules, and
- Professional standards.

The PCAOB reserves the right to make these inspection reports available to bank regulators.

For a bank's independent accountants, the greatest practical impact of Sarbox results from the FDIC's requirement that an accountant for a FDICIA reporting bank conform to SEC independence rules. See, 12 CFR, Part 363, Guideline No. 14. Responding to Sarbox, the SEC effective May 2003 significantly changed those rules. They now:

- Limit non-audit services that may be provided to an audit client;
- Require audit committee prior approval of engagements to provide both audit and non-audit services, and specify procedures for such approvals;
- Mandate rotation of audit partners;

- Prohibit the audit engagement or concurring partner from being compensated from non-audit services provided to the company;
- Restrict for one year a company's employment in certain positions of anyone who worked on the audit engagement; and
- Require the auditor to report to the company's audit committee:
  - Critical accounting policies used by the company,
  - Alternative treatments discussed with management for financial information, and
  - Other material communications with management, such as a management letter or schedule of unadjusted differences.

Under FDIC Guideline No. 14, the independent auditor for a FDICIA reporting bank must adhere in auditing the bank to each of these independence rules, whether or not the bank is publicly owned and whether or not the auditor is registered with the PCAOB.

## Conclusion

FDICIA reporting banks—particularly those that are not publicly owned—should stay tuned to the FDIC for further guidance about how the FDICIA and Sarbox requirements will be integrated.

*Meanwhile, PwC continues actively to monitor developments affecting FDICIA reporting banks. For more information, please contact Westbrook Murphy in Washington, D.C. at (202) 414-4301 or westbrook.murphy@us.pwc.com or your PwC engagement partner will be glad to respond to any questions you may have.*

# Sarbanes-Oxley, the Chief Information Officer, and the Information Technology Organization

*by Christopher Provato, William Thompson, and Beji Varghese*

*A key component of the Sarbanes-Oxley legislation is management's responsibility to establish adequate controls, policies, procedures, and documentation to ensure the validity and completeness of the financial reports. Companies are recognizing that this extends beyond departmental operating controls to the policies and procedures of the underlying technology used to calculate and store data. Many consumer finance companies are turning to the chief information officer (CIO) to facilitate the understanding and implementation of the controls, policies, and procedures that will ensure underlying systems store and produce accurate and complete financial data.*

## What Can the CIO Do?

The SEC identifies the COSO framework by name as a methodology for achieving compliance. The COSO framework defines five areas, which when implemented, can help support the requirements as set forth in the Sarbanes-Oxley legislation. These five areas and their impacts for the CIO are as follows:

1. **Risk assessment.** Before a CIO can implement the necessary controls, he or she must first assess and understand the areas of risk affecting the completeness and validity of the financial reports. The CIO must examine how the company's systems are being used and the current level and accuracy of existing documentation. Once the areas of risk are identified, they will drive the definition of the other four areas of the COSO framework.

2. **Control environment.** An environment in which the employees take ownership for the success of their projects will encourage them to escalate issues and concerns, and feel that their time and efforts contribute to the success of the organization. This is the foundation on which the IT organization will thrive. Employees should cross train with design, implementation, quality assurance, and deployment teams to better understand the entire technology lifecycle.

3. **Control activities.** Design, implementation, and quality assurance testing teams should be independent. By separating these three components of the enterprise, the CIO will be more likely to recognize design flaws, and to identify fraudulent or malicious activities before they affect financial reports. ERP and CRM systems that collect data, but feed into manual spreadsheets are prone to human error. The organization will need to document usage rules and create an audit trail for each system that contributes financial information. Further, written policies should define the security protocols, technical specifications, business requirements and other documentation expected for each project.

4. **Monitoring.** Auditing processes and schedules should be developed to address the high-risk areas within the IT organization. IT personnel should perform frequent internal audits. In addition, personnel from outside the IT organization should perform audits on a schedule that is appropriate to the level of risk in a specific area. Management should clearly understand and be held responsible for the outcome of these audits.
5. **Information and communication.** Without timely, accurate information, it will be difficult for the CIO to proactively identify and address areas of risk. He or she will be unable to react to issues as they occur. The CIO must demonstrate to the CFO an understanding of what needs to be done to comply with Sarbanes-Oxley and how to get there.

## Conclusion

The IT architecture and the systems that support the business processes are the backbone of an organization. The corporate CIO has an uphill battle and the deadlines are approaching fast, but with careful assessment and planning, it is not too late yet to put in place the required controls. At that time, the CIO will be able to effectively support ongoing 404 compliance processes.

*For more information regarding the effects of Sarbanes-Oxley on the CIO, please contact Christopher Provato in Pasadena at (602) 364-8172 or christopher.j.provato@us.pwc.com, William Thompson in New York at (646) 471-7150 or william.t.thompson@us.pwc.com, or Beji Varghese at (678) 522-6658 or at beji.m.varghese@us.pwc.com.*

*Without timely, accurate information, it will be difficult for the CIO to proactively identify and address areas of risk. He or she will be unable to react to issues as they occur.*

# 404 Considerations for the tax practitioner

*by Susan Mooradian*

While the conventional approach may be to treat tax as a completely separate area to be assessed under Section 404 of the Sarbanes-Oxley Act of 2002, an alternative approach would integrate key elements of tax risk and controls with the relevant area or activity being evaluated by the financial accountants. Key integrated areas that would merit an integrated approach would be mortgage servicing rights, securitization processes, and hedging risk management activities.

For example, a mortgage banker who is evaluating risk and controls over its hedging activities and accounting policies may want to consider integrating the tax treatment of this area. Key controls areas would include an assessment of items such as whether the asset being hedged qualifies for hedge treatment for tax purposes and whether the transaction has been properly identified as such.

As a reminder, the tax rules require this identification to be made separately for tax purposes and reliance on the financial statement identification would not be sufficient. Failure to properly identify hedges for tax purposes could result in income character mismatches, ordinary gain and capital loss. The result could be capital losses that are deductible only against capital gain income and the risk of an improperly accounted for deferred tax asset. In addition, failure to identify a transaction as a hedge for tax purposes could also result in a timing mismatch requiring the recognition of gain or loss on the hedge without the recognition of the offsetting asset position.

This integrated approach to Section 404 provides the registrant with a more complete picture of its control environment in key areas and allows for earlier recognition of complex and potentially troublesome tax areas.

*For more information on managing tax areas under Sarbanes-Oxley 404, please contact Susan Mooradian in Washington, D.C. at (202) 414-1584 or susan.mooradian@us.pwc.com, Tom Lodge in Boston at (617) 530-7335 or thomas.lodge@us.pwc.com, Jim Damato in Los Angeles at (213) 830-8244 or james.damato@us.pwc.com or Gale Blackburn in Charlotte at (704) 344-7572 or gale.blackburn@us.pwc.com.*

# Why is a model validation program necessary in a Sarbanes-Oxley environment?

*by Ric Pace and Steve Robertson*

Financial institutions rely heavily on various financial and economic models for financial reporting applications, such as financial instrument valuation and loan loss forecasting and reserving. The level of sophistication of these models typically varies greatly from relatively simple spreadsheet models to complex statistical models. Regardless of the level of sophistication, model usage exposes an organization to some level of model risk; for example, model errors may cause a valuation model to estimate incorrectly the fair market value of a financial asset. Based on our experience, model errors are usually caused by one or more of the following factors:

- Data quality / integrity issues;
- Poor / incorrect model design and development;
- Inexperienced model users / developers;
- Computer programming errors;
- Little or no internal controls; and
- Little or no on-going model validation.

In the previous issue of this newsletter, we shared some thoughts about managing financial and economic model risk management. Specifically, we discussed the expectations for model validation outlined by the Office of the Comptroller of the Currency (OCC). OCC Bulletin 2000-16 discusses regulatory guidance for elements of a sound model validation program and the scope of model validation procedures.

With the Sarbanes-Oxley Act of 2002; however, the need for a well-designed and effective model validation program is even more important. In this article, we discuss how a model validation program can form an integral part of management's internal control structure over financial reporting, and we highlight three key steps that we believe are crucial in the design and operation of an effective model validation program.

**1. Identify models used in financial reporting procedures**

A useful method for identifying models that are key elements of financial reporting procedures is to map financial statement line items back to source data and systems. This mapping exercise should enable management to recognize models that directly influence financial statement line items and develop an inventory of such models. Most financial institutions that have performed this type of mapping exercise have developed an extensive inventory of models that required an in-depth review of model risks and controls. However, given the large inventory of models that will likely require further review, management may want to consider prioritizing such reviews based on

the materiality of the financial statement line item a model impacts, or management's initial assessment of a model's controls (or lack thereof).

**2. Develop a model validation policy**

Senior management should establish a formal model validation policy to provide a framework for the company's model validation program. This model validation policy should articulate key elements of the company's model validation program such as:

- Policy scope outlining the types of models to which the model validation policy applies;
- Roles and responsibilities for key departments/ committees, model developers/owners, and Internal Audit in the model validation process [1] ;
- Minimum model documentation and performance standards that are required before a model can be approved for use in a production environment;
- A set of consistent review and documentation standards that senior management requires for all independent model reviews / validations; and
- Specific guidance on the set of required internal controls that must be developed and implemented for various types of models, including specific management approval authorities, change management controls, controls to ensure on-going model validation, model security and version controls, etc.

**3. Perform model reviews and assess model controls environment**

Using the standards articulated in the company's model validation policy, and the procedures contained in the model validation program, the company should perform model risk assessments and control reviews on the inventory of models that impact financial statement line items. Consistent with policy, management should ensure that:

- These reviews are performed by personnel with the appropriate level of modelling subject matter expertise that is commensurate with the complexity of a model being reviewed;
- The model review procedures and findings are documented to provide evidence of testing of the specific control activities for each model;
- The findings from the model review process are used to form an assessment of the design and operating effectiveness of the internal controls framework for models that impact financial reporting; and
- Action plans addressing identified model control weaknesses are established and tracked.

1. A key regulatory expectation when defining roles and responsibilities in the model validation process is that model reviewers should be independent of model developers.

## Conclusions

As discussed above, a model validation policy helps a company to establish its control environment over financial reporting risks, while a model validation program represents an important “monitoring of controls” activity. Together with appropriately designed and implemented model-level control activities, these elements should form an appropriate and effective internal control framework that satisfies the certification process for Sarbanes-Oxley Section 404.

*PricewaterhouseCoopers has a team of professionals available to answer your questions about model validation and performs reviews of a wide-range of model applications. Please contact Steve Robertson in Minneapolis at (612) 596-6000 or steve.robertson@us.pwc.com or Ric Pace in Washington, D.C. at (202) 414-1690 or ric.pace@us.pwc.com with any questions or comments.*

*... a model validation policy helps a company to establish its control environment over financial reporting risks, while a model validation program represents an important “monitoring of controls” activity.*

# 2 Accounting and Financial Reporting

# SOP 03-3 Accounting for certain loans or debt acquired in a transfer–think rifle, not shotgun

*by Christa Dewire and Brent Hicks*

For some time now, we have heard rumblings about the Purchased Loan project. After numerous rounds fired among the AcSEC, banks, and regulators, in December 2003, the AcSEC issued SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*.

**Who is impacted by this new standard?** Any nongovernmental acquirer of loans through (a) individual loan purchases, (b) purchases of pools of loans, or (c) a business combination including a portfolio of loans must apply the standard. There are certain scope exceptions identified within the standard; however, almost all financial institutions are impacted to some degree, with serial acquirers and acquirers of troubled assets being the most significantly effected.

**When is the standard effective?** For calendar year institutions, the SOP will become effective January 1, 2005.

**What loans are in the scope of the standard?** The SOP applies to any *acquired loan or loans accounted for as debt securities (hereafter "loans")* that shows evidence of *credit quality deterioration* for which it is *probable* that the investor will be *unable to collect contractually required payments receivable* in accordance with its contractual terms.

**Does this impact your institution?** It depends on:

- Whether your institution purchases loans;
- To what extent acquired loans have experienced credit deterioration since origination (i.e., has a "B" credit at origination slipped to a "C" credit at acquisition date?);
- If payments are likely to be collected according to the agreement – and if not, are you able to quantify the difference; or
- If you have loans for which Practice Bulletin 6 has already been applied?

If your company meets one or all of these criteria, the SOP may apply to your institution.

**How will the SOP impact your institution?** For loans captured by the SOP, *no carryover of the allowance for loan losses is permitted.* For many financial institutions, this represents a change to current accounting, wherein acquirers often establish a credit reserve upon acquisition of loan portfolios. As noted above, this SOP will not apply to all loan acquisitions, but it does have broader application than it may appear on first reading. Some have interpreted the standard to suggest that the SOP applies only to FAS 114 impaired loans; as such, homogeneous loans (i.e., those typically reserved for under FAS 5) are excluded. This is not the case. *All* acquired loans, regardless of size or type, are required to be assessed under the SOP.

The accounting for loans subject to the SOP is relatively complicated, as the SOP introduces several unfamiliar definitions. The first is 'accretable yield,' which is defined as the excess of the loan's expected cash flows over the initial investment in the loan. Accretable yield is recognized as interest income on the loan, similar to FAS 91 fees. However, a 'nonaccretable difference' must be assigned if the loan's contractual payments exceed the expected cash flows, and this nonaccretable difference is not reflected in the balance sheet or income statement.

However, post acquisition, there is a divergence in the treatment of changes in estimated cash flows subsequent to acquisition, depending on the direction of the change. In general, if there is a subsequent increase in estimated cash flows, the future yield on the loan is adjusted in the period of change, with no retroactive impact to income. If there is a decrease in the estimate, the institution will record a provision for credit losses in the period of the change.

The SOP allows for the aggregation or "pooling" of loans if such loans are individually in scope and share common risk characteristics. Practice is still evolving as to which types of loans institutions will elect to pool versus tracking at the individual loan level. The standard is relatively strict in relation to the maintenance of pool "integrity." If loans are to be pooled, this will present additional information technology challenges for institutions.

**Other effects of the SOP?** Implementation of this standard will also have an impact on the financial statement disclosures of acquiring institutions. Additional footnote disclosures will be required surrounding accounting policy, expected cash flows related to current period portfolio acquisitions, as well as changes in the accretable and nonaccretable yield and adjustments to the allowance for credit losses. Implementation of the SOP will also impact the presentation and prior period comparability of certain metrics currently provided to investors and analysts related to an institution's operating results including earning asset ratios, yield/net interest margin, credit quality metrics, and regulatory capital calculations.

As has been the case with many of the more complex accounting standards recently issued, the implications of adoption go well beyond accounting and disclosure. For affected institutions, there will be implementation costs as management will need to perform regular monitoring of individual loan and aggregate portfolio performance at a deeper level of detail. Subsidiary lending systems will likely require enhancements to track, analyze and report estimated and contractual cash flows on an individual loan and pool basis. **Nonaccrual is still available.**

**What should institutions be doing now to prepare?** If your institution will be impacted, there are several steps you should consider well before the SOP's effective date:

- Educate finance, operations and credit personnel as to applicability and implications of the standard to existing and future acquisitions.
- Assess information technology impact and begin modifications/work-arounds.
- Due diligence procedures may need to be enhanced such that the implications of SOP 03-3 are understood early on.
- Define "common risk characteristics" if you intend to aggregate loan pools.
- Prepare proforma disclosures in advance of the initial quarterly earnings announcements and financial statement filings after the effective date, such that the implications of the standard are more fully explored.
- Discuss the impact to financial statements and related disclosures with regulators and analysts.

The institutions that successfully implement this SOP will be those that are educated and prepared well in advance of the January 1, 2005, effective date. To assist in assessing your readiness with respect to this SOP, PwC has prepared a short survey that was distributed to a number of institutions. We anticipate releasing summarized results of the survey in September 2004.

*For more information regarding the standard, please contact Christa Dewire in New York at (646) 471-8519 or christa.l.dewire@us.pwc.com or Brent Hicks in Birmingham at (205) 250-8486 or b.hicks@us.pwc.com.*

# Group of Thirty: enhancing public confidence in financial reporting

*by Douglas Summa*

## Overview

In December 2002, the Group of Thirty [1] commissioned the formation of a Working Group to look into a range of issues relating to accounting policies and practices related to financial instruments. There were two key drivers for this initiative:

- The incidence of corporate scandals and restatements of financial information, perceived to have derived from failures in accounting policies and practice; and
- Conflicting opinions regarding the future of accounting standards and practice, especially as they relate to the use of "fair values."

The Working Group reached an early consensus that the core problem in such corporate scandals was much more a matter of shortcomings in corporate governance and controls, in addition to failures in disclosure practices, than they were related in any way to systemic weaknesses in accounting standards or frameworks. This belief focused the Working Group on efforts to strengthen corporate governance and control and to enhance the effectiveness of disclosure policies and practices.

In December 2003, the Group of Thirty issued its report titled "Enhancing Public Confidence in Financial Reporting." PricewatehouseCoopers provided assistance in the production of this report. Phil Rivett, lead partner of PricewaterhouseCoopers' Global Banking and Capital Markets Practice in London, was part of the Group of Thirty and Doug Summa, a partner in PricewaterhouseCoopers' Financial Risk Management practice in New York, was a member of the Working Group.

### The report contains four key sections:

1. An analytical framework for accounting systems, considering the goals of accounting standards and the criteria for evaluating accounting models;
2. A plain language comparison of International Financial Reporting Standards (IFRS) and US GAAP;
3. A series of best practice statements regarding the use of fair values in the preparation of financial statements; and
4. A set of guiding principles for more effective public disclosure.

1. The Group of Thirty, established in 1978, is a private, nonprofit, international body composed of senior level representatives of the private and public sectors and academia. It aims to deepen understanding of international economic and financial issues, to explore the international repercussions of decisions taken in the public and private sectors, and to examine the choices available to market practitioners and policymakers.

## Governance and controls

*A key theme is that strong governance and controls, along with appropriate systems, is an essential element in rebuilding confidence in financial reporting, particularly when fair value is a critical component of accounting practice*

Though this report had a number of recommendations concerning accounting and disclosure issues, one of the highlights of the report is related to governance and controls. A key theme is that strong governance and controls, along with appropriate systems, is an essential element in rebuilding confidence in financial reporting, particularly where fair value is a critical component of accounting practice.

The report outlines a series of best practice statements related to the use of fair values in financial statements. The application of best practices for instruments that are marked to fair value, along with the enhanced disclosures, will increase confidence in the reliability of the fair value approach.

With respect to the development of the best practice statements, PricewaterhouseCoopers supported the Group of Thirty by surveying a group of 13 internationally active banks and securities firms in Europe and the United States. The survey covered practices for ensuring the objectivity, consistency and integrity of valuation and accounting procedures for financial instruments, structured under the following headings:

- Governance;
- Controls;
- Price verification; and
- Internal and external audit.

The questions in the survey addressed the nature and extent of the involvement of the board of directors, audit committees, senior management and other management groups, the controls over model development and inputs, the frequency and nature of price verification procedures, and the extent of internal and external audit involvement.

The results obtained were summarized and reported to establish the best practices adopted by the institutions surveyed. A series of 17 best practice statements was prepared and grouped against the four headings listed above. Each is supported by detailed lists of particulars associated with that individual best practice.

## Conclusions

**The 17 best practice statements are:**

**Governance**

1. A clear and delineated governance structure should exist, including provision for appropriate segregation of duties as well as documented procedures for the escalation of issues and exceptions to the board of directors or the audit committee.
2. A senior management grouping should have responsibility for the management and oversight of control and valuation policies and procedures. This group should report the results of its work directly to the board of directors or the audit committee.
3. Initial responsibility for the determination of fair value should reside with the risk taking business. Ultimate responsibility for determining the fair values incorporated into financial statements must be outside the risk taking functions.

4. Senior management should ensure that there are adequate resources, with the appropriate experience, training and reward to ensure that control, risk management, and independent price verification functions are performed to the highest standards.

## Control

5. Risk limits (for both market and credit) should be established, approved and monitored within a framework and overall risk appetite approved by the board of directors or the audit committee.

6. For financial assets and liabilities measured at fair value, organizations should disclose information in their financial statements that is consistent with the way they measure and manage risk. Any significant differences between the day-to-day measurement and management of risk and GAAP should be well documented and approved by senior management and appropriate board level committees. The same practice should be sought for other financial assets and liabilities to the extent that risk oversight and management reporting is not based on GAAP principles. This recommendation is not intended to limit the use of risk management information based on non-GAAP principles (e.g., value-at-risk, etc).

7. There should be a procedure for the approval of new transaction types and markets (New Product Approval) and related controls and risk management approaches. This is a critical element of the control framework.

8. An appropriately qualified and experienced independent price verification (IPV) unit should be responsible for the fair values used in the financial statements.

9. There should be a group dedicated to model verification, independent of risk taking activities, employing highly experienced and qualified quantitative professionals.

10. Valuation models or changes to a valuation model must be reviewed and approved by the Model Verification Group. Details of model approvals and changes thereto should be recorded in an inventory.

11. There should be procedures for the timely review of highly structured complex trades independent of the persons responsible for their design and execution.

12. For institutions using hedge accounting, the documentation, valuation, and control requirements should be managed centrally by financial control.

## Price verification procedures

13. Institutions should undertake a rigorous process, at least monthly, to verify fair values. The results should be reported to senior management. Where fair value is a critical component of reported results, senior management should report the price verification results to the board of directors or the audit committee.

14. An independent group should be responsible for approving and monitoring valuation adjustments for consistency and appropriateness. The group's findings and any changes to the method of determining such adjustments should be reported to senior management. A report of price verification

differences and valuation adjustments should be distributed throughout senior management and, where fair value is a critical component of reported results, to the board of directors and the audit committee.

15. In addition to a rigorous monthly IPV process there should be a process for the review and explanation of daily profit and loss (and for non-traded financial assets/liabilities the relevant periodic profit and loss), which should be reported to senior management on a daily basis.

### Audit

16. Internal audit departments should review at least annually the independent price verification procedures and control processes.

17. External audit should devote considerable resources to reviewing the control environment, including the price verification processes, and performing valuations of transactions, especially in those institutions where fair value is a critical component of reported results.

Three key recommendations accompany the above best practice statements:

(1) All major banks and investment banks should evaluate their current practices against the best practice statements;

(2) The results of such a review should be reported to the board of directors or audit committee; and

(3) Public disclosures should include a written statement of each institutions governance policies consistent with the best practices regarding governance practices.

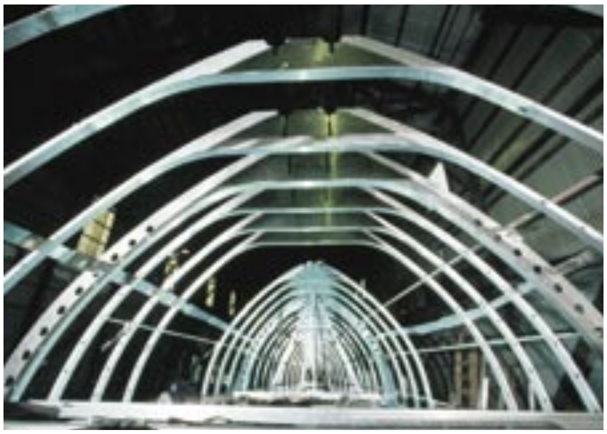
Organizations for whom the use of fair value forms a key aspect of the accounting framework should consider their position with regard to the best practice statements and the above recommendations as soon as possible. Non-compliance or non-disclosure may result in reduced confidence in published financial information. For those organizations currently conducting programs designed to ensure compliance with the requirements of the Sarbanes-Oxley legislation, the best practice statements provide an opportunity to not only benchmark ideal internal control frameworks, but also to ensure best practices are achieved in an efficient manner.

Ultimately, the report provides an opportunity for those organizations that follow the guidance to achieve the twin goal of enhancing the perception of both their organization and of the quality and transparency of publicly available financial information in general.

*For more information on the Group of Thirty report titled "Enhancing Public Confidence in Financial Reporting," please contact Mark Batten in London at [44] (20) 7804 5635 or at mark.c.batten@uk.pwc.com or Phil Rivett in London at [44] (20) 7212 4686 or phil.g.rivett@uk.pwc.com or Douglas Summa in New York at (646) 471-8596 or at douglas.summa@us.pwc.com.*

# International accounting for financial instruments: a period of change

*by Norbert Porlein*



*Many European companies will be required to implement International Financial Reporting Standards or IFRS by 2005. Other countries are currently making or considering the move to IFRS. The United States' Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) began a convergence project to reduce and finally eliminate differing accounting treatments. At the center of the IFRS debate is the accounting guidance for financial instruments – as one recent research report put it, "the rest of IAS makes no sense without IAS 39."*

International Financial Reporting Standards (IFRS) are in a period of tremendous change. Accounting for financial instruments is no exception. In December 2003, the IASB revised International Accounting Standards (IAS) No. 32, *Financial Instruments: Disclosure and Presentation*, and No. 39, *Financial Instruments: Recognition and Measurement*, reflecting a further move toward full fair value accounting. The rules are complex, sometimes significantly modified from previous guidance, and often different from US GAAP. This article highlights the most significant provisions and changes included in the revised standards.

## Comprehensive guidance for financial instruments

IAS 32/39 provide accounting guidance for most financial instruments, including cash; loans and receivables; debt and equity investments; own debt and equity issued; most derivatives; and loan commitments held for trading. Excluded from the scope are investments in subsidiaries; leases; employee benefits; certain commodity contracts; financial guarantees; and insurance contracts. Key provisions addressed by the revised standards include the distinguishment between liabilities and equity; initial recognition and classification of financial instruments; their subsequent measurement, fair values, hedge accounting and impairment; and finally their derecognition.

Financial guarantees (including letters of credit and other credit default contracts) that provide for specified payments to be made to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due under the original or modified terms of a debt instrument are initially recognized by the issuer at fair value, and subsequently measured it at the higher of (i) the amount recognized under IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, and (ii) the amount initially recognized less cumulative amortization.

## Liabilities and equity

Issued financial instruments are recorded as liabilities or equity based on their substance, rather than their legal form. Instruments requiring delivery of cash or other financial assets to the holder are classified as liabilities. Financial instruments representing a residual interest in the net assets of the issuer are classified as equity.

Compound instruments are split into liability and equity components and accounted for separately. The liability element is determined by fair valuing the cash flows excluding any equity component; the residual is assigned to equity.

## Initial recognition, classification and measurement

Financial instruments are initially recorded on an entity's balance sheet upon becoming party to the respective contractual provisions. Initial measurement is at fair value, which generally equals the fair value of the consideration given or received, including external transaction cost. Subsequent accounting treatment depends on the classification of the financial instruments:

- **Financial assets at fair value through P&L** include trading assets and other financial assets designated to this category at inception. Unless qualifying for hedge accounting, derivatives are classified as trading; purchased loans or receivables may be classified as trading. The designation of any instrument for ongoing measurement at fair value with fair value changes recorded in current income is irrevocable during the life of the instrument. Recording financial assets at fair value through income enables portfolio hedging without meeting formal hedge accounting requirements.
- **Loans and receivables** include non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. Loans entered into as participation during syndication or purchased after origination are also included in this category unless they are held for sale or trading. This category may only contain financial assets if entities expect to recover their entire initial investment (except for losses due to credit deterioration). Subsequent to initial recognition, loans and receivables included in this category are accounted for at amortized cost, subject to impairment charges.
- Financial assets with fixed or determinable payments and fixed maturity are categorized as **held-to-maturity** if the entity has the continuing positive intent and ability to hold them until maturity, excluding originated loans. Failure to comply with the rules for held-to-maturity assets may taint the category, force reclassification to available-for-sale, and prohibit an entity to utilize this category for two years. Held-to-maturity instruments are carried at amortized cost.
- Financial assets not included in another category are accounted for as **available-for-sale**, and measured at fair value, with fair value changes (other than impairment) recorded in equity until realized. Any financial asset, except for trading instruments, may be included in this category.
- **Financial liabilities at fair value through P&L** include trading liabilities (primarily derivatives and short sales) and other liabilities designated to this category at inception. The permission to account for financial liabilities at fair value through income is a major difference to U.S. GAAP.

### Financial asset categories

| | |
|---|---|
| Financial assets at fair value through P&L | Loans and receivables |
| Held-to-maturity investments | Available-for-sale |

- **Other financial liabilities** are recorded at amortized cost using the effective interest method, except for (a) financial liabilities recorded at fair value through profit or loss, and (b) financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition [1] or are accounted for using the continuing involvement approach [2].

In April 2004, the IASB proposed to restrict the use of the fair value option again by (a) limiting the types of financial assets and liabilities to which the option may be applied based on certain criteria [3], and (b) requiring that the option may be applied only to financial assets and liabilities whose fair value is verifiable.

**Reclassifications** are prohibited in and out of the fair value through P&L categories, and would in most situations cause tainting in case of a transfer out of the held-to-maturity category.

The definition of **fair value** was revised to require the use of a quoted market price in an active market (without adjustment for blockage or liquidity factors), or in its absence the application of valuation techniques that include recent market transactions, reference to similar transactions, discounted cash flow and option pricing models. In the unusual situation where no fair value can be obtained, equity instruments may be recognized at cost less impairment charges.

An individual **impairment** may only be recorded based on objective evidence for losses that have actually been incurred. Assets that were assessed, but found not to be individually impaired, should be evaluated collectively for impairment, based on similar credit risk characteristics that are relevant to the estimation of future cash flows for groups of such assets. Methodology and assumptions used for estimating future cash flows are reviewed regularly to reduce any differences between loss estimates and actual loss experience. Reversal of impairment losses taken on available-for-sale equity securities is not permitted.

### Financial liability categories

| Financial liabilities at fair value through P&L | Other financial liabilities |
|---|---|

## Derecognition

**Financial assets** are derecognized if (1) the rights to the cash flows from the asset have expired, (2) the entity has effectively transferred either its rights to receive the cash flows from the asset or substantially all risks and rewards associated with the asset, or (3) no control of the asset is retained. Additional derecognition criteria for pass through transactions (when the transferor continues to collect cash flows from the transferred asset) include: (1) there is no obligation by the transferor to pay cash flows unless equivalent cash flows are collected; (2) the transferred assets cannot be used for the transferor's benefit; and (3) the transferor is obliged to remit cash flows on a timely basis. On derecognition, a gain or loss is recognized in the income statement.

### Derecognition steps

**Step 1: Determination of transfer**

- Pass through all or some of the cash flows. If no, continue to recognize the asset.
- Pass through a fully proportional share of cash flows. If yes, derecognize the proportion sold.

**Step 2: If step 1 failed, determination if exposure has been transferred**

- If substantially all exposure transferred: derecognize in its entirety.
- If substantially all the exposure retained: continue to recognize in its entirety.

**Step 3: If step 2 failed, need to determine whether control has been retained based on practical ability to sell the asset**

- If control retained, continue to recognize the asset based on continuing involvement model.
- If control transferred, derecognize the asset.

1. See IAS 39, Par. 29
2. See IAS 39, Par. 31
3. The proposed revision of IAS 39, Par. 9 restricts the fair value option to hybrid instruments; financial liabilities whose cash flows are contractually linked to the performance of assets measured at fair value; and financial instruments whose exposure to fair value changes is substantially offset by other financial instruments, as defined. The proposal would prohibit the fair value option for loans and receivables.

**Financial liabilities** are removed from the balance sheet only when extinguished, that is, when the obligation is discharged, cancelled or expired. The condition is met when the liability is settled by paying the creditor or when the debtor is released from primary responsibility for the liability either by process of law or by the creditor. The difference between the amount paid and the liability's carrying amount is recognized in income.

Transactions that do not satisfy the conditions for derecognition are accounted for as collateralized borrowing.

## Derivatives and Hedge Accounting

The provisions for derivatives and hedge accounting remain largely unchanged. However, there are certain changes with respect to bifurcation requirements of embedded derivatives. Hedges of firm commitments are now accounted for under the cash flow hedge model; and companies are permitted to record a basis adjustment for hedges of forecasted transactions that result in the recognition of a non-financial asset or liability.

In March 2004, IAS 39 was amended to permit fair value hedge accounting for a portfolio hedge of interest rate risk. For such hedges, it allows: (a) the hedged item to be designated as an amount of a currency rather than as individual assets (or liabilities); (b) the gain or loss attributable to the hedged item to be presented either (i) in a single separate line item within assets, for those re-pricing time periods for which the hedged item is an asset, or (ii) in a single separate line item within liabilities, for those re-pricing time periods for which the hedged item is a liability; and (c) prepayment risk to be incorporated by scheduling pre-payable items into re-pricing time periods based on expected, rather than contractual, re-pricing dates.

## Effective date and transition

The revised standards are effective for fiscal years starting January 1, 2005. Early adoption is permitted, restatement of prior years is required. First-time adopters of IFRS in 2005 are permitted to not restate comparative financial statements, but must provide additional disclosure. However, there continues to be vigilant opposition to the provisions and requirements of IAS 39 in various European countries, particularly as it relates to hedge accounting. At this time, IAS 39 remains the only standard not yet approved by the European Union.

## Key differences to U.S. GAAP

While the revision of IAS 32 and IAS 39 eliminated a number of differences between U.S. GAAP and IFRS, various new differences have been created. Examples include the areas of classification, measurement, hedge accounting, and securitizations. The revised guidance on macro hedges further increased the discrepancy between IFRS and U.S. GAAP.

*For more information on the application of International Financial Reporting Standards for banks and other financial institutions, please contact Norbert Porlein in New York at (646) 471-5956 or by e-mail at norbert.porlein@us.pwc.com.*

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# 3 Regulatory and Taxation

# XBRL streamlines the FFIEC call report process

*by Keith Moss*

## The call report process

In late 2004, the Federal Financial Institutions Examination Council (FFIEC) expects to go live with a new XBRL enabled Call Report process (www.ffiec.gov/find). The process has been facilitated jointly by the Federal Deposit Insurance Corporation (FDIC), the Federal Reserve Board (FRB), and the Office of the Comptroller of the Currency (OCC) and is expected to be implemented with assistance from Unisys, PricewaterhouseCoopers, Microsoft and other partners. In short, the project is a cooperative effort to revamp and improve the current data collection process by using leading-edge XBRL (eXtensible Business Reporting Language) and Web services.

## Before

The current quarterly call report process begins with the publication and distribution of paper forms – the 031 and 041 Call Report forms – from the FFIEC. Using these paper forms as a specification, a number of software vendors, and a few tech-savvy banks, then incorporate the updated forms into their Call Report software. This software lets users manually enter accounting information and transmit it electronically to the FFIEC through a proprietary network operated by EDS. In turn, the FFIEC validates the data and resolves errors through a manual off-line process handled directly with the banks.

In total, nearly 8,400 banks each submit approximately 1,200 data elements through this process each quarter. With the Call Report changing slightly each quarter, the FFIEC collectively dedicate nearly 50 people to the management and execution of this end-to-end process. Timeliness, accuracy and availability of data are a critical part of the supervisory process, however many banks are currently allowed up to 45 days after quarter end to file their report. After institutions submit their data, it is gathered and validated prior to release. The entire process can take up to 50 days to complete, due in large part to the amount of time institutions have to submit their data.

## After

The revised Call Report process will be highly automated, replacing paper forms with electronic ones. This new Straight Through Reporting (STR) environment will leverage the functionality of XBRL to reduce the cycle time by approximately two to three weeks in the short-term and potentially even more in future years. At the heart of the improved process is the XBRL Call Report taxonomy, which is a standardized vocabulary of XML (eXtensible Markup Language) terms tailored specifically to represent the 1,200 data elements collected in the Call Report. This taxonomy will replace the paper forms from the original process, as next generation Call Report Software will retrieve updated quarterly taxonomies directly from a Web service and automatically update themselves when new form specifications are made available.

Included in the taxonomy are the unique "Linkbase" functionalities of XBRL. The Linkbases bring added dimensionality to the XBRL data – in this case they contain business rules and validation criteria to enable Call Report Software to perform real-time error checking **before** data is transmitted to the FFIEC. Through providing better information about their data quality standards, the FFIEC expects to achieve significant processing efficiencies for both the bankers and the regulatory agencies. By employing the Linkbases this way, the responsibility for data validation and error resolution will remain with the banks, the ultimate source of the data. Finally, encrypted data will be transmitted to the FFIEC through the Internet where a Web service is continuously waiting to receive the data and store it on a real-time basis in the Central Data Repository (CDR).

## What this means for banks

The banking industry will notice differences resulting from the more proactive Call Report Software. Simply put, this software will help bankers more efficiently submit higher quality data by limiting their ability to submit incorrect data. Therefore, banks could feel the impact of a hard deadline at submission time when any data inconsistencies must be resolved before the Call Report is submitted. The new FFIEC system will respond in real time to data submissions by sending electronic notifications of receipt and confirming the results of the CDR's validation. Compared to today's after-the-fact communication (aka a 'Call'), the improved responsiveness of the CDR will allow regulators to have more timely and direct discussions with bankers as they complete their call reports.

The major players in the Call Report Software market will remain the same although a few new entrants may emerge. However, in light of the unique ways that each vendor chooses to implement the new process, banks may want to reevaluate their software providers since XBRL allows flexibility in how each vendor chooses to support the new requirements.

## Leading change

In addition to streamlining the Call Report process, the FFIEC's effort paves the way for a new reporting paradigm in the banking industry. In the near term, most banks will use Call Report software as a means to manually key in the financial data collected in the Call Report. However, with a small amount of investment, it will be possible to flow XBRL formatted data electronically from back office accounting systems into the Call Report. A bank that adopts a Straight Through Reporting environment for internal and external reporting will likely see enhanced accuracy and a significant reduction in the time required to prepare management and regulatory reports that draw on financial or non-financial data. Those resources previously devoted to data collection, cleansing and preparation instead can be redirected to analysis and decision making based on the final report.

Any data collection and dissemination process in the banking industry stands to benefit from the FFIEC model. XBRL taxonomies can be developed to support the data requirements of both internal management reporting and external regulatory reporting. Business activities such as credit risk management and performance reporting are prime candidates to benefit from XBRL. Mapping from one taxonomy to another is completely supported by XBRL, greatly facilitating data integration. Web services technology leverages the Internet standard Hyper Text Transport Protocol (HTTP) and serves as the primary means to retrieve and post data. As a result, a Straight Through Reporting Environment is geographically, platform, and application independent, poising it to become the best of breed model for business financial and non-financial data management and reporting.

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# Branch Capital: two favorable rulings for the taxpayer in "NatWest v. U.S.," yet the case goes on…

*by Adam Katz and Reuben Tatz*

The attribution of capital to branch operations is rapidly becoming one of the key concerns for those managing tax in banks. Developments at the Organisation for Economic Co-operation and Development (OECD), together with legislation at the national level and the relevant treaty position, has produced a range of different, often inconsistent, approaches. The ongoing National Westminster Bank PLC case (NatWest), which is still under consideration in the U.S. Federal Court of Claims, provides insight into how conflicting approaches can play out in practice, as the attribution of branch capital becomes more rather than less complicated as time goes on – a sobering thought.

## Background

During 1981-1987, the NatWest U.S. branch offices (NatWest-US) conducted commercial banking transactions with related and unrelated parties. NatWest claimed its U.S. branch operations should be treated as a "separate entity" reflecting the income and expenses recorded on its books. Challenging the book interest expense deduction, the U.S. government (the Government) instead applied the formula embodied in U.S. Treas. Reg. Sec. 1.882-5 (882-5 regulations) which seeks to determine deductible interest by first attributing capital to a branch via a complex asset-based formula. In 1995, after a lengthy period of debate with no resolution, NatWest chose to pay the tax and interest, which the Government claimed it was owed, and then promptly sued for a refund in the U.S. Federal Court of Claims (the Court).

## Two separate rulings

### Ruling 1 - July 1999

The Court issued rulings on two separate cross motions for partial summary judgment. First, in 1999, the Court ruled that NatWest acted appropriately in applying the separate enterprise articles of 1975 U.S./U.K. Income Tax Treaty (the Treaty) rather than 882-5 regulations to determine deductible interest expense. The Court ruled that if the books and records of the permanent establishment (PE) adequately reflect profits of the U.S. branch, then those books and records should be respected (44 Fed.Ct.Cl.120, 1999). Moreover, the Court ruled that the 882-5 regulations were inconsistent with Articles 7(2) and 7(3) of the Treaty. The Court noted that adjustments could be required to reflect adequate capital and arm's-length interest rates.

### Ruling 2 - November 2003

The next phase of the trial involved fact finding as to whether NatWest-US did, in fact, deal at arm's-length with related parties and attempted to resolve the question of what constituted adequate capital that could be imputed to the Branch. The Court ruled that

NatWest's approach was consistent with the Treaty and that applying the approach suggested by the Government would be contrary to the anti-discrimination clause in Article 24(2) of the Treaty (95-758T, Fed.Ct.Cl., Nov.14, 2003).

## Conclusions from the NatWest rulings

1. The arm's-length principle is the standard under which branch profits should be determined (with the starting point being the properly maintained books and records).
2. The Treaty required that the properly maintained books of the Branch should be used to determine the taxable profits attributable to the Branch as if it were "separate and distinct" from its parent.
3. Separate and distinct does not mean the Government could impute capital as if the Branch were a separately incorporated U.S. bank and thus apply a "U.S. corporate yardstick."
4. Subsequently issued OECD statements addressing capital imputation were not relevant in analyzing the years at issue.

## Concluding remarks

The NatWest case has been under consideration for such an extended period of time and with no quick end in sight, it would be reasonable to ask whether a final adjudication of the case will ever have any meaningful impact. But in fact it already has — by nature of the case's very existence. The two rulings issued by the Court of Claims represent a *de facto* stake driven into the heart of long standing IRS theology – a theology that held that 882-5 was the law of the land and needed to be applied irrespective of treaty commitments.

Moreover, mere consideration of the case has, in some situations, caused the IRS to move away from its rules regarding the impermissibility of interbranch dealings and today, in many instances, has conceded the economic wisdom of recognizing interbranch transactions so long as they hold to an arm's-length standard. The proposed global dealing regulations are a prime example of the change in the Government's thinking and it could be argued is a direct result of its having to contend with even the **possibility** that the NatWest U.S. Branch was entitled to be treated as a separate enterprise.

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# Withholding foreign partnership and trust rules – do they simplify or complicate compliance?

*by Denise Hintzke*

In July 2003, the Internal Revenue Service (IRS) issued Revenue Procedure 2003-64 (the Procedure) which finalized guidance for withholding foreign partnership (WP) and withholding foreign trust (WT) agreements. To date, there has been minimal interest in the Procedure with few entities actually taking steps to enter into WP or WT agreements. This article briefly discusses some of the reasons for this disinterest and how this disinterest may impact banks serving as custodians.

The Procedure was enacted to simplify the complicated rules surrounding U.S. withholding and reporting obligations for payments to non-US partnerships and flow-through trusts. Under these rules, such entities must disclose the identity of their partners, beneficiaries or owners (underlying persons) and provide allocation information so that the custodian can properly withhold and report to the IRS. Payments to entities that fail to provide the required documentation and allocation information are subject to withholding at a rate of 30% on U.S. source income, including portfolio interest. The entity must still disclose directly to the IRS the identity of its underlying persons; if it fails to do so, a 20% penalty may be assessed. If the entity chooses to disregard the disclosure requirements, the IRS may freeze assets held in the U.S. by that entity

These rules are difficult to implement, as they generally require the custodian to have a system to identify persons other than direct customers for purposes of documentation, withholding and reporting. For widely held funds with many investors and high turnover, or in situations where income must be traced through numerous lower-tier partnerships, compliance with the rules may be nearly impossible.

The Procedure introduced the concept of the WP or WT – a non-U.S. partnership or flow-through trust that enters into a formal agreement with the IRS transferring responsibility for documentation, withholding and reporting from its custodian to itself. Once an entity has entered into such an agreement, it provides its custodian with documentation identifying itself as a WP or WT; it need not disclose or pass-through documentation for its direct underlying persons. In addition, the WP or WT receives the gross payment of income and then withholds and deposits tax based on the documentation that it holds for its underlying persons. Since the WP or WT is responsible for withholding and depositing taxes and only needs to do so upon the actual disbursement of income or the filing of its annual tax return, allocation information does not have to be provided to the custodian.

Conceptually, the agreements provided by the Procedure are meant to simplify withholding and reporting obligations on payments of U.S.-source income made to non-U.S. partnerships and trusts, which is probably the case if the entities enter into such agreements. However, several factors may render the agreements undesirable to many entities and implementation of the agreements complicated or impractical.

First, the IRS has not done a good job publicizing the requirements. The Procedure was released in the midst of the qualified intermediary (QI) audits and as such received little attention. Moreover, the IRS introduced transition rules for reporting partnerships and trusts and even eliminated the review of partnerships during the audits. Not surprisingly, the result of the IRS actions provided little incentive to the partnerships and trusts to address the issue or comply with the requirements. Furthermore, little effort was made by the custodians to enforce the rules.

Further, although similar to QI Agreements, there are significant differences in the WP and WT requirements, attributable in large part to the differences between such entities and financial institutions. Thus, certain provisions of the agreement are problematic, such as treatment of indirect account holders, use of documentary evidence, and reliance on presumption rules. Also, based on the complexity of the requirements, it is unlikely to be of practical benefit to many partnerships and trusts as the vast majority of them lack an infrastructure large or sophisticated enough to deal with the required documentation gathering and maintaining, due diligence reviews, withholding, depositing, and reporting.

Finally, the IRS has continued to provide alternative solutions for partnerships or trusts where the custodian is a QI or another WP or WT. These alternatives include the ability to treat the entities under the same rules that apply to joint account holders or, where the partnership or trust is “related” to the QI, WP or WT, in a manner similar to a private arrangement intermediary.

Based on the above, it is unlikely that there will be any move by foreign partnerships and trusts to enter into WP or WT agreements in the near future. In addition, since WP or WT status only applies to the entities’ direct underlying persons, it must continue to provide documentation and allocation information to the custodian for indirect persons and the compliance burden is still shifted to the custodian.

The bottom line is that regardless of the Procedure’s attempt to simplify the rules, financial institutions that are custodians for such entities will continue to struggle with the documentation and disclosure rules as these financial institutions take steps to bring the entities into compliance.

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# Regulators reinforce need to develop new products within formal risk management framework

*by Siddharth Doda and David Albright*

## Introduction

With increasing competition in the financial services sector, banks face challenges in growing their traditional lines of business. This has resulted in increased acquisitions and consolidation in the industry as banks strive for diversification, economies of scale and improved profit margins. Another way in which banks can grow and improve their financial performance is through the development and delivery of new products or services to customers.

The development of new products or services is typically a function of both external and internal drivers. External drivers include changes in economic conditions, technology or competition, or the identification of a defined market need for a product or service. Internal drivers are typically the need to improve profits as well as to increase market share and customer loyalty.

For the purposes of this article, new products or services are defined as traditional and non-traditional banking products and services, as well as modifications to existing products and services. Modifications include changes in the terms or nature of an existing product or service that significantly alter the underlying risk characteristics of the product or service (e.g., significant changes in underwriting standards, geographic or industry focus).

## Recent regulatory guidance on new products

For several years, federal bank regulators have been evaluating banks' new product approval processes as part of onsite examinations. However, after the recent, highly publicized failures in the financial markets related to Enron, which involved complex structured transactions, as well as the consumer complaints related to products such as payday and title lending, the Office of the Comptroller of the Currency (OCC) has focused even more intently on banks' procedures for authorizing new products [1]. This resulted in targeted risk management examinations focusing on new product processes that resulted in the issuance in May 2004 of formal supervisory guidance.[2] A unique aspect of the guidance is it requires banks to discuss their new product development plans in advance with their OCC examiner-in-charge or supervisory office if the new activity constitutes a significant deviation from the bank's existing business plan.

1. *OCC News Release 2002-92, Statement of Douglas Roeder, Senior Deputy Comptroller OCC, before the Permanent Subcommittee on Investigations of the Committee on Governmental Affairs of the United States Senate*, dated December 11, 2002.
2. *OCC Bulletin 2004-20, Risk Management of New, Expanded, or Modified Bank Products and Services*, dated May 10, 2004.

## Risks involved in a new product launch

There are a number of interconnected risks involved in a new product launch. Accordingly, it is essential for banks to identify those risks and modify or structure the product in such a way as to mitigate the risks in the best possible manner. The primary risks that arise in the development and introduction of new products or services include:

- **Strategic Risk:** The risk to earnings or capital arising from adverse business decisions or improper implementation of those decisions.
- **Reputation Risk:** The risk to earnings or capital arising from negative public opinion.
- **Credit Risk:** The risk to earnings or capital arising from an obligor's failure to meet the terms of any contract with the bank or otherwise fail to perform as agreed.
- **Transaction Risk:** The risk to earnings or capital arising from problems with service or product delivery.
- **Compliance Risk:** The risk to earnings or capital arising from violations of laws, rules, or regulations, or from nonconformance with internal policies and procedures or ethical standards.
- **Other Potential Risks:** Increased liquidity, interest rate, price or foreign currency translation risk.

## Key components of the risk management process

Regulators recommend that banks take a proactive approach and involve all relevant bank departments in the process up front such as risk management, compliance, audit, IT, finance and operations. This is critical because the involvement of these departments helps ensure that risks are fully understood and risk management strategies are fully vetted.

The OCC guidance highlights the process that banks should follow in order to minimize the impact of the risks outlined above. Regulators expect that all of the steps are performed prior to launch. However, the formality of the bank's risk management process should reflect the size of the bank and the complexity of the product or service offered. The key components outlined are:

*Although the board may delegate the performance of managerial duties to others, it has the ulimate responsibility for ensuring that the bank is run in a safe and sound manner.*

### Due diligence

Management and the board should conduct adequate due diligence to ensure they have a realistic understanding of the risks and rewards of the product or service being considered, as well as a clear understanding of the rationale for offering the product or service. The due diligence process should include:

- Assessing how the risks associated with the new product or service fits with the bank's current business strategy and risk profile;
- Consulting with relevant functional areas, such as credit, compliance, accounting, audit, risk management, legal, operations, information technology, and marketing, as well as the Treasury/Asset Liability Committee (ALCO), to determine risks, concerns, and necessary controls;
- Determining requirements for complying with laws, regulations and regulatory guidance;
- Determining the expertise needed to effectively manage the product or service, including the possible need to acquire additional expertise;
- Researching the background, experience, and reliability of relevant third parties that will be part of the product/service delivery;
- Developing a business and financial plan for the product or service that assesses the bank's competitive position and establishes objectives and strategies for how the product or service will be brought to market; and,
- Developing viable alternatives, including an exit strategy in the event the product or service fails to perform as expected.

Although the board may delegate the performance of managerial duties to others, it has the ultimate responsibility for ensuring that the bank is run in a safe and sound manner. In fulfilling its responsibilities, the board must ensure that a new, expanded, or modified bank product or service is consistent with the bank's strategic goals.

### Risk management controls and processes

Once the bank decides to introduce the new/expanded/modified product or service and develops a business plan, the board and management should develop and implement adequate risk management processes and internal controls to effectively control the risks of the activity. This should include:

- Expanding and amending bank policies and procedures, as appropriate, to ensure that they adequately address the product or service. Policies and procedures should establish accountability and provide for exception monitoring;
- Developing and implementing the information and reporting systems (MIS) necessary to monitor adherence to established objectives and to properly supervise the product or service. MIS reports should contain key indicators to allow the board and management to effectively identify, measure, monitor, and control risk.
- Incorporating the product or service into the bank's audit and compliance processes to ensure adherence with bank policies and procedures and customer safeguards.

### Performance monitoring

Management and the board should have appropriate performance and monitoring systems in place to allow them to assess whether the product or service is meeting operational and strategic expectations. Such systems should:

- Include limits on the size of acceptable risk exposure that management and the board are willing to assume (across measurable risk categories such as credit, operations, and ALM);
- Identify specific objectives and performance criteria to evaluate success of the product or service and the timeframe for achieving success. The performance criteria should include quantitative benchmarks that will serve as a means to evaluate success of the product or service;
- Reflect a process that periodically compares actual results with projections and qualitative benchmarks, to detect and address adverse trends or concerns in a timely manner; and
- Trigger changes in the business plan, when appropriate, based on the performance of the product or service. Such changes may include exiting the activity should actual results fail to achieve projections.

### Risk management of third parties

Unique risks are involved when a bank launches new, expanded, or modified products and services with the assistance of third-party vendors. Inferior performance or service on the part of a vendor may result in unexpected risks, including legal costs or lost business. The bank's board and management must ensure that it understands the risks associated with the activity and conducts adequate due diligence of the vendor, including assessing the proposed vendor's reputation, products, and financial condition. Management must also implement an ongoing oversight program over the vendor's activities and develop a contingency plan in the event the vendor cannot perform as expected. Management should not overly rely on the vendor's assertions, representations, or warranties, but should do its own analysis to ensure the vendor and its products are a good fit for the bank.

The OCC has issued a separate guidance [3] in order to provide additional advice to national banks on managing the risks associated with third-party vendors.

3. *OCC Bulletin 2001-47, Third Party Relationships: Risk Management Principles*, dated November 1, 2001.

## Illustration of the process

The best way to demonstrate the value of an effective new product risk management process is through the description of a successful new product launch by a large division of a bank. In this case, the concept for the product was generated by market demand that was confirmed through the survey of a wide number of clients. The survey was followed by the development of a new product proposal containing a preliminary business and financial plan with projections of market size, competition, estimated revenues and expenses. This exercise demonstrated the need for the product in the marketplace and that the product would be profitable for the bank; however, in order to get approval for the launch, the division needed to ensure that all the risks associated with the product were understood and the product was structured in a way as to minimize those risks.

### Due diligence

As part of the proposal, the sponsoring division assessed the risks inherent in the product and structured the proposed product in a way as to minimize these risks. The division worked closely with the risk management department from the beginning, as well as other departments such as operations, IT, compliance, finance and audit in order to identify risks and estimate the feasibility of the product. The product parameters and its terms and conditions were fine tuned based on their inputs. This was essentially a cross functional effort, however, the business unit/division retained the ultimate responsibility for the process.

### Risk management controls and processes

The proposal grew as the terms and conditions of the product were refined and risk management controls determined. It also specified the systems changes, accounting procedures, and credit/risk limits that would be required. It also specified the MIS that would be generated (content and frequency). Once the proposal was completed, the sponsoring business unit head approved the proposal and circulated the proposal for formal sign–offs from the risk management, operations, IT and compliance departments. The product proposal was then presented to the bank's

new product committee that is specifically constituted to review and approve new products. This committee is chaired by the head of risk management and contained senior management representation from business and infrastructure units. The sponsoring business unit presented the proposal, explained the business prospects and related risks, described the risk management processes and controls designed to mitigate the risks, and the methods of monitoring and judging the performance of the product. The committee (which included business and infrastructure functions), approved the product on a "pilot" basis subject to an internal audit and interim performance assessment.

### Performance monitoring

Regular monitoring of the product was performed during the pilot period by management and risk management. As the end of the pilot period approached, internal audit performed a special review of the product's launch and performance, and reported its results to the new product committee, which then evaluated any risk and control issues as well as compared the products results to the original business plan projections.

The launch of the new product was successful, and eventually it was launched nationally by the bank. The keys to its success were:

- Strong sponsorship/accountability for ownership by the business unit;
- Thorough market due diligence;
- The early involvement of risk and operations functions in the development effort; and,
- Defined performance metrics that were well understood and monitored.

## Conclusion

There is a common belief that “process” restrains innovation. However this perception can be overcome if the process is well-managed and aligned to the strategy of the bank. If a risk management process is implemented properly, the benefits from taking the time to identify and mitigate risk far outweigh the downside of significant financial and/or reputation risk caused by the introduction of a poorly conceived product or service. This is particularly relevant for the banking industry where reputation and compliance risks are substantial. The OCC guidance [4] helps banks in designing a process that meets their needs – and if handled properly – could even increase the number of innovations.

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4. This is broad guidance on the process of risk management for new product/service innovation. For specific products/services (e.g., delivery of services over the Internet), other relevant regulatory guidelines should also be consulted.

PricewaterhouseCoopers