HARVARD LAW SCHOOL | The Case Studies

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First National Bank of Ames Corporation

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On March 23, 2020, the independent auditors of First National Bank of Ames Corporation (FNB), a regional bank holding company based in New England, are beginning preliminary procedures for the Q1 2020 review. The engagement partner, Sally Jenkins, called a remote meeting of the auditors including audit manager, David Wright, and half a dozen staff accountants.

Jenkins: I suppose you're wondering why I called you all together on such short notice. Thanks to your efforts, the review of FNB is going well. We're on schedule compared to the timeline we drew up last fall, and, for the most part, the client has been giving us what we need when we need it. However, I just read a statement from banking regulators included in this week's newsletter from the American Institute of Certified Public Accountants (AICPA) (see **Appendix A**). The Financial Accounting Standards Board (FASB) and banking regulators are concerned about the developing COVID-19 pandemic and the possibility of economic distress. I think you ought to hear some excerpts from what they had to say yesterday on this subject:

> The United States has been operating under a presidentially declared emergency since March 13, 2020, and financial institutions and its customers are affected by COVID-19. The agencies understand that this unique and evolving situation could pose temporary business disruptions and challenges that affect banks, credit unions, businesses, borrowers, and the economy… The agencies encourage financial institutions to work prudently with borrowers who are or may be unable to meet their contractual payment obligations because of the effects of COVID-19. The

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> agencies view loan modification programs as positive actions that can mitigate adverse effects on borrowers due to COVID-19.[1]

The regulators are telling us that banks are encouraged to continue lending during these uncertain economic times. You are no doubt aware of the updated accounting standard for credit losses, called "current expected credit losses" (CECL) (see **Appendix B**), effective January of this year. This updated standard was highly controversial and meant that banks would already have to increase credit loss reserves before the pandemic worsened macroeconomic forecasts. These reserves decrease net income, which not only makes for unhappy investors, but also reduces the amount of regulatory capital available as a buffer. Historically, FNB has been close to falling below the regulatory capital requirements and I'm sure management is scrambling to come up with a workable estimate for this quarter's reserve.

Wright: I know CECL has been on the radar since 2016, but implementing a new standard related to credit losses at the start of what could be a recession seems a little risky.

Jenkins: Even before the pandemic, federal banking regulators had already agreed to phase in the application of CECL to regulatory capital. I've heard from some of my friends in government that the agencies may soon issue an interim final rule delaying further the effects of CECL on regulatory capital. This statement certainly supports that rumor. I have also read that Congress might be weighing in on statutory changes in applying CECL to regulatory capital requirements. Whatever happens over the next few weeks regarding regulatory capital requirements, those changes will not affect the financial statements for complying with U.S. GAAP. Credit losses should still be reported on the financials according to the new CECL standard, which we expect to increase losses compared to those reported last year under the incurred loss standard, but we'll have to reassure clients that the new methodology does not apply to their regulatory capital calculation. Even before the turmoil caused by COVID, banks feared increased losses under CECL, so I anticipate significant pushback and concern from our clients.

If this rule goes into effect, there also might be confusion about the difference between the financial reporting requirements and the regulatory capital reporting requirements. Make sure you understand the new guidance and can explain to clients that CECL is still effective for financial statement reporting but may or may not affect their regulatory capital requirements this year.

Also, I'm sure I don't have to remind you to maintain professional skepticism when completing testing. If anything looks strange to you, be sure to consult your supervisor, the audit manager, or me. We can then discuss it with the client if that's necessary, but we need you to raise any

[1] Interagency Statement on Loan Modifications and Reporting for Financial Institutions Working with Customers Affected by the Coronavirus issued on March 22, 2020, by The Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA), the Office of the Comptroller of the Currency (OCC), the Consumer Financial Protection Bureau (CFPB), and the State Banking Regulators.

concerns. Okay, any questions? (Pause) Then back to work. (As the auditors log out.) David, please wait a minute. I'd like to speak to you.

Wright: What is it, Sally?

Jenkins: I spent some time last night studying FNB's draft financial statements. They look good, but I notice that we haven't received its final provision for credit losses yet. From what I've been hearing from my other bank clients, that's going to be a big number. According to the timing schedule set up last fall, we should have gotten the provision by now, so what's happening?

Wright: I spoke to the controller about that this morning and they're still working on it. I'm sure that part of the problem is that they're just worried about the size of the number they're coming up with and its effect on income and regulatory capital requirements. They must also be thinking about their next regulatory examination from the Office of the Comptroller of the Currency (OCC).[2] They probably don't want to give us a number that the OCC might later criticize as either too conservative—reducing bank lending when the economy needs it; or not conservative enough—risking the bank's safety and soundness.

Jenkins: I can understand their concern, but the number for the financial statements should be calculated based on their best estimate, not what the OCC wants to see. We need FNB's provision soon so that we have time to work with them on the calculation in case there were any issues implementing CECL and can still meet the sign-off deadline for the review. This issue must be handled carefully. FNB is an important client for our office, and there are a lot of other accounting firms that would be happy to take it away from us. I don't think FNB would go shopping for another opinion this year if we take a hardline position on its provision. But who knows what will happen next year if it believes we are being too tough in order to protect ourselves?

At the same time, the economic uncertainty coupled with the implementation of a new accounting standard makes me a little nervous. This client's audit is due for a PCAOB inspection, and I don't want our firm's name in the news because of a regulatory review. I also definitely don't want the firm associated with a bank failure. I'd be very careful about signing off on a number that seemed too low.

Wright: I'll give the controller another call, but I think she's in a meeting with the CFO right now.

Wright placed a follow-up conference call with the audit team to see if they had further questions.

Staff Accountant: I didn't want to say this in front of Jenkins, but what is CECL again?

[2] The OCC Is one of several federal regulatory agencies charged with the supervision of banking institutions in the United States. It is a division of the Treasury Department and is responsible for all nationally chartered banks, including all banks owned by First National Bank of Ames Corporation. In addition, as a bank holding company, FNB is subject to consolidated supervision and regulation by the Federal Reserve Board, and as a company with publicly traded stock, to regulation by the Securities and Exchange Commission.

Wright: It's the new method of accounting for credit losses. Historically, the standards required an incurred loss method, which meant that banks would record losses when they were probable. The accounting standards provided guidance for determining probability. During the 2008 financial crisis, there was widespread concern that the incurred loss standard reported losses too late and started brainstorming on a new method of estimating credit loss reserves. In the United States, that new method is expectations based. Banks have to estimate the amount of loss over the life of the loan, based on economic information available at the reporting time. The firm recently published a brief overview (see **Appendix B**).

Staff Accountant: But the economy keeps changing, how can we incorporate economic changes that are so uncertain?

Wright: We'll have to make sure the client increases reserves in good faith and based on their best estimates of losses. Luckily CECL allows banks some flexibility in the way they forecast losses. But we'll have to make sure that the client's estimate seems reasonable and that they weren't overly optimistic in an effort to protect earnings and capital.

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Company and Economic Background

First National Bank of Ames traces its roots back to the early nineteenth century. In the last 40 years, it had grown rapidly through the acquisition of smaller banks and mergers with other banking corporations. While its primary business was still accepting deposits and making loans, it had diversified into related areas, and its noninterest revenue reflected fees from its credit card, mortgage servicing businesses, and a substantial commercial real estate operation. However, over one-half of its noninterest revenue was still generated by the more traditional customer service charges and trust fees.

To attract and retain the talented managers it needed in the rapidly changing business environment, FNB instituted an incentive compensation plan for top executives, including the chief financial officer. The plan paid bonuses of up to 30% of base salary depending in part on the relation of FNB's annual net income to projected profits. Plan participants received no bonuses if the bank reported a loss.

In December 2019, the Chinese Center for Disease Control and Prevention alerted the World Health Organization (WHO) of an outbreak of pneumonia of unknown causes in the city of Wuhan. The cause was later determined to be a novel virus belonging to a class of coronaviruses that cause respiratory illness. It is contagious and spreads through droplets from a cough or sneeze. In March 2020, the WHO characterized the novel coronavirus as a pandemic and officially named it COVID-19. In response, governments tried to contain, delay, and mitigate the effect of the disease on their national health systems. This required shutting down schools and workplaces, imposing travel restrictions, implementing stay-at-home orders, and employing social distancing measures.

In order to support the economy and reassure investors through the uncertainty of the pandemic, governments also enacted various economic relief plans, aggressive monetary expansion, and bank prudential regulatory measures.[3] Many of these measures are similar to those implemented during the 2008-2009 financial crisis, but on a larger scale and covering all economic sectors. Early on, central banks lowered interest rates. In the United States, the Federal Reserve cut the Federal Fund rate from 2.75% in February 2020 to 0.25%. Additionally, the Federal Reserve began to consider whether limits should be imposed on the ability of banks to make capital distributions and discretionary bonus payments. See **Appendix B** for a detailed discussion of CECL and the regulatory response to COVID.

The first quarter of 2020 experienced the most significant decline in stock and bond market indexes since the Great Depression. Regulators and market participants feared that without significant economic support in the medium-term, the economic uncertainty would lead to a large increase in borrowers' default, leading to large credit losses for banks. Prior to COVID-19, banks were heavily exposed to credit risk, accounting for 78.42% of risk-weighted assets, on average, for the most systemically important U.S. banks (U.S. global systemically important banking organizations, or G-SIBs).[4] There is a risk that bank capital buffers will be depleted if credit risk screening measures are relaxed and a wave of defaults occurs, possibly leading to an insolvency crisis in the recovery period. Fortunately, U.S. G-SIBs have significant capital buffers, which can be used in the short-term to support the continuous provision of credit to households and businesses.[5]

While it is the responsibility of top management and the board of directors to establish an appropriate allowance and provision for credit loss in their bank's financial statements, they are dependent, of course, upon the information supplied to them by their subordinates.

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Gina Marcoccio, controller of FNB, placed a call to Paul Shea, chief financial officer.

Shea: You must be pretty busy keeping the auditors satisfied, Gina. I'm pressed for time myself right now. I need to call the chairman before the remote board meeting about the financial statements. But you said it was important. What's up?

Marcoccio: We've got a problem, Paul. I've been working on a number of different estimates for the allowance for credit losses under the revised accounting standards, and I don't know how to interpret the results. By some measures, we look fine, and our allowance is tracking our earlier projections. But using other methodologies, I come up with a provision of about $4 billion for the

[3] Bitar and Tarazi, A note on regulatory responses to COVID-19 pandemic: Balancing banks' solvency and contribution to recovery

[4] Id.

[5] Id.

full year. That means that we'll incur a net loss for the year, and it could cause problems with the minimum regulatory capital requirements.[6]

Shea: $4 billion! That's $475 million over the most pessimistic number we came up with in our most recent estimates-and nearly twice as much as last year's provision. How did you reach a figure like that?

Marcoccio: The uncertain economic forecast for the following year includes severe worst-case scenarios and the new CECL methodology requires that I consider the current economic environment and recognize all potential losses at the time the loan is made.

I understand your concerns, this is a big deal. Investors will balk at the potential losses from the change and regulators might suspend our ability to distribute capital or pay bonuses.

Shea: Will these losses cause us to fall below the 4% requirement for Tier 1 Capital to Total Assets? Do you expect regulators to relax enforcement given the current environment?

Marcoccio: At $4 billion we would be below the 4% requirement. I think we can get away with a smaller number. Regulators seem to be evaluating different responses to the current economy. I have heard rumors that the bank regulators are issuing a rule suspending the operation of CECL for regulatory capital for the next couple of years.

Recently they announced that they want to encourage banks like us to be able to focus on supporting lending to creditworthy households and businesses in light of the recent strain on the economy. But we also have to meet our regulatory capital requirements. We have an OK capital buffer right now, so we should be able to prudently lend despite our forecasted credit losses. If the rumors are true, we won't have to worry about the effect of CECL on our regulatory capital, but CECL is still required for our financial statement reporting and this isn't going to look good to our investors.

Shea: Have the auditors heard anything about this yet?

Marcoccio: No, but the audit manager, Dave Wright, has been calling every hour to get our provision for credit losses. We're behind schedule on giving it to him.

Shea: See if you can hold off a bit longer, at least until after the board meeting. We need time to decide what to do and, until we make a decision, I don't want the external auditors getting the idea that $4 billion is the right figure for the allowance. I've got to run now, or I'll be late for my call.

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[6] Bank regulators have developed a complicated system of regulatory capital requirements for banks operating in the United States, with both risk-based and non-risk-based requirements operating in parallel. For FNB, in recent years, the binding constraint on its regulatory capital is a leverage requirement that mandates, in essence, the bank's equity be equal to or greater than four percent of the firm's total assets.

A Zoom meeting of some members of the FNB board is in progress. Participants include Chairman Peter Royston and two outside members, Alice Jones and Thomas Drummer. Present also are Chief Financial Officer (CFO) Paul Shea and Adele Kalimian, general counsel.

Royston: Now, I would like us to turn to the matter of the preliminary Q1 2020 financial statements. I've asked our CFO to give us a briefing on them and on the status of the audit in progress. Paul?

Shea: Thank you, Peter. In general, the review is going well, and the Q1 2020 financials are nearly complete. As the partial statements I have given you show (see **Exhibit 1)**, the only remaining open area is the allowance and provision for credit losses in our loan portfolio. Our people are working on the number still, and according to the most conservative methodology, the provision should be over $4 billion for the year, which means an allowance at year end of over $6 billion. But I believe that the final figure for the provision will be somewhere in the $3.3 to $3.8 billion range.

Jones: Wait a minute, Paul. I can't believe the $4 billion figure. There must be some mistake. But did I hear you say that your minimum estimate of the provision is $3.3 billion?

Shea: Yes. Based on our review of the loans in our portfolio and our appraisal of the economic climate, as well as the implementation of CECL, I believe that $3.3 billion is the minimally prudent charge to our 2020 income for credit problems.

Jones: But even with our transition to CECL, we had been forecasting a 2020 provision of only $3 billion. Your minimum provision represents an additional $300 million charge to income but will still allow us to earn $172 million of profit, similar to last year. The high end of your range on the other hand, $3.8 billion, will give us a $161 million loss before taxes for the year. That's a big hit to take, and if that ends up being the number we go with, I want to know why we didn't see it coming.

Royston: Alice, you need to put this in context. At the end of 2019, our forecasted allowance for Q1 2020 was higher in relation to the size of our loan portfolio than it's ever been, in preparation for CECL. Based on the expectations approach that CECL requires, we thought we had properly estimated reserves in accordance with the new guidance and economic conditions at the time, but we couldn’t have foreseen the economic turmoil caused by the pandemic. We still can’t be sure how the situation will unfold.

Jones: But even if we stick with a $3.3 billion provision, we'll have an allowance that is well above its historical level as a percentage of loans, and we will show an acceptable profit for the year. Why do we need more?

Shea: The issue is not just the ratio of the allowance to the loan portfolio. The economy is worse now than it was at the end of 2019, and more of our loans will become nonperforming. We have also been encouraged by regulators to continue extending credit, despite the uncertainty. Under these conditions, we need a higher allowance.

Jones: If that's the case, then why should I believe your lower estimate is appropriate? Maybe we need a $3.6 billion provision-or more. There are too many estimates floating around here and too much difference between them all. Why can't we get a better handle on the number?

Royston: This debate isn't getting us anywhere. Alice did raise a good point, though, about the timing of the loss we would have to take if we increased the allowance. We all know about the rise in the number of shareholder lawsuits filed over the alleged failure of publicly traded companies to disclose information. It's in our interest to be as transparent as possible about future losses sooner rather than later. I've asked our general counsel to attend this meeting to give us some background on this issue. Adele?

Kalimian: As Peter mentioned, the danger of shareholder lawsuits has grown in recent years. There are lawyers who specialize in this area who will file class-action suits on behalf of the stockholders of a corporation. Typically, an unusual drop in the price of the company's stock triggers the action. While I believe lawsuits are unlikely in the event that we book the minimum provision Paul recommends, the chance would increase with the size of the loss; I would say that we could probably expect some legal action if we were forced to provide as much as $3.6 billion for credit losses.

Unusual losses might also precipitate an SEC investigation, and if that turns out badly, there are federal laws that mandate penalties for directors as individuals as well as for the corporation. Of course, if we recorded a smaller provision for credit losses now, and it later turns out to be inadequate, we could be in even worse trouble than if we had originally booked a larger provision.

Royston: If we are sued or investigated, what kinds of defenses could we use?

Kalimian: The issue is whether we could have expected the loss based on economic information available at the time the loan was made and updated periodically. If we can show that it related to the total expected losses over the lifetime of the loans, then there is no basis for charges of nondisclosure. In our case, presumably, we would need prove that events or information available at this time were responsible for our credit loss estimate. Thus, it's important that the process by which the allowance is determined be reasonable and carefully documented.

Royston: Apart from the legal aspects of reporting a loss, though, I'm concerned about the reaction of the financial markets. Our stock is already down because of our poor earnings last year and because of the general economic climate (see **Exhibit 2**)**.** We may need to worry about hostile takeover attempts if it falls much lower, or at best, we may have to look around for merger partners to strengthen our position.

Shea: That may not be so much of a problem in this situation, Peter. I've seen some old studies of the reaction of financial markets to increases in the credit loss allowance. They show that investors tend to reward banks that post increases, rather than punish them. Perhaps they see the increase as a sign that management is responding to a problem and putting it behind them. Additionally, investors have been expecting significantly higher loss reserves after the implementation of CECL at the beginning of this year and nobody seems to know where the market will be going in the near-term. Of course, the way we communicate our action to the markets as well as what numbers the markets expected will have a big effect on their reaction.

Jones: Do we know what any of our competitors are planning to show in their statements this year? If we see how much of a loss they are taking, that could help us decide what to do. Also, if everyone is reporting losses, I would rather not be the first to do it. The effect on our stock price might not be as bad if we are seen as part of a trend in lower earnings, as opposed to the first to report them.

Shea: I've been avoiding any direct responses to the questions the bank analysts at the brokerage houses have been asking, but there's a limit to how long I can avoid answering. After a while, they suspect that no news is bad news, and our stock price will drop just as much from rumor and speculation as it would from the report of a loss.

Drummer: I think we also need to worry about the bank's ability to continue as a reliable payer of dividends. We have a lot of small shareholders who rely upon our dividends and an excellent record over the past 50 years of uninterrupted payment. We've recently cut it close to regulatory capital minimums and I don't want to OCC to stop our dividend payments. I think we need to be very sure that this additional allowance is needed, since an increase in the provision will reduce our income and retained earnings and will maybe even force us to cut or eliminate dividends, especially if we're getting into trouble with regulatory capital requirements.

I'm also concerned about the broader mission of our bank. We're in the business of making loans. We don't want to limit ourselves with excessive conservatism, especially now when people might need loans more than ever. We can only loan as much as our capital base can support before we come up against the regulatory minimum capital ratios, and reduced income or losses eat into our capital. The only way the economy can stabilize is for businesses to get the financing they need for expansion. We have a responsibility to them to provide it, and the Federal Reserve and other bank regulators are making that clear in their comments and speeches.

Royston: Tom's points are well taken—although our primary responsibility is financial stability and survival. I think this is a good point to adjourn until we meet again to review the final financial statements. Paul, keep me posted on how things develop with the auditors.

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Following the board meeting, Paul Shea hosts a conference call with Gina Marcoccio and Sally Jenkins.

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Jenkins: Paul, we need your provision for loan losses now. Gina has been telling Dave that you haven't finished with it yet, but we can start working with a number that isn't final. We aren't on opposite sides here: we both want an allowance for credit losses in the financial statements that is a reasonable estimate of losses inherent in the loan portfolio. I know that the guidance for determining the allowance is vague and that there's a lot of judgment involved in determining it.

Determining the number is your responsibility, but maybe we can help. Our firm audits many banks, and we have experience that might be valuable to you. Also, if we have a problem with your allowance, it's better that we have more time to talk about it. So please tell us what's going on.

Exhibit 1 First National Bank of Ames Corporation, Selected Consolidated Financial Information ($000,000)

Exhibit 1-A Income Statement, for the three-month period ended March 31, 2020

	2020 Forecast	Q1 2020	2019	2018	2017
Interest on loans	3,479	580	2,187	1,988	1,807
Other interest	380	301	362	280	201
Total interest revenue	3,859	881	2,549	2,268	2,008
Interest on deposits	5	1	5	4	4
Interest on borrowing	15	4	14	13	12
Total interest expense	20	5	19	17	16
Interest revenue less expense	3,839	876	2,530	2,251	1,992
Provision for credit loss	*	*	2,378	1,981	1,651
Net interest revenue	*	*	153	269	341
Non-interest revenue	226	74	294	271	222
Non-interest expense	492	49	197	156	63
Net income before tax	*	*	250	384	500
Tax provision	*	*	75	115	150
Net income	*	*	175	269	350
Dividends	60	60	60	60	60

Note: Q1 2020 is incomplete. Entries marked with "*" are dependent on upon the credit loss provision. Assume a corporate tax rate of 30%.

Exhibit 1-B Statement of Financial Position, as of March 31, 2020

	2020 Forecast	Q1 2020	2019	2018	2017
Cash and due from banks	1,981	1,801	1,757	1,597	1,452
Deposits in banks	1,403	1,276	1,244	1,131	1,029
Federal funds, securities	4,532	4,120	4,020	3,654	3,322
Loans	62,997	58,702	57,720	52,064	47,331
Less allowance	*	*	4,697	3,881	3,201
Net loans	*	*	52,574	48,183	44,129
Other	1,221	1,202	1,210	1,200	1,187
Total assets	*	*	60,085	55,766	51,119
Deposits	50,874	48,116	46,942	43,021	38,821
Borrowing	12,486	11,318	11,042	10,038	9,800
Other	70	(91)	57,984	53,059	48,621
Tax Adjustment	*				
Adjusted Other	*				
		*			
Total liabilities	*	*	57,984	53,059	48,621
		*			
Equity	*	*	2,821	2,707	2,498
Total liabilities and equity	*	*	60,805	55,766	51,119

Note: Q1 2020 is incomplete. Entries marked with "*" are dependent on upon the credit loss provision.

Exhibit 1-C Analysis of Allowance for Credit Losses

	2020 Projection	Q1 2020	2019	2018	2017
Allowance, January 1	4,697	4,697	3,881	3,201	2,635
Provision	*	*	2,378	1,981	1,651
Credit losses	3,155	789	2,253	1,878	1,565
Recoveries	829	207	691	576	480
Net credit losses	2,325	581	1,562	1,302	1,085
Allowance, December 31	*	*	4,697	3,881	3,201

Note: Q1 2020 is incomplete. Entries marked with "*" are dependent on upon the credit loss provision.

Exhibit 1-D Analysis of Quarter-End Loan Portfolio

	Q1 2020	2019	2018	2017
Real estate	40,372	38,526	37,641	37,213
Commercial and Industrial	15,224	15,387	13,259	9,157
Other	3,106	3,357	1,164	961
Total Loans	58,702	57,270	52,064	47,331

Exhibit 1-E Analysis of Nonperforming Loans

	Q1 2020	2019	2018	2017
Real Estate	9,253	8,090	7,428	7,443
Commercial and industrial	2,145	2,154	1,458	1,190
Other	165	120	150	165
Total Loans	11,563	10,364	9,036	8,798

Exhibit 2 DJIA Historical Value, 2017 – 2020

Appendix A

FASB, PCAOB, and Bank Regulators

In the early 2000s there was a rash of large corporate bankruptcies and historic accounting fraud scandals, including the dotcom bubble burst, Enron, and WorldCom. Enron's former audit firm, one of the largest in the world, was convicted of obstruction of justice in connection with the Enron scandal. The conviction was overturned, but the firm had already collapsed. These accounting scandals shook investor confidence in the financial markets and compelled Congressional action. In 2002, the Sarbanes-Oxley Act (SOX) passed with overwhelmingly bipartisan support and was signed into law by President George W. Bush.[7]

SOX created a new framework of public company oversight under the Public Company Accounting Oversight Board (PCAOB). Some of the PCAOB's responsibilities include:

- Setting auditing, quality control, independence, ethics, and other standards applicable to the preparation of audit reports
- Inspecting public company auditing firms
- Enforcing firms' compliance with their obligations relating to audit reports.[8]

One of the ways in which the PCAOB exercises its oversight is through inspections designed to assess member firms' compliance with applicable standards. Registered accounting firms that regularly provide audit reports for more than 100 issuers are inspected on an annual basis.[9] Although a firm knows that there will be an inspection, they are not aware of which audits will be selected until after the audit has been completed. After the inspection, the PCAOB issues an inspection report with the firm's results including deficiencies that the firm then has an opportunity to resolve before the report is publicized.

A 2010 decision in Free Enterprise Fund v. Public Company Accounting Oversight Board decided that PCAOB board members could be removed from their roles by the SEC "at will," but upheld and reaffirmed all other provisions of SOX.[10]

The Financial Accounting Standards Board (FASB) was established in 1973 as an independent non-profit that establishes financial accounting and reporting standards for companies that follow Generally Accepted Accounting Principles (GAAP). The SEC recognizes FASB as the designated accounting standards setter for public companies and its standards are considered authoritative by state Boards of Accountancy and the American Institute of CPAs (AICPA).[11] The AICPA is a membership association that represents the accounting profession, sets ethical standards for the profession, and audit standards for companies that are not registered with the SEC.

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[7] Cynthia M. Fornelli, The Creation of the PCAOB: A Watershed Moment, April 2015, The CPA Journal. https://www.nysscpa.org/news/publications/the-cpa-journal/article-detail?ArticleID=10012#sthash.hbtuupvt.dpbs

[8] Id.

[9] PCAOB, PCAOB Inspection Procedures: What Does the PCAOB Inspect and How Are Inspections Conducted? https://pcaobus.org/oversight/inspections/inspection-procedures

[10] Id.

[11] About the FASB: https://www.fasb.org/info/facts

Independent Auditor Responsibilities

The PCAOB has drafted a set of General Auditing Standards which guide the conduct and responsibilities of auditors—including independence, training, and procedures. AS 1001 lays out the Responsibilities and Functions of the Independent Auditor:

> .01 The objective of the ordinary audit of financial statements by the independent auditor is the expression of an opinion on the fairness with which they present, in all material respects, financial position, results of operations, and its cash flows in conformity with generally accepted accounting principles… he states whether his audit has been made in accordance with the standards of the PCAOB. These standards require him to state whether, in his opinion, the financial statements are presented in conformity with generally accepted accounting principles and to identify those circumstances in which such principles have not been consistently observed in the preparation of the financial statements of the current period in relation to those of the preceding period.
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> 02. The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. Because of the nature of audit evidence and the characteristics of fraud, the auditor is able to obtain reasonable, but not absolute, assurance that material misstatements are detected...
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> .03 The financial statements are management's responsibility. The auditor's responsibility is to express an opinion on the financial statements. Management is responsible for adopting sound accounting policies and for establishing and maintaining internal control that will, among other things, initiate, record, process, and report transactions (as well as events and conditions) consistent with management's assertions embodied in the financial statements. The entity's transactions and the related assets, liabilities, and equity are within the direct knowledge and control of management. The auditor's knowledge of these matters and internal control is limited to that acquired through the audit. Thus, the fair presentation of financial statements in conformity with generally accepted accounting principles is an implicit and integral part of management's responsibility. The independent auditor may make suggestions about the form or content of the financial statements or draft them, in whole or in part, based on information from management during the performance of the audit. However, the auditor's responsibility for the financial statements he or she has audited is confined to the expression of his or her opinion on them.[12]

[12] PCAOB, General Auditing Standards, AS 1001: Responsibilities and Functions of the Independent Auditor

Bank Regulators

The federal bank regulators – particularly the Federal Reserve, the OCC and the FDIC establish minimum capital ratios applicable to banks and bank holding companies. These capital ratios are determined by complex rules for calculating the ratio of loss-absorbing capital (such as common stock and retained earnings) to exposure to loss. If a bank falls below a given threshold of regulatory capital, regulators will restrict the bank from making capital distributions to investors and paying bonuses.

Appendix B

Allowance and Provision for Credit Losses

The allowance for credit losses is built up by a charge made against operating expenses in the form of a provision for credit losses. Any loans that management determines are uncollectible and must therefore be written off are charged against the allowance. Therefore, such loans do not in general directly affect the bank's income in the period in which they are written off; rather these charge-offs reduce the bank’s loan allowance reserve. The only exception to this rule is the case where write-offs exceed the amount of the allowance.

In establishing the amount of loan losses in the bank's financial statements, then, the focus should be on the appropriate level for the allowance. It should be determined based upon the expectation of loss experience inherent in the existing portfolio. Once the allowance has been established, the appropriate provision for credit loss can be calculated as the increase in the allowance compared to the prior period, plus loan write-offs during the period net of recoveries on loans previously written off.

After the 2008 financial crisis, global banking regulators—including the Financial Crisis Advisory Group (FCAG), the Basel Committee on Banking Supervision (BCBS), and the Financial Stability Board (FSB)—began discussing revisions to the "incurred loss” (IL) methodology of accounting for credit losses. They were concerned that the IL method restricted an organization’s ability to record credit losses that were expected, but not yet probable. Under GAAP, prior to adoption of the new accounting standard, a credit loss “shall be recognized when, based on all information, it is probable that a loss has been incurred based on past events and conditions existing at the date of the financial statements... Losses shall not be recognized before it is probable that they have been incurred.”[13] This standard required that a loss triggering event occurred before the valuation of an asset reflected the risk of loss. In the event of an economic downturn, financial institutions’ balance sheets would not provide accurate information about the value of receivables expected to be realized until after the losses occurred.

In 2010, the Financial Accounting Standards Board (FASB) began working on a revised standard. On June 16, 2016, after reviewing over 300 comment letters, FASB issued Accounting Standards Update (“ASU”) No. 2016-13.[14] This new accounting standard implemented a new measurement model for credit losses called Current Expected Credit Losses (CECL). CECL requires that financial institutions account for the present net amount expected to be collected on a credit asset, an expectations approach to loss reserving. The standard was effective for SEC filers for fiscal years beginning after December 15, 2019. Adopting CECL will result in increased upfront losses for financial institutions because every time a new loan is issued, they must record a corresponding loss to account for any expected default over the life of the loan. This will also impact regulatory capital, as increased charges to income will decrease the amount of retained earnings available as a buffer.

[13] FIN. ACCT. STANDARDS BD., ACCOUNTING STANDARDS UPDATE NO. 2016-13, FINANCIAL INSTRUMENTS—CREDIT LOSSES (TOPIC 326) 17 (2016).

[14] Id.