

implication of SAS 99 is that immaterial misstatements may be fraudulent financial reporting.<sup>17</sup>

Auditors that learn of intentional misstatements may also be required to (1) re-evaluate the degree of audit risk involved in the audit engagement, (2) determine whether to revise the nature, timing, and extent of audit procedures accordingly, and (3) consider whether to resign.<sup>18</sup>

Intentional misstatements also may signal the existence of reportable conditions or material weaknesses in the registrant's system of internal accounting control designed to detect and deter improper accounting and financial reporting.<sup>19</sup> As stated by the National Commission on Fraudulent Financial Reporting, also known as the Treadway Commission, in its 1987 report,

The tone set by top management—the corporate environment or culture within which financial reporting occurs—is the most important factor contributing to the integrity of the financial reporting process. Notwithstanding an impressive set of written rules and procedures, if the tone set by management is lax, fraudulent financial reporting is more likely to occur.<sup>20</sup>

An auditor is required to report to a registrant's audit committee any reportable conditions or material weaknesses in a registrant's system of internal accounting control that the auditor discovers in the course of the examination of the registrant's financial statements.<sup>21</sup>

management has a practice of committing to analysts or others that it will achieve unduly aggressive or clearly unrealistic forecasts, and the existence of assets, liabilities, revenues, or expenses based on significant estimates that involve unusually subjective judgments or uncertainties.

<sup>17</sup> In requiring the auditor to consider whether fraudulent misstatements are material, and in requiring differing responses depending on whether the misstatement is material, SAS 99 makes clear that fraud can involve immaterial misstatements. Indeed, a misstatement can be "inconsequential" and still involve fraud.

Under SAS 99, assessing whether misstatements due to fraud are material to the financial statements is a "cumulative process" that should occur both during and at the completion of the audit. SAS 99 further states that this accumulation is primarily a "qualitative matter" based on the auditor's judgment. The staff believes that in making these assessments, management and auditors should refer to the discussion in Part 1 of this SAB.

<sup>18</sup> Auditors should document their determinations in accordance with SAS 96, SAS 99, and other appropriate sections of the audit literature.

<sup>19</sup> See, e.g., SAS 99.

<sup>20</sup> Report of the National Commission on Fraudulent Financial Reporting at 32 (October 1987). See also Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (February 8, 1999).

<sup>21</sup> AU 325.02. See also AU 380.09, which, in discussing matters to be communicated by the auditor to the audit committee, states:

#### *GAAP Precedence Over Industry Practice*

Some have argued to the staff that registrants should be permitted to follow an industry accounting practice even though that practice is inconsistent with authoritative accounting literature. This situation might occur if a practice is developed when there are few transactions and the accounting results are clearly inconsequential, and that practice never changes despite a subsequent growth in the number or materiality of such transactions. The staff disagrees with this argument. Authoritative literature takes precedence over industry practice that is contrary to GAAP.<sup>22</sup>

#### *General Comments*

This SAB is not intended to change current law or guidance in the accounting or auditing literature.<sup>23</sup> This SAB and the authoritative accounting literature cannot specifically address all of the novel and complex business transactions and events that may occur. Accordingly, registrants may account for, and make disclosures about, these transactions and events based on analogies to similar situations or other factors. The staff may not, however, always be persuaded that a registrant's determination is the most appropriate under the circumstances. When disagreements occur after a transaction or an event has been reported, the

The auditor should inform the audit committee about adjustments arising from the audit that could, in his judgment, either individually or in the aggregate, have a significant effect on the entity's financial reporting process. For purposes of this section, an audit adjustment, whether or not recorded by the entity, is a proposed correction of the financial statements. \* \* \*

<sup>22</sup> See AU 411.05

<sup>23</sup> The FASB Discussion Memorandum, "Criteria for Determining Materiality;" states that the financial accounting and reporting process considers that "a great deal of the time might be spent during the accounting process considering insignificant matters. \* \* \* If presentations of financial information are to be prepared economically on a timely basis and presented in a concise intelligible form, the concept of materiality is crucial." This SAB is not intended to require that misstatements arising from insignificant errors and omissions (individually and in the aggregate) arising from the normal recurring accounting close processes, such as a clerical error or an adjustment for a missed accounts payable invoice, always be corrected, even if the error is identified in the audit process and known to management. Management and the auditor would need to consider the various factors described elsewhere in this SAB in assessing whether such misstatements are material, need to be corrected to comply with the FCPA, or trigger procedures under Section 10A of the Exchange Act. Because this SAB does not change current law or guidance in the accounting or auditing literature, adherence to the principles described in this SAB should not raise the costs associated with recordkeeping or with audits of financial statements.

consequences may be severe for registrants, auditors, and, most importantly, the users of financial statements who have a right to expect consistent accounting and reporting for, and disclosure of, similar transactions and events. The staff, therefore, encourages registrants and auditors to discuss on a timely basis with the staff proposed accounting treatments for, or disclosures about, transactions or events that are not specifically covered by the existing accounting literature.

## **Topic 2: Business Combinations**

### *A. Purchase Method*

1. Deleted by SAB 103
2. Deleted by SAB 103
3. Deleted by SAB 103
4. Deleted by SAB 103
5. Adjustments to Allowances for Loan Losses in Connection With Business Combinations

*Facts:* Bank A acquires Bank B in a business combination.

*Question:* Are there circumstances in which it is appropriate for Bank A, in assigning acquisition cost to the loan receivables acquired from Bank B, to adjust Bank B's carrying value for those loans not only to reflect appropriate current interest rates, but also to reflect a different estimate of uncollectibility?<sup>1</sup>

*Interpretive Response:* Needed changes in allowances for loan losses are ordinarily to be made through provisions for loan losses rather than through purchase accounting adjustments. Except in the limited circumstances discussed below, where Bank A has plans for ultimate recovery of loans acquired from Bank B that are demonstrably different from plans that had served as the basis for Bank B's estimate of loan losses, purchase accounting adjustments reflecting different estimates of uncollectibility may raise questions from the staff as to: (a) The reasonableness of the preacquisition allowance for loan losses recorded by Bank B, or (b) whether the adjustments will have a distortive effect on current or future period financial statements of Bank A. Similar questions may be raised by the staff regarding significant changes in allowances for loan losses that are recorded by a bank shortly before it is acquired.

Estimation of probable loan losses involves judgment, and Banks A and B

<sup>1</sup> Under Statement 141, the guidelines for allocating acquisition cost to receivable is "at present values of amounts to be received determined at appropriate current interest rates, less allowances for uncollectibility and collection cost, if necessary."