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INDEPENDENT EXTERNAL AUDITS OF FOREIGN BANKING ORGANIZATIONS (FBOs) OPERATING IN THE U.S.

by

Bernard V. Khomenko

B.S. University of Montana, 2002

presented in partial fulfillment of the requirements

for the degree of

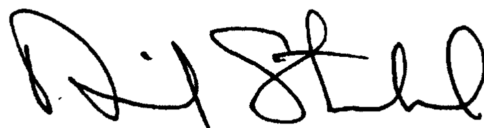
Master of Accountancy

The University of Montana

July, 2004

Approved by:

Committee Chair



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Khomenko, Bernard V., MAcct, July 2004 Accounting

Independent External Audits of Foreign Banking Organizations (FBOs) Operating in the U.S.

Committee Chair: Dr. Terri Herron

The paper begins with an overview of the U.S. banking industry and its most recent trends, such as merging of many financial institutions and increasing the number of services offered by banks to its customers. Following is the analysis of Foreign Banking Organizations (FBOs), including their distinctive characteristics, specific business risks, legal environment and advantages / disadvantages affecting FBO operations. The next section provides a detailed analysis of external audits, including the discussion of external audits' objectives, methods and structure. The last section presents the off-balance sheet activities and the issues considered in the off-balance sheet activities audit program. The external audit program for the guarantees issued, a type of off-balance sheet activity often conducted by FBOs, is presented in an appendix. For illustrative purposes, the financial statements of Deutsche Bank, one of the largest FBOs working on the U.S. financial markets are also presented in an appendix.

A number of secondary sources were used during the work on the paper, including the Examination Manual for U.S. Branches of FBOs, AICPA Professional Standards, AICPA Audit and Accounting Guide, and textbooks on auditing and bank management.

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About the Author:

Bernard Khomenko grew up in the city of Novosibirsk, a capital of the Siberian region of Russia. In 1997 he came to the US to study at the College of Technology - UM. In 1999, Bernard graduated from the College of Technology – UM with an A.A.S. degree in Accounting. After the graduation, he worked for more than a year for Regional Accounting Office of Sage Company in Missoula. In 2000, Bernard returned to school to pursue the B.S. degree in Business Administration at UM; he graduated with honors in December 2002. Currently, through employment with the Montana Association of Health Care Purchasers, Bernard is involved in a number of unique projects concerning the health care field. Bernard began his Masters of Accountancy program in the summer of 2003 and will graduate in the summer of 2004.

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1.0 INTRODUCTION AND OBJECTIVES

Throughout the accounting program, auditing attracted the author's attention due to the analytical, logical and disciplined manner of the field. Being interested in banking and finance and having come from a foreign country, this paper presented a perfect chance to combine the author's interests in auditing and banking with his international background. This paper is an attempt to gain additional knowledge in the field of auditing, through analyzing the work and operating environment of FBOs in the U.S. and methods applied by independent auditors in auditing such organizations.

The paper has two main objectives: to research and become familiar with auditing practices applied to the banking industry by independent auditors and to better understand the operating environment of FBOs in the U.S. The first objective is achieved by discussing the general auditing issues as well as issues specifically related to FBOs' audits, such as their exposure to off-balance sheet activities and consideration of additional types of risks during audits. The second objective is achieved through analyses of banking industry and operational issues specific to FBOs, such as increasing supervision of their activities by regulatory agencies.

The outcome of this research is the FBO's off-balance sheet activities partial audit program presented in Appendix A. Experience gained through the research should familiarize the author with the real-world auditing practices, assist in preparing for the Uniform Certified Public Accountant exam and provide knowledge useful in the future career of the professional paper's author. It is the author's desire to make his paper easy to read and understandable for anyone with a general business background and to provide

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valuable information to anyone interested in the subject. A list of acronyms used throughout the paper is presented in Appendix B.

2.0 FBOs' OPERATIONS AND REGULATORY ENVIRONMENT

2.1 FBOs' OPERATIONS

Overview of the Banking Industry

The banking sector has been among the leaders in embracing innovation and new technologies, with globalization and financial innovations being the main forces behind the changing face of the banking sector. Consumers have a wide range of choices in banking – they can go to their local or national bank, open an account with a brokerage firm, or even go on-line and bank with an internet-based bank that exists only in the cyber-world. All these financial institutions are offering a wide range of financial services to the consumers – from opening checking and savings accounts to offering credit cards to transferring and receiving funds anywhere in the world.

Banking institutions play an important role in the economy. Two main types of banking institutions are commercial banks and thrifts. **Commercial banks** represent the primary channel of the Federal Reserve monetary policy. Commercial banks comprise the largest group of depository institutions both in numbers and size of their assets. Their key functions are to accept deposits (liabilities) and to make loans (assets). Commercial bank liabilities usually include several types of nondeposit sources of funds, such as funds borrowed through the Federal Reserve System (FRS), while their loans include consumer, commercial, and real estate loans. The number of commercial banks in the U.S. has been decreasing mostly due to mergers; between 1980 and 2001 the number of commercial banks dropped from 14,163 to 8,080. However, despite those mergers, there

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are still a large number of small banks, often called community banks, with assets under $500 million. These small banks currently account for about 90 percent of the total number of banks and for some 20 percent of the total banking industry's assets[1]. From these numbers we can conclude that the remaining ten percent of the banks account for about 80 percent of the banking industry's assets. The latter group is most widely represented by either regional or superregional banks. These types of commercial banks engage in all areas of banking such as consumer, commercial and industrial lending. In order to finance their lending activities, regional and superregional banks have to access markets for purchased funds, such as the interbank and federal funds market. Some banks, such as Salomon Brothers, have even created separate money center banks which heavily rely on nondeposit or borrowed sources of funds. Most commercial banks possess four main types of earning assets – business loans, securities, mortgages, and consumer loans. Financing for assets comes from three main sources – equity provided by owners, deposits and borrowed funds.

Thrift institutions comprise three different groups of financial institutions – savings and loan associations, savings banks, and credit unions. Historically, savings and loan associations have concentrated mostly on residential mortgages, credit-unions have focused on consumer loans, and savings banks have been operated as more diversified savings and loan associations having residential mortgage assets and commercial loans, as well as corporate bonds and stocks.

Commercial banks in the U.S. are subject to monitoring and regulation by four different agencies – the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), the FRS, and state bank regulators. The three main

[1] Saunders, 1997

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regulators for thrifts are the Office of Thrift Supervision, the Federal Insurance Corporation – Savings Association Insurance Fund, and the National Credit Union Administration which regulates the work of credit unions. In addition, both commercial banks and thrifts are among the most regulated business establishments, with most of commercial banks' activities being regulated separately from thrifts. However, some laws and regulations apply to both types of banks. Major U.S. banking laws are presented in **Table 1**.

Table 1: Major U.S. Laws Regulating Operations of Banks in the U.S.

U.S. Banking Law	Year of Enactment	Major Provisions
The McFadden Act	1927	Established state insurance regulation and barred interstate banking
The Glass-Steagall Act	1933	Separated commercial and investment banking
The Bank Holding Company Act	1956	Brought bank holding companies under federal supervision
International Banking Act	1978	Brought foreign banks within the federal regulatory framework. Required deposit insurance for branches of foreign banks engaged in retail deposit taking in the U.S.
Depository Institutions Deregulation and Monetary Control Act	1980	Phased out interest ceiling on deposits, expanded thrift powers, and raised insurance coverage to $100,000
Federal Deposit Insurance Corporation Improvement Act	1991	Greatly increased the powers and authority of the FDIC. Major provisions recapitalized the Bank Insurance Fund and allowed the FDIC to strengthen the fund by borrowing from the Treasury.
The Foreign Banks Supervision Enhancement Act	1991	Enhance federal regulatory authority over foreign banks in the U.S.
Riegel-Neal Interstate Banking Branching Efficiency Act	1994	Permitted interstate expansion
Gramm-Leach-Biley Act	1999	Allowed financial holding companies to offer banking, securities, and insurance under one corporate roof and established sweeping consumer privacy protections.

Source: Koch and Macdonald, 2003

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FBOs' Overview

Globalization is the process caused by the gradual evolution of markets and institutions where geographic boundaries do not restrict financial transactions. One country's economic policies affect the economies of other countries, and funds flow freely between countries because of efficient money and capital markets and currency exchanges (the establishment of the European Community in 1992 represents a prime example). Financial markets and institutions are becoming increasingly international in scope due to globalization, and the presence of Foreign Banking Organizations is the direct result of this. Over the last 28 years the presence of foreign banks in the U.S. increased from 3.8 percent of U.S. banking assets and 1.6 percent of deposits in 1973 to 20.2 percent of U.S. banking assets and 17.4 percent of deposits in 2001[2].

Global banking involves both traditional commercial and investment banking products, with foreign banks offering products and services denominated in the FBOs' domestic currencies and in U.S. dollars. Many global banks often follow different business strategies. Some U.S. banks, such as Citigroup, have aggressively located offices outside the U.S. and attempted to establish their brand with extensive marketing efforts.

Many foreign banks have, in contrast, been content to take silent participations in deals originated by U.S. banks, with little display of their involvement. Domestic borrowers that might object to negotiating a credit agreement with a foreign bank are often unaware that the originating U.S. bank can later sell these loans to a foreign bank. Foreign banks, in addition, are extremely aggressive in underwriting Eurobonds and engaging in off-balance sheet activities, including interest swaps, standby letters of credit,

[2] Koch and Macdonald, 2003.

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and municipal bond guarantees. These activities provide FBOs with instant credibility and a foothold when negotiating with U.S. banks.

In 1973, U.S. offices of foreign banks controlled 3.7 percent of total loans and 7.6 percent of business loans within the U.S.; by 2001 these offices controlled 13.4 percent of total loans and 26.4 percent of business loans[3]. The four largest FBO's operating in the U.S. are listed in **Table 2**.

Table 2: List of the Largest FBOs Operating in the U.S.

FBO's Name, Headquarter	Home Country	Assets ($ millions) as of 12/31/02
HSBC Banks USA, Buffalo, NY	Great Britain	77,634
LaSalle Banks NA, Chicago, IL	Holland	57,442
Standard Federal Bank NA, Troy, MI	Holland	44,382
Union Bank of CA NA, San Francisco, CA	Japan	35,591

Source: Source: Koch and Macdonald, 2003

HSBC Bank, owned by HSBC Holding in London, is the largest foreign bank operating in the U.S with close to $80 billion in assets. ABN Amro, an Amsterdam-based holding company, owns both LaSalle Bank, Chicago, and Standard Federal, Troy, MI. Together, Lasalle Bank and Standard Federal control almost $102 billion in assets. The foreign-owned banks operating in the U.S. operate primarily through their branches. Geographically speaking, the most active foreign banks operating on the west coast of the U.S. have been those headquartered in Japan and Taiwan. The most active foreign banks operating on the east coast and Midwest U.S. have been those headquartered in western Europe and Hong Kong. However, regardless of the region of their expansion in the US, almost every medium and large FBO in the U.S. has an office in New York City (due to the city's status as the world's largest financial center).

[3] Koch and Macdonald, 2003.

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It comes as no surprise that banks, both foreign and domestic, compete aggressively for consumers' business. Foreign banking organizations have had a long-standing presence in the United States. Their operations encompass a wide variety of banking and nonbanking activities, through subsidiaries, branches, agencies, Edge Act Corporations and representative offices (see **Table 3**). Indeed, FBOs can be found among the largest financial holding companies, such as the Taunus Corporation which is a subsidiary of Deutsche Bank AG. FBOs are most actively represented primarily in the major U.S. cities where finance and international trade are most aggressively conducted.

Table 3: Five Major Forms of Entry by Foreign Banks into the U.S. Banking

Type of FBO	Characteristics
Subsidiary	A foreign bank's **subsidiary** has its own capital and charter; operates the same as any U.S. domestic bank; has access to retail and wholesale markets.
Branch	**A branch** bank is a direct expansion of the parent bank; reliant on its parent bank for capital support; normally, has access to both wholesale and retail deposit and funding markets.
Agency	**An agency** is a restrictive form of entry; restricts access of funds to those borrowed on the wholesale and money markets; a special case of an agency is a New York Agreement Company (has agency and limited investment banking functions).
Edge Act Corporation	**An Edge Act Corporation** is open to U.S. domestic banks since 1919 and to foreign banks since 1978; specializes in international trade-related banking transactions or investments.
Representativ e Office	**A representative office** acts as a loan production office; generates loan business for its parent banks at home; the most limited organizational form for FBOs entering the United States.

Source: Koch and Macdonald, 2003

Prior to entering the U.S. market, foreign banks have to weigh many pros and cons of such a decision. The rest of this section concentrates on the economic advantages and disadvantages facing FBOs operating in the U.S. Regulatory and compliance aspects of operations are discussed in the Section 2.0.

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There are four major advantages to FBOs that could help in generating greater returns and better diversifying operations' risk through opening operations in the U.S: risk diversification, economies of scale, new product innovations, and avoidance of a corrupt and unfair regulatory environment. First, as with domestic geographic expansions, an FBO's activities could enhance its parent financial institution's opportunities to **diversify the risk** of earnings flows. Often, domestic earnings flow from financial services are strongly linked to the state of that economy. Therefore, the less integrated the economies of the world are, the greater potential for earnings diversification through international expansion. Second, to the extent that **economies of scale** exist, by expanding its activities beyond domestic boundaries, a financial institution can potentially lower its average operating costs.

Third, a financial institution can generate extra returns from **new product innovations** if it can sell such services internationally rather that just domestically. For instance, complex financial innovations such as securitization, caps, floors, and options, initially introduced in the United States, became known to foreign financial institutions through their FBOs operating in the U.S. Subsequently, foreign financial institutions began to offer such financial innovations in their home countries. Finally, domestic regulations such as activities restrictions and reserve requirements impose constraints or taxes on the operations of a financial institution. Seeking out low regulatory tax countries can allow businesses to lower their net regulatory burden and to increase their potential net profitability. As shown in Section 2.2, the U.S. has a very restrictive regulatory environment. Nevertheless, that environment makes the rule of law fair for all businesses, encouraging and promoting healthy, fair competition. One can conclude that

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in the instance of FBOs operating in the United States, foreign banking institutions could **avoid a corrupt and unfair regulatory environment.**

There are also several disadvantages of FBOs as well, such as information and monitoring costs, risk of nationalization or expropriation, and fixed costs. While global expansion allows financial institutions to better diversify geographic risk, the level of risk exposure in certain areas of operations can potentially be high. Foreign activities require mastering of expertise in operating, legal, and compliance environments of other countries, which can drive up **compliance and professional assistance costs.** Also, it requires translation and transferring of information between the parent financial institution and its FBOs, which could cause **monitoring and information collection costs** to soar as well. For instance, differences in the accounting principles can create reporting and interpreting problems. In addition, language and cultural problems can impose further transaction costs on international activities.

A financial institution faces the political risk of **nationalization and expropriation** of its investments and assets when it expands operations into foreign countries. However, in the United States, where rights of ownership are highly respected, such risk is minimal. Nevertheless, as the expropriation of some alleged terrorists' assets shows, under a certain level of political pressure, instances of government nationalization of foreign organizations' assets in the U.S. (including FBOs' assets), could occur. The **fixed costs** of establishing overseas operations may be extremely high. A bank from a country with real-estate prices lower than in the U.S. faces a high cost of establishing a branch in the U.S, especially if a branch is in a city like New York. Such costs can be even higher if a bank would decide to buy a bank in the United States. These high fixed

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costs become a very important consideration for a foreign bank if there is uncertainty about the expected volume of business to be generated and, thus, revenue flows from operations in the U.S. A good example of unrealized revenue expectation versus the high fixed costs of entry and the costs of maintaining a competitive position could be the failure of U.S. acquisitions to realize expected profits following the 1986 "big bang" deregulation in the United Kingdom[4].

2.2 FBOs JURISDICTION AND REGULATIONS

FBO banking activities are conducted primarily through branches and agencies licensed by the individual states and by the OCC, or to a lesser degree through banks and special-purpose banking corporations chartered by the states and the Federal Reserve. Some of the branches, agencies and special-purpose banking corporations are insured and therefore subject to the oversight of the FDIC. FBO non-banking activities are authorized by the Federal Reserve pursuant to the Banking Holding Company Act and the International Banking Act. Branches of foreign banking organizations are licensed by the state banking authorities or the OCC; in addition, certain grandfathered branches may be insured by the FDIC. Agencies are licensed by the state banking authorities. Separately, the Board of Governors delegates certain of its supervisory and regulatory functions to the Reserve Banks and directs, coordinates, and reviews actions taken by the Reserve Banks. As a result, FBOs are subject to a number of state and federal statues, and their operations are supervised and regulated by both state and federal banking authorities.

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[4]Saunders, 1997.

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The International Banking Act

Prior to 1978, foreign branches and agencies in the United States were licensed primarily at the state level, and issues regarding their entry, regulation, and oversight were almost totally confined to the state level. With the passage of the International Banking Act (IBA) in 1978 and the Foreign Bank Supervision Enhancement Act (FBSEA) in 1991 (discussed later), federal regulators have drastically increased control over foreign banks in the United States. FBO operations were profoundly affected by both acts.

Before the passage of IBA, FBOs entering the U.S. with state licenses had certain competitive advantages and disadvantages relative to most domestic banks. On the one hand, being state-licensed entities, they were not subject to the Federal Reserve's reserve requirements, Federal Reserve audits and exams, interstate branching restrictions, or restrictions on corporate securities underwriting activities (the Glass-Steagall Act). On the other hand, they had no access to the Federal Reserve's discount window, no direct access to Fedwire nor the fed funds market, and no access to FDIC deposit insurance. Inability to gain access to deposit insurance effectively precluded FBOs from the U.S. retail banking markets. As a result, prior to 1978, foreign banks in the United States largely concentrated mostly on business or wholesale banking.

The unequal treatment of domestic and foreign banks regarding federal regulation and lobbying by domestic banks regarding the unfairness of this situation provided the force for Congress to pass the IBA in 1978. The fundamental regulatory philosophy underlying the IBA was one of national treatment, which means foreign banks should be regulated in the same fashion as domestic banks. As a result of this act, foreign banks

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were required to hold Federal Reserve-specified reserve requirements if their worldwide assets exceeded $1 billion, were subject to Federal Reserve examinations, and were subject to the McFadden and Glass-Steagall Acts. With respect to the latter, an important grandfather provision was inserted into the act that allowed foreign banks established in the U.S. prior to 1978 to keep their interstate branches and securities-activity operations, which became illegal under the Glass-Steagall Act. That is, interstate and security activities restrictions were applied only to new FBOs entered the U.S. after 1978.

The passage of the IBA accelerated the expansion of FBOs in the U.S. The IBA gave foreign banks access to the Federal Reserve's discount window, Fedwire, and FDIC insurance. In particular, access to FDIC insurance allowed access to retail banking. For example, a year after the passage of the IBA, foreign banks acquired four large U.S. banks (Crocker, National Bank of North America, Union Planters, and Marine Midland)[5]

The Foreign Banks Supervision Enhancement Act (FBSEA) of 1991

After passage of the IBA, the supervision and regulation of federal and state branches and agencies of foreign banks was largely the responsibility of the states and the OCC. The following three events compounded the concern about the weakness of the federal regulatory oversight of FBO operations and urged the Congress to act. The **first** event was the collapse of the Bank of Credit and Commerce International (BCCI), which had a highly complex international organizational structure based in the Middle East, the Cayman Islands and Luxembourg and had undisclosed ownership stakes in two large U.S. banks. BCCI was not subject to any consolidated supervision by a home country regulator; this quickly became apparent after its collapse, when massive fraud, insider lending abuses, and money-laundering operations were discovered. The **second** event

[5] Saunders, 1997.

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was the issuance of more that $1 billion in unauthorized letters of credit to Saddam Hussein's Iraq by the Atlanta agency of the Italian bank, Banca Nazionale del Lavoro. The **third** event was the unauthorized taking of deposits by the U.S. representative office of the Greek National Mortgage Bank of New York.

These events and related concerns led to the passage of the Foreign Bank Supervision Enhancement Act of 1991. The act had five main features that have significantly enhanced the powers of federal regulators over foreign banks in the United States. These features are summarized in **Table 4** and include regulation over entry, closure, examination, deposit taking, and activity powers. It is important to note that

Table 4: Five Regulatory Features of the FBSEA of 1991

Regulatory Feature Name	Description
Entry	The Fed's approval is needed to establish a subsidiary, branch, agency, or representative office in the United States; it applies to both a new entry or an entry by acquisition; two mandatory approvals have to be met: • the foreign bank must be subject to comprehensive supervision on a consolidated basis by a home country regulator • that regulator must furnish all the information needed by the Federal Reserve to evaluate the application. Both standards are aimed at eliminating the lack of disclosure and supervision associated with BCCI's failure.
Closure	The act gives the Federal Reserve power to close a foreign bank if its home country supervision is inadequate, it has violated U.S. laws, or it is engaged in unsound and unsafe banking practices.
Examination	The Federal Reserve has the power to examine each office of a foreign bank, including its representative offices; each branch or agency has to be examined at least once a year.
Deposit taking	Only foreign subsidiaries with access to FDIC insurance can take retail deposits under $100,000; it rolls back the provision of the IBA that gave foreign branches and agencies access to FDIC.
Activity powers	As of 12/19/92 state-licensed branches and agencies of foreign banks could not engage in any activity not permitted for domestic banks.

Source: Saunders, 1997

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along with the increased regulatory and supervisory role of the Federal Reserve, the FBSEA established uniform federal standards for entry and expansion of foreign banks in the U.S. Despite strict rules and regulations the U.S. banking market did not become less attractive to the foreign banks.

Strength Of Support Assessment

As a result of the increased supervisory burden over foreign banking institutions in the U.S., the federal and state regulatory authorities had to come up with a standardized framework for evaluating and assimilating significant financial and managerial information related to individual FBO's operations. The two-component strength-of-support assessment (SOSA) program provided regulatory agencies with such capabilities. The SOSA rating of individual FBOs provides information to supervisory agencies that is used in determining the appropriate supervisory initiatives, such as the scope and frequency of examinations. The assessment also provides a basis for more efficient utilization of supervisory resources.

Developing the SOSA

The SOSA is developed annually through a process that involves all U.S. supervisors with licensing, chartering, or examining responsibilities over the FBO's operations in the U.S. The process includes an analysis of available information on the financial condition of the FBO within the context of four items: (1) the home country financial system, (2) the banking supervisory system, (3) the record of the authorities in preventing or successfully dealing with banking system problems, and (4) **transfer risk** considerations, which focus on the FBO's capacity to obtain the sufficient amount of foreign currency required to service its cross-border operations. For some FBOs, transfer

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risk could be increased due to heavy debt servicing or other financial restraints related to the home country regulations, which often lead to exchange controls and hard currency restrictions in the home country. Often such information can be compiled through discussions with the U.S. and head office management of the FBOs as well as the home country supervisor(s).

Relevant information obtained during the SOSA development process is transmitted to the Federal Reserve, which assumes responsibility for organizing and maintaining a database of this information. This database is available to all of the relevant U.S. banking supervisory agencies. To ensure that the database contains the most current information, all relevant information is collected and updated on a continuing basis. The development of the SOSA results in two components: a supervisory rating and compliance evaluation.

SOSA - First Component

The first component of the SOSA addresses whether any factors relating to the ability of the FBO to meet its U.S. obligations warrant special monitoring. This results in a rating that reflects the overall financial viability of the FBO, as well as several external factors such as the degree of supervision the FBO receives from its home country supervisor. Factors considered in assessing the first component include a review of the FBO's financial condition and prospects, the system of supervision in the FBO's home country, the record of home country government support of the banking system or other sources of support of the FBO, and any transfer risk concerns. All relevant factors are weighed and evaluated in determining the rating.

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Determining whether an individual FBO has the internal or external resources to provide necessary financial or managerial support to its U.S. operations depends upon its financial condition, operating record, and general outlook. A good financial condition combined with capable management is generally sufficient to ensure that support. However, the degree of certainty regarding the ability of an FBO to provide any necessary financial support may be limited by weaknesses in its home country supervisory system or a significant degree of transfer risk associated with its major operations. These two factors also may influence the home country's record of support for its financial institutions. All assessment factors are considered as a whole in the rating. The five SOSA ratings and the associated indicators are presented in **Table 5** and range from A (best) to E (worst).

SOSA – Second Component

The second component of the SOSA, which is utilized on an as-needed basis, identifies whether there are any factors that raise questions about the ability of the FBO to maintain **adequate internal controls and compliance procedures** at its U.S. offices, irrespective of the overall financial condition of the FBO. Factors considered in applying the second component of the SOSA include the FBO's managerial and operational record, changes in operation such as a recent merger or other significant expansion, or reported control problems at non-U.S. operations posing a potential risk to the U.S. operations. The purpose of this component is to indicate whether any concerns over the above mentioned procedures exist, a determination that is largely judgmental in nature and not readily quantifiable.

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Table 5: Five Levels of Assessment for the First Component Indicators of the SOSA

Rating	Supervisory Assessment Indicators
Assessment of A	• strong financial profile by both home country peer and international standards • more than ample access to U.S. dollar funding • one of the two highest market or investment ratings and categories • supervision by the home country supervisory agency is conducted on a comprehensive basis, covering the worldwide operations of the FBO • the home country has a good record of supervising financial institutions and dealing with problem institutions.
Assessment of B	• the financial profile and outlook pose a low risk that the FBO will be unable to support its U.S. operations • has an investment grade or equivalent • financial factors are not as strong as FBOs with an A assessment • the home country has a good record for dealing with problems in the local financial system • transfer risk factors consistent with FBOs with an assessment of A
Assessment of C	• the home country has demonstrated an ability and willingness to support the FBO or similar financial institutions (even if FBO currently doesn't meet all financial standards) • lack of an investment grade rating • any other factors that are considered less than adequate by international standards, without posing significant concerns about the ability of the organization to honor its U.S. liabilities.
Assessment of D	• significant financial or supervisory weaknesses are apparent • imposition of asset maintenance requirements on the U.S. branches and agencies should be considered • FBO may be expected to continue as a going concern due primarily to government support, ownership, or other significant factors • resource constraints, transfer risk considerations, operating structure, or other factors may place important limitations on that support • the financial profile, may imply a higher assessment, but home country supervision is deemed to be substantially or wholly deficient, or there are significant transfer risk concerns.
Assessment of E	• serious deficient financial profile • poor operating practices • absence of any sufficient supervisory oversight and support • there is a strong possibility that the FBO will be unable to honor its U.S. obligations in the near future • considered to present a hazard to U.S. financial markets.

Source: Federal Reserve System, 1997

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General Supervisory Implications

As discussed earlier, one of the principal goals of the SOSA is to identify those FBOs that may pose risks to their U.S. operations or to U.S. financial markets due to financial, operational, or other concerns at the FBO as a whole. The SOSA serves to categorize all FBOs conducting banking operations in the United States and to highlight those FBOs warranting higher levels of supervisory attention with respect to their U.S. operations. An FBO's SOSA is taken into consideration by supervisory agencies in setting the examination plan for the FBO's U.S. operations. The examination plan considers any issues raised in the assessment process and addresses them accordingly.

Recommended supervisory follow-up actions depend on the outcome of the SOSA process. **A or B Assessments**—Normally, any supervisory follow-up action for FBOs with a SOSA rating of A or B is applied only if warranted by the condition of the U.S. operations. Supervisory measures generally would not relate to liquidation concerns. As such, asset maintenance usually would not be required for branches and agencies of these FBOs; however, supervisory actions would be undertaken, if necessary, to resolve any significant deficiencies in risk management, operations and internal controls, or compliance at any of the U.S. offices. **C Assessment**—The FBO's SOSA is reviewed at least annually. The due to/due from positions, which are represented by deposits by other banks (due to) or deposits in other banks (due from), that are used to facilitate the transfer of funds among banks are closely monitored and any substantial due from positions are fully analyzed for risk implications. If warranted by the condition of the combined U.S. operations or the asset quality at the U.S. offices of such an FBO, asset maintenance would be considered for branches and agencies, and U.S. subsidiary

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banks could be required to operate at capital levels above the minima. **D Assessment**— There is a strong presumption of asset maintenance for branches and agencies of an FBO in this category, and U.S. bank subsidiaries should operate at strong capital levels. The FBO is more closely monitored and its assessment may be subject to review at least semi-annually. **E Assessment**— The FBO will be placed under continuous surveillance and reporting as warranted. Termination proceedings for the U.S. operations of such an FBO will be considered under applicable regulatory guidelines.

All SOSA results are for internal supervisory use only and are not disclosed to the general public, the FBO's management, or the home country regulators. If deemed appropriate, any specific concerns raised through the assessment process, rather than the assessment itself, will be communicated directly to the FBO's management and home country regulators, particularly if those concerns lead to supervisory follow-up action with regard to the FBO's U.S. operations.

This section presented an overview of the banking industry by focusing on its business functions, operating environment and role in the economy. The discussion focused on the FBOs role in American and global economies. FBO operations encompass a wide variety of banking and non-banking activities and also serve as links among integrated global economies. Services are usually provided through established subsidiaries, branches and representative offices. The section explained why the foreign ownership of FBOs makes them unique players in the market and exposes them to potentially far greater industry risks than domestic financial institutions.

The second part of this section addressed FBOs' regulations and jurisdiction. Work of banking institutions in the U.S. is heavily regulated, especially foreign-band

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banks like FBOs. Many branches of the federal government, along with state regulating authorities, take special interest in FBOs' work in order to insure legitimacy and soundness of their operations. The section is concluded by discussion of the strength-or-support assessment that was developed by federal regulating authorities in order to better coordinate and enhance the supervision of the U.S. activities of FBOs.

3.0 EXTERNAL AUDITS

Thanks to globalization we cannot imagine economic progress being restricted by the borders of a single country or a continent. International banking facilitates further economic progress and integration without borders. FBOs play a vital role in promoting such progress and integration. However, such progress is impossible without some system of regulations. While conducting an extensive supervision of FBOs operations, the U.S. government entrusts and allows the market to conduct its own supervision of FBOs operations. Most often independent auditors carry-out the will of the market in evaluating the work of FBOs. Such audits are complicated by the unique international nature of the FBO's origin. The next section provides an overview of the external audits and other issues relevant to such audits of FBOs.

3.1 INTRODUCTION TO EXTERNAL AUDITING

Generally Accepted Auditing Standards

Many U.S. branches and agencies of FBOs are required by state law or the head office to have independent audits performed periodically. For insured depository institutions, Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991 requires annual independent audits for all FDIC insured banks and insured branches that have total assets in excess of $500 million. Independent audits enhance the probability that financial statements and reports to regulatory authorities and other financial

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statement users will be accurate and help detect conditions that could adversely affect either banking organizations or the public. The independent audit process may also subject the internal controls and the accounting policies, procedures, and records of each banking organization to periodic review. External auditors frequently conduct financial audits and certain other procedures and services. In the case of U.S. financial audits, these must be conducted by Certified Public Accountants (CPAs) in conformance with Generally Accepted Auditing Standards (GAAS). During an audit, the auditor uses particular and specialized actions, called audit procedures, to obtain evidence in a specific audit engagement. While the nature, timing, and extent of procedures is largely left up to the auditor's judgment, much of what an auditor does is guided by GAAS.

Audit standards are issued and codified (AU = Audit Standards) by the American Institute of CPAs (AICPA). They were first written as a short statement of 10 standards, classified as general standards (relate to the personal integrity and professional qualifications of auditors), fieldwork standards (specify quality criteria for conducting an audit), and reporting standards (guide issuance of an audit report). Audit standards are audit quality guides that remain the same in any kind of audit. The 10 GAAS standards are presented in **Table 6**. This section and the next section will discuss select audit standards and audit procedures most relevant to the audit of FBOs (scope of the paper precludes a complete discussion of all audit standards and procedures).

The objective of an audit of financial statements is to express an opinion on whether an entity's financial statements present fairly, in all material respects, its financial position, the results of its operations, and its cash flows in conformity with Generally Accepted Accounting Principles (GAAP). To accomplish that objective, the

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Table 6: AICPA Generally Accepted Auditing Standards

Standard Type	Standard Element
General Standards	• Competence • Independence • Due Professional Care
Field Work Standards	• Planning and Supervision • Internal Control • Sufficient, Competent Evidential Matter
Reporting Standards	• GAAP • Consistency • Informative Disclosure • Opinion and Degree of Responsibility

Source: AICPA, 2003a, AU 150

auditor assesses the risk that the financial statements contain material misstatements, and then the auditor plans and performs audit procedures to provide reasonable assurance that the financial statements are free of material misstatements. The "opinion" is contained in the auditor's report. The auditor's opinion can be one of four types, as follows[6]:

- **Unqualified opinion**—sometimes referred to as a "clean opinion," is the most common type of opinion. This type states that the financial statements are "presented fairly" in conformity with GAAP, and that the necessary audit work was done. This report is often referred to as the standard audit report and may include additional explanatory language regarding particular issues.
- **Qualified opinion**—indicates that financial statements are presented fairly in all material respects "except for" the effects of a particular matter. Such matters may include the inability to examine sufficient evidential matter, restrictions on the scope of audit work, or material departures from GAAP in preparing a portion of the financial statements.

[6] AICPA, 2003a, AU 508.

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- **Adverse opinion**—concludes that the financial statements taken as a whole are not presented fairly or are in "significant nonconformance with U.S. GAAP."
- **Disclaimer**—expresses no opinion on the financial statements. CPAs may issue a disclaimer when they cannot express an opinion on the financial statements as a whole. This disclaimer is intended to indicate that the CPA is not assuming any responsibility for these statements. Disclaimers may also be issued when auditors have concluded that the scope of their work has been significantly restricted.

The auditor may generate other reports which typically include:

- A letter to the company's management and, if the company is public, the audit committee in which the auditor confidentially presents detailed findings and recommendations to management regarding the company's internal controls.
- Reports from the auditor to regulators during the audit period.

Audit Risk Model

The auditor is required to design the audit to provide reasonable assurance of detecting material errors and frauds[7] in the financial statements. However, it is not practical or feasible for auditors to examine 100 percent of transactions making up the financial statements. The overall risk that the auditor would give an inappropriate opinion on financial statements is called an **audit risk**. The worst appearance of such risk is giving an unqualified opinion on financial statements that are misleading because of material misstatements the auditor failed to discover. Audit risk contains three major components – **inherent risk, control risk, and detection risk**. **Inherent risk** is the probability that material errors or frauds have occurred in transactions entering the

[7] AICPA, 2003a, AU 316.

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accounting system used to develop financial statements[8]. **Control risk** is the probability that the client's internal control activities will fail to detect material misstatements, provided any enter the accounting system in the first place[9]. **Detection risk** is the probability that audit procedures will fail to produce evidence of material misstatement, provided any have entered the accounting system in the first place and have not been detected and corrected by the client's control activities[10].

The foregoing components of audit risk can be expressed in a model that assumes that each of the elements is independent:

Audit Risk (AR) = Inherent Risk (IR) x Control Risk (CR) x Detection Risk (DR).

This equation describes the way the AR model is used in practice. AR is a target or goal and is based on professional judgment. IR, CR and DR are estimates based on a combination of professional judgment and evidence. IR and CR are not controllable by the auditor but are evaluated and measured. DR is controllable by the auditor and is inversely related to IR and CR. After assessing IR and CR and supporting the assessment with evidence, DR is then derived so that AR is at an acceptably low level. It is important to remember that the audit risk model is only a conceptual tool in the audit and represents more of a way to think about audit risks than a way to calculate them.

3.2 GENERAL AUDITING CONSIDERATIONS

Prior to and during the engagement multiple areas of professional work should be considered by the independent auditor. This areas are presented in the **Illustration 1**.

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[8] AICPA, 2003a, AU 350, 312.
[9] AICPA, 2003a, AU 350, 317.
[10] AICPA, 2003a, AU 350, 312.

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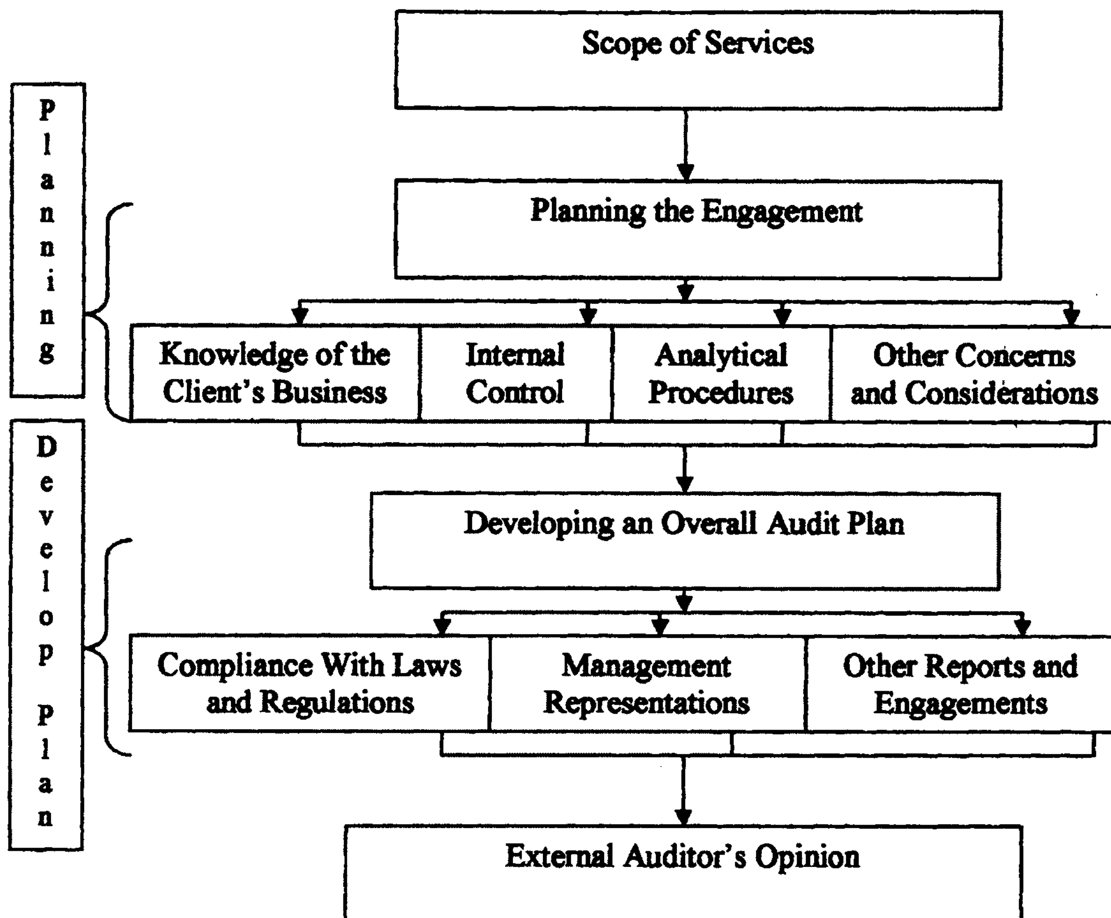
Illustration 1: Flowchart of General Auditing Considerations[11]



The balance of this section will discuss each of the stages outlined in the flowchart, both in general and in an FBO context.

Scope of Services

The scope of services rendered by the auditor may vary significantly and generally depends on the types of reports to be issued as a result of the engagement. The goal of this section is to describe the scope of services applicable to an audit of an FBO.

Before starting the engagement, the external auditor should establish an understanding with the financial institution's management regarding the scope of services

[11] AICPA, 2000.

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to be performed and the reports to be issued. If dealing with a public company, this understanding is to be established with the public company's audit committee. Such an understanding reduces the risk that either the auditor or the client may misinterpret the needs or expectations of the other party. It should be documented in the workpapers, preferably through a written communication with the client. Standard auditor-client communication should include the following elements:

- the objectives of the engagement,
- management's responsibilities,
- the auditor's responsibilities, and
- limitations of the engagement.[12]

The best way to establish a solid understanding and to avoid future problems related to miscommunication is through an engagement letter produced by the auditor and signed by either the company's management or the audit committee. Such letter includes, among other things, the scope of the audit, the period of time to be covered by the audit, and the reports expected to be rendered. In many cases, the highlights of these matters will be summarized in the body of the letter with greater detail being provided in schedules or appendices to the letter. Procedures may be specific by audit area. In addition, if there are any limitations on the scope of the audit, the letter may specify any auditing procedures that are to be omitted, such as confirmation of loans or deposits, if the auditor is expected to render an opinion on the branch's financial statements.

As in any other audit engagement, when dealing with an FBO, the auditor should obtain a clear knowledge of who the appropriate party is inside of the FBO to establish

[12] AICPA, 2003a, AU 310.

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and communicate such understanding. Before enactment of the Sarbanes-Oxley Act, the auditor most often had to submit an engagement letter to the FBO's main U.S. branch or its head office abroad before commencing his or her work. Now, when dealing with the publicly traded FBO, such as "Deautsche Bank," the auditor must consider provisions of Sec. 301 of the Sarbanes-Oxley Act and establish communications only with the FBO's audit committee. For audits of non-public FBOs, however, the auditor can still use the old scheme for establishing client-auditor communications. If the external auditor believes an understanding with the client has not been established, he or she should decline to accept or perform the engagement.

Planning the Engagement

The first standard of field work requires that audit work be adequately planned and that assistants, if any, be properly supervised[13]. The auditor should develop procedures for audit planning, preparing a written audit program, obtaining knowledge of the entity's business, and developing an overall strategy for the conduct and scope of the audit. The auditor should recognize that the nature, timing, and extent of planning vary with the size and complexity of the entity whose financial statements are being audited, as well as with the auditor's experience with the entity and knowledge of the entity's business.

Knowledge of the Client's Business

The auditor undertaking audits of financial statements of an FBO should possess sufficient knowledge of matters that affect such institution, including applicable regulatory matters. In the planning stage, the auditor gathers in-depth information about

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[13] AICPA, 2003a, AU 311.

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the FBO operations and structure. Such information should provide the auditor with a solid understanding of the financial institution's areas of operations which are critical to the audit, such as internal controls mechanisms, off-balance sheet activities, and related-party transactions. These topics are explored in more details below.

In addition to general knowledge of the industry, the auditor should have knowledge of matters that are unique to the entity whose financial statements are being audited. This knowledge should be sufficient to provide an understanding of events, transactions, and practices that may have a significant effect on the institution's financial statements. For public companies, the independent accountant should also obtain an understanding of the operating segments of the business, as defined by Financial Accounting Standard (FAS) No. 131. With regards to FBOs, such matters include:

- regulatory matters applicable to FBOs,
- operations risks unique to FBOs, such as transfer risk
- management strategies,
- organizational structure,
- product lines and services,
- capital structure,
- locations, and
- other operating characteristics.

Such knowledge of an FBO's business could be obtained through the auditor's past audits with the institution, discussions with predecessor auditors, meetings with institution personnel and documents such as the FBO's charter and bylaws, minutes of meetings of the board of directors and audit committee, prior period financial statements,

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management and internal reports, etc.

While learning about the FBO's operations, the auditor should be particularly concerned about determining the existence of related party relationships, gaining sufficient knowledge about such parties and transactions with them[14]. Related parties are defined as:

a. Affiliates of the institution (a party that, directly or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with an institution);

b. Investments in entities that are accounted for by the institution using the equity method;

c. Trusts for the benefit of employees, such as pension and profit-sharing trusts, that are managed by or are under the trusteeship of management of the institution;

d. Principal owners of the institution;

e. Management of the institution;

f. Members of the immediate families of the principal owners and management;

g. Other parties with which the institution may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests.

One party's control or influence over other party's management decisions or operating policies is decisive criterion in characterizing parties as related. Such knowledge is

[14] AICPA, 2003a, AU 334.

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essential in the audit due to the international nature of FBOs, the likelihood of transactions being conducted with related parties located abroad, and the relative ease of concealing the existence of related parties. Also, discrepancies in defining related parties can exist between the U.S. GAAS and the FBO's home country auditing standards.

Among other procedures used to identify related parties and obtain knowledge about them, in the FBO's audit the auditor should consider:

a. Evaluating the company's procedures for identifying and properly accounting for related party transactions;

b. Requesting from appropriate management personnel (from the main U.S. branch or from the FBO's headquarter) the names of all related parties and inquire whether there were any transactions with these parties during the period;

c. Reviewing the FBO's filings with the Securities and Exchange Commission (SEC) and other regulatory agencies, both within U.S. and in the FBO's home country;

d. Reviewing closely held companies' stockholders listings to identify principal stockholders;

e. Inquiring of prior auditors or auditors conducting the audit of the FBO's headquarter in its home-country about any known related parties;

f. Reviewing material investment transactions during the period under audit to determine whether the nature and extent of investments during the period create related parties.

In auditing related party transactions that are identified during the course of the

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audit, the auditor should be aware that the substance of a particular transaction could be significantly different from its form and that financial statements should recognize the substance of particular transactions rather than merely their legal form.

Internal Control

By the nature of their business, financial institutions possess assets which are more negotiable and liquid than those of most other commercial enterprises, which subjects them to a greater risk of loss, misappropriation and theft of those assets. As a result, the effectiveness of internal control is a significant audit consideration. The importance of assessing internal controls has been increased by the Sarbanes-Oxley Act. As outlined in the "Corporate Responsibility for Financial Reports" section[15] of the Act, public company management in their reports filed with SEC should disclose (1) all "significant deficiencies" in the design or operation of internal controls which could adversely affect the company's ability to record, process, summarize, and report financial data and (2) any "material weaknesses" in internal controls. The signing officer must indicate in the report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls. Such a report by the company's management becomes a valuable source of information on internal controls for the auditor.

In addition, as stated in the "Management Assessment of Internal Controls" section of the Sarbanes-Oxley Act[16], management of a public company should issue a report of their assessment of the company's internal controls; it also obligates auditors,

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[15] Sarbanes-Oxley Act, Section 302, 2002.
[16] Sarbanes-Oxley Act, Section 404, 2002.

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when issuing their audit report, to evaluate the audited company's internal controls and to issue a report about their internal control evaluation findings.

While companies subject to the Sarbanes-Oxley Act must have an expanded internal control examination, non-public companies do not have a similar requirement. In all audits, however, the auditor is required to obtain an understanding of each of the five components of internal control. Such an understanding is obtained by performing procedures to follow the design of controls relevant to financial statements and whether they have been placed in operation. The five components of internal control are:

- the control environment,
- risk assessment,
- control activities,
- information and communication, and
- monitoring.[17]

The applicability and importance of specific components of internal control should be considered in the context of (1) the FBO's size, (2) its organizational characteristics, (3) the nature of its business, (4) the diversity and complexity of its operations, and (5) its applicable legal and regulatory requirements.

Any FBO operating in the U.S. is expected to have a fully effective system of internal controls similar to that required of U.S. banks. The auditor should consider the internal controls implemented not only by the audited FBO's branch, but also those implemented by an FBO's headquarter and all other branches. One way to obtain such knowledge is through a review of established internal control policies presented in a

[17] AICPA, 2003a, AU 319.

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written policies document. The auditor could also consider testing such policies employed by the FBO's other branches and a headquarter, if necessary.

Analytical Procedures

Auditing standards require the use of analytical procedures in both the planning and review stages of financial statements audits[18]. The objective of analytical procedures is to identify unusual transactions and events and amounts, ratios, and trends that might indicate matters that have financial statement and audit planning ramifications. Analytical procedures involve the comparison of recorded amounts or ratios developed from recorded amounts with expectations developed by the auditor. For planning purposes, analytical procedures focus on:

- enhancing the independent accountant's understanding of the institution's business, transactions, and events that have occurred since the last financial statement audit, and
- identifying areas that may present specific risks relevant to the financial statement audit.

Analytical procedures used in planning the audit generally use data aggregated at a high level. The procedures may consist of reviewing changes in account balances from the prior year to the current year (horizontal) and analyzing the relationship amongst financial statement elements (vertical). Alternatively, the procedures may involve an extensive analysis of quarterly financial statements, ratios, statistics, and budgeted amounts, including their relationship to performance of the industry as a whole. In either case, the analytical procedures, combined with the independent accountant's knowledge of the business, serve as a basis for additional inquiries and effective planning. The

[18] AICPA, 2003a, AU 329.

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nature, extent, and timing of the procedures, which are based on the independent accountant's judgment, may vary widely depending on the size and complexity of the institution.

Ratios, operating statistics, and other analytical information that may be useful in assessing an FBO's position relative to other similar institutions and industry norms, as well as in identifying unusual relationships amongst data about the institution itself, are generally readily available from reports published by regulatory agencies such as the FDIC. Such ratios could also be developed by the auditors or by the company's management. A number of ratios that may be useful in applying analytical review procedures of FBO's financial statements are presented in **Table 7**.

Table 7: Ratios for Analytical Procedures Used in Audits of Banks

Ratio	Measures
Investments/Total Assets	Mix of earning assets
Loans/Total Assets	Mix of earnings assets
Investments (by type)/Total Investments	Composition of investment portfolio
Loans/Deposits	Funding sources for the loan base
Allowance for Loans Losses/Total Loans	Loans portfolio credit risk coverage
Loan Losses Recoveries/Prior-Year Write-Offs	Write-off policy and recovery experience
Net Income/Average Total Assets	Return-on-assets (ROA)
Net Income/Average Capital	Return-on-equity (ROE)
Capital ratios	Financial strength

Source: AICPA, 1997

Other Concerns and Considerations

Many FBOs' branches are scattered internationally. As a result, the auditor would have to limit physical observation of internal control procedures or any other types of on-site inspection and place more reliance on the analytical procedures (as discussed earlier)

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and substantive testing, such as transactions' recalculation, confirmation by letter, verbal inquiry, examination and scanning of documents. The auditor should also consider using the work of other independent auditors to perform some parts of the audit, such as internal control testing in the FBO's branches located abroad. In some situations, mostly due to the peculiar and complicated types of transactions performed by FBOs, such as off-balance sheet activities, the auditor might require help of a specialist in understanding transactions and developing proper audit procedures. Before using the work of an external specialist, the auditor is required to evaluate the professional qualifications of the specialist and whether they match the type of work being performed. The auditor should also understand the nature and purpose of the specialist's work.

Financial institutions often use service organizations to process daily transactions. Since most FBOs lack full-service comprehensive support operations in the U.S. and have relatively limited office staff, they are forced to extensively use service organizations. Examples include using a currency-broker in conducting transactions with home-country clients and exchanging large sums of currencies. When the FBO uses a service organization, transactions that affect the FBO's financial statements are subject to controls that are in part physically and operationally separate from the institution. The significance of the internal controls of the service organization to those of the FBO vary, depending on the nature and materiality of the services provided. The auditor should consider the effect of a service organization on the client's internal control and the availability of audit evidence[19].

[19] AICPA, 2003a, AU 324.

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Consideration of Fraud

The independent auditor is required to assess the risk of material misstatement due to fraud and consider and document that assessment in designing the audit procedures to be performed. In making this assessment, the auditor should consider fraud risk factors that relate to:

- misstatements arising from fraudulent financial reporting, such as management's characteristics and influence over the control environment, industry conditions, operating characteristics and financial stability; and
- misstatements arising from misappropriation of assets, such as susceptibility of assets to misappropriation and internal controls[20].

Auditors should consider other fraud risk factors and indicators, such as:

a. Noncompliance with laws and regulations;
b. Material changes in operations or operating performance;
c. Practices that fail to consider changing economic conditions, for example, over-reliance on historical data in the evaluation of credit risk;
d. Material one-time transactions, particularly those that (1) account for a material portion of related income or otherwise indicate attempts to realize large, short-term benefits or (2) occur at or near the end of a reporting period;
e. Highly complex or speculative transactions;
f. Nontraditional or unusual loan transactions;
g. Potential for insider abuse, that is actions by the institution's offers, directors, and major shareholders.

[20] AICPA, 2003a, AU 312, AU 316.

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When conducting an FBO audit, the auditor should carefully consider the possibility of fraud and identify areas with high potential for material misstatements. Fraud risk factors such as noncompliance with laws and regulations, material one-time transactions, and off-balance sheet transactions are areas with the highest potential for material misstatements in an FBO audit.

Going Concern

Audit standards require the auditor to evaluate – as part of every financial statement audit – whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited. The auditor's evaluation of an institution's ability to continue as a going concern may be one of the most complex and important portions of the audit and should be conducted in the following manner:

a. The auditor considers whether the results of procedures performed identify conditions and events that, when considered in the aggregate, indicate there could be substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time.

b. If such substantial doubts exist, the auditor should obtain information about management's plans intended to mitigate the adverse effects of the conditions or events that gave rise to the doubt and assess the likelihood that such plans can be effectively implemented.

c. After evaluating management's plans, the auditor concludes whether he or she has substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time.

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d. If the auditor makes such conclusion, the audit report must contain a paragraph expressing the auditor's "substantial doubt" about the entity's ability to continue as a going concern.

The following are examples of **conditions and events** that may be encountered in audits of FBOs that could indicate substantial doubt about the institution's ability to continue as a going concern for a reasonable period of time:

- Recurring operating losses
- Indications of strained liquidity
- Failure to meet minimum regulatory capital requirements
- Concerns expressed or actions taken by regulatory authorities regarding alleged unsafe or unsound practices
- Indications of strained relationships between management and regulatory authorities.[21]

The following are examples of **procedures** normally performed in audits of the financial statements of FBOs that may identify going concern conditions and events:

- Perform analytical procedures
- Review events subsequent to the balance sheet date
- Review compliance with the terms of debt and loan agreements
- Read minutes of meetings of the board of directors and important committees of the board
- Inquire of an entity's legal counsel about litigation, claims, and assessments
- Confirm with related and third parties the details of arrangements to provide or maintain financial support

[21] AICPA, 2003a, AU 341.

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- Review the financial strength and liquidity of the parent company, if applicable
- Review reports of significant examinations and related communications between examiners and the institution
- Review compliance with regulatory capital requirements

As discussed previously, one of the main reasons for the increase in FBOs' supervision by the federal agencies was the government's and investors' concerns over soundness of FBOs in the U.S and their ability to continue their operations due to higher failure rate of FBOs' than domestic banks. **Value-at-risk model** summarizes in one figure the expected maximum loss on a line of business over a set time period with a given probability. Such analysis can be very useful to the auditor in evaluating the FBO's ability to continue as a going concern. However, in conducting such analysis the auditor is likely to require help of a specialist. The auditor should recognize the importance of in-depth analysis of unique risks facing the FBO that could affect the bank's ability to continue its operations.

Developing an Overall Audit Plan

Before starting the engagement work, the overall audit plan needs to be developed. The auditor relies on his or her professional judgment about assessing the level of inherent risk in an engagement, because that type of risk affects the planning process in terms of staffing, the extent of supervision, overall audit scope and strategy, and the degree of professional skepticism that would need to be applied during the audit work. By the nature of their business, all financial institutions, including domestic banks and savings institutions as well as FBOs, are exposed to more risks than other non-financial businesses; financial institutions also operate in a highly regulated business

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environment. All these aspects are to be considered while developing an overall audit plan in such a way that appropriate personnel are assigned to areas of the engagement that involve relatively higher risk, supervision is adequate, and a higher degree of professional skepticism is maintained.

In developing an overall audit plan for an FBO, risk-focused pre-audit planning could be used by the auditor. Such approach allows the auditor to better plan the audit according to the size and unique business activities conducted by an FBO, and to concentrate resources on areas that expose an FBO to the highest degree of risk.

Compliance With Laws and Regulations

In planning the audit, the auditor should consider "matters affecting the industry in which the entity operates, such as economic conditions, government regulations, and changes in technology, as they relate to the audit."[22] In performing an audit of financial statements in accordance with GAAS, the auditor considers government regulations in light of how they might affect the financial statement assertions. Some laws and regulations, such as tax laws, have a direct and material effect on the determination of financial statement amounts. Other laws and regulations, such as those related to securities trading, occupational safety, and reporting requirements, relate more to an institution's operating aspects than to its financial and accounting aspects, and their effect on the financial statements is indirect. The indirect effect of violations of such laws and regulations is normally the result of the need to disclose a contingent liability or determination of illegality.

When dealing with FBOs, the auditor needs to be aware of their home country regulations and their potential effect on the FBO's financial position in the U.S. Testing

[22] AICPA, 2003a, AU 311.

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of compliance with both the U.S. and the home country's laws and regulations is necessary. Despite the fact that the ultimate responsibility for compliance with laws and regulations rests with management of the institution, the auditor should be aware of the potential for illegal acts with material effects on the institution's financial statements. The auditor should design the audit to provide reasonable assurance of detecting misstatements resulting from illegal acts having a direct and material effect on the determination of financial statement amounts.[23] Also, as a result of the Sarbanes-Oxley Act, a public company's management is required to file periodic reports with the SEC certifying that the annual and quarterly reports are free of material misstatements and presented fairly. Management of a public company is also required to disclose to the auditor:

- all significant deficiencies in the design or operation of internal controls which could materially affect the financial statements,
- any fraud, whether or not material, that involves management or other employees who have a significant role in the company's internal controls.

The auditor of a publicly-traded FBO should obtain and review such reports before planning the audit. For a non-publicly traded FBO, the auditor should consider obtaining similar reports and assertions from the management as well.

Management Representations

The auditor is required to obtain written representations from management as part of an audit of financial statements performed in accordance with GAAS.[24] Such representations are part of the evidential matter the auditor obtains, rather than a

[23] AICPA, 2003a, AU 317.
[24] AICPA, 2003a, AU 333.

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substitute for the application of auditing procedures. Representations take the form of a letter on the client's letterhead, addressed to the auditor, signed by the responsible officer such as the CEO, and dated as of the date of the auditor's report. Written representations from management should be obtained for all financial statements and periods covered by the auditor's report. The specific written representations to be obtained depend on the circumstances of the engagement and the nature and basis of the presentation of the financial statements. Only an FBO's management is in position to know fine details about the business operations of an institution. Therefore, an FBO management's representation is a unique source of information about the FBO's complicated operations, such as off-balance sheet activities. Representations that may be obtained from banks and savings institutions' management are presented in **Table 8**.

Some of management's representations may be limited to matters that are considered either individually or collectively material to the financial statements, provided management and the accountant have reached an understanding on materiality for this purpose. The representations should be made as of a date no earlier than the date of the accountant's report. Management's refusal to furnish written representations constitutes a limitation on the scope of the audit sufficient to preclude an unqualified opinion and is ordinarily sufficient to cause an accountant to disclaim an opinion or withdraw from the engagement.

Other Reports and Engagements

The auditor should consider whether the nature of the work includes a need to provide the independent auditor's reports to satisfy:

- relevant regulatory requirements;

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Table 8: Management's Representations

Representation's Intent	Type of Representations
Compliance/Regulatory Issues	Make available to auditor: • regulatory examination reports, • institution's supervisory correspondence, • correspondence from applicable regulatory agencies concerning supervisory actions, noncompliance issues.
Securities Held	• classification of securities between held-to-maturity, available for sale, or trading categories accurately reflects management's ability and intent.
Fair Value Disclosures/Assumptions	• the methodology used for determining fair value disclosures and assumptions.
Disclosure of Losses/Costs/Expenses of the Institution's Business Activities	• adequate provision has been made for losses, costs, or expenses incurred on securities, loans, leases and real estate as of the balance-sheet date.
Evaluation of Investment Securities Held	• other than temporary declines in the value of investment securities have been properly recognized in the financial statements.
Financial Instruments with Off-Balance Sheet Risk and Credit Risk	• disclosure of financial instruments with significant off-balance sheet risk; • disclosure of concentrations of credit risk.
Capital Plan Disclosure	• status of the institution's capital plan filed with regulators • reports on compliance with any formal agreement/orders.
Contingent Items	• contingent assets and liabilities have been adequately disclosed in the financial statements.
Related Parties Transactions	• related party transactions have been entered into in compliance with existing regulations.

Source: AICPA, 2000

- o audits of common trust funds or agreed-upon procedures related to trust activities;
- o identifying and audit of related-parties activities;
- o assessment/audits of an entire FBO's U.S. or world-wide operations;
- o agreed-upon procedures on management assertions related to unique business operations;
- o compliance audit;

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- reports on internal control over financial reporting (required for public companies under the Sarbanes-Oxley Act);
- reports on the processing of transactions by banks and savings institutions functioning as service organizations in accordance with Statement on Auditing Standards (SAS) No. 70, *Service Organizations.*

External Auditor's Opinion

As was mentioned before, the result of the audit engagement is the audit report where the auditor expresses an opinion on whether the company's financial statements present fairly, in all material respects, its financial position, the results of its operations, and its cash flows in conformity with GAAP. This conclusion may be expressed only when the auditor has formed such an opinion on the basis of an audit performed in accordance with GAAS. In the case of FBOs, this opinion becomes an important document used and relied on by many investors and regulators both domestically and internationally. The unqualified opinion (most often type issued) on the financial statements is the most desirable by any business entity. It means that the auditor is unaware of any material misstatements on the financial statements. An example of the auditor's (KPMG) report expressed on the audit of the FBO (Deautsche Bank) is presented in the Appendix C.

There are many challenges the auditor faces while auditing an FBO. Many of them relate to distinctive business functions performed by FBOs. Off-balance sheet activities represent one of the most common and difficult challenges the auditor is likely to encounter during the audit of an FBO. The following section discusses off-balance sheet activities and presents an off-balance sheet activities' audit program.

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4.0 AUDITING OFF-BALANCE SHEET ACTIVITIES

4.1 OVERVIEW OF FBO OFF-BALANCE SHEET ACTIVITIES

Many FBOs are involved in a wide spectrum of banking activities designed to generate fee income, such as securities clearance and brokerage activities, data processing services, investment services and management advisory services. As the branches of foreign banks find more avenues of non-traditional banking activities available to them, they expand the scope of services offered to customers. For the majority of FBOs, off-balance sheet activities have become a regular part of their operations that generate a sizable amount of fee income. Activities off-balance sheet mean that a bank enters into agreements that either do not have or have only a partial balance sheet reporting impact until a transaction is effected. These off-balance sheet items are quite diverse in nature and purpose and may include such instruments as firm loan commitments, standby letters of credit, foreign exchange, financial futures, forward contracts, options, interest rate swap contracts, and other derivative products.
Usually, until the customer actually borrows the funds, no loan is booked as part of the bank's assets. These agreements, in turn, entail some risk as the bank must perform under the contract.

An FBO might have a substantial interest in the performance of the transaction involved and have a segregated deposit sufficient to cover its total potential liability. The branch may also guarantee or endorse notes or other obligations sold by the branch for its own account. The amount of the obligations covered by such guarantee or endorsement is to be disclosed as a contingent liability of the financial institution. Furthermore, the contingent liabilities are included in computing the aggregate indebtedness, which may

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be subject to limitations imposed by any applicable law or regulation. Usually, the party for whom the guarantee was issued will reimburse the branch should it be required to pay under the guarantee; however, in certain situations, some other designated party may reimburse the branch. That other party may be designated in the guarantee agreement with the branch or in the guarantee instrument itself. The branch may also be reimbursed from segregated deposits held, pledged collateral, or by a counter-guarantor. A list of off-balance sheet items (contingent liabilities) most frequently issued by FBOs includes the items presented below.

Most Common Off-Balance Sheet Activities

Letters of credit are the most widely used instrument to finance international trade transactions. The two major types of letters of credit are the commercial documentary letter of credit and the standby letter of credit.

Commercial Documentary Letters of Credit

This type of letter of credit is used most commonly to provide a bank's credit and possible financing to a commercial contract for the shipment of goods from seller to buyer. A commercial documentary letter of credit is a letter issued by a bank (issuing bank) on behalf of its customer (account party, a buyer of merchandise), to a seller (beneficiary), authorizing the seller to draw drafts up to a stipulated amount, under specified terms and undertaking to provide eventual payment for drafts drawn. The beneficiary will be paid when the terms of the letter of credit are met and the required supporting documents are submitted to the paying or negotiating bank. The issuance and negotiation of letters of credit are governed by Article 5 of the Uniform Commercial

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Code (UCC) and the Uniform Customs and Practice for Documentary Credits published by the International Chamber of Commerce (ICC). All letters of credit must be issued

- In favor of a definite beneficiary
- For a specific amount of money
- In a form clearly stating how payment to the beneficiary is to be made and under what conditions
- With a definite expiration date.

Commercial letters of credit are issued in either irrevocable or revocable form. An irrevocable letter of credit cannot be changed without the agreement of all parties. Conversely, a revocable letter of credit can be canceled or amended by the issuing bank at any time, without notice to or the agreement of the beneficiary. An irrevocable letter of credit constitutes a definite commitment by the issuing bank to pay, provided the beneficiary complies with the letter's terms and conditions. In contrast, the revocable letter of credit is not truly a bank credit but serves as a device that provides the buyer and seller a means of settling payments. Because a revocable letter of credit can be canceled or changed without notice, the beneficiary should not rely on the credit, but rather on the willingness and ability of the buyer to meet the terms of the underlying contract. The letter of credit may be sent to the beneficiary directly by the issuing bank, through the beneficiary's bank, or through the issuing bank's correspondent located in the same place as the beneficiary. The correspondent may act as an "advising bank" that is, it may act as an agent of the issuing bank in forwarding the letter on to the beneficiary without any commitment to pay on its part. Advised letters of credit will bear a notation by the advising bank that it makes "no engagement" or words to that effect. An irrevocable

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advised letter of credit is, therefore, an undertaking to pay by the issuing bank but not by the advising bank. Some beneficiaries (sellers), particularly those not familiar with the issuing bank, request that the buyer have the issuing bank ask the advising bank to add its "confirmation" to the issuing bank's irrevocable letter of credit.

Confirmed letters of credit are evidenced by the confirming bank's notation: "We undertake that all drafts drawn . . . will be honored by us" or similar words. The beneficiary of a confirmed credit has a definite commitment to pay from a bank in his or her country and does not need to be concerned with the willingness or ability of the issuing bank to pay. One bank may play more than one role. For example, an advising bank may add its confirmation and be designated in the letter as the paying bank. Payment terms of a letter of credit usually vary from sight to 180 days, although other terms sometimes are used. If the draft is a time draft, the drawee bank can accept the draft (by stamping "Accepted" on the face of the draft), which then can be held by either the seller or the seller's bank or the accepting bank until maturity. Alternatively, the accepted draft can be sold or discounted. (Refer to the Bankers' Acceptances section.) Certain categories of commercial letters of credit, such as "back-to-back, " "transferable," "deferred payment," "revolving," and "red clause" credits, contain specific elements of risk.

- A back-to-back letter of credit is one where a commercial letter of credit (master credit) is used as security to support the issuance of a second credit to another supplier (seller). The beneficiary (seller) of the credit becomes the applicant of the second letter of credit. In other words, the beneficiary assumes the role of a middleman between the actual supplier and the ultimate buyer of the merchandise.

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The difference between the master credit amount and the back-to-back credit is the middleman's profit. Back-to-back credits are most frequently seen in situations where the exporter (middleman) is unable to purchase merchandise on his own credit rating.

- A transferable letter of credit enables the original beneficiary to transfer the rights of payment to one or more beneficiaries. These credits are normally seen when the original beneficiary acts as an agent and does not supply some or all of the merchandise or does not have the financial resources or credit necessary to purchase the merchandise. In some instances, the beneficiary may wish to keep the supplier and applicant ignorant of each other (so as to protect his profit as middleman) by requesting the advising bank to substitute his own name for that of the applicant. The rights in a transferable letter of credit may not be transferred by the second beneficiary to a third party unless otherwise stated.
- Deferred payment letters of credit are similar to commercial letters of credit in that they provide for payment at some date after shipment of the goods. However, this type of credit does not require a time draft to be presented for payment. The merchandise is released without payment. Instead, the issuing bank undertakes to reimburse the paying bank at some future date as stipulated in the credit. Deferred payment credits are discouraged by banks since no debt instrument exists to discount.
- A revolving letter of credit allows for the amount of the credit to be renewed or automatically reinstated without specific amendments to the credit. Such credits allow for flexibility in commercial dealings between exporters and importers;

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however, credits of this type usually specify a maximum overall amount which can be drawn for control purposes. Credits of this type can revolve in relation to time or value, and be cumulative or non-cumulative. In practice, the vast majority of letters of credit are non-revolving. Since the maximum exposure under an irrevocable revolving credit can be large, most revolving credits are issued in revocable form.

- Originally a clause in the letter of credit was written in red ink to draw attention to the special nature of the credit. Hence, the name <u>Red Clause Credits</u> was derived. The use of this clause permits the beneficiary to obtain an advance or pre-shipment advances from the advising or confirming bank. Its purpose is to provide the seller credit. Any advances are the responsibility of the issuing bank. Interest is normally charged by the bank making the advance until documents are presented and the bank is reimbursed by the issuing bank.

<u>Standby Letters of Credit</u>

A standby letter of credit provides for payment to the beneficiary by the issuing bank in the event of default or nonperformance by the account party (the issuing bank's customer) upon the presentation of a draft or the documentation, as required in the letter of credit. Although a standby letter of credit may arise from a commercial transaction, it usually is not linked directly to the shipment of goods from seller to buyer. It may cover performance of a construction contract, serve as an assurance to a bank that the seller will honor his or her obligations under warranties, or relate to the payment of a purely monetary obligation, for example, when the credit is used in backing payment of commercial paper. Under all letters of credit, the banker expects the account party to be

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financially able to meet his or her commitments. A banker's payment under a commercial letter of credit for the customer's account is usually reimbursed immediately by the customer and does not become a loan. However, payment under a standby letter of credit generally occurs because the account party has defaulted on its primary obligation. That default can be a result of the customer being unable to pay or a dispute between the beneficiary and the account party.

A standby letter of credit transaction involves greater potential risk for the issuing bank than does a commercial documentary letter of credit. Unless the transaction is fully secured, the issuer of a standby letter of credit retains nothing of value to protect against loss, whereas a commercial documentary letter of credit may provide the bank with title to the goods being shipped. To reduce the risk of a standby letter of credit, the issuing bank's credit analysis of the account party should be equivalent to that applicable to a borrower in an ordinary unsecured loan situation. For reporting purposes, standby letters of credit are shown as contingent liabilities in the branch's Report of Assets and Liabilities. Depending on any applicable state and federal laws and regulations, standby letters of credit may be subject to prudential limitations.

Government and Agency Guaranteed Letters Of Credit

The process of foreign trade also is facilitated by various U.S. government agencies and international organizations. Some programs guarantee payments under letters of credit issued by commercial banks to promote U.S. exports or at the request of international organizations which reimburse banks for letters of credit issued on their behalf. The most common agencies which guarantee letters of credit are presented in **Table 9**.

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Table 9: Agencies Guaranteeing Letters Of Credit

Name	Major Functions
Export-Import Bank of the U.S. (Eximbank)	Independent agency of the U.S. government, facilitates the financing of U.S. exports.
Private Export Funding Corporation (PEFCO)	Private corporation, makes U.S. dollar loans to foreign importers to finance purchases of goods or services of U.S. manufacture or origin.
Commodity Credit Corporation (CCC)	U.S. government agency, provides commercial credit and political risk guarantees to facilitate the financing of U.S. commodity exports.
Agency for International Development (AID)	The largest unit of the International Development Co-operation Agency; it administers the bilateral foreign aid programs of the U.S. government; provides U.S. dollars through loans and grants for foreign assistance recipients to purchase, products needed for development programs and related technical and professional services.
International Bank for Reconstruction and Development (IBRD)	Transnational organization organized for the purpose of financing infrastructure and development projects in lesser developed countries.
Inter-American Development Bank (IADB)	Oldest and largest regional multilateral development institution; helps accelerate social and economic development projects in Latin America and the Caribbean.
Overseas Private Investment Corporation (OPIC)	Self-sustaining U.S. government corporation; promotes economic growth in developing nations by encouraging U.S. private investment in those countries; it insures U.S. investors against political risks and finances selected investment projects through direct loans or loan guarantees.

Source: Federal Reserve System, 1997

Other Types of FBO Off-Balance Sheet Activities

Steam Letter of Guarantee

Frequently, in an international sale of goods, the merchandise arrives at the importer's (buyer's) port and the complete negotiable bills of lading are either lost or delayed in transit. In such instances, it is customary for the importer (buyer) to obtain immediate possession of

the goods by providing the shipping company with a bank guarantee, often called a steamship guarantee, which relieves the shipping company of liability resulting from

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release of the goods without proper or complete negotiable title documents. Usually, the guarantee relies on a counter-guarantee issued to the branch by the importer.

Other Commitments

These transactions include the portion of commitments that obligate the branch to extend credit in the form of loans (including credit card lines), participations in loans, lease financing receivables, or similar transactions. This category would include commitments for which the branch has charged a commitment fee or other consideration or otherwise has a legally binding commitment.

Futures and Forward Contracts

Futures and forward contracts are tools for use in asset and liability management, which can be used by FBOs to effectively hedge portions of their portfolios against interest rate risk. Branches that engage in futures and forward contract activities should only do so in accordance with safe and sound banking practices, with levels of activity reasonably related to the branch's business needs and capacity to fulfill its obligations under the contracts. In managing their assets and liabilities, branches should evaluate the interest rate risk exposure resulting from their overall activities to ensure that the positions they take in futures and forward contract markets will reduce their risk exposure. Policy objectives should be formulated in light of the branch's entire asset and liability mix. Definitions of futures and forward contracts are as follows:

- Futures contracts are standardized contracts traded on organized exchanges to purchase or sell a specified security, money market instrument, or other financial undertaking on a future date at a specified price.

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- Forward contracts are over-the-counter contracts for forward placement or delayed delivery of securities in which one party agrees to purchase and another to sell a specified security at a specified price for future delivery. Contracts specifying settlement in excess of 30 days following the trade date are considered to be forward contracts. Forward contracts are not traded on organized exchanges, generally have no required margin payments, and can only be terminated by agreement of both parties to the transaction.

Standby Contracts and Other Option Arrangements

Standby contracts and other option arrangements are also tools for asset and liability management which, when properly used, can reduce the risks of interest rate fluctuations, Standby contracts are optional delivery forward contracts on U.S. government and agency securities, arranged between securities dealers and customers. The buyer of a standby contract (put option) acquires, upon paying a fee, the right to sell securities to the other party at a stated price at a future time. The seller of the standby (the issuer) receives the fee and must stand ready to buy the securities at the other party's option. Exchange trading is conducted in options specifying delivery of debt securities, money market instruments, or futures contracts specifying delivery of debt securities.

Foreign Exchange Contracts

These are contracts to exchange one currency for another as of a specified date and time at a specified rate of exchange (price). Delivery of the currency may be spot (two or less business days) or forward (more than two business days).

Interest Rate Swap Contracts

Interest rate swap contacts are private, over-the-counter contracts between

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counterparties for exchanging interest payments for a specified period based on a notional principal amount. Entities generally enter into interest rate swaps for interest rate risk management, namely, to manage the interest rate exposures arising from asset and liability positions.

Trading Activities

Trading activities include the purchase or sale of a wide range of financial instruments for speculative or hedging purposes. The range of trading instruments has experienced substantial growth in recent years. The most common instruments seen at branches include derivative products, foreign exchange, and securities.

Due to their complex nature, a solid understanding of off-balance sheet activities is required of the auditor. A list of most common off-balance sheet activities as discussed above includes essentially two types of such activities – letters of credit and other types. However, the list is limited and simplified for the purpose of this research. Indeed, to satisfy demand of customers, FBOs are constantly coming up with new, sometimes controversial and risky, off-balance sheet activities which are often difficult to understand and even more challenging to audit. The goal of the next section is to discuss selected issues facing the auditor in the off-balance sheet activities audit.

4.2 OFF-BALANCE SHEET ACTIVITIES AUDIT PROGRAM

The process of creating an external audit program for FBO off-balance sheet activities makes up this section of the research. A discussion of the off-balance sheet activities audit program's scope, analytical procedures, planning, objectives, management consideration and internal controls are introduced in this section. The main goal of this section is to present a real life partial audit program for FBOs. The focus is on presenting

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and discussing the audit process and objectives and their relevance and impact on the final outcome of any independent external audits – the Independent Auditor's Report. The program itself is presented in Appendix A.

General Financial Reporting Issues

The primary objective of financial reporting is to provide present and potential investors, creditors, and other users with information that is useful in making investment, credit, and other decisions. All these different user groups want different information. Developed to achieve that goal, GAAP is a dynamic set of both broad and specific guidelines that companies should follow when measuring and reporting information in their financial statements. General-purpose financial statements prepared in conformity with GAAP are assumed to be the most cost-effective way to provide the desired information. In an attempt to make such statements as comprehensive as possible, the tendency has been to require disclosure of virtually any material item of information that may be of interest to financial statement users. On the other hand, it is impossible to present all the information about a firm essential for decision making in a balance sheet, income statement, statement of cash flows, and statement of stockholders' equity.

Statement of Financial Accounting Concepts (SFAC) No. 5 outlines various types of information beyond financial statement information used in investment, credit, and similar decisions. In accordance to SFAC No. 5, information useful for investment, credit, and similar decisions includes financial statements, notes to financial statements, supplementary information, management discussion and analysis, and other information such as discussion of competition, order backlogs, analysts' reports, etc. The problem any user of financial statements is facing is that not all of this relevant information is

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captured and presented in financial statements. The challenge facing the auditor is to decide whether financial statements of a company are presented fairly (free of material errors) and are in accordance to GAAP. However, even if the statements meet all these requirements the auditor must make a decision whether information other than that required by GAAP needs to be disclosed in financial statements. Also, GAAP is vague on the accounting and reporting treatment of some issues, and off-balance sheet activities is one of them.

Accounting and Disclosure of Off-Balance Sheet Activities

Accounting treatment of off-balance sheet activities has always been a controversial one, with businesses, politicians, creditors and regulators taking part in the discussion, trying to influence the issue. The issue is so complicated and controversial that even multiple FASB standards on accounting and disclosure of off-balance sheet activities have not addressed the problem. The biggest problem for accountants and auditors is how to measure, account for and verify the value of the off-balance sheet activity, all steps necessary to record and/or disclose that amount in the financial statements.

Some off-balance sheet activities, such as derivatives, are to be recognized in the financial statements and partially reported as assets or liabilities on the balance sheet at their fair value as of the balance sheet date. A consequence of this approach is that changes in the fair value of derivatives must also be recognized on the income statement. Companies are required to provide a description of their risk management strategy and how derivatives fit into that strategy. Companies must also disclose the gains and losses on derivatives. Another item that is also required to be disclosed is the **notional amount**

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of the contract, which is the total face amount of the asset or liability that underlies the contract (notional amount is disclosed in the footnotes of the financial statements). The problem is that the notional amount of the contract is often misleading and the fair-market value of the contact is often zero and prompts no entry. An example of accounting for an off-balance sheet activity (a currency forward contract) is presented in **Illustration 2.**

Illustration 2: Example of Accounting Entries for Currency Forward Contract

On November 1, 2003, an American company sold a machine to a Japanese company for ¥30,000,000 to be received on January 1, 2004 (the exchange rate is ¥120 per $1 on the day of sale). On the same date, an American company entered into a yen forward contract with an FBO for $1,000 fee. The FBO makes a journal entry to record this transaction:

11/01/03	**Cash**	**$ 1,000**	
	Fee Revenue – currency forward contract		**$ 1,000**

No entry is made to record the potential liabilities associated with the forward contract, and as of 11/01/03 the forward contract has a fair value of $0. The value is zero because settlement payments are made under the contract only if the exchange rate on 01/01/04 differs from ¥120 per $1.

Let's assume that the actual exchange rate on 12/31/03 is ¥125 per $1. At this exchange rate, an FBO will have a loss of $10,000 on the forward contract and be required to make a $10,000 payment[25] on 01/01/04 to settle the forward contract.

[25] $\frac{\text{Potential liability}}{\text{Current yen rate}} - \frac{\text{Potential liability}}{\text{Original yen rate}} = \frac{30{,}000{,}000}{125} - \frac{30{,}000{,}000}{120} = 240{,}000 - 250{,}000 = 10{,}000$ loss

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Accordingly, on 12/31/03, the FBO recognizes a $10,000 loss and liability under the forward contract. The adjusting entry to recognize the exchange rate change is:

12/31/03	**Loss on Forward Contract**	**$ 10,000**	
	Forward Contract (liability)		**$ 10,000**

Notes to the financial statements would disclose the current notional amount of the contract of $240,000. The journal entry necessary on the FBO's books to record the settlement of the yen forward contract on 01/01/04 are as follows:

01/01/04	**Forward Contract**	**$ 10,000**	
	Cash		**$ 10,000**

Note that if the exchange rate has changed to ¥150 per $1 then the losses and liabilities would have been $50,000 at 12/31/03. This example illustrates that the risk related to off-balance sheet liabilities could be almost unlimited, and that the mechanism to disclose, measure and quantify such risk is less than adequate. The obvious shortfall with such valuation is that at the time of inception of the contract and throughout the year, no amounts of losses and liabilities are being disclosed. It is disclosed later on the date the financial statements are prepared. Another shortfall is that the amount disclosed on the date the financial statements are prepared doesn't represent the full amount of potential losses and liabilities.

Speaking about off-balance sheet activities, one must mention off-balance sheet risk, which refers to the volatility in income and market value of bank equity that may arise from unanticipated losses due to these off-balance sheet liabilities (sometimes referred to as contingent liabilities). These activities may also involve risks which are

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difficult to quantify, such as legal risk or reputation risk. The most commonly recognized types of FBO's risks associated with off-balance sheet activities are:

- principal (position), credit, and settlement risk (i.e., loss of principal due to default by a contractual party);
- interest rate (basis), market, and foreign exchange risk (i.e., depreciation of principal amount or loss of income due to rate, market or currency fluctuations);
- daylight overdraft risk (i.e., exposure due to transactions originating and settling during the same day);
- liquidity risk (i.e., lack of funds to honor commitments leading to higher borrowing costs);
- country risk; and
- litigation risk.

Of these, the major risks to consider would be credit risk, interest rate risk, and market risk.

Audit Activities For Off-Balance Sheet Items

The audit of off-balance sheet activities is similar to the audits of any other transaction – its goal is to ensure completeness, existence, valuation, ownership, and disclosure in accordance with GAAP. But because generally accepted accounting principles are only beginning to address the problem of recording these contracts on the face of the balance sheet, notional and contractual amounts for off-balance sheet activities are not always recognized in the statement of financial position. Off-balance sheet items should be analyzed as part of the FBO's overall risk management assessment. Potential exposure, funding sources, the adequacy of risk management, and internal

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controls for off-balance sheet risks are specific matters that should be considered. Disclosure requirements related to off-balance sheet activities can be complicated and extensive and be a challenge for the auditor to audit.

Planning

It is obvious that off-balance sheet items may be complex, volatile, and sometimes difficult to fully understand; also, ways of accounting for them are affected by management's intentions. Those matters are likely to increase audit risk in auditing financial statements of any financial institution that carries such items. A key question for addressing the audit of off-balance sheet activities is whether and to what extent the FBO engages in such activities.

In general, a good starting point in learning about off-balance sheet activities would be to gather information from the management by inquiry, review minutes of the board of directors' meetings or if available, finance committees of the FBO, review activity in accounts such as investments (where transactions are being recorded), and look into prior periods' financial statements disclosures. In the instances where transactions are complicated and the auditor lacks the knowledge to fully understand them, it may be advisable to use the work of specialists in such areas of banking.

Assessing Audit Risk

Once the information about the nature and extent of off-balance sheet activities is available, the auditor can use that information in assessing the audit risk and carrying out the engagement in accordance with GAAS. Assessment of each of three elements of audit risk is discussed next.

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Inherent Risk

The auditor should consider inherent risk in planning and designing the audit and in issuing the opinion on the statements as a whole. The following factors may indicate a potential for higher inherent risk, which will increase audit risk if additional audit work is not performed:

- Sudden or rapid growth in derivatives activities
- Significant use of derivatives without relevant expertise within the FBO
- High volatility in interest rates, currencies, or other factors affecting the values of derivatives
- Inclusion of embedded options or other complex contractual terms
- Concentration of credit risk with one counterparty
- Large one-time transactions
- Inadequate information to effectively monitor derivatives transactions, including inadequate or untimely information about derivatives values

These and other factors should be considered in the context of the items' complexity, the extent of such activities and their affect on the FBO's financial statements taken as a whole.

Control Risk

It is essential that a system of controls be in place to limit and manage off-balance sheet risk. These controls, including policies, procedures, recordkeeping systems, and audit coverage, should be sufficiently detailed to ensure proper performance evaluation by an FBO and head office management, auditors, and regulatory authorities. Formal written policies, stating goals and strategies and setting limitations at various levels, are

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necessary to prevent abuses and to act as benchmarks against which performance may be gauged. A limit should be placed on an activity's total volume. In addition, limits should be established for individual customers, and parameters should be set for traders. Procedures should be in place to ensure that operations are consistent with written policies. Comprehensive recordkeeping and reporting are needed for adequate audit coverage and management of information. Most importantly, branch management should be aware of all off-balance sheet activity and ensure that controls and procedures are in place to identify and monitor attendant risk.

According to the auditing standards, the auditor is required to obtain sufficient understanding of each of the five components of the internal control (the control environment, risk assessment, control activities, information and communication, and monitoring). The level of internal control for off-balance sheet items employed by FBOs could vary as it would be affected by the extent of the institution's use of such activities and their relative complexity. Effective internal control over financial reporting of off-balance sheet activities would include adequate segregation of duties, management oversight, and other policies which are designed to reasonably assure that –

- Off-balance sheet transactions are done in accordance with the FBO's written policies (as approved at the appropriate company's level, such as the main office)
- Information about such transactions entered into the accounting system is complete and accurate
- Misstatements in the processing of accounting information are prevented or detected in a timely manner

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- o Such transactions are monitored on an ongoing basis to recognize and measure events affecting related financial statements' assertions

Detection Risk

In contrast to inherent and control risk, the auditor is responsible for performing the evidence gathering procedures that manage and control detection risk. These audit procedures (commonly referred to as substantive testing), represent the auditor's opportunity to detect material misstatements that can cause statements to be misleading. Objectives of substantive tests for off-balance sheet transactions include the following:

a. Off-balance sheet contracts have been executed and processed according to management's authorization;
b. Income on derivatives, including premiums and discounts, is properly measured and recorded;
c. Such items are accounted for in the financial statements according to the GAAP;
d. Changes in the market value of off-balance sheet items have been appropriately measured and accounted for;
e. Information about off-balance sheet items is complete and has been properly classified, described, and disclosed.

Specific substantive tests that are used to detect material misstatements in dollar amounts and disclosures presented in the financial statements and footnotes are discussed next.

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Substantive Tests

Many off-balance sheet items are negotiated contracts between the institution and its counterparty. Because such transactions are usually not routine, a substantive audit approach may be the most effective mean of achieving the planned audit objectives. Procedures performed in other financial statement areas might also provide evidence about the completeness of the transactions related to off-balance sheet items. These procedures may include tests of subsequent cash receipts and payments, reviewing cutoff bank statements, and the search for unrecorded liabilities.

A primary audit objective addressed through substantive procedures is determining the **propriety of the institutions' accounting and disclosure** for such activities. To do so, the auditor gains an understanding of management's objectives in engaging in off-balance sheet activities transactions. For off-balance sheet items accounted for as hedges, the auditor generally tests whether the applicable hedging criteria are met. This might determine that the institution is appropriately distinguishing between speculating and hedging. The auditor also may examine support for completed transactions to ascertain that they have been accounted for appropriately. For example, the auditor might review transactions that resulted in deferrals of losses during the period to determine whether they qualified for deferral accounting. Similarly, the auditor might review gains recognized during the period to determine whether they were hedging gains that should have been deferred.

If the institution's off-balance sheet items are not exchange-traded or otherwise standardized, the auditor may consider inspecting the contracts and related transaction tickets to understand the terms of the transaction and identify nonstandard features, such

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as the existence of embedded options. Nonstandard features may significantly increase the risks and complexities of the transactions and may involve potential accounting and disclosure consequences.

Analytical procedures might be effectively used as a substantive test to obtain evidential matter about particular assertions related to off-balance sheet activities. These procedures become very important in auditing off-balance sheet activities, because they allow the auditor to efficiently compare recorded amounts and ratios to expectations developed by the auditor. However, in order to effectively perform analytical procedures, the auditor needs to gain a full understanding of the nature of such activities. The following are examples of sources of information that the auditor can use to develop expectations for off-balance sheet activities:

- Prior periods' financial information, giving consideration to known changes;
- Budgets and forecasts that could be extrapolated from either interim financial data or from sources used by management (internal reports);
- Information regarding the industry in which the financial institution operates – this becomes critical with respect to auditing FBOs since their operations are influenced by numerous factors outside the scope of the audit engagement (home country economic and regulatory information);
- Relationship of financial information to relevant non-financial information.

Confirmation is the process of obtaining and evaluating a direct communication from a third party in response to a request for information about a particular item affecting financial statement assertions. The auditor can confirm the accuracy of off-balance sheet items by sending confirmation letters to all parties involved in the

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contractual arrangement. The process includes selecting items for which confirmation are to be requested, designing the confirmation request and communicating the confirmation request to the appropriate third party. Other tests the auditor may perform include testing the mathematical accuracy of the accounting records, examining documentation for completed transactions to ascertain that they have been accounted for appropriately and in the proper period, and verifying computations and rates used for realized gains and losses during the period.

The auditor is responsible for determining the extent of substantive testing considered necessary, based on the nature and significance of the related transactions and the assessment of audit risk. SAS No. 31 provide s guidance on evaluating evidential matter and relating it to assertions in an institutions' financial statements.

Auditing Fair Values and Other Estimates

Auditing estimates and fair-values of the FBO's off-balance sheet items becomes critical, since many of these items would not have a stated face or notional amount, and they might be difficult to identify. The FBO's management is responsible for establishing a process for preparing such estimates and recording them. The auditor's responsibility for the audit in conformity with GAAS is to obtain sufficient competent evidential matter to provide reasonable assurance that –

a. All accounting estimates that could be material to the financial statements have been developed;
b. Those accounting estimates are reasonable in the circumstances;
c. The accounting estimates are presented in conformity with applicable accounting principles and are properly disclosed.

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The auditor should obtain an understanding of how management developed estimates, concentrating on the key factors and assumptions used. The auditor may also review and test the process used by management to develop an estimate. The fair value of certain off-balance sheet items, such as exchange-traded options, is generally readily available from independent pricing sources. Such sources include financial publications or brokers and dealers independent of the financial institution. Determining the fair value of other one-time off-balance sheet items can be difficult, especially if the item was customized just for the needs of the institution, and it may require complicated mathematical modeling and various levels of quantitative assumptions; it also involves a high risk of errors. All these considerations make fair-value calculations subjective and dependent on specifics of the transaction (such as the credit risk associated with specific counterparties). After considering all of the above mentioned factors, the auditor might consider using a work of a specialist in helping with such transactions' estimates.

5.0 SUMMARY

Globalization provided FBOs with an opportunity to increase their presence in the banking market of the U.S. Many foreign banks seized that opportunity and aggressively expanded into the U.S. market. Along with FBOs' expansion came new issues specific to operations of foreign banks, such as a need to ensure foreign banks' soundness, legitimacy and compliance with laws and regulations. Only increased supervision by regulatory government agencies such as the Federal Reserve System, the Office of the Comptroller of the Currency and the Securities and Exchange Commission can guarantee safe and dynamic work of the banking sector. However, many of the supervision mechanisms can be implemented with the help of independent auditors. Recent

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developments in the auditing profession such as passing of the Sarbanes-Oxley Act, increasing demand for forensic accounting, and auditors' increasing emphasis on detection of fraud indicate that independent auditors are playing a vital role in providing greater assurances to the market. Conducting independent audits and governments supervising FBOs have become and will continue to be some of the biggest issues related to foreign banks' operations.

One activity pioneered by FBOs was the spread of off-balance sheet transactions. As was shown, accounting treatment of off-balance sheet activities does not provide a complete picture of the economic substance of such transactions. With FBOs the risks related to inadequate disclosure of such activities is increased. To mitigate the problem and following the passage of the Sarbanes-Oxley Act, the SEC voted to require public companies to include an explanation of their off-balance sheet arrangements in a separately captioned subsection of the "Management's Discussion and Analysis." As in the case of the FBSEA of 1991, dramatic events in the banking industry promoted equally dramatic changes to the way the banking sector operates in the U.S. Auditors and regulators have to adjust their procedures and methods in accordance with the complicated nature of many off-balance sheet items and the changing regulatory environment. This paper's discussion of FBOs' off-balance sheet activities and procedures auditors use to audit such activities illustrates the numerous challenges facing auditors and regulators.

Growth of foreign trade, international banking, and communication tools will only further stimulate the spread of FBOs. The regulators, domestic banks, and customers should welcome the arrival of new players to the banking sector. It will promote healthy

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competition and an increase in the industry's efficiency and effectiveness. The way to prepare for the arrival of new players is to stay informed about new developments and be prepared to deal with them. The goal of this research is to assist in fulfilling that objective.

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APPENDIX A

Audit Program – Off-Balance Sheet Items[26]

I. Audit Objectives

1. To determine if policies, practices, procedures, and internal controls regarding guarantees issued are adequate.
2. To determine if branch officers are operating in conformance with established guidelines.
3. To evaluate the portfolio for credit quality, collectibility, and collateral sufficiency.
4. To determine the scope and adequacy of the audit function, as it applies to guarantees.
5. To determine compliance with applicable laws and regulations.
6. To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of law or regulations have been noted.

II. Internal Control Consideration and Control Testing

Review the branch's internal controls, policies, practices, and procedures for issuing and servicing guarantees.

1. Has branch and head office management adopted written policies pertaining to guarantees issued that:

    a. Establish procedures for reviewing guarantee applications?

    b. Define qualified guarantee account parties?

    c. Establish minimum standards for documentation in accordance with the Uniform Commercial Code?

[26] Federal Reserve System, 1997.

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2. Are policies reviewed at least annually to determine if they are compatible with changing market conditions?

3. Are the subsidiary guarantees issued records balanced daily with the general ledger and are reconciling items adequately investigated by persons who do not normally handle guarantees?

4. Is a daily record maintained summarizing guarantee transaction details which support ledger entries (i.e., guarantees issued, guarantees canceled or renewed, payment made under guarantees, and fees collected)?

5. Are blank guarantee forms safeguarded during banking hours and locked in the vault overnight?

6. Are all guarantees issued recorded as contingent liabilities and assigned consecutive numbers?

7. Are all guarantees issued recorded on individual customer (account party) liability ledgers?

8. Is the information covered by this internal controls questionnaire adequate for evaluating internal controls in this area? If not, consider performing any additional examination procedures deemed necessary.

9. Based on the information gathered, evaluate the internal controls in this area (i.e. strong, satisfactory, fair, marginal, unsatisfactory).

III. Substantive Tests

1. Test the mathematical accuracy of amount recorded in financial statements and disclosed in footnotes.

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2. Using an appropriate sampling technique, select guarantees issued from the trial balance and:

   a. Prepare and mail confirmation forms to account parties and beneficiaries. Guarantees serviced by other institutions, either whole guarantees or syndicate participations, should be confirmed only with the servicing institution (or lead bank). Guarantees serviced for other institutions, either whole guarantees or syndicate participations, should be confirmed with the buying institution and the account party. Confirmation forms should include account party's name, guarantee number, amount, fee charged, and a brief description of any collateral or counter-guarantee held.
   b. After a reasonable time, mail second requests.
   c. Follow up on any no-replies or exceptions and resolve differences.
   d. Examine written guarantee instruments for completeness and terms, and verify amount to the trial balance.
   e. Check to see that required initials of the approving officer are on the guarantee instrument.
   f. Check to see that the signature on the guarantee is authorized.
   g. Compare any collateral held with the description on the collateral register.
   h. Determine that the proper assignments, agreements, etc., are on file.
   i. Test the pricing of any negotiable collateral held.
   j. Determine that collateral margins are reasonable and in line with branch policy and legal requirements.

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k. List all collateral discrepancies and investigate.

l. Determine if any collateral is held by an outside custodian or has been temporarily removed for any reason.

m. Forward a confirmation request on any collateral held outside the branch.

n. Determine that each file contains documentation supporting counter-guarantees, if applicable.

o. Review guarantee participation agreements for such items as fees charged the account party or remittance requirements and determine whether the account party has complied.

p. If the branch paid a beneficiary under its guarantee, review disbursement ledgers and authorizations to determine whether payment was effected in accordance with the terms of the guarantee agreement and whether the branch was recompensed by the account party.

3. For guarantees issued in the selected review sample, check central liability file on borrowers indebted above the selected cutoff review line or borrower(s) displaying credit weakness or suspected of having additional liability in loan areas.

4. Determine compliance with any applicable laws and regulations pertaining to guarantees issued by performing the following steps:

   a. Determine that the obligations covered by such guarantees or endorsements are shown as contingent liabilities on the records and in the reports of assets and liabilities of the branch and that such liabilities are included in computing the aggregate indebtedness of the branch.

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b. Determine which guarantees are subject to individual loan limitations to any one customer. Combine guarantees with any other extensions of credit to the account party by the issuing branch subject to loan limitations.

5. Determine if the trial balance contains expired guarantees. If so, determine the branch's policies, practices, and procedures for disposing these guarantees.

6. Review accounts of off-balance sheet related fees collected:

   a. Review and test procedures for accounting for fees collected and for handling any adjustments.

   b. Scan fees collected for any unusual entries and follow up on any unusual items by tracing them to initial and supporting records.

7. Update the work-papers with any information that will facilitate future examinations.

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APPENDIX B

List of Acronyms

AICPA – American Institute of Certified Public Accountants

BCCI – Bank of Credit and Commerce International

CPA – Certified Public Accountant

FAS – Financial Accounting Standard

FBO – Foreign Banking Organization

FBSEA – Foreign Banks Supervision Enhancement Act

FDIC – Federal Deposit Insurance Company

FDICIA – Federal Deposit Insurance Corporation Improvement Act

FRS – Federal Reserve System

GAAP – Generally Accepted Accounting Principles

GAAS – Generally Accepted Auditing Standards

IBA – International Banking Act

ICC – International Chamber of Commerce

OCC – Office of the Comptroller of the Currency

ROA – Return on Assets

ROE – Return on Equity

SAS – Statements on Auditing Standards

SEC – Securities and Exchange Commission

SFAC – Statements of Financial Accounting Concepts

SOSA – Strength Of Support Assessment

UCC – Uniformed Commercial Code

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APPENDIX C

Independent Auditors' Report and Partial Financial Statements of Deutsche Bank - 2003

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Guide to Off-Balance Sheet Activities Reporting

- Consolidated Statement of Income:
  - Noninterest revenues
- Consolidated Statement of Comprehensive Income:
  - Unrealized net gains (losses) on derivatives hedging variability of cash flows, net of tax
- Consolidated Balance Sheet:
  - Due from customers on acceptances (Assets)
  - Acceptances outstanding (Liabilities)
- Consolidated Statement of Changes in Shareholders' Equity:
  - Change in unrealized net gains/losses on derivatives hedging variability of cash flows, net of tax
- Notes to the Consolidated Financial Statements:
  - Derivatives

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INDEPENDENT AUDITORS' REPORT

The Supervisory Board of
Deutsche Bank Aktiengesellschaft

We have audited the accompanying consolidated balance sheets of Deutsche Bank Aktiengesellschaft and subsidiaries (the "Company") as of December 31, 2003 and 2002, and the related consolidated statements of income, comprehensive income, changes in shareholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2003. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Deutsche Bank Aktiengesellschaft and subsidiaries as of December 31, 2003 and 2002, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2003, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 2 to the consolidated financial statements, the Company adopted FASB Interpretation No. 46, "Consolidation of Variable Interest Entities" and Statement of Financial Accounting Standards No. 150, "Accounting for Certain Instruments with Characteristics of Both Liabilities and Equity" during 2003 and Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets" effective January 1, 2002.

KPMG Deutsche Treuhand-Gesellschaft
Aktiengesellschaft Wirtschaftsprüfungsgesellschaft

Frankfurt am Main
March 9, 2004

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DEUTSCHE BANK AKTIENGESELLSCHAFT

CONSOLIDATED STATEMENT OF INCOME
(€ in millions, except per share data)

	Year ended December 31,		
	2003	2002	2001
Net interest revenues:			
Interest revenues	€ 27,583	€ 35,781	€ 53,639
Interest expense	21,736	28,595	45,019
Net interest revenues	€ 5,847	€ 7,186	€ 8,620
Provision for loan losses	1,113	2,091	1,024
Net interest revenues after provision for loan losses	€ 4,734	€ 5,095	€ 7,596
Noninterest revenues:			
Commissions and fees from fiduciary activities	3,273	3,926	3,537
Commissions, broker's fees, markups on securities underwriting and other securities activities	3,584	4,319	4,557
Fees for other customer services	2,495	2,589	2,633
Insurance premiums	112	744	2,717
Trading revenues, net	5,611	4,024	6,031
Net gains on securities available for sale	20	3,523	1,516
Net loss from equity method investments	(422)	(887)	(365)
Other revenues	768	1,123	295
Total noninterest revenues	€ 15,421	€ 19,361	€ 20,921
Noninterest expenses:			
Compensation and benefits	10,495	11,358	13,360
Net occupancy expense of premises	1,251	1,291	1,334
Furniture and equipment	193	230	357
IT costs	1,913	2,188	2,343
Agency and other professional service fees	724	761	1,080
Communication and data services	626	792	891
Policyholder benefits and claims	110	759	3,002
Other expenses	2,002	2,883	3,182
Goodwill impairment/amortization	114	62	871
Restructuring activities	(29)	583	294
Total noninterest expenses	€ 17,399	€ 20,907	€ 26,714
Income before income tax expense and cumulative effect of accounting changes	2,756	3,549	1,803
Income tax expense	1,327	372	434
Reversal of 1999/2000 credits for tax rate changes	215	2,817	995
Income before cumulative effect of accounting changes, net of tax	€ 1,214	€ 360	€ 374
Cumulative effect of accounting changes, net of tax	151	37	(207)
Net income	€ 1,365	€ 397	€ 167
Earnings per common share:			
Basic			
Income before cumulative effect of accounting changes, net of tax	€ 2.17	€ 0.58	€ 0.60
Cumulative effect of accounting changes, net of tax	0.27	0.06	(0.33)
Net income	€ 2.44	€ 0.64	€ 0.27
Diluted			
Income before cumulative effect of accounting changes, net of tax	€ 2.06	€ 0.57	€ 0.60
Cumulative effect of accounting changes, net of tax	0.25	0.06	(0.33)
Net income	€ 2.31	€ 0.63	€ 0.27
Cash dividends declared per common share	€ 1.30	€ 1.30	€ 1.30

The accompanying notes are an integral part of the Consolidated Financial Statements.

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DEUTSCHE BANK AKTIENGESELLSCHAFT

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME
(€ in millions)

	Year ended December 31,		
	2003	2002	2001
Net income	€ 1,365	€ 397	€ 167
Other comprehensive income (loss):			
Reversal of 1999/2000 credits for tax rate changes	215	2,817	995
Unrealized gains (losses) on securities available for sale and other:			
Unrealized net gains (losses) arising during the year, net of tax and other[1]	1,619	(5,596)	(2,496)
Net reclassification adjustment for realized net (gains) losses, net of applicable tax and other[2]	162	(3,527)	(1,423)
Unrealized net gains (losses) on derivatives hedging variability of cash flows, net of tax[3]	(4)	2	(1)
Minimum pension liability, net of tax[4]	8	(8)	—
Foreign currency translation:			
Unrealized net gains (losses) arising during the year, net of tax[5]	(936)	(1,602)	85
Net reclassification adjustment for realized net gains, net of tax[6]	(54)	—	—
Total other comprehensive income (loss)	€ 1,010	€ (7,914)	€ (2,840)
Comprehensive income (loss)	€ 2,375	€ (7,517)	€ (2,673)

(1) Amounts are net of income tax expense (benefit) of € 38 million, € (69) million and € (105) million for the years ended December 31, 2003, 2002 and 2001, respectively, and adjustments to insurance policyholder liabilities and deferred acquisition costs of € 4 million, € (230) million and € (610) million for the years ended December 31, 2003, 2002 and 2001, respectively.

(2) Amounts are net of applicable income tax expense of € 41 million, € 15 million and € 144 million for the years ended December 31, 2003, 2002 and 2001, respectively, and adjustments to insurance policyholder liabilities and deferred acquisition costs of € (10) million, € 110 million and € (44) million for the years ended December 31, 2003, 2002 and 2001, respectively.

(3) Amount is net of an income tax benefit for the years ended December 31, 2003 and 2001 and income tax expense for the year ended December 2002.

(4) Amount is net of income tax expense of € 3 million for the year ended December 31, 2003 and an income tax benefit of € 3 million for the year ended December 31, 2002.

(5) Amounts are net of an income tax expense (benefit) of € 70 million, € 26 million and € (41) million for the years ended December 31, 2003, 2002 and 2001, respectively.

(6) Amount is net of an income tax benefit of € 5 million for the year ended December 31, 2003.

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DEUTSCHE BANK AKTIENGESELLSCHAFT

CONSOLIDATED BALANCE SHEET
(€ in millions, except nominal value)

	December 31, 2003	December 31, 2002
ASSETS		
Cash and due from banks	€ 6,636	€ 8,979
Interest-earning deposits with banks	14,649	25,691
Central bank funds sold and securities purchased under resale agreements	112,419	117,689
Securities borrowed	72,796	37,569
Trading assets (of which € 107 billion and € 70 billion were pledged to creditors and can be sold or repledged at December 31, 2003 and 2002, respectively)	345,371	294,679
Securities available for sale (of which € 404 million and € 736 million were pledged to creditors and can be sold or repledged at December 31, 2003 and 2002, respectively)	24,631	21,619
Other investments	8,570	10,768
Loans, net	144,946	167,303
Premises and equipment, net	5,786	8,883
Goodwill	6,735	8,372
Other intangible assets, net	1,122	1,411
Other assets related to insurance business	8,249	7,797
Due from customers on acceptances	60	99
Accrued interest receivable	3,612	4,208
Pending securities transactions past settlement date	11,082	5,524
Other assets	36,950	37,764
Total	€ 803,814	€ 758,355
LIABILITIES		
Deposits	€ 306,154	€ 327,625
Trading liabilities	153,234	131,212
Central bank funds purchased and securities sold under repurchase agreements	102,433	90,709
Securities loaned	14,817	8,790
Other short-term borrowings	22,290	11,573
Acceptances outstanding	60	99
Insurance policy claims and reserves	9,071	8,557
Accrued interest payable	3,793	4,668
Pending securities transactions past settlement date	10,390	4,611
Other liabilities	53,380	33,084
Long-term debt	97,480	104,055
Trust preferred securities	—	3,103
Obligation to purchase common shares	2,310	278
Total liabilities	€ 775,412	€ 728,364
Commitments and contingent liabilities (Notes 11, 31 and 35)		
SHAREHOLDERS' EQUITY		
Common shares, no par value, nominal value of € 2.56	1,490	1,592
Issued: 2003, 581.9 million shares; 2002, 621.9 million shares		
Additional paid-in capital	11,147	11,199
Retained earnings	20,486	22,087
Common shares in treasury, at cost:	(971)	(1,960)
2003, 16.8 million shares; 2002, 36.4 million shares		
Equity classified as obligation to purchase common shares	(2,310)	(278)
Share awards	954	955
Accumulated other comprehensive income (loss):		
Deferred tax on unrealized net gains on securities available for sale relating to 1999 and 2000 tax rate changes in Germany	(2,828)	(3,043)
Unrealized net gains on securities available for sale, net of applicable tax and other	1,937	156
Unrealized net gains (losses) on derivatives hedging variability of cash flows, net of tax	(3)	1
Minimum pension liability, net of tax	—	(8)
Foreign currency translation, net of tax	(1,700)	(710)
Total accumulated other comprehensive loss	€ (2,594)	€ (3,604)
Total shareholders' equity	€ 28,202	€ 29,991
Total	€ 803,614	€ 758,355

The accompanying notes are an integral part of the Consolidated Financial Statements.

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DEUTSCHE BANK AKTIENGESELLSCHAFT

CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY

(€ in millions)

	Year ended December 31,		
	2003	2002	2001
Common shares:			
Balance, beginning of year	€ 1,592	€ 1,591	€ 1,578
Common shares distributed under employee benefit plans	—	1	13
Retirement of common shares	(102)	—	—
Balance, end of year	€ 1,490	€ 1,592	€ 1,591
Additional paid-in capital:			
Balance, beginning of year	€ 11,199	€ 11,253	€ 10,876
Common shares distributed under employee benefit plans	—	21	462
Net losses on treasury shares sold	(36)	(129)	(85)
Other	(16)	54	—
Balance, end of year	€ 11,147	€ 11,199	€ 11,253
Retained earnings:			
Balance, beginning of year	€ 22,087	€ 22,619	€ 23,331
Net income	1,365	397	167
Cash dividends declared and paid	(756)	(800)	(801)
Net losses on treasury shares sold	(386)	—	—
Retirement of common shares	(1,801)	—	—
Other	(23)	(129)	(78)
Balance, end of year	€ 20,486	€ 22,087	€ 22,619
Common shares in treasury, at cost:			
Balance, beginning of year	€ (1,960)	€ (479)	€ (119)
Purchases of shares	(25,464)	(30,755)	(37,032)
Sale of shares	23,903	28,441	36,090
Retirement of shares	1,903	—	—
Treasury shares distributed under employee benefit plans	847	833	582
Balance, end of year	€ (971)	€ (1,960)	€ (479)
Equity classified as obligation to purchase common shares:			
Balance, beginning of year	€ (278)	€ —	€ —
Additions	(2,911)	(330)	—
Deductions	879	52	—
Balance, end of year	€ (2,310)	€ (278)	€ —
Share awards—common shares issuable:			
Balance, beginning of year	€ 1,955	€ 1,666	€ 1,883
Deferred share awards granted, net	888	1,098	487
Deferred shares distributed	(647)	(809)	(704)
Balance, end of year	€ 2,196	€ 1,955	€ 1,666
Share awards—deferred compensation:			
Balance, beginning of year	€ (1,000)	€ (767)	€ (1,016)
Deferred share awards granted, net	(888)	(1,098)	(487)
Amortization of deferred compensation, net	646	865	736
Balance, end of year	€ (1,242)	€ (1,000)	€ (767)
Accumulated other comprehensive income (loss):			
Balance, beginning of year	€ (3,604)	€ 4,310	€ 7,150
Reversal of 1999/2000 credits for tax rate changes	215	2,817	995
Change in unrealized net gains on securities available for sale, net of applicable tax and other	1,781	(9,123)	(3,919)
Change in unrealized net gains/losses on derivatives hedging variability of cash flows, net of tax	(4)	2	(1)
Change in minimum pension liability, net of tax	8	(8)	—
Foreign currency translation, net of tax	(990)	(1,602)	65
Balance, end of year	€ (2,594)	€ (3,604)	€ 4,310
Total shareholders' equity, end of year	€ 28,202	€ 29,991	€ 40,193

The accompanying notes are an integral part of the Consolidated Financial Statements.

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DEUTSCHE BANK AKTIENGESELLSCHAFT

CONSOLIDATED STATEMENT OF CASH FLOWS
(€ in millions)

	Year ended December 31,		
	2003	2002	2001
Cash flows from operating activities:			
Net income	€ 1,365	€ 397	€ 167
Adjustments to reconcile net income to net cash used in operating activities:			
Provision for loan losses	1,113	2,091	1,024
Restructuring activities	(29)	583	294
Gain on sale of securities available for sale, other investments, loans and other	(201)	(4,928)	(2,806)
Deferred income taxes, net	269	2,480	(159)
Impairment, depreciation and other amortization and accretion	3,072	2,845	4,886
Cumulative effect of accounting changes, net of tax	(151)	(37)	207
Share of net loss (income) from equity method investments	(42)	753	278
Net change in:			
Trading assets	(37,624)	(4,071)	(1,263)
Other assets	(7,452)	8,627	(9,670)
Trading liabilities	22,719	11,412	(3,022)
Other liabilities	8,095	(20,839)	(4,559)
Other, net	47	(298)	1,412
Net cash used in operating activities	€ (8,819)	€ (783)	€(13,211)
Cash flows from investing activities:			
Net change in:			
Interest-earning deposits with banks	11,305	7,800	9,232
Central bank funds sold and securities purchased under resale agreements	5,378	(14,004)	(47,959)
Securities borrowed	(35,226)	2,749	33,138
Loans	12,789	9,634	5,802
Proceeds from:			
Sale of securities available for sale	13,620	25,835	41,128
Maturities of securities available for sale	7,511	7,731	2,746
Sale of other investments	2,068	5,089	7,096
Sale of loans	16,703	9,508	16,185
Sale of premises and equipment	2,628	717	1,015
Purchase of:			
Securities available for sale	(19,942)	(22,464)	(34,289)
Other investments	(2,141)	(4,474)	(7,976)
Loans	(9,030)	(2,364)	(8,903)
Premises and equipment	(991)	(1,696)	(3,689)
Net cash received (paid) for business combinations/divestitures	2,469	(1,110)	924
Other, net	327	687	958
Net cash provided by investing activities	€ 7,468	€ 23,838	€ 15,408
Cash flows from financing activities:			
Net change in:			
Deposits	(21,423)	(41,278)	22,548
Securities loaned and central bank funds purchased and securities sold under repurchase agreements	17,751	7,603	(16,096)
Other short-term borrowings	(4,303)	274	(15,151)
Issuances of long-term debt and trust preferred securities	43,191	40,245	32,958
Repayments and extinguishments of long-term debt and trust preferred securities	(32,366)	(27,201)	(22,884)
Issuances of common shares	—	73	320
Purchases of treasury shares	(25,464)	(30,755)	(37,032)
Sale of treasury shares	23,389	28,685	36,024
Cash dividends paid	(756)	(800)	(801)
Other, net	(37)	(455)	(522)
Net cash used in financing activities	€ (18)	€(23,629)	€ (636)
Net effect of exchange rate changes on cash and due from banks	(974)	(635)	325
Net increase (decrease) in cash and due from banks	€ (2,343)	€ (1,409)	€ 1,886
Cash and due from banks, beginning of the year	8,979	10,388	8,502
Cash and due from banks, end of the year	€ 6,636	€ 8,979	€ 10,388
Interest paid	€ 22,612	€ 31,349	€ 48,099
Income taxes paid, net	€ 911	€ 408	€ 1,251
Noncash investing activities:			
Transfer from available for sale securities to trading assets	€ —	€ —	€ 22.101
Transfer from trading assets to available for sale securities	€ —	€ —	€ 14,938

The accompanying notes are an integral part of the Consolidated Financial Statements.

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DEUTSCHE BANK AKTIENGESELLSCHAFT

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 1—Significant Accounting Policies

Deutsche Bank Aktiengesellschaft ("Deutsche Bank" or the "Parent") is a stock corporation organized under the laws of the Federal Republic of Germany. Deutsche Bank together with all entities in which Deutsche Bank has a controlling financial interest (the "Group") is a global provider of a full range of corporate and investment banking, private clients and asset management products and services. For a discussion of the Group's business segment information, see Note 28.

The accompanying consolidated financial statements are stated in Euros and have been prepared in accordance with accounting principles generally accepted in the United States of America ("U.S. GAAP"). The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the balance sheet date, and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from management's estimates. Certain prior period amounts have been reclassified to conform to the current presentation.

The following is a description of the significant accounting policies of the Group.

Principles of Consolidation

The consolidated financial statements include Deutsche Bank together with all entities in which Deutsche Bank has a controlling financial interest. The Group consolidates entities in which it has a majority voting interest when the entity is controlled through substantive voting equity interests and the equity investors bear the residual economic risks of the entity. The Group consolidates those entities that do not meet these criteria when the Group absorbs a majority of the entity's expected losses, or if no party absorbs a majority of the expected losses, when the Group receives a majority of the entity's expected residual returns.

Notwithstanding the above, certain securitization vehicles (commonly known as qualifying special purpose entities) are not consolidated if they are distinct from and not controlled by the entities that transferred the assets into the vehicle, and their activities are legally prescribed, significantly limited from inception, and meet certain restrictions regarding the assets they can hold and the circumstances in which those assets can be sold.

For consolidated guaranteed value mutual funds, in which the Group has only minor equity interests, the obligation to pass the net revenues of these funds to the investors is reported in other liabilities, with a corresponding charge to other revenues.

Prior to January 1, 2003, the Group consolidated all majority-owned subsidiaries as well as special purpose entities that the Group was deemed to control or from which the Group retained the majority of the risks and rewards. Qualifying special purpose entities were not consolidated.

All material intercompany transactions and balances have been eliminated. Issuances of a subsidiary's stock to third parties are treated as capital transactions.

Revenue Recognition

Revenue is recognized when it is realized or realizable, and earned. This concept is applied to the key revenue generating activities of the Group as follows:

Net interest revenues—Interest from interest-bearing assets and liabilities is recognized on an accrual basis over the life of the asset or liability based on the constant effective yield reflected in the terms of the contract and any related net deferred fees, premiums, discounts

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or debt issuance costs. See the "Loans" section of this footnote for more specific information regarding interest from loans receivable.

Valuation of assets and liabilities—Certain assets and liabilities are required to be revalued each period end and the offset to the change in the carrying amount is recognized as revenue. These include assets and liabilities held for trading purposes, certain derivatives held for nontrading purposes, loans held for sale, and investments accounted for under the equity method. In addition, assets are revalued to recognize impairment losses within revenues when certain criteria are met. See the discussions in the "Trading Assets and Liabilities, and Securities Available for Sale," "Derivatives," "Other Investments," "Allowances for Credit Losses," and "Impairment" sections of this footnote for more detailed explanations of the valuation methods used and the methods for determining impairment losses for the various types of assets involved.

Fees and commissions—Revenue from the various services the Group performs are recognized when the following criteria are met: persuasive evidence of an arrangement exists, the services have been rendered, the fee or commission is fixed or determinable, and collectability is reasonably assured. Incentive fee revenues from investment advisory services are recognized at the end of the contract period when the incentive contingencies have been resolved.

Sales of assets—Gains and losses from sales of assets result primarily from sales of financial assets in monetary exchanges, which include sales of trading assets, securities available for sale, other investments, and loans. In addition, the Group records revenue from sales of non-financial assets such as real estate, subsidiaries and other assets.

To the extent assets are exchanged for beneficial or ownership interests in those same assets, the exchange is not considered a sale and no gain or loss is recorded. Otherwise, gains and losses on exchanges of financial assets that are held at fair value, and gains on financial assets not held at fair value, are recorded when the Group has surrendered control of those financial assets. Gains on exchanges of non-financial assets are recorded once the sale has been closed or consummated, except when the Group maintains certain types of continuing involvement with the asset sold, in which case the gains are deferred. Losses from sales of non-financial assets and financial assets not held at fair value are recognized once the asset is deemed held for sale.

Gains and losses from monetary exchanges are calculated as the difference between the book value of the assets given up and the fair value of the proceeds received and liabilities incurred. Gains or losses from nonmonetary exchanges are calculated as the difference between the book value of the assets given up and the fair value of the assets given up and liabilities incurred as part of the transaction, except that the fair value of the assets received is used if it is more readily determinable.

Foreign Currency Translation

Assets and liabilities denominated in currencies other than an entity's functional currency are translated into its functional currency using the period-end exchange rates, and the resulting transaction gains and losses are reported in trading revenues. Foreign currency revenues, expenses, gains, and losses are recorded at the exchange rate at the dates recognized.

Gains and losses resulting from translating the financial statements of net investments in foreign operations into the reporting currency of the parent entity are reported, net of any hedge and tax effects, in accumulated other comprehensive income within shareholders'

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equity. Revenues and expenses are translated at the weighted-average rate during the year whereas assets and liabilities are translated at the period end rate.

Reverse Repurchase and Repurchase Agreements

Securities purchased under resale agreements ("reverse repurchase agreements") and securities sold under agreements to repurchase ("repurchase agreements") are treated as collateralized financings and are carried at the amount of cash disbursed and received, respectively. The party disbursing the cash takes possession of the securities serving as collateral for the financing. Securities purchased under resale agreements consist primarily of OECD country sovereign bonds or sovereign guaranteed bonds. Securities owned and pledged as collateral under repurchase agreements in which the counterparty has the right by contract or custom to sell or repledge the collateral are disclosed on the Consolidated Balance Sheet.

The Group monitors the fair value of the securities received or delivered. For securities purchased under resale agreements, the Group requests additional securities or the return of a portion of the cash disbursed when appropriate in response to a decline in the market value of the securities received. Similarly, the return of excess securities or additional cash is requested when appropriate in response to an increase in the market value of securities sold under repurchase agreements. The Group offsets reverse repurchase and repurchase agreements with the same counterparty under master netting agreements when they have the same maturity date and meet certain other criteria regarding settlement and transfer mechanisms. Interest earned on reverse repurchase agreements and interest incurred on repurchase agreements are reported as interest revenues and interest expense, respectively.

Securities Borrowed and Securities Loaned

Securities borrowed and securities loaned are recorded at the amount of cash advanced or received. Securities borrowed transactions generally require the Group to deposit cash with the securities lender. In a securities loaned transaction, the Group generally receives either cash collateral, in an amount equal to or in excess of the market value of securities loaned, or securities. If the securities received may be sold or repledged, they are accounted for as trading assets and a corresponding liability to return the security is recorded. The Group monitors the fair value of securities borrowed and securities loaned and additional collateral is obtained, if necessary. Fees received or paid are reported in interest revenues and interest expense, respectively. Securities owned and pledged as collateral under securities lending agreements in which the counterparty has the right by contract or custom to sell or repledge the collateral are disclosed on the Consolidated Balance Sheet.

Trading Assets and Liabilities, and Securities Available for Sale

The Group designates debt and marketable equity securities as either held for trading purposes or available for sale at the date of acquisition.

Trading assets and trading liabilities are carried at their fair values and related realized and unrealized gains and losses are included in trading revenues.

Securities available for sale are carried at fair value with the changes in fair value reported in accumulated other comprehensive income within shareholders' equity unless the security is subject to a fair value hedge, in which case changes in fair value resulting from the risk being hedged are recorded in other revenues. The amounts reported in other comprehensive income are net of deferred income taxes and adjustments to insurance policyholder liabilities and deferred acquisition costs.

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Declines in fair value of securities available for sale below their amortized cost that are deemed to be other than temporary and realized gains and losses are reported in the Consolidated Statement of Income in net gains on securities available for sale. The amortization of premiums and accretion of discounts are recorded in interest revenues. Generally, the weighted-average cost method is used to determine the cost of securities sold.

Fair value is based on quoted market prices, price quotes from brokers or dealers, or estimates based upon discounted expected cash flows.

Derivatives

All freestanding contracts that are considered derivatives for accounting purposes are carried at fair value in the balance sheet regardless of whether they are held for trading or nontrading purposes. Derivative features embedded in other contracts that meet certain criteria are also measured at fair value. Fair values for derivatives are based on quoted market prices, discounted cash flow analysis, comparison to similar observable market transactions, or pricing models that take into account current market and contractual prices of the underlying instruments as well as time value and yield curve or volatility factors underlying the positions. Fair values also take into account expected market risks, modeling risks, administrative costs and credit considerations. Derivative assets and liabilities arising from contracts with the same counterparty that are covered by qualifying and legally enforceable master netting agreements are reported on a net basis.

The Group enters into various contracts for trading purposes, including swaps, futures contracts, forward commitments, options and other similar types of contracts and commitments based on interest and foreign exchange rates, equity and commodity prices, and credit risk. The Group also makes commitments to originate mortgage loans that will be held for sale. Such positions are considered derivatives and are carried at their fair values as either trading assets or trading liabilities, and related gains and losses are included in trading revenues.

Derivative features embedded in other nontrading contracts are measured separately at fair value when they are not clearly and closely related to the host contract and meet the definition of a derivative. Unless designated as a hedge, changes in the fair value of such an embedded derivative are reported in trading revenues. The carrying amount is reported on the Consolidated Balance Sheet with the host contract.

Certain derivatives entered into for nontrading purposes, not qualifying for hedge accounting, that are otherwise effective in offsetting the effect of transactions on noninterest revenues and expenses are recorded in other assets or other liabilities with changes in fair value recorded in the same noninterest revenues and expense captions affected by the transaction being offset. The changes in fair value of all other derivatives not qualifying for hedge accounting are recorded in trading revenues.

For accounting purposes there are three possible types of hedges, each of which is accounted for differently: (1) hedges of the changes in fair value of assets, liabilities or firm commitments (fair value hedges), (2) hedges of the variability of future cash flows from forecasted transactions and floating rate assets and liabilities (cash flow hedges), and (3) hedges of the translation adjustments resulting from translating the financial statements of net investments in foreign operations into the reporting currency of the parent. Hedge accounting, as described in the following paragraphs, is applied for each of these types of hedges, if the hedge is properly documented at inception and the hedge is highly effective in offsetting changes in fair value, variability of cash flows, or the translation effects of net investments in foreign operations.

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For hedges of changes in fair value, the changes in the fair value of the hedged asset or liability due to the risk being hedged are recognized in earnings along with changes in the entire fair value of the derivative. When hedging interest rate risk, for both the derivative and the hedged item any interest accrued or paid is reported in interest revenue or expense and the unrealized gains and losses from the fair value adjustments are reported in other revenues. When hedging the foreign exchange risk in an available-for-sale security, the fair value adjustments related to the foreign exchange exposures are also recorded in other revenues. Hedge ineffectiveness is reported in other revenues and is measured as the net effect of the fair value adjustments made to the derivative and the hedged item arising from changes in the market rate or price related to the risk being hedged.

If a hedge of changes in fair value is canceled because the derivative is terminated or de-designated, any remaining interest rate-related fair value adjustment made to the carrying amount of a hedged debt instrument is amortized to interest revenue or expense over the remaining life of the hedged item. For other types of fair value adjustments or whenever the hedged asset or liability is sold or terminated, any basis adjustments are included in the calculation of the gain or loss on sale or termination.

For hedges of the variability of cash flows, there is no special accounting for the hedged item and the derivative is carried at fair value with changes in value reported initially in other comprehensive income to the extent the hedge is effective. These amounts initially recorded in other comprehensive income are subsequently reclassified into earnings in the same periods during which the forecasted transaction affects earnings. Thus, for hedges of interest rate risk the amounts are amortized into interest revenues or expense along with the interest accruals on the hedged transaction. When hedging the foreign exchange risk in an available-for-sale security, the amounts resulting from foreign exchange risk are included in the calculation of the gain or loss on sale once the hedged security is sold. Hedge ineffectiveness is recorded in other revenues and is usually measured as the difference between the changes in fair value of the actual hedging derivative and a hypothetically perfect hedge.

When hedges of the variability of cash flows due to interest rate risk are canceled, amounts remaining in accumulated other comprehensive income are amortized to interest revenues or expense over the original life of the hedge. For cancellations of other types of hedges of the variability of cash flows, the related amounts accumulated in other comprehensive income are reclassified into earnings either in the same income statement caption and period as the forecasted transaction, or in other revenues when it is no longer probable that the forecasted transaction will occur.

For hedges of the translation adjustments resulting from translating the financial statements of net investments in foreign operations into the reporting currency of the parent, the portion of the change in fair value of the derivative due to changes in the spot foreign exchange rate is recorded as a foreign currency translation adjustment in other comprehensive income to the extent the hedge is effective; and the remainder is recorded as other revenues.

Any derivative de-designated as a hedging derivative is transferred to trading assets and liabilities and marked to market with changes in fair value recognized in trading revenues. For any hedging derivative that is terminated, the difference between the derivative's carrying amount and the cash paid or received is recognized as other revenues.

Other Investments

Other investments include investments accounted for under the equity method, holdings of designated consolidated investment companies, and other nonmarketable equity interests and investments in venture capital companies.

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