



REGULATORY INTERPRETATION 2000-RI-26

Date: November 21, 2000

Subject: Office of Finance Audit Committee and the Combined Financial Statements

Request Summary:

The Office of Finance (OF) has submitted a request for a regulatory interpretation consisting of three parts. First, it requests that all 12 Federal Home Loan Bank (FHLBank) presidents be permitted to constitute the Office of Finance audit committee, or, in the alternative, all 12 FHLBank presidents be permitted to serve on an audit advisory committee that advises the OF audit committee on the combined financial statements. Second, it requests the Federal Housing Finance Board (Finance Board) to clarify that the scope of responsibilities of the OF audit committee with respect to the combined financial statements is limited to the combining aspects and not the underlying FHLBank financial information. Third, it requests clarification that the OF board could elect to present a compilation of the 12 FHLBank financial statements instead of combined financial statements.

Background:

On June 2, 2000, the Board of Directors of the Finance Board adopted a final rule affecting the OF. *See* Res. No. 2000-24 (June 2, 2000). The rule was published in the *Federal Register* on June 7, 2000, and became effective on July 1, 2000. *See* 65 Fed. Reg. 36290 (June 7, 2000) (OF Rule). Among other things, the OF Rule will change the issuer of the consolidated obligations (COs) of the FHLBanks. Presently, the Finance Board, under the authority of section 11(c) of the Federal Home Loan Bank Act (Act), 12 U.S.C. § 1431(c), issues COs on behalf of the FHLBanks through the OF. As of a date that is mutually agreeable to the Finance Board, FHLBanks, and the OF, the FHLBanks will issue COs in their own name through the OF under the authority of section 11(a) of the Act, 12 U.S.C. § 1431(a).

The OF Rule contains three provisions that relate to this request for regulatory interpretation. First, section 985.3(b) transfers to the OF from the Finance Board the responsibility for preparing the combined annual and quarterly financial reports of the FHLBank System. That provision also incorporates the standard in section 985.6(b) that the combined financial statements adhere to Statement of Financial Accounting Standards No. 131 (SFAS 131), *Disclosure about Segments of an Enterprise and Related Information*, whereby each FHLBank is treated as a segment. SFAS 131 establishes standards on the presentation of segment financial information, and the application of this standard to the combined financial reports requires combining schedules that show each FHLBank's financial information, the combined information, and any material combining adjustments.

Second, section 985.8(d)(4) requires the OF board of directors to constitute and perform the duties of an audit committee consistent with the Finance Board regulations dealing with FHLBank audit committees (12 C.F.R. § 917.6)¹. In addition, section 985.8(d)(4)(ii) subjects the OF audit committee to the provisions of Item 306 of Regulation S-K promulgated by the Securities and Exchange Commission (SEC), 17 C.F.R. § 229.306. That rule requires the audit committees of SEC registrants to state in their annual financial reports whether:

1. The audit committee has reviewed and discussed the audited financial statements with management.
2. The audit committee has discussed with the independent auditors the matters required to be discussed by Statement of Auditing Standards (SAS) No. 61, *Communication with Audit Committees*, as may be modified or supplemented. (SAS No. 90, *Audit Committee Communications*, amends SAS No. 61.)
3. The audit committee has received the written disclosures and the letter from the independent auditors required by Independence Standards Board (ISB) Standard No. 1, *Independence Discussions with Audit Committees*, as may be modified or supplemented, and has discussed with the auditors the auditor's independence.
4. Based on the review and discussions referred to in (1) - (3) above, it recommended to the Board of Directors that the financial statements be included in the Annual Report on Form 10-K or 10-KSB for the last fiscal year for filing with the SEC.

Item 306 of the SEC's Regulation S-K also requires that these disclosures appear over the printed names of each member of the audit committee. The disclosure needs to be provided only once during the year.²

Third, section 989.3 requires that "each Bank shall provide to the Office of Finance in such form and within such timeframes as the Finance Board or the Office of Finance shall specify, all financial information and other information and assistance the Office of Finance shall request for [the preparation of the combined annual and quarterly reports]."

Issue 1: Can all 12 FHLBank presidents constitute the OF audit committee, or, in the alternative, can all 12 FHLBank presidents be mandated to serve on an audit advisory committee that advises the OF audit committee on the combined financial statements.

Analysis:

Section 985.7(a) of the Finance Board regulations states that the OF board of directors "shall consist of three part-time members appointed by the Finance Board," which includes two FHLBank presidents and one non-FHLBank-affiliated U.S. citizen with demonstrated expertise in financial markets. *See* 12 C.F.R. § 985.7(a). Section 985.8(d)(4) states that the OF board of

¹ Section 917.6 deals with the internal control systems, including the audit responsibilities of boards of directors, and the OF Rule specifically cross-references this section. *See* 12 C.F.R. § 985.8(d)(4)(i). The OF Rule also should have explicitly cross-referenced section 917.7, which addresses audit committees. This drafting oversight can be remedied by a future technical amendment to section 985.8(d)(4)(i).

² Regulatory Interpretation 2000-RI-24, *Accounting Issues: Audit Committee Disclosures* (Sept. 19, 2000), requires that the audit committee of each FHLBank meet the requirements of Item 306.

directors shall “[c]onstitute and perform the duties of an audit committee.” No provision of the regulations contemplates that any person, beyond the three individuals appointed by the Finance Board pursuant to section 985.7(a), will serve on either the board of directors or the audit committee of the OF. As such, the audit committee of the OF board of directors may not consist of the 12 FHLBank presidents serving simultaneously.

However, the OF board of directors and audit committee may consult with one or more FHLBank presidents, either individually or collectively, on an advisory basis on matters relating to the preparation of the combined financial statements. Section 985.2(a) of the regulations permits the OF board to “contract with a Bank or Banks for the use of Bank facilities or personnel in order to perform its functions or duties.” *See* 12 C.F.R. § 985.2(a). At the same time, section 989.3 requires that each FHLBank “provide to the Office of Finance in such form and within such timeframes as...the Office of Finance shall specify, all... assistance that the Office of Finance shall request” to facilitate the preparation of combined Bank System annual and quarterly reports. 12 C.F.R. § 989.3.

In 2000, the Finance Board adopted a final rule addressing the corporate governance responsibilities of FHLBank boards of directors and senior management. *See* 65 Fed. Reg. 25277 (May 1, 2000), *codified at* 12 C.F.R. part 917. That rule articulates that among the key roles of FHLBank boards of directors are to ensure that an internal control system is established and maintained, that an internal audit of the internal control system be performed annually and that such audit is designed to be effective and comprehensive, and that reporting requirements be established. *See* 12 C.F.R. § 917.6. The provision outlining these internal control responsibilities is cross-referenced in section 985.8(d)(4)(i) and thereby is made applicable to the OF board of directors.³ These key duties may not be delegated to non-directors, even if only for financial statement preparation purposes.

Under the regulations, FHLBank audit committees, and by cross-reference the OF audit committee, have the duty to:

- Direct senior management to maintain the reliability and integrity of the accounting policies and financial reporting and disclosure practices, 12 C.F.R. § 917.7(e)(1);
- Review the basis for the financial statements and the external auditor’s opinion rendered with respect to such financial statements and ensure that policies are in place that are reasonably designed to achieve disclosure and transparency regarding true financial performance and governance practices, 12 C.F.R. § 917.7(e)(2);
- Oversee the internal audit function by reviewing the scope of audit services required, significant accounting policies, significant risks and exposures, audit activities and audit findings and by assessing the performance and determining the compensation of the internal auditor, 12 C.F.R. § 917.7(e)(3); and
- Oversee the external audit function, 12 C.F.R. § 917.7(e)(4).

To the extent that the interest of one or more of the FHLBanks may diverge from the interests of the OF in its role as preparer of the financial statements, the Finance Board has determined that the best corporate governance procedure is to have both a board of directors and an audit committee whose primary corporate allegiance in the area of the combined financial statements

³ *See* note 1 *supra*.

is to the OF. With an audit committee consisting of 12 FHLBank presidents, each president would be likely to represent the interests of his FHLBank, whereas the interests of any particular FHLBank would be less likely to bind the two FHLBank presidents in their corporate roles as OF directors.

Interpretation:

While all 12 FHLBank presidents may not constitute the audit committee for the purposes of the combined financial statements, section 989.3 gives the OF board of directors latitude in establishing and mandating participation by FHLBank personnel in a financial reports advisory committee, constituted however the OF board of directors determines. Furthermore, that section does not limit the ability of the OF to establish policies or procedures binding on the FHLBanks that are necessary for the OF to prepare the combined financial reports in a timely manner. As such, the OF board of directors may elect to establish an audit advisory committee consisting of all 12 FHLBank presidents to act in an advisory capacity.

Issue 2: Is the scope of the audit committee's duties concerning financial statements limited to the combining aspects of the combined financial reports?

Analysis:

The annual combined financial report presents FHLBank System information by adding the audited financial information from each of the FHLBanks with appropriate combining adjustments. The quarterly financial report is an addition of the unaudited financial reports of the 12 FHLBanks with appropriate combining adjustments. While unaudited, the quarterly financial information from each of the FHLBanks is subject to a formal review by its (and the FHLBank System's) independent external accountant. In addition, the independent external accountant performs a formal review of the combined quarterly financial reports.

The principal combining adjustment is to eliminate as assets and liabilities the COs for which one or more FHLBanks are the primary obligor that another FHLBank(s) has purchased (interbank bonds). In addition to removing the asset and liability associated with interbank bonds, the combining process eliminates the interest income and interest expense and the accrued interest receivable and accrued interest payable associated with such bonds. The combining adjustment affects many of the footnotes in the combined annual report. The independent external accountant examines the combining adjustments in its audit of the combined FHLBanks. Interbank bonds now represent less than one percent of consolidated obligations outstanding. No other transaction among the FHLBanks has a material effect on the financial condition or results of operations of the FHLBanks.

The OF audit committee has neither the resources nor the authority independently to verify the financial information submitted by each FHLBank. However, the OF audit committee can operate under the following assurances:

- The independent external accountant for the audited combined annual report has audited the information submitted by each FHLBank.
- The independent external accountant for the unaudited combined quarterly reports has formally reviewed the information submitted by each FHLBank.

- The president, chief financial officer, and controller of each FHLBank have made a formal representation about the financial condition and results of operation of the respective FHLBank. In addition, they must make an inquiry of the FHLBank's internal auditor before making this formal representation.
- Section 989.3 allows the OF to mandate the participation of each FHLBank in the financial statement preparation and review process so long as the three-person board of directors of the OF remains the audit committee for financial statement purposes.

Interpretation:

The OF audit committee responsibilities as they relate to the combined financial statements are limited to a review of the audit of the combination aspects of the FHLBank System's combined financial reports and not the underlying financial statements of each FHLBank.

Issue 3: May the OF elect to present a compilation of the audited FHLBank financial statements rather than a combined financial statement as has been presented in the past?

Analysis or Discussion:

By compiling statements, the request means simply binding up the audit reports of the 12 FHLBanks with no attempt at summary information or FHLBank System totals.

The specific reference in section 985.6(b)(2) clearly contemplates that the OF will present combined financial reports complete with combining schedules and combining adjustments as required by SFAS 131. *See* 12 C.F.R. § 985.6(b)(2). Moreover, a simple compilation of audited financial reports is far too unwieldy for a purchaser of COs to use. The market reaction to compiled audited financial reports would undoubtedly be negative, reducing the demand for consolidated obligations and thus driving up the interest rate on COs.

Interpretation:

The OF may not elect to present a compilation of the audited FHLBank financial statements rather than a combined financial statement.

<p>A <u>Regulatory Interpretation</u> applies only to the particular transaction or activity proposed by the requestor, may be relied upon only by the requestor, and is subject to modification or rescission by action of the Board of Directors of the Finance Board. 12 CFR. part 907.</p>
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