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Presentation at the Office of Management and Budget’s Annual Credit Training

Audits of Credit Subsidy Estimates
What to Expect

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- Agencies prepare credit subsidy estimates and reestimates for their budgets based on cash flow models and assumptions.

- Generally, the same cash flow models and assumptions are used to prepare accounting estimates for the financial statements.

  - Examples of accounting estimates include the direct loan allowance for subsidy, the liability for loan guarantees, and subsidy expense.

- Reasons why credit subsidy estimates might be audited
  - Financial statement audit
  - Congressional request
  - Mandate
- Depending on the reason for the audit, the objectives, scope, and methodology may differ.
  - For example, a congressional request may ask for the audit to focus on one particular aspect of the subsidy estimate (e.g. defaults) while a financial statement audit would cover all material components of the subsidy estimate.
- This presentation focuses on the financial statement audit.

- The purpose of a financial statement audit is to provide an independent verification of the assertions in financial statements.

  - When auditing an accounting estimate, the auditor evaluates the reasonableness of the estimate made by management in the context of the financial statements taken as a whole.

Example of the direct loan allowance for subsidy

Department of Education – Federal Direct Loan Program

(dollars in thousands)	2003	2002
Principal receivable	$ 84,520,521	$ 80,070,351
Interest receivable	2,770,780	2,661,242
Receivables	87,291,301	82,731,593
Allowance for subsidy	**(657,404)**	**2,114,941**
Net loans receivable	$ 86,633,897	$ 84,846,534

Source: Department of Education's fiscal year 2003 financial statements.

- When preparing credit subsidy estimates, management’s responsibilities include
  - identifying the relevant factors that may affect the estimate (loan terms, borrower characteristics, etc.);
  - accumulating relevant, sufficient, and reliable data on which to base the estimate;
  - developing assumptions that represent management’s judgment of the most likely circumstances; and
  - properly calculating estimates based on assumptions and relevant factors.

- Management should also implement internal controls over the estimation process in order to reduce the likelihood of significant errors in the estimates.

- Internal controls over the estimation process include
  - preparation of the estimates by qualified staff;
  - adequate review and approval of the estimates (including coordination between program, accounting and budget offices); and
  - comparison of prior estimates with subsequent results to assess the reliability of the process used to develop the estimates.

- Management should also determine that the estimate is prepared in accordance with applicable accounting principles (SFFAS #2, 18, 19) and that financial statement disclosures are adequate.

- Examples of disclosure requirements, include
  - a description of the program characteristics;
  - the total amount of direct or guaranteed loans disbursed in the current and prior year;
  - the subsidy expense by component;
  - the amount of the interest and technical reestimate;
  - a reconciliation of the allowance for subsidy and liability for loan guarantees; and
  - a discussion of events or factors that had a significant impact on the subsidy estimate.

- In order to avoid common problems
  - document the rationale for key decisions and the basis for assumptions;
  - assess assumption values for consistency with historical experience;
  - update outyear assumptions when doing reestimates;
  - verify the accuracy of formulas in cash flow models;
  - review trends in account balances and investigate unusual fluctuations or balances;
  - compare estimates to actuals to validate the reasonableness of estimates; and
  - establish a formal review process.

- A financial statement auditor's objective when evaluating an estimate is to obtain sufficient competent evidence to provide reasonable assurance that an estimate

  - is reasonable in the given circumstances and
  - is presented in conformity with applicable accounting principles and is properly disclosed in the financial statements.

- Auditing accounting estimates involves judgment.

- In evaluating the reasonableness of an estimate, an auditor should

  - obtain an understanding of how management developed the estimate, including the relevant internal controls, and

  - consider key factors and assumptions that are
    - significant to the estimate,
    - sensitive to variation,
    - deviations from historical patterns, and
    - subjective and susceptible to misstatement and possible bias.

- To obtain an understanding of how management developed the estimate, an auditor considers
  - the data, key assumptions, and formulas in the cash flow model used to calculate the estimate and
  - the qualifications and inclusion of key staff from budget, accounting, and program offices during the preparation of the estimate.

- Based on that understanding, an auditor may also develop an independent expectation of the estimate to corroborate the reasonableness of the estimate.

- To evaluate key factors and assumptions affecting the estimate, an auditor typically will
  - identify the material credit programs;
  - evaluate management’s sensitivity analysis;
  - review the sources of data that management used in forming key assumptions and consider whether such data are relevant, reliable, and sufficient;
  - determine whether management’s assumptions are in line with applicable program regulations and are consistent with historical experience; and
  - review the accuracy of calculations included in the estimation process.

- Usually the audit work will focus on both the reestimates and the estimates.

- Combined, the work will assess the estimated cost of the credit programs in the financial statements as well as the balances of the direct loan allowance for subsidy and liability for loan guarantees accounts.

- Management can refer to audit guidance to gain a better understanding of what to expect during an audit of credit subsidy estimates.

  - Statement on Auditing Standards No. 57, *Auditing Accounting Estimates*

    http://www.aicpa.org/members/div/auditstd/index.htm
  - Technical Release 3, *Auditing Estimates for Direct Loan and Loan Guarantee Subsidies Under the Federal Credit Reform Act*, which was recently revised.

    http://www.fasab.gov/aapc/technicl.html
  - OMB Bulletin 01-02, *Audit Requirements for Federal Financial Statements*

    http://www.whitehouse.gov/omb/bulletins/index.html

Other guidance used by the auditor includes

- OMB Circular A-11, *Preparation, Submission,and Execution of the Budget*
- OMB Circular A-134, *Financial Accounting Principles and Standards*
- OMB Bulletin 01-09, *Form and Content of Agency Financial Statements*

http://www.whitehouse.gov/omb/

- Accelerated financial reporting
  - Fiscal year 2004 financial statements are due November 15, 2004.

- The recently issued Technical Release 6, *Preparing Estimates for Direct Loan and Loan Guarantee Subsidies Under the Federal Credit Reform Act,* allows for using interim data when appropriate monitoring is in effect.
  - Technical/default reestimates may be made with
    - 12 months of actual data ending no earlier than March 31 or
    - 2 quarters of actual data and an estimation of the last 2 quarters of data.

- When using interim data
    - Interest rate reestimates are as of September 30 based on actual interest rates.
    - Major events in the third or fourth quarter that are measurable will likely require a reestimate with actual data.
    - Major events that are not measurable will require financial statement disclosure with the actual effect included in the following year’s reestimates.

- If you have questions about audits of credit subsidy estimates, contact

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