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

Overview of the Processes for Preparing and Auditing Credit Subsidy Estimates

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Contents

- Agencies estimate and reestimate the costs of loan and loan guarantee programs for budget and financial statement purposes with cash flow models and assumptions used to predict loan performance.

- For financial statement purposes, subsidy estimates form the basis for several accounting estimates: (1) the direct loan subsidy allowance, (2) the liability for loan guarantees, and (3) subsidy expense.

Example of the direct loan subsidy allowance:

Department of Education – Federal Direct Loan Program

(dollars in millions)	2004	2003
Principal receivable	$ 89,245	$ 84,520
Interest receivable	2,858	2,771
Total loans receivables	92,103	87,291
Subsidy allowance	**1,644**	**(657)**
Net loans receivable	$ 93,747	$ 86,634

Source: Department of Education's fiscal year 2004 financial statements.

- Reasons why subsidy estimates and reestimates 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. to analyze defaults or factors contributing to a reestimate), while a financial statement audit covers all material aspects of the estimate.

- This presentation focuses on the financial statement audit.

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

- When preparing 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 that form a basis the estimate;
  - developing assumptions that represent management's judgment of the most likely circumstances;
  - properly calculating estimates based on a sound methodology; and
  - preparing adequate documentation to support the methods and assumptions used to develop the estimate.

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

- Examples of 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 help assess the reliability of the process (cash flow model and assumptions) used to develop the estimates.

- Management should also determine that the estimate is prepared in accordance with applicable accounting standards (SFFAS #2, 18, 19), which generally mirror the budget requirements, 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 (financing, net defaults, fees, and other);
    - the amount of the interest rate and technical reestimate;
    - a reconciliation of the subsidy allowance 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 data;
  - 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 standards and is properly disclosed in the financial statements.

- Since an estimate cannot be considered accurate with certainty, auditing accounting estimates involves judgment.

    - The auditor evaluates the estimate based on a range of reasonableness.

- 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 at risk to misstatement and possible bias.

- To obtain an understanding of how management developed the estimate, an auditor considers
  - the data, key assumptions, and formulas/methodologies 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 of assumptions;
  - review the sources of data 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.

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- 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 subsidy allowance and liability for loan guarantees.

Guidance used by auditors

- 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*

    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 auditors 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/

- 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 actual data through March 31 and an estimate for the last two quarters of the year.

- 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.