

AU Section 9336

Using the Work of a Specialist: Auditing Interpretations of Section 336

1. The Use of Legal Interpretations As Audit Evidence to Support Management's Assertion That a Transfer of Financial Assets Has Met the Isolation Criterion in Paragraphs 7–14 of FASB ASC 860-10-40

.01 Introduction—Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 860,^[1] *Transfers and Servicing*, requires that a transferor of financial assets must surrender control over the financial assets to account for the transfer as a sale. FASB ASC 860-10-40-5(a) states one of several conditions that must be met to provide evidence of surrender of control:

The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.

Paragraphs 8–10 of FASB ASC 860-10-40 describe in greater detail the evidence required to support management's assertion that transferred financial assets have been isolated:

Derecognition of transferred assets is appropriate only if the available evidence provides reasonable assurance that the transferred assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor or any *consolidated affiliate of the transferor*² that is not a special-purpose corporation or other entity designed to make remote the possibility that it would enter bankruptcy or other receivership (see FASB ASC 860-10-55-23[c]). The nature and extent of supporting evidence required for an assertion in financial statements that transferred financial assets have been isolated—put presumptively beyond the reach of the transferor and its creditors, either by a single transaction or a series of transactions taken as a whole—depend on the facts and circumstances. FASB ASC 860 does not provide guidance as to the type and amount of evidence that must be obtained to conclude that transferred financial assets have been isolated from the transferor. All available evidence that either supports or questions an assertion shall be considered. That consideration includes making judgments about whether the contract or circumstances permit the transferor to revoke the transfer. It also may include making judgments about the kind of bankruptcy or other receivership into which a transferor or SPE might be placed, whether a transfer of financial assets would likely be deemed a true sale at law, whether the transferor is affiliated with the transferee, and other factors pertinent under applicable law.

^[1] [Footnote deleted, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

² The Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) glossary defines *consolidated affiliate of the transferor* as "an entity whose assets and liabilities are included with those of the transferor in the consolidated, combined, or other financial statements being presented". [Footnote added, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

A determination about whether the isolation criterion has been met to support a conclusion regarding surrender of control is largely a matter of law. This aspect of surrender of control, therefore, is assessed primarily from a legal perspective.

.02 *Effective Date and Applicability*—This interpretation is effective for auditing procedures related to transfers of financial assets that are required to be accounted for under FASB ASC 860.^[3]

.03 *Question*—What should the auditor consider in determining whether to use the work of a legal specialist⁴ to obtain persuasive evidence to support management's assertion that a transfer of financial assets meets the isolation criterion of FASB ASC 860-10-40-5(a)?

.04 *Interpretation*—Section 336, *Using the Work of a Specialist*, paragraph .06 states that "during the audit . . . an auditor may encounter complex or subjective matters potentially material to the financial statements. Such matters may require special skill or knowledge and in the auditor's judgment require using the work of a specialist to obtain appropriate audit evidence."

.05 Use of a legal specialist may not be necessary to obtain appropriate audit evidence to support management's assertion that the isolation criterion is met in certain situations, such as when there is a routine transfer of financial assets that does not result in any continuing involvement by the transferor.⁵

.06 Many transfers of financial assets involve complex legal structures, continuing involvement by the transferor, or other legal issues that, in the auditor's judgment, make it difficult to determine whether the isolation criterion is met. In these situations, use of a legal specialist usually is necessary. A legal specialist formulating an opinion as to whether a transfer isolates the transferred assets beyond the reach of the transferor and its creditors may consider, among other things, the structure of the transaction taken as a whole, the nature of any continuing involvement, the type of insolvency or other receivership proceedings to which the transferor might become subject, and other factors pertinent under applicable law.

.07 If a legal opinion is used as evidence to support the accounting conclusion related to multiple transfers under a single structure, and such transfers occur over an extended period of time under that structure, the auditor should evaluate the need for management to obtain periodic updates of that opinion to confirm that there have been no subsequent changes in relevant law or applicable regulations that may change the applicability of the previous opinion to such transfers. The auditor also should evaluate the need for management to obtain periodic updates of an opinion to confirm that there have been no subsequent changes in relevant law or applicable regulations that may affect the conclusions reached in the previous opinion in the case of other transfers (see FASB ASC 860-10-40-41 and FASB ASC 860-20-25).

^[3] [Footnote deleted and renumbered, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

⁴ Client's internal or external attorney who is knowledgeable about relevant sections of the U.S. Bankruptcy Code and other federal, state, or foreign laws, as applicable. [Footnote renumbered, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

⁵ FASB ASC 860-10-55-28 characterizes no continuing involvement with the transferred assets as "no servicing responsibilities, no participation in future cash flows, no recourse obligations other than standard representations and warranties that the financial assets transferred met the delivery requirements under the arrangement, no further involvement of any kind. The transferee is significantly limited in its ability to pledge or exchange the transferred assets."

If a contractual provision (such as a call or removal of accounts provision) gives the transferor the unilateral ability to require the return of specific financial assets, the auditor should consider the effect of FASB ASC 860-10-40-5(c). [Footnote revised and renumbered, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.08 If management's assertion with respect to a new transaction is that the transaction structure is the same as a prior structure for which a legal opinion that complies with this interpretation was used as evidence to support an assertion that the transfer of assets met the isolation criterion, the auditor should evaluate the need for management to obtain an update of that opinion to confirm that there have been no changes in relevant law, applicable regulations, or in the pertinent facts of the transaction that may affect the applicability of the previous opinion to the new transaction.

.09 Question—If the auditor determines that the use of a legal specialist is required, what should he or she consider in assessing the adequacy of the legal opinion?

.10 Interpretation—In assessing the adequacy of the legal opinion, the auditor should consider whether the legal specialist has experience with relevant matters, including knowledge of the U.S. Bankruptcy Code, and other federal, state, or foreign law, as applicable, as well as knowledge of the transaction upon which management's assertion is based. For transactions that may be affected by provisions of the Federal Deposit Insurance Act, the auditor should consider whether the legal specialist has experience with the rights and powers of receivers, conservators, and liquidating agents under that act. The auditor should obtain an understanding of the assumptions that are used by the legal specialist, and make appropriate tests of any information that management provides to the legal specialist and upon which the specialist indicates it relied. For example, testing management's information underlying a legal specialist's assumption regarding the adequacy of consideration received may depend on the nature of the transaction and the relationship of the parties. When the legal specialist's opinion has assumed the adequacy of consideration for transfers from a particular legal entity to its wholly owned subsidiary, changes in the subsidiary's capital accounts plus other consideration generally would be sufficient audit evidence as to the adequacy of consideration. In the case of other transfers, such as those that are not to a wholly owned subsidiary of a particular legal entity that is the transferor, obtaining additional audit evidence may be necessary to evaluate management's assertion with regard to the adequacy of consideration upon which the legal specialist relied, because changes in the transferee's capital accounts do not solely benefit the transferring entity.

.11 The auditor also should consider the form and content of the documentation that the legal specialist provides and evaluate whether the legal specialist's findings support management's assertions with respect to the isolation criterion. Section 336 paragraph .13 states that "if the auditor determines that the specialist's findings support the related assertions in the financial statements, he or she reasonably may conclude that sufficient appropriate audit evidence has been obtained." FASB ASC 860's requirement regarding reasonable assurance that the transferred assets would be isolated provides the basis for what auditors should consider in evaluating the work of a legal specialist.

.12 Findings of a legal specialist that relate to the isolation of transferred financial assets are often in the form of a reasoned legal opinion that is restricted to particular facts and circumstances relevant to the specific transaction. The reasoning of such opinion may rely upon analogy to legal precedents that may not involve facts and circumstances that are comparable to that specific transaction. The auditor also should consider the effect of any limitations or disclaimers of opinion in assessing the adequacy of any legal opinion.

.13 An example of the conclusions in a legal opinion for an entity that is subject to the U.S. Bankruptcy Code that provides persuasive evidence, in the absence of contradictory evidence, to support management's assertion that the

transferred financial assets have been put presumptively beyond the reach of the entity and its creditors, even in bankruptcy or other receivership, follows:

We believe (or it is our opinion) that in a properly presented and argued case, as a legal matter, in the event the Seller were to become a Debtor, the transfer of the Financial Assets from the Seller to the Purchaser would be considered to be a sale (or a true sale) of the Financial Assets from the Seller to the Purchaser and not a loan and, accordingly, the Financial Assets and the proceeds thereof transferred to the Purchaser by the Seller in accordance with the Purchase Agreement would not be deemed to be property of the Seller's estate for purposes of [the relevant sections] of the U.S. Bankruptcy Code.

The following additional paragraph addressing substantive consolidation applies when the entity to which the assets are sold (as described in the opinion) is an affiliate of the selling entity and may also apply in other situations as noted by the legal specialist. For example, if a so-called "two-step" structure has been used to achieve isolation, this paragraph usually will be required with respect to the transferee in the first step of such structure (see paragraph .15 and related footnotes for additional guidance on the second step of a two-step structure as described in paragraphs 22–23 of FASB ASC 860-10-55). When the transferor has entered into transactions with an affiliate that could affect the issue of substantive consolidation, the opinion should address the effect of that involvement on the opinion.

"Based upon the assumptions of fact and the discussion set forth previously, and on a reasoned analysis of analogous case law, *we are of the opinion that in a properly presented and argued case, as a legal matter, in a proceeding under the U.S. Bankruptcy Code,*⁶ in which the Seller is a Debtor, a court *would not* grant an order consolidating the assets and liabilities of the Purchaser with those of the Seller in a case involving the insolvency of the Seller under the doctrine of substantive consolidation."

In the case of a transferor that is not entitled to become a debtor under the U.S. Bankruptcy Code, a legal opinion regarding whether the isolation criterion is met would consider whether isolation is satisfactorily achieved under the insolvency or receivership laws that apply to the transferor.

.14 Following are two examples of the conclusions in a legal opinion for an entity that is subject to receivership or conservatorship under provisions of the Federal Deposit Insurance Act. The conclusions in these two examples provide persuasive evidence, in the absence of contradictory evidence, to support management's assertion that the transferred financial assets have been put presumptively beyond the reach of the entity and its creditors, even in conservatorship or receivership. Insolvency and receivership laws applicable to depository institutions, and how those laws affect the legal isolation criterion, differ depending upon the nature of the depository institution and its chartering authority. Accordingly, legal opinions addressing the legal isolation criterion may be formulated in different ways to accommodate those differences.⁷

⁶ For an entity subject to additional regulation (for example, a broker-dealer subject to the Securities Investor Protection Act), the legal opinion also generally should address the effect of such regulation and the policies of the regulators implementing such regulations (for example, the Securities Investor Protection Corporation). [Footnote renumbered, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

⁷ For an entity subject to conservatorship or liquidation under the National Credit Union Act, the examples and discussion in this paragraph would be modified to make appropriate references to "liquidation" and "liquidating agent" and additional information relating to rights and regulations of the National Credit Union Administration. [Footnote renumbered, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

Example 1: "*We believe (or it is our opinion) that in a properly presented and argued case, as a legal matter, in the event the Seller were to become subject to receivership or conservatorship, the transfer of the Financial Assets from the Seller to the Purchaser would be considered to be a sale (or a true sale) of the Financial Assets from the Seller to the Purchaser and not a loan and, accordingly, the Financial Assets and the proceeds thereof transferred to the Purchaser by the Seller in accordance with the Purchase Agreement would not be deemed to be property of, or subject to repudiation, reclamation, recovery, or recharacterization by, the receiver or conservator appointed with respect to the Seller.*"⁸

Example 2: "The Federal Deposit Insurance Corporation (FDIC) has issued a regulation, 'Treatment by the Federal Deposit Insurance Corporation as Conservator or Receiver of Financial Assets Transferred by an Insured Depository Institution in Connection with a Securitization or Participation,' 12 CFR section 360.6 (the Rule). Based on and subject to the discussion, assumptions, and qualifications herein, it is our opinion that:

- A. Following the appointment of the FDIC as the conservator or receiver for the Bank:
 - (i) The Rule will apply to the Transfers,
 - (ii) Under the Rule, the FDIC acting as conservator or receiver for the Bank could not, by exercise of its authority to disaffirm or repudiate contracts under 12 U.S.C. §1821(e), reclaim or recover the Transferred Assets from the Issuer or recharacterize the Transferred Assets as property of the Bank or of the conservatorship or receivership for the Bank,
 - (iii) Neither the FDIC (acting for itself as a creditor or as representative of the Bank or its shareholders or creditors) nor any creditor of the Bank would have the right, under any bankruptcy or insolvency law applicable in the conservatorship or receivership of the Bank, to avoid the Transfers, to recover the Transferred Assets, or to require the Transferred Assets to be turned over to the FDIC or such creditor, and
 - (iv) There is no other power exercisable by the FDIC as conservator or receiver for the Bank that would permit the FDIC as such conservator or receiver to reclaim or recover the Transferred Assets from the Issuer, or to recharacterize the Transferred Assets as property of the Bank or of the conservatorship or receivership for the Bank; provided, however, that we offer no opinion as to whether, in receivership, the FDIC or any creditor of the Bank may take any such actions if the Holders [*holders of beneficial interests in the transferred assets*] receive payment of the principal amount of the Interests and the interest earned thereon (at the contractual yield) through the date the Holders are so paid; and
- B. Prior to the appointment of the FDIC as conservator or receiver for the Bank, the Bank and its other creditors would not have the right to reclaim or recover the Transferred Assets from the Issuer, except by the exercise of a contractual provision [insert appropri-

⁸ When the opinion indicates that isolation is achieved without reference to a true sale, the opinion also should provide reasonable assurance that the transferred assets are beyond the reach of the transferor and its creditors other than the transferee to the same extent that is provided in example 2 paragraph B. [Footnote renumbered, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

ate citation] to require the transfer, or return, of the Transferred Assets that exists solely as a result of the contract between the Bank and the Issuer.⁹

The following additional paragraph addressing substantive consolidation applies when the entity to which the assets are sold or transferred (as described in the opinion) is an affiliate of the selling entity and may also apply in other situations as noted by the legal specialist.¹⁰ For example, if a so-called two-step structure has been used to achieve isolation, the following paragraph usually will be required with respect to the transferee in the first step of the structure (see paragraph .15 and related footnotes for additional guidance on the second step of a two-step structure as described in paragraphs 22–23 of FASB ASC 860-10-55). When the transferor has entered into transactions with an affiliate that could affect the issue of substantive consolidation, the opinion should address the effect of that involvement on the opinion:

Based upon the assumptions of fact and the discussion set forth previously, and on a reasoned analysis of analogous case law, *we are of the opinion that* in a properly presented and argued case, as a legal matter, in a receivership, conservatorship, or liquidation proceeding in respect of the Seller, a court *would not* grant an order consolidating the assets and liabilities of the Purchaser with those of the Seller.

Certain powers to repudiate contracts, recover, reclaim, or recharacterize transferred assets as property of a transferor that are exercisable by the FDIC under the Federal Deposit Insurance Act may, as of the date of the transfer, be limited by a regulation that may be repealed or amended only in respect of transfers occurring on or after the effective date of such repeal or amendment.¹¹ With respect to the powers of a receiver or conservator that may not be exercised under that regulation, it is acceptable for attorneys to rely upon the effectiveness of the limitation on such powers set forth in the applicable regulation, provided that the attorney states, based on reasonable assumptions, that: (a) the affected transfer of financial assets meets all qualification requirements of the regulation, and (b) the regulation had not, as of the date of the opinion, been amended, repealed, or held inapplicable by a court with jurisdiction with respect to such transfer. The opinion should separately address any powers of repudiation, recovery, reclamation, or recharacterization exercisable by a receiver or conservator notwithstanding that regulation (for example, rights, powers, or remedies regarding transfers specifically excluded from the regulation) in a manner that provides the same level of assurance as would be provided in the case of opinions that conform with requirements of paragraph .13, except that such opinion shall address powers arising under the Federal Deposit Insurance Act. The considerations in the immediately preceding three sentences are adequately addressed either by the example 1 opinion or the

⁹ See the second paragraph of footnote 5.

Paragraph B is not required if the opinion includes both a conclusion, as set forth in example 1, that the transfer constitutes a "true sale" and the conclusions set forth of example 2 paragraph A. It is not necessary to include any provision of Example 2 if the opinion is as set forth in example 1. [Footnote revised and renumbered, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

¹⁰ An additional substantive consolidation opinion is not required if the opinion states that its conclusion includes the inability to recover the transferred financial assets or recharacterize the transfer by application of the doctrine of "substantive consolidation." [Footnote renumbered, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

¹¹ The applicable regulation is 12 U.S. Code of Federal Regulations 360.6, effective September 11, 2000. [Footnote renumbered, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

example 2 opinion described in this paragraph or by the variations described in the second paragraph of footnote 9 and in footnote 10.

.15 A legal letter that includes an inadequate opinion, inappropriate limitations, or a disclaimer of opinion, or that effectively limits the scope of the opinion to facts and circumstances that are not applicable to the transaction, does not provide persuasive evidence to support the entity's assertion that the transferred assets have been put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership. Likewise, a legal letter that includes conclusions that are expressed using some of the following language would not provide persuasive evidence that a transfer of financial assets has met the isolation criterion of FASB ASC 860-10-40-5(a) (see paragraphs .20–.21 of this interpretation):

- "We are unable to express an opinion..."
- "It is our opinion, based upon limited facts..."
- "We are of the view..." or "it appears..."
- "There is a reasonable basis to conclude that..."
- "In our opinion, the transfer would *either* be a sale *or* a grant of a perfected security interest..."¹²
- "In our opinion, there is a reasonable possibility..."
- "In our opinion, the transfer *should* be considered a sale..."
- "It is our opinion that the company will be able to assert meritorious arguments..."
- "In our opinion, it is more likely than not ..."
- "In our opinion, the transfer would *presumptively* be..."
- "In our opinion, it is probable that..."

Furthermore, conclusions about hypothetical transactions may not be relevant to the transaction that is the subject of management's assertions. Section 326, *Audit Evidence*, paragraph .06 states "The auditor should consider the sufficiency and appropriateness of audit evidence to be obtained when assessing risks and designing further audit procedures." Additionally, conclusions about hypothetical transactions may not contemplate all of the facts and circumstances or the provisions in the agreements of the transaction that is the subject of management's assertions, and generally would not provide persuasive evidence.¹³

¹² Certain transferors are subject only to receivership (and not to proceedings under the U.S. Bankruptcy Code or the Federal Deposit Insurance Act) under laws that do not allow a receiver to reach assets in which a security interest has been granted. In such circumstances, an opinion that concludes that the transfer would either be a sale or a grant of a security interest that puts the transferred assets beyond the reach of such receiver and other creditors would provide persuasive evidence that the isolation criterion is met.

In certain circumstances, a legal specialist may provide an opinion on both steps of a two-step structure. Such language would be acceptable in an opinion for a transfer of assets in the second step of a two-step structure as described in paragraphs 22–23 of FASB ASC 860-10-55 provided that the opinion on the transfer in the first step is consistent with paragraphs .13 or .14 of this interpretation. [Footnote revised and renumbered, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

¹³ For example, a memorandum of law from a legal specialist usually analyzes (and may make conclusions about) a transaction that may be completed subsequently. Such memorandum generally would not provide persuasive evidence unless the conclusions conform with this interpretation and a legal specialist opines that such conclusions apply to a completed transaction that is the subject of management's assertion. [Footnote renumbered, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.16 Question—Are legal opinions that restrict the use of the opinion to the client, or to third parties other than the auditor, acceptable audit evidence?

.17 Interpretation—No. Footnote 5 to section 336 paragraph .09 states: "In some cases, the auditor may decide it is necessary to contact the specialist to determine that the specialist is aware that his or her work will be used for evaluating the assertions in the financial statements." Given the importance of the legal opinion to the assertion in this case, and the precision that legal specialists use in drafting such opinions, an auditor should not use as evidence a legal opinion that he or she deems otherwise adequate if the letter restricts use of the findings expressed therein to the client or to third parties other than the auditor. In that event, the auditor should request that the client obtain the legal specialist's written permission for the auditor to use the opinion for the purpose of evaluating management's assertion that a transfer of financial assets meets the isolation criterion of FASB ASC 860-10-40-5(a).

.18 An example of a letter from a legal specialist to a client that adequately communicates permission for the auditor to use the legal specialist's opinion for the purpose of evaluating management's assertion that a transfer of financial assets meets the isolation criterion of FASB ASC 860-10-40-5(a) is as follows:

Notwithstanding any language to the contrary in our opinions of even date with respect to certain bankruptcy issues relating to the previously referenced transaction, you are authorized to make available to your auditors such opinions solely as audit evidence in support of their evaluation of management's assertion that the transfer of the receivables meets the isolation criterion of Financial Accounting Standards Board *Accounting Standards Codification* 860-10-40-5(a), provided a copy of this letter is furnished to them in connection therewith. In authorizing you to make copies of such opinions available to your auditors for such purpose, we are not undertaking or assuming any duty or obligation to your auditors or establishing any lawyer-client relationship with them. Further, we do not undertake or assume any responsibility with respect to financial statements of you or your affiliates.¹⁴

.19 A letter from a legal specialist to a client might authorize the client to make copies of the legal opinion available to the auditor to use in his or her evaluation of management's assertion that a transfer of financial assets meets the isolation criterion of FASB ASC 860-10-40-5(a), but then state that the auditor is not authorized to rely thereon. Such "use but not rely on" language, or other language that similarly restricts the auditor's use of the legal specialist's opinion, does not adequately communicate permission for the auditor to use the legal specialist's opinion as audit evidence. The auditor may wish to consult with his or her legal counsel in circumstances where it is not clear that the auditor may use the legal specialist's opinion.

.20 Question—If the auditor determines that it is appropriate to use the work of a legal specialist, and either the resulting legal response does not provide persuasive evidence that a transfer of assets has met the isolation criterion, or the legal specialist does not grant permission for the auditor to use a legal opinion that is restricted to the client or to third parties other than the auditor, what other steps might an auditor consider?

.21 Interpretation—When other relevant audit evidence exists, the auditor should consider it before reaching a conclusion about the appropriateness of

¹⁴ This language may appear in the legal specialist's opinion rather than in a separate letter. In that case, the wording would be modified slightly to indicate the context. [Footnote renumbered, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

management's accounting for a transfer.¹⁵ However, since the isolation aspect of surrender of control is assessed primarily from a legal perspective, the auditor usually will not be able to obtain persuasive evidence in a form other than a legal opinion. In the absence of persuasive evidence that a transfer has met the isolation criterion, derecognition of the transferred assets is not in conformity with generally accepted accounting principles and the auditor should consider the need to express a qualified or adverse opinion in accordance with section 508, *Reports on Audited Financial Statements*, paragraphs .35–.60. However, if permission for the auditor to use a legal opinion that he or she deems otherwise adequate is not granted, this would be a scope limitation and the auditor should consider the need to express a qualified opinion or to disclaim an opinion in accordance with section 508 paragraphs .22–.26 and .61–.63.

[Issue Date: December 2001; Revised: March 2006; Revised: June 2009.]

¹⁵ See section 336 paragraph .13 as to additional procedures that may be applied. [Footnote renumbered, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]