Auditing & Accounting I

2008 Financial Management Seminars

Discussion Topics

Auditing – What's going on

- AICPA
- PCAOB
- SEC

Accounting I

- Fair Value – SFAS 157 & 159
- Troubled Debt Restructurings (TDR)

Auditing Update

- A thumbnail sketch of what's new in the auditing world
  - AICPA
  - PCAOB
  - SEC

Auditing Update - AICPA

AICPA SAS's 104 – 111 – The Risk Assessment Standards

It's all about "Risk"!

• Identifying • Understanding • Assessing • Documenting	• Planning • Auditing • Supervising • Reporting

Auditing Update - AICPA

- In March 2006, the AICPA issued twelve new Statements on Auditing Standards (SAS') no.'s 103-114 became effective for fiscal years beginning on or after 12/15/2006. The "risk-assessment suite" of the standards (Std.'s 104-111) encourage auditors to perform more detailed procedures in assessing risk in non-public audits.

- The standards provide guidance on planning and supervision of the audit (e.g. understanding and documenting major systems, classes and flows of transactions) assessing the risks of material misstatement, designing and performing audit procedures that are responsive to the risks identified and obtaining and evaluating audit evidence and its sufficiency.

Auditing Update - AICPA

- Independence
  - AICPA Issues "Plain Language" Initiative
  - Issued January 1, 2008
  - Purpose is to provide a concise guidance on the independence requirements under the *Code of Professional Conduct*.

Auditing Update - AICPA

- Independence Cont'd.
  - The Initiative Addresses:
    - Definition of Independence
    - Covered Members
    - Family Members
    - Financial Relationships
    - Business Relationships
    - Non-attest services
    - Fees

Auditing Update - AICPA

- ET Section 501- *Acts Discreditable*

  HOT OFF THE PRESS! NEWS FLASH!

  - *The AICPA is expected to revise ET 501. OTS' understanding is that CPA's not following Interagency Guidance will be found to be performing a discreditable act.*

Auditing Update - PCAOB

- **Audit Standard No. 5 *An Audit of Internal Control over Financial Reporting that is integrated with an Audit of Financial Statements* (Supersedes AS 2)**
- **Purpose**
  - Focus the I/C audit on the most important/high risk matters/areas
  - Eliminate procedures unnecessary to achieving intended benefits
  - Make an audit scalable to fit any company
  - Simplify the standard

Auditing Update – PCAOB, Cont'd.

- Public Institutions follow Audit Standard 5 (AS 5).
  - Accelerated filers for fiscal years ending on after November 15, 2007.
  - Non-accelerated filers for fiscal years ending on or after December 15, 2008.
- Non-Public institutions may follow AICPA Standards "AT 501".

Auditing Update – PCAOB, Cont'd.

- PCAOB Staff Audit Practice Alert No. 2., organization
  - Auditing Fair Value measurements
  - Classification within the fair value hierarchy under SFAS 157
  - Using the work of specialists, and
  - Use of a pricing service

Auditing Update – SEC

SAB 108 – Overview

Released September 13, 2006

- Sets forth SEC staff's views on the proper method for public companies to quantify current year errors when there were uncorrected errors in the prior year(s)
- Issued to address diversity in practice and weaknesses in common quantification methods
- Only addresses *quantification* of errors – does not affect SAB 99, which addresses the evaluation of errors

Auditing Update – SEC Cont'd.

SAB 108 – Methods for Quantifying Misstatements

- **Rollover Method;** considers the impact of misstatements primarily from an ***income statement perspective*.**

  (Errors are quantified as the amount by which the current income statement is misstated, exclusive of the reversing or correcting effects of previously uncorrected prior year(s) misstatements.)

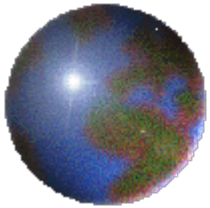
- **Iron Curtain Method:** focuses on the impact from a ***balance sheet perspective.***

  (Considers any adjustment(s) which would be required to properly reflect the balance sheet at period end, thereby including any prior years errors which may have accumulated on the balance sheet.)

Auditing Update

- The Center for Audit Quality (www.thecaq.org)
  - "The Center is an autonomous, nonpartisan, nonprofit group based in Washington, D.C. It is governed by a Board that comprises leaders from the public company auditing firms, the American Institute of CPAs and the investor and issuer communities. The organization is affiliated with the American Institute of CPAs."
  - Appendix: 2007- Year in Review

SFAS No. 157 & 159



Fair Value Accounting

Butch Cassidy & The Sundance Kid!

Who are these guys?

New FASB Statements

- SFAS 157 – Fair Value ***Measurements*** (9/06)
- SFAS 159 – Fair Value ***Option*** for Financial Assets and Financial Liabilities (2/07)

SFAS No. 157 – Fair Value Measurements

- Adoption is NOT optional
- Applies to all areas that require use of FV
- Now one definition for FV throughout GAAP*
- Applies to all companies, both private and public
- Created hierarchy of FV with focus on HOW to measure NOT WHAT to measure
- Objective is to provide one framework for FV (one-stop shopping)

*FAS 157 amended 67 APB and FASB accounting pronouncements that referred to fair value.

SFAS No.157 - Fair Value Measurements

Fair Value Defined

*The price that would be **received** to sell an asset or **paid** to transfer a liability in an **orderly** transaction between market **participants** at the measurement date*

SFAS No. 157 – Fair Value Measurements

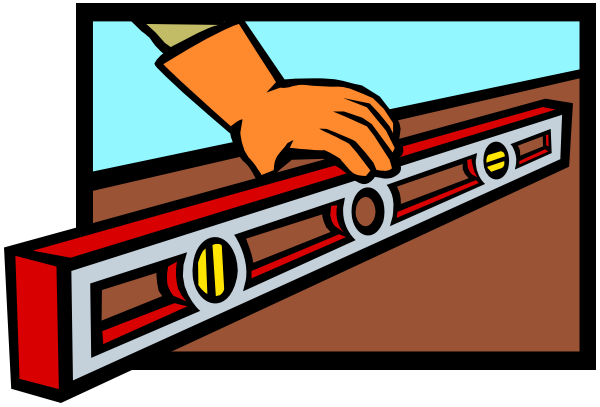
What's different about the NEW definition?

- Concept of exit price vs. entry price (selling price for asset)
- Selling price applies regardless of entity's intent
- Market-based, not entity-specific measurement (highest and best use in hands of mkt. participant)
  - Must utilize assumptions independent, knowledgeable, willing, and able market participants would use in pricing

SFAS No. 157 - Fair Value Measurements

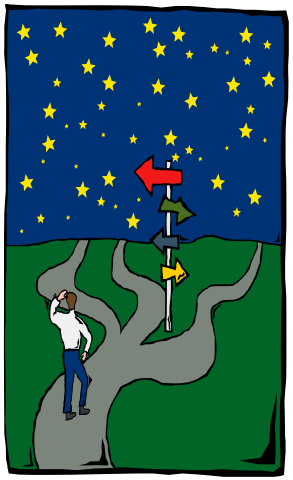
Fair value hierarchy

- To increase consistency and comparability in fair value measurements, the fair value hierarchy prioritizes the inputs to valuation techniques used to measure fair value into three broad levels
- FV hierarchy prioritizes inputs (not techniques)



SFAS No. 157 - Fair Value Measurements

- Observable inputs
  - Assumptions market participants would use based on independent, verifiable market data
- Unobservable inputs
  - Reflect the reporting entity's own assumptions about what market participants would assume
- Maximize observable inputs; minimize unobservable inputs



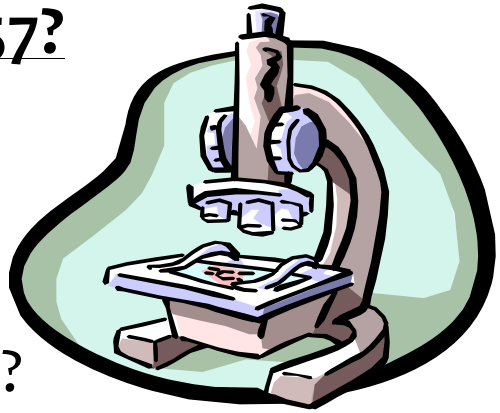
SFAS No. 157 - Fair Value Measurements

Most ← Reliability → Least

Level 1 Inputs	Level 2 Inputs	Level 3 Inputs
Quoted prices for identical assets in active markets, unadjusted for "blockage factor" (unit of measure) (price x quantity)	• Quoted prices for similar assets, • Quoted prices in inactive markets, • Observable market data (interest rates, yield curves, prepayment speeds)	Unobservable (entity generated) inputs used when observable inputs unavailable
Example:	*Example:*	*Example:*
Exchange traded securities, futures or options	Residential mortgage loans held-for-sale	Mortgage servicing rights or retained residual interest in securitization

SFAS No. 157 - Fair Value Measurements

What should we consider in implementing 157?



- What assets/liabilities are affected?
- Should I elect FVO under 159?
- Is there market data? Which level of hierarchy?
- What is the principal market for the asset/liability?
- Are the right systems in place to meet the new financial reporting and disclosure requirements?
- What accounting policies need to be developed and implemented?
- Are the proper internal controls in place for the new fair value world?

SFAS No.157 - Fair Value Measurements

After adoption, must apply FAS 157 to all FV measurements, including:

- **FAS 114** FV-based impairment measures
  - FV of collateral
  - Loan's observable market price
- **FAS 115**
  - AFS & trading securities
  - HTM if OTTI
- Loans held-for-sale
- **FAS 140**
- Derivatives

- Real estate owned (REO)
- Long-lived assets HFS (**FAS 144**)
- Servicing rights (**FAS 156**)
  - Initial measurement
  - FV method
  - LOCOM for amortization method
- **FAS 107** disclosures
- Mergers & acquisitions
- Asset/liability purchases

SFAS No. 157 - Fair Value Measurements

- Effective Date for Statement 157:
  - Beginning of first fiscal year that begins <u>after</u> November 15, 2007
  - January 1, 2008 for calendar year entities
  - Early application encouraged
  - <u>FSP 157-2 deferred</u> for one year the effective date for items within its scope

SFAS No. 157 - Fair Value Measurements

- **FSP 157-2** deferred the effective date for one year to fiscal years beginning after November 15, 2008
  - Nonfinancial assets and nonfinancial liabilities that are not recognized or disclosed at fair value on a recurring basis (at least annually)
  - Does not apply to early-adopters
  - Examples
    - Deferral applies
      - REO and intangibles measured at fair value for impairment assessment
    - Deferral does not apply
      - Impaired collateral-dependent loans, even though the underlying collateral is nonfinancial

SFAS No. 159 *– "Fair Value Option for Financial Assets and Financial Liabilities" (aka* ***Fair Value Option****)*

What is the fair value option?

- Permits all entities to ***choose*** to measure eligible items at fair value
- Unrealized gains and losses for the FVO-elected items reported in current period earnings
  - Difference between FV and carrying amount at adoption is recorded through retained earnings
- Upfront costs and fees recognized in current earnings - not deferred and amortized

SFAS No. 159 – Fair Value Option

SFAS 159 - Objective(s)

- **Improve financial reporting** by providing entities opportunity to **mitigate volatility** in reported earning caused by measuring related assets and liabilities differently without having to apply complex hedge accounting
- Expected to **expand use of fair value** measurement
- Presentation and disclosure requirements designed to **facilitate comparisons** between entities
- International convergence

SFAS No. 159 - Fair Value Option

- What are the benefits?
  - Relevant, current information
  - "Principles-based" and less complex *(in concept)*
  - Comparable approach to valuation *(in concept)*
  - Market risks reflected in primary financial statements
  - Hedge-like accounting without restraints and cumbersome documentation requirements of FAS 133
  - Eliminate or reduce accounting mismatches
  - Financial instruments' earnings recognition better reflects management's strategy

SFAS No. 159 - Fair Value Option

- Decision to elect fair value:
  - Applied instrument by instrument
  - Applied to entire instrument, not to portions
  - Irrevocable!!
  - Generally must be elected when the financial instrument is initially recognized (with some exceptions)
  - Requires extensive additional disclosures
  - If FVO is early adopted, must simultaneously apply all provisions of FAS 157, *Fair Value Measurements*

SFAS No. 159 - Fair Value Option

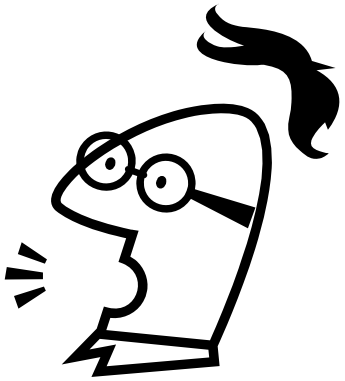
***What's Eligible* for FVO under SFAS 159?**

- Recognized financial assets, e.g.:
  - Investments in debt and equity securities
  - Accounts and loans receivable
    - **No more ALLL or deferral of loan fees/costs**
  - Equity method investments
- Recognized financial liabilities, e.g.:
  - Time deposits
  - Debt issued
  - Accounts payable
  - Guarantees

SFAS No. 159 - Fair Value Option

FVO may be elected for a single instrument without electing it for other identical instruments

… with exceptions



Fair Value – Relevance vs. Reliability

- Why did the FASB want to expand the use of fair value for financial instruments?

FAIR VALUE

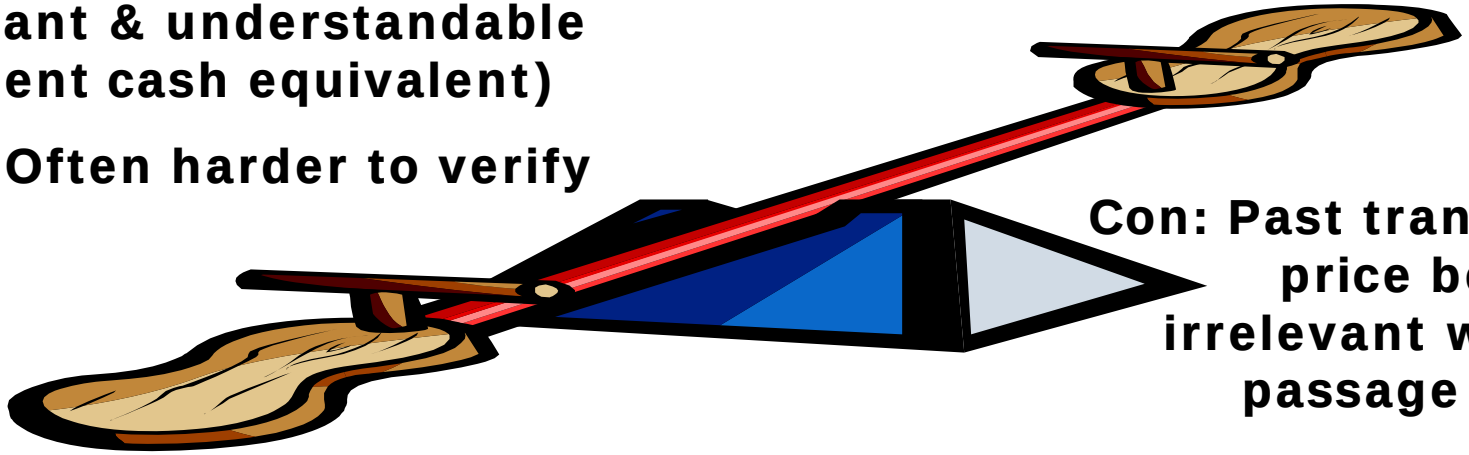
Pro: Fair value is more relevant & understandable (current cash equivalent)

Con: Often harder to verify

HISTORICAL COST

Pro: Cost or cost-based measures are more reliable

Con: Past transaction price becomes irrelevant with the passage of time



RELEVANCE vs. RELIABILITY

FVO Regulatory Concerns

- Reliability
  - Especially for non-traded, illiquid financial instruments
  - Fair values for loans, securitized interests, commitments, deposits, and even some securities can vary widely based on valuation inputs and methodologies used
  - Unsettled, fundamental issues regarding valuation of certain complex instruments (e.g., core deposits, embedded customer relationships)
  - Smaller institutions

FVO Regulatory Concerns

- Management bias in estimation
  - Potential for overly optimistic estimates
  - Potential for earnings and capital management motivations
  - Troubled institutions – how do we ensure appropriate fair values?

FVO Regulatory Concerns

- Verifiability
  - Difficult for increasingly complex and illiquid financial instruments, especially those based on unobservable market pricing
  - Auditors and supervisors may need to understand, test, and rely more on the controls surrounding the fair value estimates

FVO Regulatory Concerns

- Relevance
  - Performance measurement – “core” versus “non-core” earnings effects
  - Stressful economic conditions or “froth”
  - Credit risk on a thrift’s own liabilities

FVO Regulatory Concerns

- Effects on management behavior in running the business
  - Transition allows management to "cherry pick" instruments with built-in gains (or losses)
  - Short-term focus?
  - How will front-loading of income affect business practices?
- Scarcity of valuation expertise
  - Institutions, particularly smaller ones
  - Auditors
  - Supervisors

Fair Value – Interagency Guidance

- Interagency supervisory guidance in response to the increased use of fair value measurements – ***In Process***
- Guidance will be applicable to institutions recognizing fair value gains and losses in earnings using FAS 157
- Guidance addresses areas of concerns and related regulatory capital treatment

Fair Value – Interagency Guidance

Guidance will likely address:

- Sound risk management practices
- Strong corporate governance
  - Board of Directors
  - Senior Management
- Written **policies** and procedures commensurate with the size of institution, extent of FVO use
- Proper **controls** over valuation models and inputs
- Model **validation** procedures
- **Reliability** of FV measurements esp. Levels 2 & 3
- **Comparison** to actual transactions (back-testing)

Fair Value – Interagency Guidance

Guidance will provide that:

- Institutions **not adopt FVO** for assets and liabilities they **cannot reliably** measure
- Institutions **exclude** from **regulatory capital** amounts attributable to **changes in own creditworthiness** for liabilities carried at FV
  - Working on change to capital rules
- Examiners have the latitude to consider a **full range of supervisory measures** when use of FVO is not consistent with safe and sound practices

*Fair Value – **Liquidity** & Valuation Issues*

The Liquidity Crisis

- Sharp rise in delinquencies in subprime loans
  - 2/28 & 3/27 ARMs that reset at substantially higher rates
  - Stated income/asset loans
  - Underwriting practices
- Several hundreds of billions of subprime ARMs repricing or set to reprice soon
- Declining real estate prices, exacerbated by foreclosures
- Resulting increase in credit losses, fear by investors that it will only get worse
- Markets dried up
- Fear spreading to other credit markets

*Fair Value – **Liquidity** & Accounting Issues*

Measuring FV in illiquid (or less liquid) markets?

Center for Audit Quality (CAQ) Alert 2007-51, 10/07

- "It is important to distinguish between an imbalance between supply and demand (e.g. fewer buyers than sellers, thereby forcing prices down) and a 'forced' or 'distressed' transaction referred to in FAS 157, paragraph 7."

- Alert makes reference to an SEC enforcement release where registrant violated GAAP "by using a definition of fair value that assumed that supply and demand were in reasonable balance when, in fact, GAAP defines fair value as that amount at which an asset could be bought or sold in a current transaction."

*Fair Value – **Liquidity** & Accounting Issues*

Measuring FV in illiquid (or less liquid) markets?

Center for Audit Quality (CAQ) Alert 2007-51, 10/07 – Cont'd

- In essence, the registrant ignored observable market prices, modeled an equilibrium market environment, and used the prices calculated from that theorized market environment to price investments.

- "The Commission concluded that the registrant should have considered current market conditions, such as imbalances in supply and demand, when determining the then-current market value. *Specifically, the Commission objected to the practice of ignoring quoted market prices by external pricing sources and taking a 'longer view' of the market (i.e. a view that assumes equilibrium will occur and facilitate transacting at more 'rational' prices."* (Emphasis added)

*Fair Value – **Liquidity** & Accounting Issues*

SEC Division of Corporate Finance 3/08 letter to certain public companies. Page one of that letter states, in part:

- "Fair value assumes the exchange of assets and liabilities in orderly transactions. Under SFAS No. 157, it is appropriate for you to consider actual market prices, or observable inputs, even when the market is less liquid than historical volumes, unless those prices are the result of a forced liquidation or distress sale. ***Only when actual market prices or relevant observable inputs are not available is it appropriate for you to use unobservable inputs which reflect your assumptions of what market participants would use in pricing the asset or liability.*** Current market conditions may require you to use valuation models that require significant unobservable inputs for some of your assets and liabilities. As a consequence…. you will classify these assets and liabilities as Level 3 measurements under SFAS No. 157." (Emphasis Added)

*Fair Value – Liquidity & **Accounting** Issues*

What are some of the accounting issues in the market?

- **Loans** – management intent and ability (flips from HFS to HFI and back when market recovers)
- **OTTI** – lack of written/robust analysis, documentation and policies
- **SFAS 159** – substantive adoption, not merely to achieve an accounting result (i.e. allow unrealized losses to by-pass earnings)
- **SFAS 157** – valuation issues
  - Assumptions used in valuation should include assumptions that market participants would consider (illiquidity is a factor)
  - Moving to less reliable measurements of value (e.g. Level 1 might move to Level 2 or even 3)
  - What are "active markets"?
  - Illiquid market does not necessarily equate to a non-orderly transaction
  - Inability to obtain quotes
  - Large bid/ask spreads
  - "Happy Price"

Geer, Jeffrey J

From: [redacted]
Sent: Monday, October 01, 2007 3:42 PM
To: [redacted]

Subject: The "Happy Price" - (Auditor's Price)

Sensitivity: Private

This weekend I spoke with a woman who participates in the month end pricing of the securities portfolio of a large financial conglomerate.

She said that when her firm goes to the market at month end to price their securities (to the same broker who originally sold them the securities) its market convention to get the "Happy Price" from the broker; a price that will make her firm "happy" (mitigate loss). The price keeps the auditor happy because it's an independent third party valuation.

The broker also shows a good price because the broker wants to show that the securities they underwrite are good securities and maintain value. It's also post sale support and helps maintain the relationship with the firm. It's understood between the firm and the broker that the broker will not pay the Happy Price if asked and that it's just for financial reporting purposes.

Have a Happy Day,

Troubled Debt Restructurings (TDR)

It's scratched and dented! Can I just kick the tires or should I get my best people working on it!

What is a TDR?

A restructuring of debt is a TDR if the creditor for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider.

Criteria:

1. borrower experiencing financial difficulty
2. lender grants concession it would not otherwise consider but for borrowers financial difficulties

Troubled Debt Restructurings (TDR)

You’ve kicked the tires and determined that the vehicle is not only scratched and dented, this baby is wrecked. Now, what do you do?

- Making the best of a difficult situation
- Creditor expects to obtain more cash or other value from the debt, or to increase the probability of receipt, by granting the concession than by not granting it
- Substance over form governs (do it, but do it right)

Troubled Debt Restructurings (TDR)

Understand & Consider "the Accounting Standards"

(aka Getting your best people on it!)

- **SFAS 15** – "Accounting by Debtors and Creditors for Troubled Debt Restructuring" (6/77)
- **SFAS 114** – "Accounting by Creditors for Impairment of a Loan" (3/93)
- **SFAS 118** – "Accounting by Creditors for Impairment of a Loan, Income Recognition and Disclosures" (10/94)
- **EITF 02-4** – "Determining whether a Debtor's Modification or Exchange of Debt Instruments Is Within the Scope of SFAS No. 15" (3/02)

Troubled Debt Restructurings (TDR)

Are TDRs "impaired" loans? They are "scratched and dented or wrecked", of course they're impaired. Otherwise, you wouldn't be making "repairs".

Among other things, FAS 114 amended FAS 15 "to require creditors to measure **all** loans that are restructured in a troubled debt restructuring involving modification of terms in accordance with this statement".

Troubled Debt Restructurings (TDR)

- How do I measure impairment on a TDR?
  - FAS 114, para. 13 (see ALLL **slide 9**)

- How do I know if a loans might be "collateral dependent"? If it is, what should I do?
  - Collateral sole source of repayment?
  - Measure impairment based on collateral's FV
  - If foreclosure probable, deduct costs to sell

Troubled Debt Restructurings (TDR)

Signs that vehicles are more than just "scratched and dented".

Remember, you have to do more than just "kick the tires".

Some considerations to evaluate in your restructurings

- Why are we modifying?
- Borrower in financial difficulty?
- Ability to perform under original terms of loan?
- Modifications at market terms?
- Forgiveness of any P or I?
- FICO scores?
- Concentrations?
- LTV and/or appraisal reliability?
- What about those limited, low and no-doc loans?
- Stated income features?
- Cash-out Refis?
- Owner or Non-owner occupied property?
- Should we re-underwrite the modified loans?

Troubled Debt Restructurings (TDR)

Do we re-underwrite or not re-underwrite?

(aka Do you have to lift the hood to see what's wrong with the engine?)

Apparently, Downey forgot to look under the hood.

The Downey "Borrower Retention Program"

Third quarter 2007 - $99 million of "modified" option ARM loans treated as TDRs and reclassified as "nonperforming loans".

Troubled Debt Restructurings (TDR)

Should we "re-underwrite" and how does it fit into the TDR equation?

1. Downey's retention program offered borrowers who were current the opportunity to modify their ARM loans
2. Rates offered were lower than the original (contractual) loan rate but the same or less than those offered new borrowers
3. Because of 1 & 2 (above), Downey saw no need to re-underwrite the modified loans (wanted to just kick the tires)
4. To quote Coach Lee Corso; "Not so fast my friend"!

Troubled Debt Restructurings (TDR)

Should we "re-underwrite" and how does it fit into the TDR equation?

"Inside Regulatory Strategies", January 28, 2008 article

"However, in the current interpretation of GAAP, there is a rebuttable presumption that a modification is deemed a TDR unless the interest rate on the modified loan reflects the prevailing market rate based on a new underwriting of the loan. Re-underwriting of the loan includes a new appraisal, credit report and income analysis."

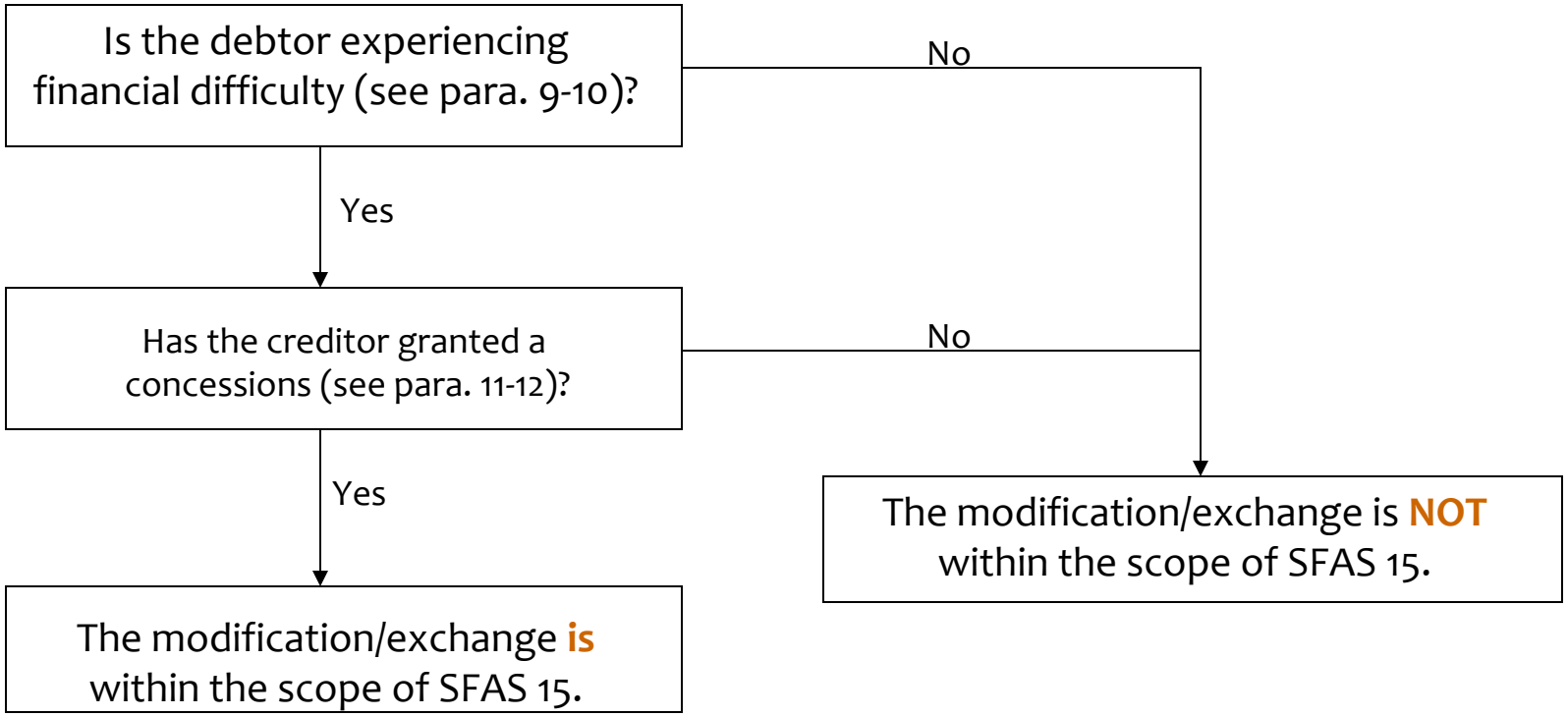
Troubled Debt Restructurings (TDR)

Common Misunderstandings

- Are TDRs nonperforming assets? Not automatically, only if full payment of P&I is no longer anticipated or the P&I is 90 days or more past due (TFR Manual p. 1936)
- Are TDRs non-accrual loans? Interest income on non-accrual loans recognized in accordance with an institution's established written policies and procedures
- Modified loans remain on non-accrual status until timely payments are made (e.g. minimum of 6 consecutive months)
- Likely result in increase in ALLL
- Loans will continue to be reported as TDR until paid off, or if modified to market rates, for the first year following modification (TFR Manual p. 415)

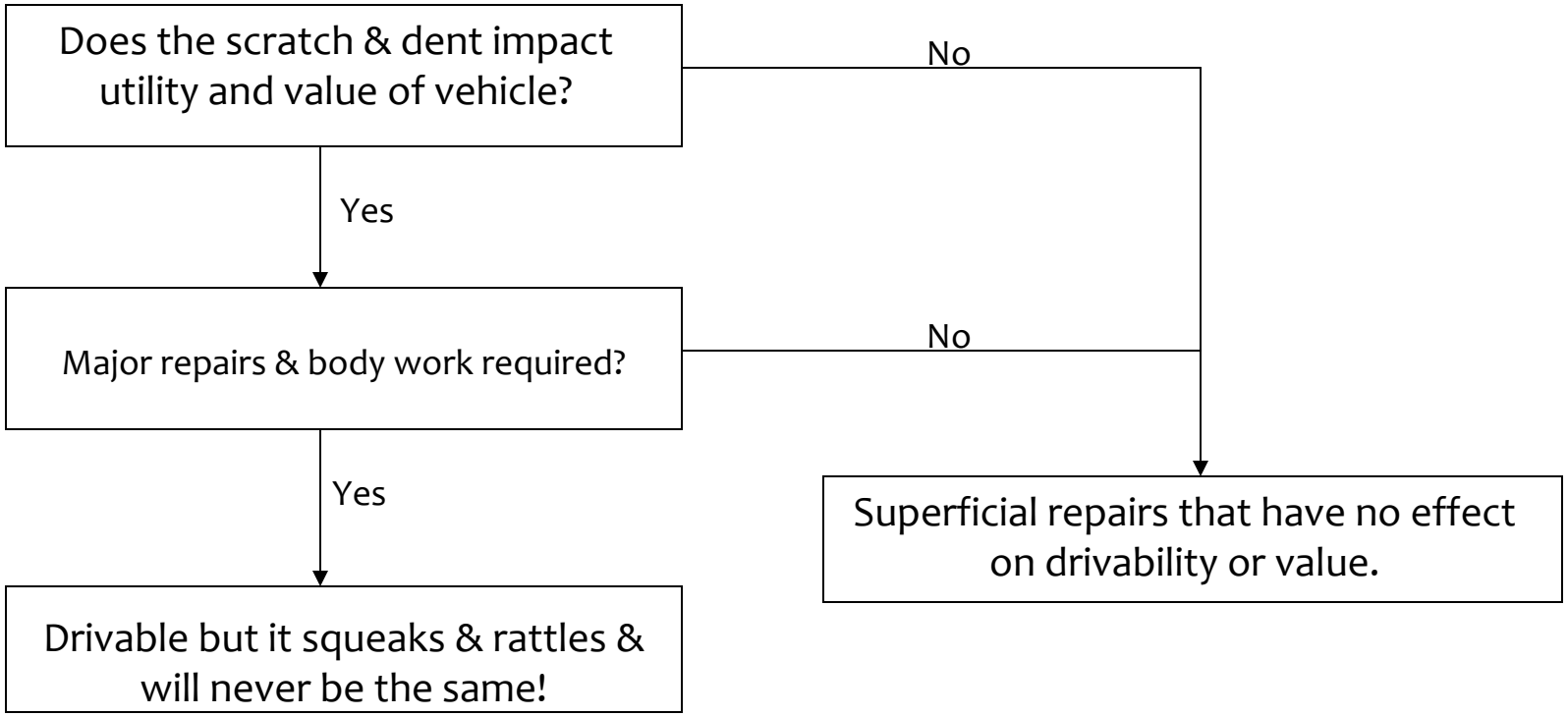
Troubled Debt Restructuring (TDR)

For those who like flowcharts –Accountant's Version



Troubled Debt Restructuring (TDR)

The Scratch and Dent Flowchart – for Non-Accountants



Troubled Debt Restructurings (TDR)

Rocket Science for Accountants

Subprime Loan Subject to Modification

	At Origination	At Time of Modification
Loan balance	$100,000	$96,084
FV of collateral	125,000	100,000
LTV	80%	96%
Term	360 months	360 months
Interest rate	6% (3-years) LIBOR + 6% (27 years)	
LIBOR	4%	6%
Assumed first reset	10%	12%
Estimated yield (IRR)	8.85%	

Measure of Impairment

	A-1	A-2	B-1	B-2
Modified terms	**6% for five more years, then LIBOR + 6%**	**6% for five more years, then LIBOR + 6%**	**6% for remaining 27-years**	**6% for remaining 27-years**
Assumed prepayment	None	8 years after modification	None	8 years after modification
Discount rate	8.85%	8.85%	8.85%	8.85%
Outstanding loan balance	$96,084	$96,084	$96,084	$96,084
PV of expected future CF	99,632	90,047	73,752	81,354
Measure of Impairment	None	$6,037	$22,332	$14,730
% impairment	--	6.28%	23.24%	15.33%

QUESTIONS???

To lodge "Accounting Complaints" take a number.

Frank Haugh, CPA

Regional Accountant

972-277-9593

frank.haugh@ots.treas.gov

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Kevin Smith, CPA

Policy Accountant

972-277-9556

kevin.smith@ots.treas.gov