Audit Negligence Issues in the Thrift Industry

by Gordon Yale

As the thrift industry debacle continues to unfold, audit negligence allegations by government plaintiffs have become disturbingly common. Cases such as the locally prominent Silverado Banking Savings & Loan Association have exposed formerly arcane audit procedures to intense scrutiny, resulting in some instances in governmental claims of audit negligence and charges against a number of national accounting firms. These charges, in turn, have led to several multi-million-dollar settlements.

While many cases against auditors are still pending, it is not too early to identify the key battlegrounds on which these cases will likely be fought. The purpose of this article, then, is to outline accounting and auditing issues in thrift frauds and to begin to examine whether the professional literature provided adequate guidance to examining auditors.

Inflated Real Estate Appraisals

Common to many claims is the auditor's reliance on inflated real estate appraisals. The adequacy of real estate appraisals is fundamental to the fair presentation of thrift financial statements. One critical audit area, for example, is adequate loan loss provisions, which are calculated, in large part, as the difference between the carrying amount of the real estate-based loan and the appraised value of the real property securing the loan (less disposal, holding and financing costs). Inflated appraisals not only minimize loss provisions, but distort net income. This often results in the overstatement of regulatory capital and exaggerates a thrift's net worth, calculated on the basis of generally accepted accounting principles ("GAAP"). Such overstatements, which allegedly misled outside directors and regulators in one Colorado case, allegedly prevented outside directors from questioning additional large loans and prevented regulators from discontinuing funding and requiring the thrift to discontinue lending activities.[1]

Real estate appraisals also are the primary evidence in valuing real estate owned or in judgment (real estate acquired or in the process of being acquired through foreclosure), as well as real estate held for sale or development (real estate purchased for resale or development by the thrift or its subsidiaries). Failure to write-down real estate assets acquired in foreclosure to a "fair value" or real estate purchased directly to "net realizable value" also distorts earnings, regulatory capital and GAAP net worth.

Accounting and auditing standards clearly recognize the sensitivity of thrift financial statements to real estate appraisals. These standards provide for a variety of procedures which should offer assurance that loan and real estate asset values and loss provisions are fairly stated. The *Savings & Loan Association Audit and Accounting Guide* ("*Audit Guide*"), published by the American Institute of Certified Public Accountants ("AICPA"), states as follows:

> In evaluating the adequacy of allowances for losses on loans, the independent auditor should consider delinquencies, evidence of the value of collateral, credit standing of the borrower, unusual economic conditions that may affect the collectibility of loans, the location and type of collateral, and all other relevant information.[2]

Further, GAAP requires that assets acquired in troubled debt restructurings be valued on a "fair value" basis[3] and that real estate acquired other than by troubled debt restructurings be valued on the basis of the lower of cost or "estimated net realizable value."[4]

Auditing Real Estate Appraisals

Reliance on management representations concerning fair value or estimated net realizable value is acceptable. However, the AICPA *Audit Guide* states that the "independent auditor's examination should provide sufficient evidence supporting management's determination. . ."[5] Further, when "evidential matter can be obtained from independent sources outside an entity, it provides greater assurance of reliability. "[6]

Prior to 1990, auditors were directed to evaluate real estate appraisals in accordance with Statement on Auditing Standards ("SAS") No. 11 ("Using the Work of a Specialist"). Under those provisions, which still stand, auditors must inquire as to the professional qualifications and

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reputation of the specialist and should consider the specialist's relationship to the client. Further, SAS No. 11 states that

> [although] the appropriateness and reasonableness of methods or assumptions used and their application are the responsibility of the specialist, the auditor should obtain an understanding of the methods or assumptions used by the specialist to determine whether the findings are suitable for corroborating the representations in the financial statements. If the specialist is related to the client, the auditor should consider performing additional procedures with respect to some or all of the related specialist's assumptions, methods, or findings to determine that the findings are not unreasonable or engage an outside specialist for that purpose.[7]

Although SAS No. 11 broadly defines the auditor's obligation to "determine whether the findings are suitable for corroborating the representations in the financial statements," the pronouncement is largely silent as to procedures for accomplishing this. The *AICPA Guide for the Use of Real Estate Appraisal Information* ("*Appraisal Guide*"), issued December 31, 1990, provides more specific guidance. It states as follows:

> The auditor normally relies on the work of an appraiser unless the auditor's procedures lead to the belief that the appraiser's methods, assumptions, or findings are unreasonable.[8]

The *Appraisal Guide* also lists procedures the auditor can consider when reviewing the appraiser's findings. The following (among others) are included:

1) whether the number and quality of market comparables appear reasonable;
2) whether capitalization rates, discount rates, financing terms and projections of net income or loss and cash flow appear reasonable in terms of market conditions;
3) whether assumptions about the rate of future sales, sales prices, selling costs and cost to complete appear reasonable;
4) whether assumptions about the development or other use of the property appear reasonable; and
5) whether the developer's profit has been deducted.

The very precision of the above guidelines may result in their being used in negligence cases against auditors, even in audit examinations which took place prior to 1990 (the *Appraisal Guide*'s issue date). Conceptually, the *Appraisal Guide* does little to broaden the SAS No. 11 obligation regarding understanding the specialist's methods or assumptions in order to make a determination about whether the specialist's findings are suitable. However, the *Appraisal Guide* adds an outline of specific, in-depth procedures which "may be considered" by auditors when making those judgments. Such procedures, it will probably be argued, are necessary to the understanding of "methods or assumptions," whether or not specific auditing standards required them.

> "Certain accounts, such as acquisition, development and construction loans receivable, may require additional attention because of inherent risk."

Audit Risk

Establishing audit risk in audit negligence cases is crucial because the level of such risk substantially determines the scope and extent of the auditor's procedures. Accounting and auditing standards fully recognize that audits are not conducted in a vacuum. For example, SAS No. 47 ("Audit Risk and Materiality in Conducting an Audit") provides that

> [the] auditor should plan the audit so that audit risk will be limited to a low level that is, in his professional judgment, appropriate for issuing an opinion on the financial statements.[9]

SAS No. 47 defines audit risk as

> the risk that the auditor may unknowingly fail to appropriately modify his opinion on financial statements that are materially misstated.

It further states that audit risk should be considered at the "account-balance or class-of-transactions level" because such consideration "directly assists [the auditor] in determining the scope of auditing procedures."

Certain accounts, such as acquisition, development and construction loans receivable, may require additional attention because of inherent risk. For example, SAS No. 47 states that the

> risk of material misstatement of the financial statements is generally greater when account balances and classes of transactions include accounting estimates rather than essentially factual data because of the inherent subjectivity in estimating future events.[10]

Uncollectible receivables are among the classes of transactions specified in the literature.

Further, SAS No. 47 provides that sources of audit risk include endemic risks such as an entity suffering from "a lack of sufficient working capital or a declining industry characterized by a large number of business failures." Under this standard, the scope and extent of audit procedures for thinly capitalized thrifts engaged in high-yield, high-risk lending in volatile markets should have been greater than for healthy thrifts engaged in the traditional residential mortgage business.

It follows, then, that establishing the relative audit risk of a thrift can be a critical element in negligence cases. Establishing audit risk includes (1) evaluating the adequacy of internal controls; (2) analyzing, in detail, the association's capital position and its composition; (3) identifying the proportion of its loan portfolio dedicated to high-yield, high-risk loans; (4) noting the imbalance between the maturities of assets and liabilities; (5) learning the costs and sources of the association's funds; and (6) thoroughly analyzing the markets in which the association lends.

Related-Party Transactions

Another area of audit risk is the existence of material, related-party transactions. While in the absence of evidence to the contrary, transactions with related parties should not be assumed to be outside the course of business, SAS No. 45 ("Related Parties") requires caution. In addition, SAS No. 45 describes a series of procedures for identifying these transactions, stating that "[t]he auditor should be aware of the possibility that transactions with related parties may have been motivated solely, or in large measure, by conditions similar" to the following:

1) lack of sufficient working capital or credit to continue the business;
2) an urgent desire for a continued favorable earnings record in the hope of supporting the price of the company's stock; and
3) a declining industry characterized by a large number of business failures.[11]

After identifying related-party transactions, the auditor is obliged to apply procedures considered necessary to obtain satisfaction concerning "the purpose, nature, and extent of these transactions and their effect on the financial statements." This includes obtaining "an understanding of the business purpose of the transaction." An accompanying footnote in SAS No. 45 states that "[u]ntil the auditor understands the business sense of material transactions, he cannot complete his audit." When it is necessary to understand a particular transaction fully, the auditor is urged to consider a series of additional procedures " which might not otherwise be deemed necessary to comply with generally accepted auditing standards. " Clearly, a circumstance such as a purchase of real estate from a shareholder who then invests a large portion of the sales proceeds in the purchaser's common stock would appear to require the scrutiny described in SAS No. 45.

Income Realization Issues

Appraisals also figure into certain income realization issues. Typically, thrift institutions are permitted to accrue interest income on delinquent loans until "it is probable that interest will not be received."[12] Such determinations should be based not only on the borrower's ability and willingness to pay, but also on an analysis of whether the asset value covers both unpaid principal and interest.

The issue of interest income recognition has also arisen in situations where interest was self-funded by a thrift institution. Interest reserves or capitalized interest were common to the structures of many acquisition, development and construction loans. In several instances, the accrual of interest income and the recognition of loan and commitment fees continued even when the underlying debt was extended or restructured.

The propriety of these transactions has been attacked on the basis of accounting rules relating to collectibility of receivables. Because self-funded interest payments and loan and commitment fees increase loan balances, auditors must assure themselves that adequate provisions against losses have been recorded. As the *Appraisal Guide* states:

> In evaluating the adequacy of allowances for losses on loans, the independent auditor should consider delinquencies, evidence of the value of collateral, credit standing of the borrower, unusual economic conditions that may affect the collectibility of loans, the location and type of collateral, and all other relevant information.[13]

Unless it is probable that the loan will be foreclosed, allowances on loans should be based on estimated net realizable value ("NRV"). Estimated NRV is defined as the estimated sales price of the asset reduced by direct selling expenses, disposition, completion, holding and capital costs.

If it is probable that a loan will be foreclosed, GAAP is defined by Financial Accounting Standards Board ("FASB") Statement No. 15 ("Accounting by Debtors and Creditors for Troubled Debt Restructurings"). In the simplest terms, debt restructurings are defined as "troubled" 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.[14]

Extending maturities, granting interest rate concessions, releasing security as a result of the debtor's inability to repay debt or the transfer of property to satisfy debt all constitute debt restructurings.

In the event of foreclosure, FASB Statement No. 15 requires that the assets received be recorded not on the carrying value of the debt but on the "fair value" of the assets received at the time of the restructuring, if determinable. Fair value is defined as

> the amount that the debtor could reasonably expect to receive in a current sale between the willing buyer and a willing seller, that is, other than in a forced or liquidation sale.[15]

Reliance on aging appraisals in a dynamic real estate market to determine "fair market value" is not permissible.

In troubled debt restructurings which involve the modification of loan payments, no loss is recognized currently unless the aggregate of expected payments is less than the carrying amount of the underlying loan.

Sales of Real Estate Owned

A final area which is beginning to surface in audit negligence cases involves the recognition of income from the sale of real estate owned. In one Colorado case, the plaintiff alleged that the thrift institution accomplished sales of real estate owned at prices in excess of market value by "tying" the transactions to other developer loans—an apparent regulatory violation.[16] From an accounting standpoint, tying facilitated the avoidance of recognizing losses on real estate owned.

In some instances, it resulted in the recognition of gains.

If the allegations concerning tying are sustained, these abuses will be the second cycle of accounting fraud involving self-funded real estate sales. Various schemes relating to retail and other land sales in the 1970s led to more precise accounting criteria for revenue recognition. In 1982, the standards for specialized profit recognition previously covered by AICPA industry audit guides and other pronouncements were adopted in FASB Statement No. 66 ("Accounting for the Sales of Real Estate").

Generally, FASB Statement No. 66 provides that

> [p]rofit shall be recognized in full when real estate is sold, provided (a) the profit is determinable, that is, the collectibility of the sales price is reasonably assured or the amount that will not be collectible can be estimated, and (b) the earnings process is virtually complete, that is, the seller is not obligated to perform significant activities after the sale to earn the profit. Unless both conditions exist, recognition of all or part of the profit shall be postponed.[17]

Under FASB Statement No. 66, the collectibility of the sales price is determined not only by "the credit standing of the buyer, the age and location of the property, and adequacy of cash flow from the property," but also by

> the buyer's commitment to pay, which in turn is supported by substantial initial and continuing investments that give the buyer a stake in the property sufficient that the risk of loss through default motivates the buyer to honor the obligation to the seller.[18]

FASB Statement No. 66 provides that income can be recognized only if certain minimum investments have been made. Raw land held for development within two years requires a downpayment of 20 percent of the sales price. If development is not anticipated to begin within two years, the required downpayment is 25 percent. Commercial and industrial properties require initial investments ranging from 10 to 25 percent, depending on whether cash flows are adequate to meet debt service (10 percent) or not (25 percent).

FASB Statement No. 66 also provides that the initial investment shall not include

> [a]ny funds that have been or will be loaned, refunded, or directly or indirectly provided to the buyer by the seller or loans guaranteed or collateralized by the seller for the buyer.[19]

Given the complexity that multiple loans to multiple entities ultimately controlled by a single group can create, it may be difficult to establish the self-funding of downpayments in some instances.

Conclusion

Critics of the accounting profession have long asserted that generally accepted auditing standards ("GAAS") and GAAP too often have been the result of a reactive process. The courts and even regulators at times have redefined GAAP and GAAS, causing some consternation in the profession.

For the last twenty years, in fact, the denouement of many national financial scandals has been accompanied by angry and persistent demands for accounting and audit reform. While the savings and loan scandal has yet to play itself out, a preliminary review of complaints against auditors provides increasing evidence that plaintiffs need go no further than the substantial body of existing professional literature to establish what should have been done to detect and prevent the financial reporting abuses in the savings and loan industry. Arguably, the breakdown in thrift audits came not from the inadequacy of professional standards but was, instead, the unfortunate product of their application.

NOTES

1. *The Resolution Trust Corporation, as Receiver of Otero Savings & Loan Association v. Deloitte & Touche, a partnership,* et al., Case No. 92-Z-408 (D.Colo., case pending).
2. AICPA, *Savings & Loan Association Audit and Accounting Guide (hereinafter, "Audit Guide")* (1987) at 40.
3. Financial Accounting Standards Board (*hereinafter*, "FASB") Statement No. 15 (1977) at ¶ 28.
4. *Audit Guide, supra*, note 2 at 41.
5. *Id.* at 40.
6. Statement on Auditing Standard (*hereinafter*, "SAS") Nos. 31 and 48 at AU § 326, ¶ .19.
7. SAS No. 11 at AU § 336, ¶ .8.
8. *AICPA Guide for the Use of Real Estate Appraisal Information (hereinafter, "Appraisal Guide")* (1990) at 13, § 4.04.
9. SAS No. 47, AU § 312, ¶ .09.
10. *Id.* at ¶ .29.
11. SAS No. 45, AU § 334, ¶ .06.
12. *Audit Guide, supra*, note 2 at 33.
13. *Id.* at 40.
14. FASB Statement No. 15 (June 1977) at ¶ 2.
15. *Id.* at ¶ 13.
16. *The Resolution Trust Corporation, as Receiver of First Federal Savings and Loan Association of Colorado Springs v. James R. Glaskin* et al., Case No. 92-Z-418 (D.Colo., case pending).
17. FASB Statement No. 66 (Oct. 1982) at ¶ 3.
18. *Id.* at ¶¶ 4 and 5.
19. *Id.* at ¶ 10.

Twenty-fifth Annual Rocky Mountain State-Federal-Provincial Securities Conference: October 9

Continuing Legal Education in Colorado, Inc., and the Denver Regional Office of the U.S. Securities and Exchange Commission will sponsor the Twenty-fifth Annual Rocky Mountain State-Federal-Provincial Securities Conference on October 9 at the Red Lion Hotel in Denver. Program participants include distinguished lawyers, CPAs and the staff of the Commission from Colorado and throughout the country. The program agenda includes sessions on: corporate finance developments; current developments in market regulation and investment management; recent developments in friendly acquisitions of public companies and in corporate governance; and an enforcement-judicial-legislative developments update. The luncheon keynote speaker will be The Hon. Mary L. Schapiro, Commissioner of the SEC.

For additional information, contact CLECI in Denver at (303) 860-0608.